MONETARY POLICY REPORT

September 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 closing date of this *Monetary Policy Report* was 28 August, 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 publisize 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 28 August 2014 for presentation to the Senate on 3 September 2014.

The Board

SUMMARY

Domestic output and demand have shown a more intense and persistent weakening than expected a few months back. The fall in investment coupled with a more marked slowdown in private consumption prompted a downward revision to the growth forecast for this year below the range foreseen in June. The labor market has shown signs of a slowdown, but the unemployment rate remains low while nominal wages have grown faster. Annual inflation, however, has been in line with expectations and it is still estimated that the current high levels will be temporary. Inflation prospects two years ahead have remained around 3%. The external scenario, though somewhat less dynamic in terms of growth, has changed little since June, with only minor variations in commodity prices and still favorable international financial conditions. The recent geopolitical tensions have had a limited impact on markets. The Chilean peso depreciated further, partly due to the strengthening of the U.S. dollar and partly to idiosyncratic factors, including a more expansionary monetary policy. The Board has cut the monetary policy rate (MPR) since June by 50 basis points (bp) , taking it to 3.5%, and has continued to state that it will consider the possibility of making further reductions to the MPR in line with the evolution of domestic and external macroeconomic conditions and its implications on the inflationary outlook.

Annual CPI inflation remains above 4%, but with no new surprises in its monthly rates, which have declined with respect to the first half of the year. This was most visible in the behavior of the CPIEFE, reflecting, on one hand, that the transmission from the peso depreciation to inflation is an important development, but which tends to dissipate as time passes and, on the other hand, that the poor performance of the economy is already affecting prices. Accordingly, estimates remain that the current high inflation figures will be transitory, a vision that is shared by market expectations for inflation one and two years ahead, which have stayed close to 3%.

What is most notorious is the much weaker-than-expected performance of domestic expenditure and output. In the second quarter, GDP growth was 1.9% and domestic demand dropped 0.9% annually. The poor performance of expenditure spilled over all its components, with fast deterioration of the more persistent ones, including non-durable consumption and investment in construction and other works. By sectors, the y-o-y drop in trade, mainly wholesale, and the meager results of many manufacturing sectors are worth noting. Of these, only export-related ones show a better marginal performance.

ECONOMIC GROWTH AND CURRENT ACCOUNT

	2013	2014 (f)	2015 (f)
	(annual change. percent)		
GDP	4.1	1.75-2.25	3.0-4.0
National income	3.4	2.0	3.2
Domestic demand	3.4	0.1	3.4
Domestic demand (w/o inventory change)	4.2	1.0	3.2
Gross fixed capital formation	0.4	-4.1	1.8
Total consumption	5.4	2.6	3.6
Goods and services exports	4.3	2.4	3.8
Goods and services imports	2.2	-3.9	4.0
Current account (% of GDP)	-3.4	-1.8	-2.2
Gross national saving (% of GDP)	20.5	19.8	19.7
Gross national investment (% of GDP)	23.9	21.6	21.9
GFCF (% of nominal GDP)	23.6	22.0	21.6
GFCF (% of real GDP)	25.8	24.3	23.9
	(US$ million)		
Current account	-9.485	-4.600	-5.880
Trade balance	2.117	7.850	6.750
Exports	76.684	77.450	79.650
Imports	-74.568	-69.600	-72.900
Services	-2.908	-3.060	-3.150
Rent	-11.102	-11.790	-11.930
Current transfers	2.408	2.400	2.450

(f) Forecast.

Source: Central Bank of Chile.

The evolution of expenditure has also resulted in a drop in imports, leading to a sharper adjustment in the current account. Partial indicators of the beginning of the third quarter point to a weak performance of the economy.

As for the labor market, the unemployment rate has risen marginally, but it remains low by historic standards. Total employment continues to grow on a yearly basis, but at a slower pace, and with a change in composition, as the salaried component has been stagnant for some months. Job vacancies are down and unemployment insurance claims have increased. However, growth in nominal wages remains high, and should this persist, it could delay the convergence of inflation.

The economic slowdown was to some extent an expected phenomenon. As has been mentioned in several *Reports*, the end of the cycle of high commodity prices has had a negative impact on our external scenario. Moreover, external financial conditions, although still favorable, have deteriorated and some further tightening is expected. Domestically, as the Board has noted before, pressures on the installed capacity that built up during the years of Chile's high economic growth led to expect some adjustment in the pace of GDP growth. Aside from the foregoing reasons, there were important idiosyncratic factors, such as the completion of the mining investment cycle and the fiscal stimulus associated with reconstruction works after the earthquake of 2010. Most recently, the slowdown in real labor income has negatively affected the evolution of private consumption.

Overall, the weakening of output and expenditure, in both consumption and investment, has exceeded forecasts. Expectations for investment and consumption have deteriorated sharply, particularly in recent months. The Economic Perceptions Index (IPEC) and the Monthly Business Confidence Indicator (IMCE) have decreased markedly throughout 2014. As of July, they are both below their neutral levels. They also show significant deterioration in some specific items, where the perception about employment and the appropriate inventory levels are worth singling out. By sector, the outlook for the manufacturing industry, construction and trade have worsened substantially. In turn, August's *Business Perceptions Report* (IPN) reveals that companies perceive an increase in uncertainty, which has affected both their and their customers' investment and spending decisions.

The domestic scenario has deteriorated in a context of significantly stronger monetary stimulus. Since mid-2013 the Board has expressed the need to adopt a more expansionary monetary policy that will ensure the convergence of inflation to the target. Consequently, it has lowered the MPR by 150bp since October 2013 and maintained an expansionary bias. This, together with the evolution of the domestic and external macroeconomic scenario has had a marked impact on the structure of market interest rates. In particular, long-term rates are now at or near their all-time lows. At the same time, the lower cost of bank funding has been transmitted to the lending rates for businesses and individuals, which have fallen as much as 140bp since October last year. However, growth in commercial and consumer loans has declined in real terms, while mortgage lending growth has remained stable. This reflects the more cautious behavior of both suppliers and demanders of credit, as is apparent in June's *Bank Lending Survey* (ECB) and August's IPN.

The changed macroeconomic scenario has also been reflected in real and nominal exchange rate movements. The Chilean peso depreciated by 5.8% between the statistical cutoffs of this and the last *Report*, especially during the last few weeks. Although part of this depreciation responded to a globally stronger U.S. dollar, the peso/dollar parity increased more than other emerging economy currencies. This, because of less favorable cyclical internal conditions and a more expansionary monetary policy in the domestic economy.

The external financing conditions, beyond temporary fluctuations, have remained favorable from a historical perspective, although the risk of a reversal remains latent. Chile's sovereign and corporate risk premiums have posted small hikes, and have remained below the levels of a year ago. Something similar is observed in other emerging economies. Long-term interest rates in the developed world have receded since June, which in the case of the U.S. is peculiar given its stronger economy and expectations that its policy rate will begin rising by the middle of next year. Chile's terms of trade have also remained favorable since June, and are even marginally higher compared with June estimates, owing largely to a higher copper price resulting from tighter supply. In the baseline scenario, the copper price forecast for 2014 and 2015 is US$3.15 and US$3.05 per pound, respectively.

Chile's trading partners' growth outlook weakened somewhat since June, but higher growth rates are still expected for 2015 than for 2014. Growth forecasts in developed economies were revised slightly down for this year. In addition to deteriorated figures in Japan there is the slower recovery of the Eurozone, including Germany, where the confidence of consumers and businesses has declined, partly because of the geopolitical conflicts in the region. The United States regained strength in the second quarter, thanks to the good performance of private consumption and investment, and improved expectations. Growth in Latin America was revised downwards for this year and next in most countries, but there is heterogeneity in their performance. In China, government measures have succeeded in stabilizing growth. In the baseline scenario, the trading partners will expand 3.6% on average in 2014-2015, two tenths of a point less than expected in June.

The baseline scenario assumes that the slowdown of the domestic economy will be more persistent than previously expected. Thus, the GDP growth forecast for this year is changed to a rate between 1.75% and 2.25%, that is, less than thought in June. In 2015, consistent with the low basis of comparison and a limited dynamism of the economy, GDP is expected to grow between 3.0% and 4.0% annually. The recovery, though moderate, is grounded on the stronger monetary stimulus and lower market rates; greater fiscal stimulus; a stronger impulse from the growth of trading partners and the real depreciation of the peso; and improved private expectations. In this projection, the Board believes that the medium-term growth of the Chilean economy lies between 4% and 4.5%. This is lower than estimated in the recent past, and owes to a revision of the evolution of total factor productivity, the expected growth of the capital stock, and the natural convergence of an economy that has attained high levels of percapita income (Medium Term Growth Box).

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	0.0	-0.8	-0.5
Trading partners GDP (*)	3.6	4.6	3.5	3.4	3.8	3.9
World GDP at PPP (*)	4.2	4.0	3.1	3.2	3.7	4.1
World GDP at market exchange rate (*)	3.3	3.1	2.4	2.6	3.1	3.3
Developed economies' GDP at PPP (*)	2.6	1.8	1.3	1.7	2.4	2.5
Emerging economies ' GDP at PPP (*)	7.4	5.9	4.6	4.5	4.8	5.0
External prices (in US$*)	4.6	5.2	0.3	0.9	1.2	1.3
	(levels)					
LME copper price (US¢/lb)	154	367	332	315	305	300
WTI oil price (US$/barrel)	44	90	98	98	92	89
Brent oil price (US$/barrel)	42	101	109	106	104	101
Gasoline parity price (US$/m^3) (*)	367	742	785	779	753	732
Libor US$ (nominal, 90 días)	3.6	0.4	0.3	0.2	0.7	1.6

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

Source: Central Bank of Chile.

INFLATION

	2013	2014 (f)	2015 (f)	2016 (f)
	(annual change, percent)			
Average CPI inflation	1.8	4.1	3.0	
December CPI inflation	3.0	4.1	2.8	
CPI inflation in around 2 years (*)				3.0
Average CPIEFE inflation	1.2	3.4	2.6	
December CPIEFE inflation	2.1	3.4	2.5	
CPIEFE inflation in around 2 years (*)				2.9

(f) Forescast.

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

Source: Central Bank of Chile.

Growth in domestic demand in 2014 has also been revised downwards, especially for investment, because second-quarter actual data was lower than expected and the CBC's investment projects for 2014 and 2015 were revised downwards in the last survey. In contrast, a further boost from public expenditure is foreseen, led by public investment. As for private consumption, it is expected to resume a moderate expansion going forward, which will imply slower growth than projected in June.

Annual CPI inflation, still affected by the high monthly variations early in the year and the direct effects of the recent depreciation of the peso, will stay above 4% throughout the remainder of this year. By 2015, because of lower inflationary pressures derived from the cyclic evolution of the economy and the high basis for comparison, annual CPI and CPIEFE inflation will show a rapid decline to 3%. Then, they will hover around 3% until the end of the projection horizon, this time the third quarter of 2016.

This inflation trajectory considers that the indirect effects of nominal and real peso depreciation of the last months will be more than offset by the state of output gaps within the projection period. The Board evaluates the current level of the real exchange rate (RER) to be consistent with the state of the economic cycle and with domestic and external financial conditions, although it is slightly above its estimated range of long-term values. As a methodological assumption, the exchange rate is forecast to have a slight real appreciation in the long term, in line with the normalization of cyclical conditions of the economy. Regarding the MPR, the change in the local macroeconomic scenario has reduced its expected level from June. As a working assumption, the MPR is projected to follow a path comparable to what can be inferred from the various measures of expectations available at the statistical closing of this *Report*.

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 materialized, may reshape the macroeconomic environment and, therefore, may alter the course of monetary policy. On this opportunity, having evaluated the alternative scenarios, the Board estimates that the risk balance for inflation is unbiased, whereas for output it is unbiased in 2014 and downward biased in 2015.

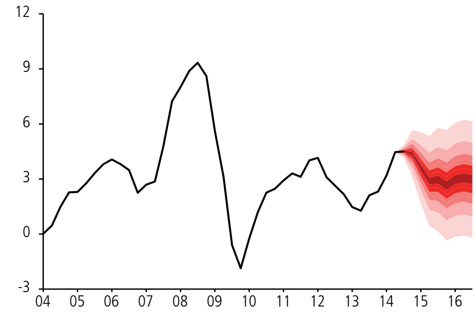
Abroad, the risks mentioned in previous *Reports* remain. Although growth in China and its outlook have stabilized most recently, its future performance is still a risk factor, in particular because of the uncertainty about its financial system and real estate sector. Also, it cannot be ruled out that the vulnerabilities in other emerging economies could generate new episodes of volatility. In the

Eurozone, the macro-financial situation remains an element of uncertainty, which is compounded with the geopolitical tensions in the continent and aggravates the risks of a slower recovery in the region. In the United States, the withdrawal of unconventional monetary stimulus has proceeded as expected, but financial markets could suffer major episodes of stress when facing events that anticipate the moment when the Fed Funds rate will begin to rise. In particular, in the current context of low long-term interest rates and limited sovereign premiums, abrupt reversals could occur with significant stress. This could affect the cost of external financing and currency parities, with significant effects on emerging economies. However, it is most likely that a better performance of the U.S. economy will provide a stronger external impulse and a more favorable medium-term scenario.

In the local economy, one risk is growth in domestic output and demand being less than projected. As indicated, the weakening of these variables has been more intense than expected, coinciding with a widespread worsening of expectations. The baseline scenario assumes that such deterioration will be gradually reversed, which explains to some extent the consumption and investment growth forecasts for 2015. However, if such reversal does not occur, it is likely that a faster and more intense adjustment will be observed in the labor market, taking a toll on consumption and output. Moreover, worsening of business expectations would result in a sharper adjustment in investment. Such a scenario could also trigger greater rebalancing towards the tradable sector and mitigate the economic slowdown to some point. On the other hand, although a weaker economy could widen output gaps and ease inflationary pressures, it cannot be ruled out that the resulting effects on the exchange rate could offset its effects on prices, at least temporarily, thus delaying the convergence of inflation.

In the past few months, domestic output and demand have shown greater and more persistent weakness than expected. As from mid-2013, the Board began to communicate that monetary policy would be more expansionary to prevent the wider gaps in the economy from jeopardizing the achievement of the inflation target. Accordingly, it has lowered the MPR by 150bp in the last year and the interest rate structure has been adjusted significantly, adding a significant monetary stimulus to the economy. Also, the Board has stressed that it will consider the possibility of making additional cuts to the monetary policy rate in line with the evolution of domestic and external macroeconomic conditions and its implications on the inflationary outlook. At the same time, the Board reiterates its commitment to conduct monetary policy with flexibility, so that projected inflation stands at 3% over the policy horizon.

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 methodological assumption that the policy rate will follow a path comparable to the one that can be inferred from the various measures of expectations available at the statistical closing of this *Report*.

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 inflation as assessed by the Board. The baseline scenario uses as a methodological assumption that the policy rate will follow a path comparable to the one that can be inferred from the various measures of expectations available at the statistical closing of this *Report*.

Source: Central Bank of Chile.

BOX
MEDIUM-TERM GROWTH

The Board's forecasts, reported in each *Monetary Policy Report,* are built using a set of working assumptions. One of the most important of these is medium-term growth, since it anchors expectations for the growth of the Chilean economy and sheds light on the state of the domestic output gap.

The reference range used for this variable is reviewed periodically, though it may not necessarily be adjusted. For example, the working assumption has been revised in response to the publication of the National Accounts data with base year 2008[1]/,the earthquake and tsunami of 2010 and changes in energy costs[2]/.

This box presents the Board's assessment of medium-term growth for the September 2014 *Monetary Policy Report*. At this time, the Board believes it is accurate to lower the projection from around 5%, the benchmark level used in previous *Reports*, to a range of 4.0 to 4.5%.

Determinants of medium-term growth

Medium-term output is determined by the supply of productive factors (capital and labor) in the economy and the efficiency with which they are combined. Measuring these factors is a complex exercise, for several reasons.

First, employment, investment, the capital stock and output itself can only be imperfectly measured. Second, the efficiency of economy is not directly observable, which implies that it can only be measured indirectly. This is done by calculating total factor productivity (TFP), which represents the share of growth that cannot be attributed to the accumulation of productive resources. Third, both the utilization of productive factors and efficiency vary over the economic cycle for a number of reasons that are unrelated to the evolution of the economy in the medium term, which complicates the calculation of TFP at that horizon. Finally, there are sectoral differences in the lag between the point at which investment is made and the point at which capital is available for use. In the mining sector, where investment has grown strongly in recent periods, these lags tend to be longer than in the rest of the economy.

Furthermore, calculating productivity in the mining sector is complicated by the steady decline in the ore grade of the deposits. Given the sector's importance in the national economy, this problem contaminates the aggregate productivity measure. These issues, combined with the fact that inflation is more closely related to what happens in non-natural-resource sectors, suggest that it is reasonable to calculate medium-term GDP separately for the two groups: natural resources and other sectors[3]/. This is the methodology used by the Central Bank.

In the case of natural resource sectors, the medium-term growth estimate is based on a projection of the future production of the main companies in the sector. For all other sectors, the estimate is based on a trend analysis of capital, labor and productivity.

Medium-term growth in other sectors

Employment, adjusted for hours worked and labor quality, is expected to grow at an annual rate of between 2.0 and 2.5% over the next few years. This figure is somewhat higher than previously estimated and is based on the following assumptions. First, the labor participation of women is still lower than in the set of OECD countries, so the working assumption is that it will continue to gradually increase in the coming years (figure 1). Second, the measure incorporates a new adjustment for labor quality, which takes into account the fact that workers entering the labor market in recent years have a higher average number of years of study, resulting in higher productivity. The number of hours worked has not changed relative to previous estimates. Finally, in line with forecasts by the National Statistics Institute (INE), the growth rate of the population aged 15 years and over is expected to decline to around 0.9% by 2020[4]/ (figure 2).

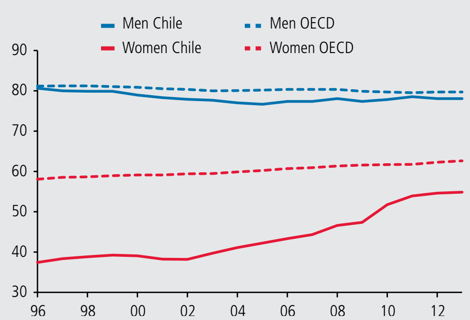
[1]/ Box V.1, *Monetary Policy Report,* June 2012.
[2]/ Box V.1, *Monetary Policy Report,* March 2010; Box VI.1, *Monetary Policy Report,* May 2008.

[3]/ Natural resource sectors include mining, fishing, and electricity, gas and water.
[4]/ Other organizations, such as the United Nations, estimate that the growth rate of the working-age population is lower, which could bias the forecast upward.

The growth rate of TFP in other sectors has slowed in recent years, as evidenced in the data (figure 3) and corroborated in recent estimates by the Committee of Experts convened by the Ministry of Finance, as well as other studies[5]/. This trend has also been recorded in other OECD economies. The working assumption used in the growth estimates is that trend TFP of other sectors will grow at an annual rate of around 1% in the coming years.

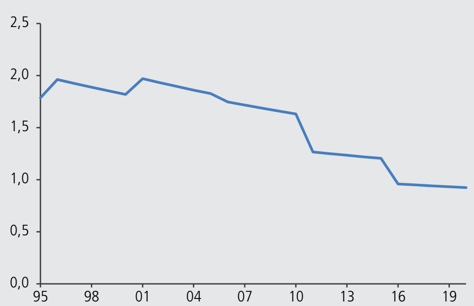
Capital, in turn, is expected to grow more slowly, with a forecast of 4.5% versus an average of 5.8% over the last five years. Thus, the investment-to-GDP ratio should remain around the level of the last ten years (figure 4). The lower growth rate of investment is consistent with the projected absence of factors that have driven the increase in capital over the last few years. In particular, investment in other sectors has been bolstered by the strong growth of investment in mining starting in 2006.

FIGURE 1
Labor participation
(percent of working-age population)



Source: OECD.

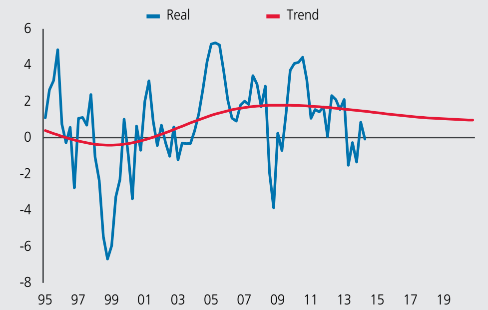
FIGURE 2
Population aged 15 years and over
(annual change, percent)



Source: National Statistics Institute (INE).

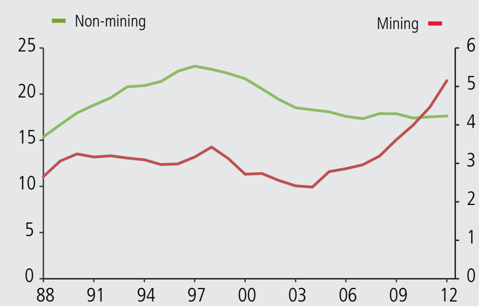
[5]/ Corbo and González (2014). Sosa et al. (2013).

FIGURE 3
Total factor productivity in other sectors
(annual change, percent)



Source: Central Bank of Chile.

FIGURE 4
Gross fixed capital formation
(percent of nominal GDP, accumulated in five years)



Source: Central Bank of Chile.

Medium-term growth in natural resource sectors

For the mining and electricity, gas and water (EGW) sectors, the growth forecast for the next five years is based on the investment registry maintained by the Capital Goods and Technological Development Corporation (*Corporación de Desarrollo Tecnológico y de Bienes de Capital,* CBC); data provided by the Chilean Copper Commission (*Cochilco*), the National Energy Commission (CNE) and the Economic Load Dispatch Center (CDEC); and an analysis of the historical evolution of copper ore grade. For fishing, the growth forecast is based on the historical average production of the sector.

Medium-term growth of total GDP

The medium-term growth rate of total GDP is calculated by aggregating the assumptions on the natural resource sectors and other sectors. They are weighted according to the relative weight of each group of sectors in nominal GDP in 2013: 14%

for natural resources and 77% for other sectors. The remaining 9% corresponds to indirect taxes, which are included to obtain the market value of output. This item has systematically increased more than GDP, and the assumption used here is that the growth rate will fluctuate between 5 and 6%. Thus, the medium-term growth rate of the economy is estimated between 4.0 and 4.5% (table 1)[6]/.

TABLE 1
Medium-term growth
(annual change, percent)

Period	GDP total	Other GDP (1)				Nat. res. GDP
		Total	Other TFP	Capital	Labor	
Historical decomposition of GDP growth						
1987-90	6.5	6.9	2.0	4.0	5.8	3.4
1991-95	7.5	7.4	1.6	6.8	4.9	8.1
1996-00	3.8	3.4	-1.4	6.5	3.3	6.9
2001-05	4.3	4.8	1.6	3.8	2.8	0.8
2006-10	3.6	4.5	1.8	3.9	1.6	0.6
2011-14:2	4.7	5.1	0.8	5.8	2.8	2.7
Medium-term GDP growth forecast (2)						
2015-20	4.0-4.5	4.1-4.6	1.0	4.5	2.0-2.5	2.5

(1) Capital and labor account for 48 and 52% of GDP, respectively.

(2) The medium-term forecast uses the 2013 shares of other GDP and natural resource GDP in nominal GDP. To arrive at total GDP, indirect taxes are assumed to grow in line with historical trends, in a range of 5–6%.

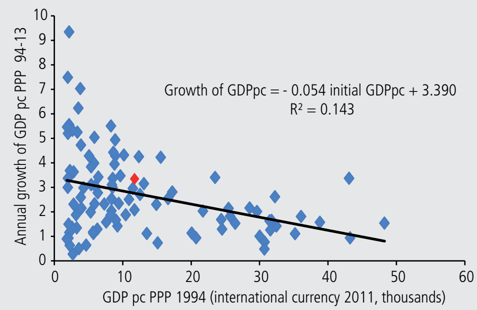
Source: Central Bank of Chile.

Medium-term growth from a global perspective

From a global perspective, the reduction in the medium-term growth rate is to be expected as the economy develops, due to a process of convergence (figure 5). According to Contreras and Pinto (2014), convergence could explain a reduction in Chile's medium-term growth rate of between 0.4 and 1.4 percentage points in 2014–2018 relative to 2009-2013[7]/.

Moreover, a small, open economy such as Chile is very influenced by what happens around it. Contreras and Pinto (2014) suggest that the external environment will be marginally less favorable in the next five-year period, at least with regard to the terms of trade and financial conditions, which will be only partially offset by increased growth among the country's trading partners (figure 6).

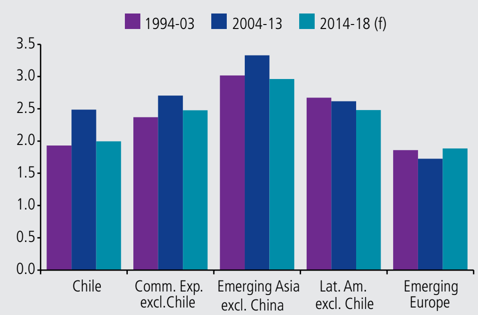
FIGURE 5
GDP per capita and economic development (*)



(*) In red, Chile. In blue, 100 medium- to high-income countries with a population of over two million people.

Source: World Bank.

FIGURE 6
GDP growth contribution of commercial factors
(percentage points)



(f) Forecast.

Source: Contreras and Pinto (2014).

Conclusion

At this time, the Board estimates that the medium-term growth rate of the Chilean economy will be between 4.0 and 4.5%, which is lower than the growth estimates used in previous *Reports*. The downward adjustment reflects the evolution of total factor productivity, the projected growth of the capital stock and the natural convergence of an economy that has reached higher levels of per capita income.

[6]/ See Fornero et al. (2014) for more details on the calculation of the assumptions described herein.

[7]/ In this paper, the authors estimate a panel regression for different sets of countries, including Chile, where the determinants of medium-term growth include the traditional variables used in neoclassical theory and other traditions to capture the contribution of external conditions.

MONETARY POLICY DECISIONS IN THE LAST THREE MONTHS

BACKGROUND: JUNE 2014 MEETING AND *MONETARY POLICY REPORT*

In the second quarter of 2014, output and domestic demand continued to slow. Investment had been falling for several quarters, and the performance of private consumption worsened. Inflation had increased to over 4% in annual terms, mainly due to the pass-through of the depreciation of the peso to final prices. Although this increase was greater than projected, it was considered transitory, and annual inflation was expected to return to 3% within the usual monetary policy horizon, which was consistent with medium-term inflation expectations. The external scenario had not changed significantly since the close of the last *Monetary Policy Report*, and the volatility of the financial markets had lessened.

In this context, the Board had kept the monetary policy rate (MPR) at 4% for the past few months 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 of the June *Monetary Policy Report* considered that inflation would remain above 4% for several more months, ending 2014 at around that level. In 2015, inflation would continue to fall to about 3% in the first half of the year, where it would stay through the end of the forecast horizon in the second quarter of 2016. This projection rested on the fact that the lower degree of installed capacity utilization would reduce domestic inflationary pressures, helping inflation return to 3%. The Board estimated that the economy would grow between 2.5 and 3.5% this year, adjusting the March forecast downward due to the weakening of economic sectors tied to domestic demand in the first quarter. The economy was expected to recover gradually, with higher annual growth rates toward the end of 2014. Investment was also expected to recover somewhat, given internal and external financing conditions. The MPR had been cut 100 basis points in recent quarters, long-term interest rates were at their lowest level in a decade and risk spreads had narrowed. External drivers included the better prices in dollars, the reallocation of domestic resources deriving from the real currency depreciation and the improved economic forecast for the developed world. Finally, an additional impetus would be provided by public spending, especially investment, due to the low budget execution in 2013. In the other direction, measures of business expectations had deteriorated, and the schedule of investment projects had been revised downward for 2014 by the CBC.

The baseline scenario reflected the events that had the highest probability of occurrence based on the information available at the close of that *Report*. However, there were risk scenarios that, if they materialized, would change the macroeconomic environment and, therefore, the course of monetary policy. After evaluating the alternative scenarios, the Board estimated that the risk balance was unbiased for both output and inflation.

Internationally, the biggest risk continued to be the performance of the Chinese economy and financial system. There was also the possibility that vulnerabilities in other emerging economies could produce new episodes of volatility. The risks associated with the withdrawal of the monetary stimulus in the United States and the microfinancial situation in the Eurozone had eased, and a better performance of the U.S. economy would provide a stronger external impetus.

Domestically, the leading risk centered on the short-term inflation scenario, due to the difficulty of measuring the real level of the output gap and tight margins. A second risk had to do with the poor performance of investment in the past few quarters. Although the baseline scenario assumed a slight recovery in the coming period, the inertia characteristic of this component could prolong the weak performance beyond projections. In fact, since September of the previous year, the annual growth forecast for investment in 2014 had been revised downward more than five percentage points.

At the June meeting, the Studies Division presented two main options: holding the MPR at 4.0% or cutting it by 25 basis points, to 3.75%. Holding it at the current rate would give time to collect more information on the persistence of the inflation surprises recorded in recent months. Under the most probable scenario, the increase in annual inflation to over 4% would be transitory, but the string of upward surprises called for a degree of caution in this area. The option of reducing the MPR was consistent with the expectation that the economy would continue to accumulate excess capacity, which would reduce inflationary pressures in the medium term. This scenario would require an additional monetary stimulus to ensure that inflation would remain around the target in the policy horizon. The Board decided to hold the MPR at 4%, although a minority voted to reduce it by 25 basis points, to 3.75%.

MEETINGS IN JULY AND AUGUST

In July, the international scenario had not changed significantly. Domestically, the available information indicated that in the second quarter, other output and final demand had grown less than forecast in the last *Report*. This had induced a reduction in the growth estimate for 2014. Moreover, the fact that the economy had continued to accumulate excess installed capacity had reduced domestic inflationary pressures and the current account deficit expected for the year. Although the estimation of excess capacity was subject to uncertainty, it had clearly increased in the economy in recent quarters. With regard to June inflation, for the second consecutive month, the magnitude of the inflation surprises had been lower than previously, when the economy recorded significant surprises mainly associated with the direct and indirect effects of the peso depreciation. Short-term inflation expectations were stable, as were expectations for the monetary policy horizon.

In this context, the Studies Division presented two main options: holding the MPR at 4.0% or cutting it by 25 basis points, to 3.75%. Holding it at the current rate would give time to collect more information on the convergence of inflation to 3%, as contemplated in the *Monetary Policy Report* scenario. While this scenario estimated that the spike in inflation to over 4% would be transitory, the series of upward surprises and their magnitude in recent months, together with the persistence of the growth in nominal wages, called for a degree of caution in this area. This risk was mitigated to a degree by recent developments in the labor market, in particular the weakening of wage employment and the increase in the unemployment rate after adjustment for self-employment dynamics. The option of reducing the MPR was consistent with the *Monetary Policy Report* scenario, which contemplated MPR levels below 4.0% to ensure the convergence of inflation to 3% within the policy horizon. The fact that the growth forecast was lower than projected in the last *Report* reinforced the need to provide an additional monetary stimulus. The Board therefore decided to reduce the MPR by 25 basis points, to 3.75%.

In August, the international scenario had not changed significantly relative to the previous month in terms of output and inflation. The geopolitical conflicts in the Middle East and Ukraine had had a moderate impact on the financial markets. Most currencies had depreciated against the U.S. dollar. Commodity prices had fallen. Domestically, the economy had grown just 1.9% in annual terms in the second quarter, which was below the projection in the June *Report*. On the demand side, the more persistent components, such as regular consumption and investment in construction and engineering works, had been surprisingly slow. The data accumulated to date pointed to a downward adjustment in the 2014 growth rate, possibly even below the estimated floor in the June *Report* and also below market expectations. The lower forecasts were associated with both the negative surprises in the first half and a lower evaluation of the output dynamics in the coming quarters. However, labor market data did not show an adjustment of the same magnitude: nominal wages continued to grow at over 6.5%. Total CPI inflation had been in line with expectations, although the CPIEFE (CPI excluding food and energy) was somewhat lower. Private expectations at one and two years out remained around 3%, illustrating the temporary nature of the inflation spike. Market expectations thus anticipated that a greater monetary stimulus would be needed than projected in July.

In this context, the Studies Division presented three main options: holding the MPR at 3.75%; cutting it by 25 basis points, to 3.50%; or cutting it by 50 basis points, to 3.25%. Holding it at the current rate would give time to collect more information on the evolution of the labor market, especially nominal wages —which had been more dynamic than expected— and its implications for the convergence of inflation to 3%. However, the available information suggested that the risk of inflationary pressures deriving from the labor market dynamics had attenuated. In addition, this decision would come as a surprise and could be interpreted as a signal that the monetary easing process was coming to an end. The option of reducing the MPR by 25 basis points would send a clear signal of the need for a greater monetary stimulus than considered in the last *Report*, especially if the downward bias was maintained. A cut of 50 basis points could be justified based on the benefits of speeding up the process of lowering the MPR in the face of a sharper slowdown. However, this option would come as a surprise and would reduce the rate structure even further. While the possibility of a greater monetary stimulus than currently present in financial instruments could not be immediately ruled out, the communication of the decision would require a detailed explanation of the macroeconomic outlook, which would not be published until the September *Monetary Policy Report*. The Board therefore decided to reduce the MPR by 25 basis points, to 3.5%.

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.

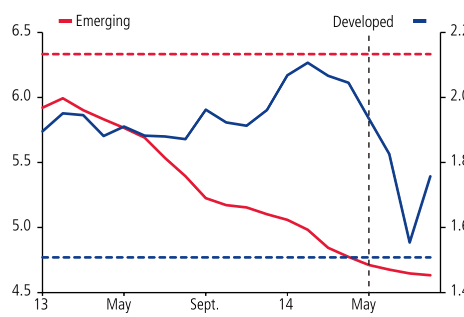
WORLD GROWTH

The real data released over the past few months have led to a revision of the world growth forecast for this year, although the scenario for the two-year period 2014–2015 has not changed substantially. The scenario is more heterogeneous within economic blocks. In the developed world, the outlook for 2014 declined due to the weak performance of the United States in the first quarter, together with the deterioration in Japan and the Eurozone in recent months. In the emerging world, the slowdown in Latin America intensified, while China recovered somewhat in the most recent period (figure I.1). Consequently, the projected growth of Chile's trading partners was revised downward for 2014 and 2015, to 3.4 and 3.8%, respectively (table I.1).

The United States recovered strongly in the second quarter, with an annualized quarterly growth rate of 4.2% (versus –2.1% in the first), providing confirmation that the contraction of the previous quarter was transitory and mainly due to climatic factors. Revised historical data largely explain the reduction in the 2014 growth outlook for this economy, while the forecast for next year has not changed significantly. The second quarter result mainly reflects the contribution of investment and personal consumption, especially durable goods. The labor market continues to recover, with a lower unemployment rate (6.2% in July) and more dynamic labor income. Consumer expectations remain high, while expectations in the service and manufacturing sectors improved (figure I.2). Credit access conditions have loosened, and the demand for financing has strengthened, in general. The real estate market has also continued its gradual recovery.

In the second quarter, activity in the Eurozone eased relative to previous quarters. Annualized quarterly GDP growth was 0.2% (versus +0.8% in the first quarter). This is largely explained by a less dynamic performance of the main drivers: Germany contracted 0.8% in annualized quarterly terms (+3.3% in the first), France remained stagnant and Italy recorded another contraction. In the former cases, foreign trade and investment were particularly weak, while

FIGURE I.1
Evolution of growth forecasts for 2014 (1) (2)
(annual change, percent)



(1) The vertical dashed line indicates the statistical closing date of the June 2014 *Monetary Policy Report*.
(2) The horizontal dashed lines indicate average growth in the 2010–2013 period.

Sources: Central Bank of Chile and Consensus Forecasts.

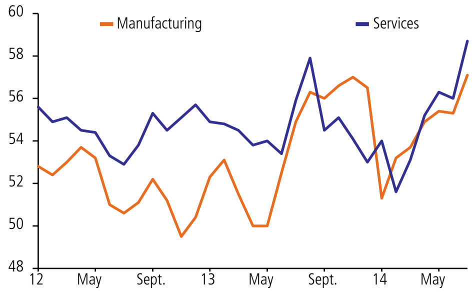
TABLE I.1
World growth (*)
(annual change, percent)

	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	3.7	4.1
World at market XR	2.7	3.3	2.4	2.4	2.6	3.1	3.3
Trading partners	3.1	3.6	3.3	3.5	3.4	3.8	3.9
United States	3.2	2.7	2.3	2.2	2.1	3.0	3.2
Eurozone	1.6	2.2	-0.6	-0.4	0.8	1.7	1.8
Japan	1.5	1.7	1.4	1.5	1.0	1.5	1.2
China	10.0	10.5	7.7	7.7	7.3	7.2	7.0
India	5.8	7.1	4.7	4.4	5.4	6.2	6.5
Rest of Asia	5.6	5.1	3.9	3.9	4.0	4.5	4.8
Latin America (excl. Chile)	2.8	3.5	2.9	2.6	1.7	2.6	3.3
Commodity exporters	2.7	3.1	2.5	2.2	2.5	2.5	2.8

(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.

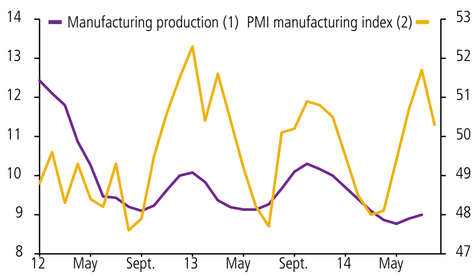
FIGURE I.2
Sectoral outlook in the United States (*)
(diffusion index)



(*) A value over (under) 50 indicates optimism (pessimism). Data are from surveys of purchasing managers carried out by ISM.

Source: Bloomberg.

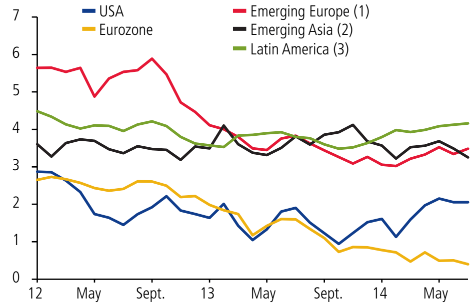
FIGURE I.3
China: manufacturing production and outlook
(annual change, percent; diffusion index)



(1) Quarterly moving average.
(2) A value over (under) 50 indicates optimism (pessimism). Index estimated by HSBC.

Source: Bloomberg.

FIGURE I.4
Total inflation
(annual change, percent)



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

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

consumption improved somewhat. Spain, in turn, continued to post positive signs. The uncertainty surrounding the tension in Ukraine has affected consumer and business confidence in the zone. In the coming months, a recovery is expected in response to the stimulus measures announced by the European Central Bank (ECB) in June, which are expected to be implemented starting in September. In sum, given the weak second quarter, the outlook for 2014 has been revised downward, but the 2015 forecast remains unchanged.

With regard to other developed economies, the tax adjustments in Japan caused a high degree of volatility in domestic demand in the first half of the year. In the second quarter, the deterioration in consumption and investment largely reflected the earlier rise in these items in advance of the tax increases. The economy thus contracted strongly in the period (–6.8% in annualized quarterly terms, versus 6.1% in the first quarter), which contributed to the downward revision of the forecast for this year. However, the manufacturing outlook is expansive, and consumer confidence has improved in recent months. When combined with the low basis for comparison this year, this explains the higher growth rate projected for 2015. Finally, the United Kingdom presents more positive data: the economy maintained an annualized quarterly growth rate of 3.2% in the second quarter, and unemployment fell. Moreover, business expectation remained above the neutral level in July.

China has responded to fiscal spending measures, although the economy remains tight. The annualized growth rate thus increased marginally to 7.5% in the second quarter (7.4% in the first). Manufacturing production and retail trade improved somewhat in annual terms, while foreign trade data have been especially encouraging on the shipments side. With regard to expectations, manufacturing purchasing agents were expansive, after several months in contractionary territory (figure I.3), while consumer expectations were stable, on average. The improvement in these indicators has partially mitigated the threat of a sharper slowdown, which has been reflected in the stabilization of growth forecasts. The key risks in this economy include the fragility of the real estate sector (as evidenced, for example, in housing prices, which have been falling since late 2013), the high public debt and the risks in the financial system.

In Latin America, the slowdown has become more pronounced. Consequently, the region posted the largest adjustment to the 2014 growth forecast within the emerging world: 1.7% (excluding Chile) (2.0% in June). The region will thus grow over two percentage points less than its average in 2010-2013. By country, the biggest cuts were in Brazil and Peru. The latter, in particular, reflects the economy's poor performance in the second quarter, but a recovery is expected over the course of the rest of the year in response to measures adopted by the country's authorities. Peru thus continues to have one of the highest growth forecasts of the group, together with Colombia. The deceleration of this bloc has essentially been determined by the contraction of sectors tied to investment, although consumer sectors have also slumped. Manufacturing production remains weak in the majority of these economies. At the same time, business and consumer expectations have deteriorated.

INFLATION AND MONETARY POLICY

In the developed world, the inflation gap between the United States and the Eurozone has widened. The U.S. economy saw an increase in the price level in the second quarter, which brought the annual rate in line with the Federal Reserve's target of 2%. In the Eurozone, deflation remains a threat, to the extent that inflation has contracted in recent months in step with the weaker economic data (figure I.4).

With regard to the emerging economies, inflation stabilized at high levels in Latin America, mainly due to the more volatile components, and most countries with an inflation target recorded levels in the upper end of the range. The inflation outlook continued to rise, reflecting a combination of idiosyncratic factors and, almost across the board, a currency depreciation trend. For the emerging economies of Asia and Europe, both real and forecast inflation remained low.

Most economies held their monetary policy rate. There was some movement toward the end of the period, but the changes were mixed. For the remainder of the year, no significant changes are expected in the emerging economies. In the developed world, the United States is expected to continue its gradual rate normalization process. Recent announcements by the U.S. Federal Reserve (the Fed) raised the probability that the increase could come sooner than previously expected. In the United Kingdom, there were strong signals that the adjustment process could be pending, and the country is increasingly expected to be the first to initiate the process (figure I.5).

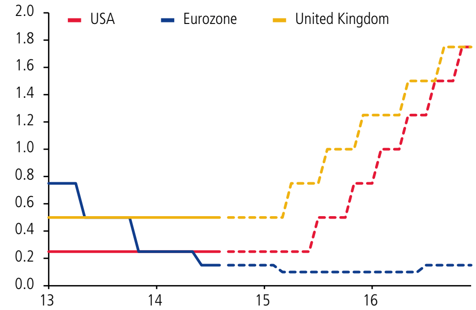
With regard to unconventional monetary policy, the United States continued withdrawing the quantitative stimulus, in line with market expectations, while the United Kingdom and Japan maintained their asset purchase programs. The deflationary threat in the Eurozone reinforced the expectation that the ECB would consider taking additional stimulus measures. In Latin America, Peru and Brazil adjusted the bank reserve rate to boost growth.

COMMODITIES

Commodity prices have been mixed since the last *Report*, with a reduction in fuel and agricultural prices and an increase in metals. The improved short-term output data for the United States and China, the appreciation of the dollar and the supply conditions in the different markets determined the disparate price movements (figure I.6).

The copper price increased about 3% between the statistical closing dates of the June and September *Reports*, trading at around US$3.20 per pound in late August. This trend was largely determined by the favorable data on manufacturing production and expectations for the manufacturing sector in the United States and China, as well as tighter supply conditions. The upward trend halted with the July data on metal imports to China (around –4% in monthly terms). Given the increase in prices recorded since June, the baseline

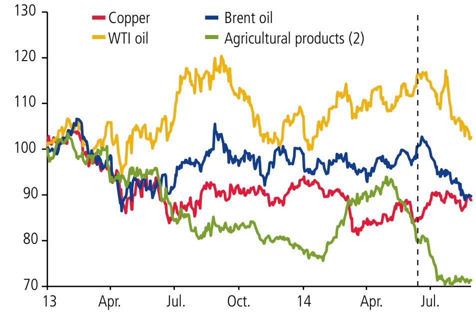
FIGURE I.5
MPR in developed economies (*)
(percent)



(*) The dashed line represents MPR expectations implicit in the prices of interest rate futures contracts.

Source: Bloomberg.

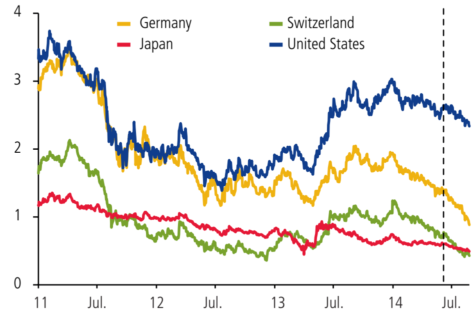
FIGURE I.6
Commodity prices (1)
(index, 01.Jan.13=100)



(1) The vertical dashed line indicates the statistical closing date of the June 2014 *Monetary Policy Report*.
(2) Goldman Sachs aggregate index.

Source: Bloomberg.

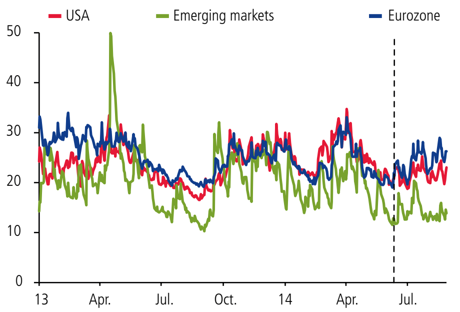
FIGURE I.7
Interest rates on ten-year government bonds (*)
(percent)



(*) The vertical dashed line indicates the statistical closing date of the June 2014 *Monetary Policy Report*.

Source: Bloomberg.

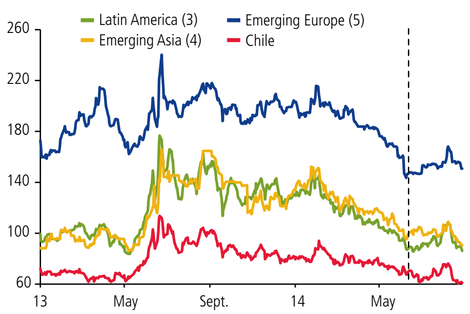
FIGURE I.8
Stock market volatility (1)(2)
(percent)



(1) The vertical dashed line indicates the statistical closing date of the June 2014 *Monetary Policy Report.*
(2) 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.9
Emerging market spreads (1) (2)
(basis points)



(1) The vertical dashed line indicates the statistical closing date of the June 2014 *Monetary Policy Report.*
(2) Five-year CDS spreads; simple average of the countries in each region.
(3) Includes Brazil, Peru, Mexico, Panama and Colombia.
(4) Includes China, Philippines, Indonesia, Thailand and Malaysia.
(5) Includes Czech Rep., Hungary, Croatia, Bulgaria and Turkey.

Source: Bloomberg.

scenario raises the copper price forecast, but maintains the downward trend in the forecast horizon: US$3.15 per pound in 2014, US$3.05 in 2015 and US$3.00 in 2016.

Oil prices —both the WTI and Brent— fell around 8% relative to the June closing date, albeit with fluctuations. The oil supply has been stable despite the geopolitical tensions in the Middle East and the Ukrainian-Russian conflict, which have had a limited impact. The weak economy in Japan and the Eurozone was more sharply reflected in fuel prices; the effect was partially offset by increased demand in the United States, where inventories have fallen significantly in recent weeks. Based on average futures contracts in the last ten business days prior to the close of this *Report*, fuel prices are expected to continue their downward trend, with no major change since June.

Agricultural prices, measured by the Goldman Sachs index, contracted 14.6% since the June *Report*, largely due to grains and cereals. This reflects the favorable climate and good crops, especially in the United States.

INTERNATIONAL FINANCIAL MARKETS

The international financial markets, in general, have not recorded any major movements in the last three months. Long-term interest rates fell, mainly in the developed world. Thus far in the year, ten-year rates have decreased on the order of 70 basis point in the Eurozone and 40 basis points in the United States (figure I.7). Several factors have contributed to this trend, including the current geopolitical tensions, the limited economic performance of the Eurozone in the second quarter and the strengthening of demand for and the reduction in the supply of U.S. Treasury bonds. As the market internalizes the more positive indicators from the United States and as the Fed begins to signal tightening, the low long-term rates could reverse sharply, which would pose a serious challenge to emerging economies carrying high levels of debt with the rest of the world. Another important trend has been the generalized appreciation of the U.S. dollar.

Other global financial indicators were relatively stable. There was some fluctuation toward the end of the period, which was related to the ongoing geopolitical conflicts, concerns about the banking sector in peripheral Europe and Argentina's default. The latter events had a limited impact, however, which tended to dissipate in recent weeks. Market volatility indices increased slightly, as did corporate and sovereign spreads in the emerging world (figures I.8 and I.9).

II. FINANCIAL MARKETS

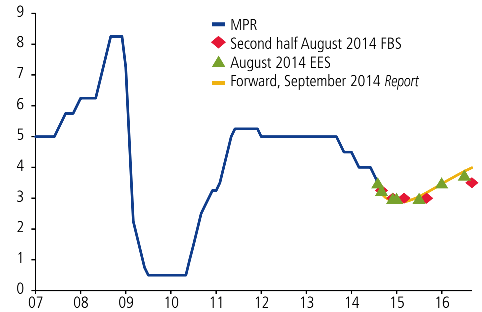
This chapter reviews the evolution of local financial market in connection with the transmission of monetary policy.

MONETARY POLICY

In recent months, the performance of output and domestic demand has been weaker and more persistent than projected. The drop in investment, combined with a sharper slowdown in consumption, gave rise to a reduction in the growth outlook for 2014. Annual inflation, however, was in line with expectations, and its current high level is still expected to be temporary. The two-year forecast thus remains around 3%. The world growth scenario has declined slightly, and financial conditions remain favorable. In this context, the Board has continued to implement a process of monetary easing, reducing the monetary policy rate (MPR) by 25 basis points at both the July and August meetings. This brought the MPR to 3.5% in annual terms, following a total reduction of 150 basis points since October 2013. In addition, the Board has signaled that it will evaluate the possibility of introducing additional cuts, depending on the evolution of internal and external macroeconomic conditions and the implications for inflation.

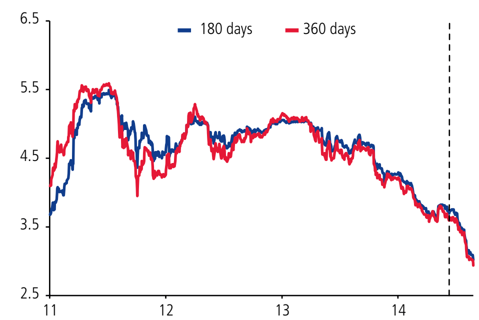
The weaker domestic economic scenario lowered expectations for the MPR in the last few months. In June expectations for the second half of this year had the MPR bottoming out at around 3.5%; now the market expects it to reach 3.0% or slightly lower by the end of this year or the beginning of the next. Going forward, expectations for the MPR have also been reduced. Surveys predict that it will be around 3.0% in one year (versus 3.50 to 3.75% in the last *Report*), while financial asset prices will be between 2.9 and 3.1% (3.7 to 3.9% in the last *Report*). In two years, surveys put the MPR between 3.50 and 3.75% (versus 4.0% in the last *Report*), with financial asset prices between 3.3 and 3.9% (3.7 to 4.6% in the last *Report*) (figure and table II.1).

FIGURE II.1
MPR and expectations
(percent)



Source: Central Bank of Chile.

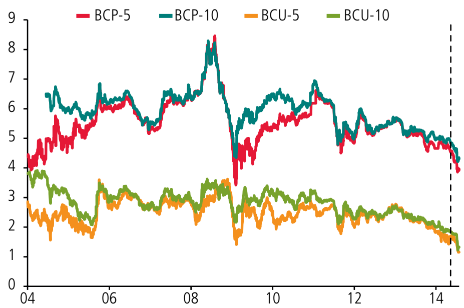
FIGURE II.2
Swap rates (*)
(percent)



(*)The vertical dashed line indicates the statistical closing date of the June 2014 *Monetary Policy Report.*

Source: Central Bank of Chile

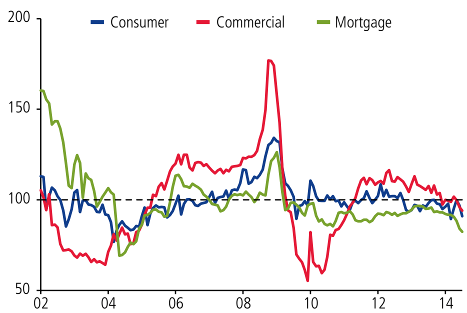
FIGURE II.3
Interest rates on Central Bank of Chile bonds (*)
(percent)



(*) The vertical dashed line indicates the statistical closing date of the June 2014 *Monetary Policy Report.*

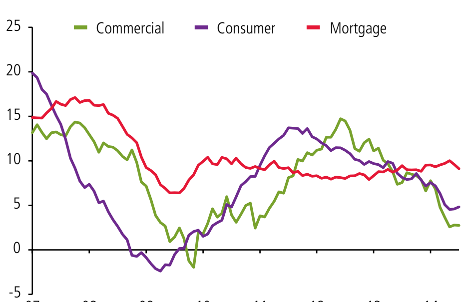
Source: Central Bank of Chile.

FIGURE II.4
Average interest rates on bank loans
(index: average Jan 2002 – July 2014 = 100)



Sources: Central Bank of Chile and Superintendence of Banks and Financial Institutions.

FIGURE II.5
Loans by type of credit
(real annual change, percent)



Sources: Central Bank of Chile and Superintendence of Banks and Financial Institutions.

TABLE II.1
MPR expectations
(percent)

	December 2014		One year ahead		Two years ahead	
	June *Report*	September *Report*	June *Report*	September *Report*	June *Report*	September *Report*
EES (1)	3.50	3.00	3.50	3.00	4.00	3.75
FBS (2)	3.50	3.00	3.75	3.00	4.00	3.50
Forward curve (3)	3.63	2.90	3.88	3.12	4.60	3.93
Swap contracts (4)	3.73	3.03	3.66	2.90	3.70	3.31

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

Source: Central Bank of Chile.

The developments in the internal and external macroeconomic scenario and the changes in the MPR led to a reduction in interest rates in the fixed-income and money markets. Swap rates fell 65 basis points, on average, relative to the last *Report* and nearly 175 basis points compared with rates in mid-2013, when the Board began to anticipate a more expansionary monetary policy (figure II.2). Prime rates at one to twelve months fell between 65 and 90 basis points relative to the last *Report* and between 165 and 190 basis points relative to June 2013. A similar downward trend was recorded for the rates on peso time deposits traded on secondary markets and nominal TAB rates (the *tasa activa bancaria*, calculated by the SBIF), which reflect the banks' funding costs.

The expansionary bias of monetary policy and the evolution of the internal and external macroeconomic scenario, including lower external long-term interest rates mainly in the developed markets, are behind the significant reduction in local long-term interest rates in the last year. As of the closing date of this *Monetary Policy Repor*t, practically all interest rates are at or near their historical low. Five- and ten-year BCPs closed with rates around 65 basis points lower than the last *Report,* while BCUs at the same maturities fell between 50 and 55 basis points (figure II.3).

FINANCIAL CONDITIONS

The more expansionary monetary policy has also been reflected in the interest rates on business and personal loans. Relative to mid-2013, consumer loan rates fell 140 basis points, on average, while mortgage loans dropped 60 basis points and commercial loans 100 basis points (figure II.4).

Despite the favorable lending conditions, the growth rate of loans slowed over the last few quarters, mainly for commercial and consumer credit (figure II.5). This reflects the lower investment by firms, the slowdown in domestic output and the deterioration of expectations. Not only has the demand for credit been lower, but banks have been more rigorous in reviewing credit histories for loan applications. The Bank Lending Survey (BLS) for June and the *Business Perceptions Report* for August reflect these trends (figures II.6 and II.7).

In July, the real annual growth rate of commercial and consumer loans was 2.8 and 4.8%, respectively, versus on average of 7.9% for both in the second half of 2013. The growth rate of housing loans in UF (*unidad de fomento*, an inflation-indexed unit of account of widespread use) was stable, with an annualized increase of 9.1% in July; this rate is similar to the second half of last year.

In addition to the positive lending conditions in the domestic market, external financing conditions have been favorable from a historical perspective, with some fluctuation, although there is still the risk of a reversal. Thus, Chile's five-year sovereign spread (measured by the credit default swap, or CDS), corporate bond spreads (measured by the CEMBI) and the spreads on loans contracted by Chilean banks overseas are all lower than a year ago, although they have increased somewhat at the margin. These trends, together with dynamic corporate bond placements abroad, reveal the good financing conditions in those markets and the solid risk perception of Chile overseas (figure I.9).

Other sources of corporate financing also remain favorable, as reflected in the numerous local corporate bond issues thus far in the year (figure II.8). The amounts issued have exceeded placements in the same period of 2013, and the rates and spreads obtained continue to be favorable, although they have increased slightly in the most recent period.

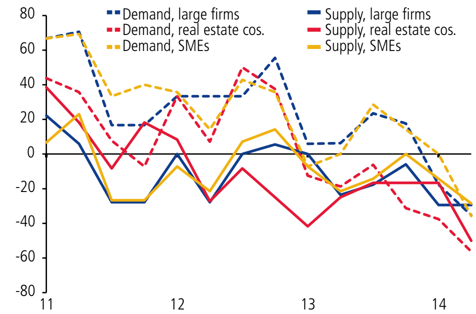
With regard to the monetary aggregates, M1 (primarily unremunerated bank liabilities) recorded a decrease in its annual growth rate relative to the close of the last *Report*. Based on data for August, the nominal annual growth rate was 10.8% (versus 12.5% in May), due to a drop in the annual growth of demand savings, while the growth rate of currency in circulation and checking account deposits increased slightly. The nominal growth rate of M2 and M3, which had already decreased in the second quarter of the year, was more stable in July, at 6.7 and 9.2%, respectively (versus 6.5 and 9.6% in May).

FINANCIAL MARKETS

In both the international and Chilean financial markets, the scenario has not changed significantly since the last *Report*, with the exception of some recent fluctuations that are mainly related to geopolitical tensions. Overall, the markets are calmer in terms of volatility, risk aversion and stock market movements relative to mid-2013 and early 2014.

Relative to the last *Report*, the developed stock exchanges, measured by the MSCI index in dollars, ended the period with no major movements as of the closing date of this *Report:* +0.6% in dollars and +1.2% in local currency. Emerging market stock exchanges recorded an increase of 3.9% in dollars (+4.4% in local currency), mainly due to Asia and Latin America. Emerging Europe declined, being the region most affected by the geopolitical tensions. In Chile, the stock market, measured by the IPSA stock index, increased slightly in local currency (+1.1%) and fell 4.4% in dollars.

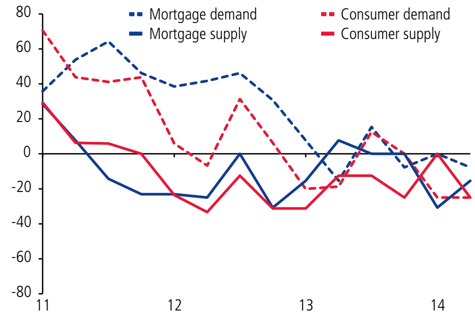
FIGURE II.6
Bank Lending Survey: Firms (*)
(average response, percent)



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

Source: Central Bank of Chile.

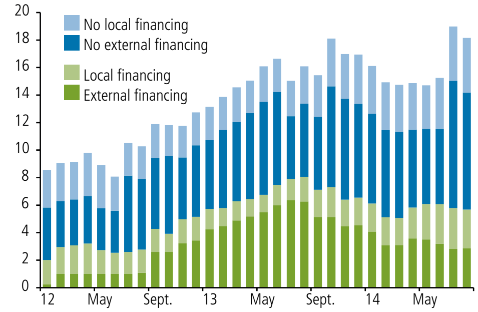
FIGURE II.7
Bank Lending Survey: Individuals (*)
(average response, percent)



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

Source: Central Bank of Chile.

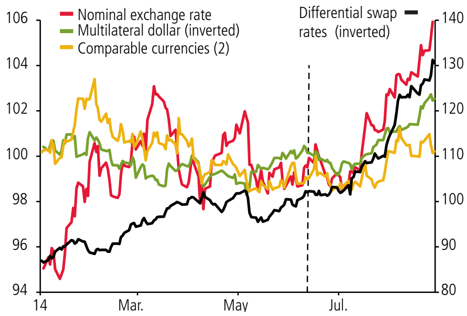
FIGURE II.8
Corporate bond issues (*)
(US$ billion in 12 months)



(*) Figure for August 2014 includes data through the 28th.

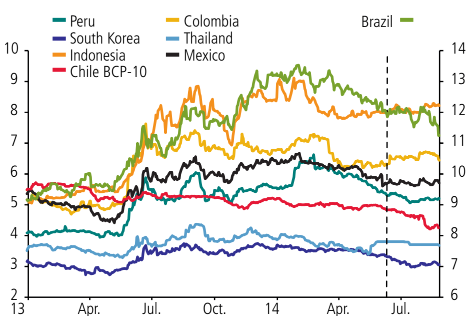
Source: Central Bank of Chile, based on data from Bloomberg and the Santiago Stock Exchange.

FIGURE II.9
Nominal exchange rate (1)
(index: 02.Jan.14 – 28.Aug.14 = 100)



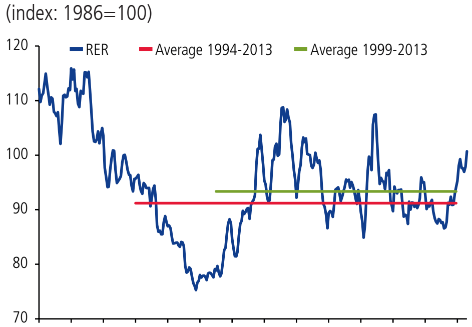
(1) An increase indicates depreciation. The vertical dashed line indicates the statistical closing date of the June 2014 *Monetary Policy Report.*
(2) Brazil, Mexico, Colombia, South Korea, the Philippines, South Africa, the Czech Rep., Turkey, Israel and Poland. Weighted according to the April 2014 WEO.
Sources: Bloomberg and International Monetary Fund.

FIGURE II.10
Interest rates on ten-year government bonds (*)
(percent)



(*)The vertical dashed line indicates the statistical closing date of the June 2014 *Monetary Policy Report.*
Sources: Bloomberg and Central Bank of Chile.

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



(*) Figure for August 2014 includes data through the 28th.
Source: Central Bank of Chile.

In the foreign currency market, the nominal and real exchange rate reflected changes in the internal and external macroeconomic scenario. Thus, the Chilean peso depreciated 5.8% between the statistical closing dates of this and the last *Reports*. The increase intensified in recent weeks, with the exchange rate rising above Ch$590 to the dollar at the close of this *Report*. While part of the depreciation is due to a global phenomenon of a strengthening dollar, the increase in the peso/dollar exchange rate exceeded depreciation recorded in other emerging economies, in response to less favorable domestic cyclical conditions and a more expansionary local monetary policy. This was reflected, in particular, in the swap rate differential, which has fallen around 70 basis points since June; this is larger than in comparable economies, especially in Latin America (figures II.9, II.10 and table II.2).

TABLE II.2
U.S. dollar exchange rates (1)
(percent)

	Change in the nominal exchange rate					
Country	Mar.2014/Dec. 2013 (2) *Report*	Jun./Mar. 2014 (2) *Report*	Sep./Jun. 2014 (2) *Report*	Accrued 2014	Spot/minimum 2013	Spot/minimum 2014
Brazil	1.8	-3.5	0.5	-5.1	15.3	2.5
Indonesia	-2.2	3.8	-0.9	-3.9	21.7	3.6
Malaysia	2.7	-2.2	-1.8	-3.9	6.3	0.1
Turkey	10.1	-5.5	3.2	0.5	23.4	4.4
Australia	2.1	-2.5	0.2	-5.0	13.3	1.5
Thailand	2.0	0.7	-2.0	-2.4	11.5	0.6
Chile	**9.0**	**-2.7**	**5.8**	**13.0**	**27.1**	**12.6**
Peru	0.3	-0.9	1.6	1.7	12.1	2.9
South Africa	6.3	-1.0	-0.2	1.1	25.6	3.2
Canada	6.4	-2.3	0.2	2.0	10.4	2.1
Hungary	2.2	-0.7	5.7	10.7	13.0	10.7
Colombia	4.4	-6.0	1.4	-0.1	9.5	4.5
Mexico	1.6	-1.9	1.2	0.3	9.2	1.9
United Kingdom	-2.6	-1.3	1.1	-0.1	-0.2	3.5
Switzerland	-3.7	2.0	1.7	2.6	3.4	4.9
Czech Republic	-1.8	2.0	4.0	6.2	13.3	7.3
New Zealand	-3.4	0.7	1.2	-2.3	3.0	5.2
Sweden	-3.3	4.4	3.5	8.3	10.9	10.2
Eurozone	-2.5	1.8	2.6	4.4	4.7	5.7
Israel	-1.8	-0.2	2.1	2.8	2.8	4.6
Poland	-2.1	-0.2	4.3	6.1	6.6	6.7
South Korea	1.1	-5.0	-0.2	-3.9	-3.4	0.6

(1) A positive (negative) sign indicates a depreciation (appreciation) of the currency against the U.S. dollar.
(2) Calculated based on the average in the last ten business days prior to the close of each indicated date.
Sources: Central Bank of Chile and Bloomberg.

In line with the nominal exchange rate, the real exchange rate (RER) has also increased: 4% between June and August. Based on the nominal exchange rate level and the effective parities in the last ten business days prior to the close of this *Report,* the RER in August would have been 100.8 using a fixed-base index of 1986 = 100 (figure II.11). The Board deems that the current level of the RER is consistent with the cyclical phase of the economy and internal and external financial conditions, although it is somewhat higher than its long-term range. The working assumption used in the baseline scenario for this *Report* is that the exchange rate will undergo a slight real appreciation in the long term, in accordance with the normalization of the cyclical conditions of the economy.

III. OUTPUT AND DEMAND

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

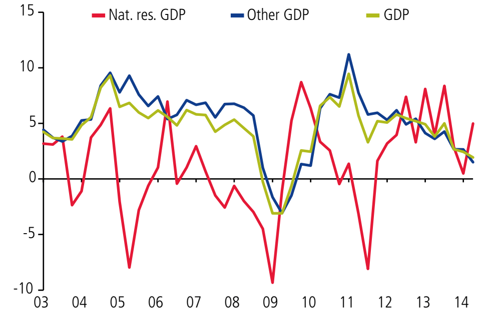
SECTORAL ACTIVITY

In the last three months, output and domestic demand have weakened more than projected in the last *Monetary Policy Report,* and the trend is now expected to be more persistent. As mentioned in previous *Reports*, the slowdown in activity and demand was, in part, expected due to the level of installed capacity utilization and the projected deterioration in external conditions for Chile. Beginning in mid-2013, the Board began to indicate that monetary policy would follow a more expansionary path, to prevent the slowdown from affecting the achievement of the inflation target. As time progressed, however, the economic downturn deepened beyond expectations, although external factors have not changed significantly and domestic financial conditions have become more favorable, in line with the more expansive monetary policy.

In the second quarter, output increased 1.9% in annual terms (2.4% in the previous quarter) (figure and table III.1). This mainly reflects the poor performance of sectors tied to domestic demand (other GDP), which grew at an annual rate of 1.5% (2.7% in the previous quarter). Consistent with the consumption and investment scenario, the fragility of the other sectors was fairly generalized. Manufacturing and retail trade posted negative annual growth rates in the quarter: –1.7 and –0.4%, respectively. The sharpest contractions were in areas associated with investment. In manufacturing, only export lines made a positive contribution at the margin. Construction also contracted substantially, with an annual growth rate of 1.1% in the second quarter (2.2% in the first quarter) (figure III.2). Transportation, telecommunications and financial and business services similarly posted a reduction in their annual growth rates, but they remain a somewhat higher level. The agriculture, ranching and forestry sector recorded a decline in production, deriving from climatic problems last year.

In contrast, the annual growth rate of the natural resource sectors increased, to 5.0% (0.5% in the previous quarter). This was mainly due to the performance of mining (4% annual growth in the period), based on increased production

FIGURE III.1
GDP growth
(annual change, percent)



Source: Central Bank of Chile.

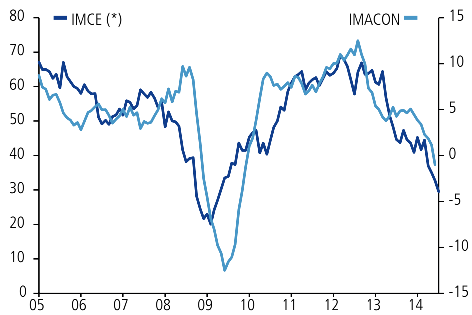
TABLE III.1
Gross domestic product (1)
(share of GDP; real annual change, percent)

	Share	2013				2014	
	2013	I	II	III	IV	I	II
Agriculture, livestock and forestry	2.7	6.0	3.2	4.5	3.9	4.1	-4.4
Fishing	0.4	-14.7	-12.2	-10.1	-14.2	-4.5	13.2
Mining	11.1	9.8	3.9	9.4	2.1	0.0	4.0
Manufacturing	10.5	0.0	-0.4	2.8	-1.3	-0.1	-1.7
EGW	2.8	4.2	7.5	6.8	10.3	3.2	7.1
Construction	7.8	4.2	4.4	4.3	0.2	2.2	1.1
Trade	8.5	8.9	7.5	8.1	4.6	2.0	-0.4
Restaurants and hotels	1.7	3.6	3.3	4.6	0.7	0.2	-0.8
Transportation	3.9	4.2	3.1	4.7	1.0	3.6	1.6
Communications	2.0	6.8	5.3	4.0	3.7	3.4	2.7
Financial services	4.7	7.7	5.8	5.1	3.6	3.6	2.2
Business services	14.4	3.0	3.6	3.3	4.0	2.7	2.9
Housing services	5.1	3.4	3.4	3.4	3.4	3.5	3.5
Personal services (2)	11.3	4.1	3.3	3.2	3.7	3.9	3.9
Total GDP	**100.0**	**4.9**	**3.8**	**5.0**	**2.7**	**2.4**	**1.9**
Other GDP (3)	**77.1**	**4.1**	**3.6**	**4.3**	**2.7**	**2.7**	**1.5**
Natural resource GDP (3)	**14.4**	**8.1**	**3.9**	**8.4**	**2.9**	**0.5**	**5.0**

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

Source: Central Bank of Chile.

FIGURE III.2
Construction sector
(index; annual change, percent)



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

Sources: Chilean Chamber of Construction and Icare/Universidad Adolfo Ibáñez.

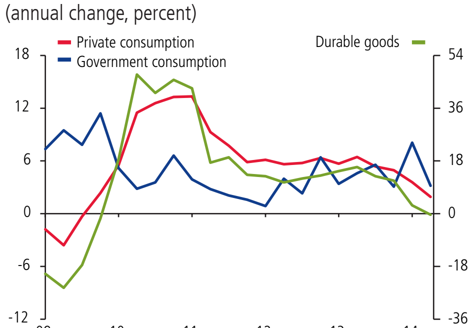
TABLE III.2
Domestic demand (1)
(share of GDP; real annual change, percent)

	Share	2013				2014	
	2013	I	II	III	IV	I	II
Domestic demand	100.3	7.2	4.4	1.3	1.1	-0.2	-0.9
Domestic demand (excl. change in inventories)	100.0	6.1	7.1	3.7	0.4	1.8	-0.3
Gross fixed capital formation	23.6	8.2	10.2	-1.5	-12.3	-5.5	-8.1
Construction and engineering works	15.2	4.8	4.5	4.0	0.0	1.3	-0.5
Machinery and equipment	8.4	14.0	20.1	-8.3	-28.5	-18.9	-21.1
Total consumption	76.4	5.4	6.1	5.4	4.6	4.1	2.1
Private consumption	64.0	5.7	6.4	5.4	4.9	3.6	1.9
Durable goods	6.6	14.5	15.9	12.8	11.3	2.9	-0.4
Non-durable goods	26.4	5.1	7.0	5.7	4.7	3.9	1.6
Services	31.1	4.5	4.2	3.6	3.8	3.4	2.6
Government consumption	12.4	3.4	4.6	5.6	3.1	8.1	3.2
Change in inventories (2)	0.3	1.4	0.7	0.2	0.4	-0.2	-0.3
Goods and services exports	32.6	1.1	6.4	11.3	-0.9	3.5	-0.4
Goods and services imports	32.9	7.0	8.1	0.5	-5.3	-4.6	-9.1
Total GDP	**100.0**	**4.9**	**3.8**	**5.0**	**2.7**	**2.4**	**1.9**

(1) Preliminary data.
(2) Ratio of inventory change to GDP, at average prices of previous year, accumulated in the last moving year.

Source: Central Bank of Chile.

FIGURE III.3
Consumption
(annual change, percent)



Source: Central Bank of Chile.

in some important copper mines. The electricity, gas and water (EGW) sector also recovered strongly (7.1%) due to the increase in hydroelectric generation, which has a higher value added. Fishing recorded a positive annual growth rate, after several quarters of contraction.

The growth forecast for 2014 has been revised downward since the last *Report*. In the baseline scenario, the economy will grow at an annual rate of between 1.75 and 2.25% (versus 2.5 to 3.5% in June). The adjustment in the forecast reflects not only the real data, but also the expectation that the weak trend in output and demand will be more persistent than projected a few months ago, especially in sectors tied to domestic demand. Additional indicators that the economy's poor performance in the second quarter will continue into the third and even the fourth quarter of the year include business expectations, as measured by the Monthly Business Confidence Index (IMCE); consumer confidence, as measured by the Economic Perceptions Index (IPEC); and the opinions collected in interviews for the August *Business Perception Report.* For 2015, the baseline scenario projects that the annual growth rate of output will be between 3 and 4%, in line with a gradual recovery of the economy. According to the median of the August Economic Expectations Survey (EES), the outlook for GDP growth this year and next is 2.5 and 3.5%, respectively (3.0 and 4.0% in June).

DOMESTIC DEMAND

In the second quarter, the annual growth rate of final demand (excluding inventories) fell: –0.3% (+1.8% in the previous quarter) (table III.2). This contraction was due to scant investment combined with a sharper slowdown in consumption, with even weaker data at the margin. Inventories contracted at a similar rate as in the previous quarter, consistent with weak spending, a sharper contraction of imports than in the last quarter and less willingness to hold inventories in some sectors. Consequently, the annual growth rate of domestic was –0,9% (–0.2% in the first quarter). Exports also posted a reduction in annual growth, mainly as a result of lower mining shipments.

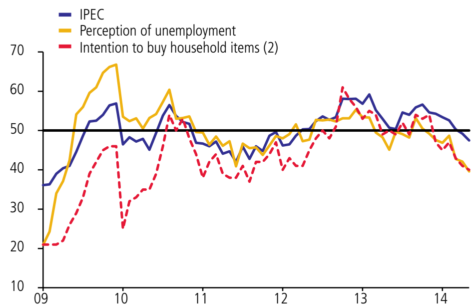
The weakness of total consumption was seen across all components, albeit to varying degrees, a trend that intensified toward the end of the second quarter (figure III.3). Private consumption increased 1.9% annually in the second quarter (3.6% in the previous quarter). A key factor in this poor performance was durable goods consumption, which contracted –0.4% annually in the second quarter (+2.9% in the previous quarter); a slowdown of this component was expected, to a degree, as projected in various past *Reports*. In 2013, retail sales of durable goods grew around 17% annually, on average, whereas the growth rate was practically null in the second quarter of this year, and it continued falling at the margin in seasonally adjusted terms. This trend was mainly driven by car sales, which, like car imports, recorded a markedly more negative growth rate than in the first quarter. Non-durable goods consumption contracted sharply, with an annual growth rate of 1.6% (3.9% in the previous quarter). Because this component tends to be more inertial, the drop could signal that consumption will be weak for some time. Finally, the annual growth rate of government consumption declined significantly in the second quarter.

The weak performance of private consumption is consistent with the deterioration of many of its fundamentals. In this line, one of the clearest signals is the worsening of consumer expectations, as measured by the Economic Perceptions Index (IPEC), which have followed a decreasing trend since the beginning of the year and recently dipped into pessimistic territory (figure III.4). In the past few months, the intention to buy household items has fallen dramatically, and the perception of unemployment one year out has plunged toward pessimism. This coincides with information collected for the August *Business Perception Report,* with regard to the greater consumer caution surrounding the time to make purchases or take on debt. The growth of real labor income has slowed to its lowest rate in several years, due to both the lower growth of total employment and the effect of higher inflation on real wages (figure III.5). These trends suggest that the weak consumption will be persistent. With regard to financial conditions, real consumer credit has, if anything, decreased slightly at the margin, despite the drop in interest rates for this type of loan.

The labor market has shown new signs of deterioration. As indicated, annual employment growth, which was being propped up by the increase in self-employment, began to decline. In addition, the growth of wage employment has stagnated, and the number of vacant jobs has decreased. The unemployment rate remains low from a historical perspective, albeit with a slight increase at the margin, and it ended the second quarter with no change relative to the first, after some fluctuation. However, some indicators suggest that this variable will increase in the coming months. In particular, labor market slack, measured as the ratio between the number of unemployed workers and available jobs, has increased, as has the annual growth rate of people receiving unemployment insurance payments (figure III.6). Despite these trends, nominal wages continued to grow at a higher annual rate than the historical average. In real terms, however, the annual growth rate fell relative to the beginning of the year.

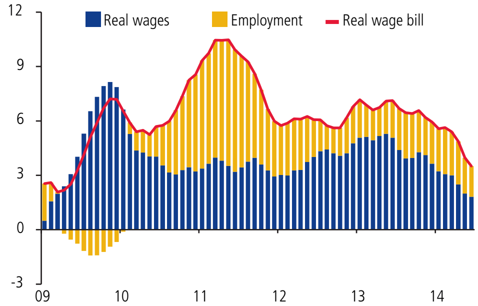
Investment deteriorated in the second quarter (figure III.7). The contraction in the annual growth rate was steeper in this period, at –8.1% (–5.5% in the previous quarter). The machinery and equipment component continues to be the hardest hit, with an annual growth rate of –21.1% (–18.9% in the first quarter). Investment in construction and engineering works also fell in annual terms (–0.5%), which was a substantial surprise. Nevertheless, the decline in investment in recent quarters was at least partially expected. First, the strong mining investment cycle of previous years has matured; this is a common factor in economies with a significant mining sector, such as Australia and Peru. Second, the high level of transport material imports, which tended to inflate investment in machinery and equipment in the second half of 2012 and the

FIGURE III.4
Consumer expectations: IPEC (1)
(index: pivot=50)



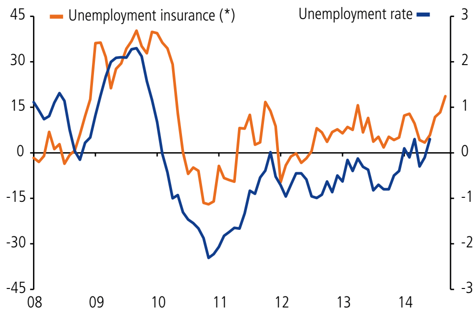
(1) A value over (under) 50 indicates optimism (pessimism).
(2) The percentage of affirmative responses to the following question: Would you say that this is a good time or a bad time to buy household items such as furniture, a refrigerator or a range?
Source: Adimark.

FIGURE III.5
Real labor income (*)
(annual change, percent)



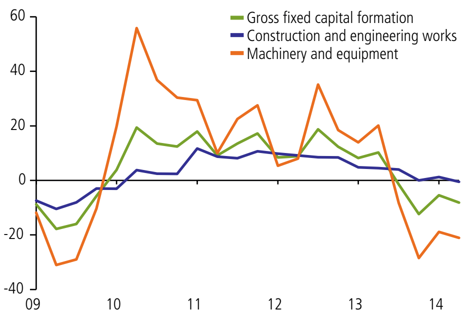
(*) Quarterly moving average.
Sources: Central Bank of Chile and National Statistics Institute (INE).

FIGURE III.6
Labor market indicators
(annual difference, percentage points)



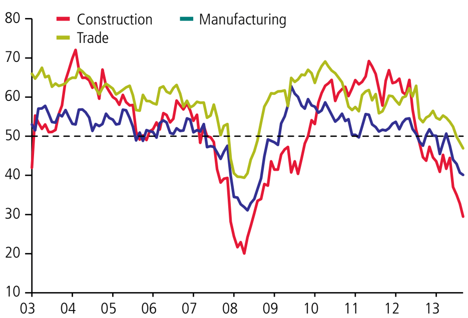
(*) Affiliates that apply for and receive payment for unemployment insurance. This series is four months ahead.
Sources: Central Bank of Chile, National Statistics Institute (INE) and Superintendence of Pensions.

FIGURE III.7
Gross fixed capital formation
(annual change, percent)



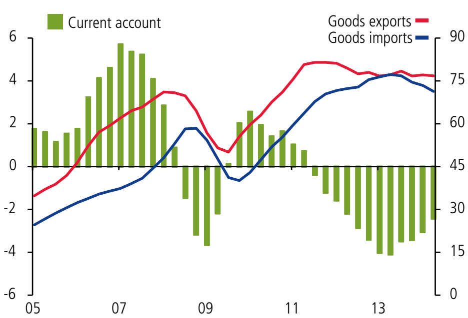
Source: Central Bank of Chile.

FIGURE III.8
IMCE: Business expectations (*)
(index)



(*) A value over (under) 50 indicates optimism (pessimism).
Source: Icare/Universidad Adolfo Ibáñez.

FIGURE III.9
Current account and trade balance (*)
(percent of GDP; US$ billion)



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

first half of 2013, have not been maintained in 2014. Even taking these factors into account, the decline in investment cannot fully be explained by the usual determinants, as described in the last *Report*[1]/.

More current data confirm that the weak investment performance will be more persistent than projected. Capital goods imports (excluding transport) and wholesale trade, which are related to this component, recovered somewhat at the end of the first quarter, but began to fall again in the second quarter and into the third. Construction activity has slowed substantially, as illustrated by indicators such as supplier sales, cement and concrete production and construction employment. Additionally, expectations (IMCE) have continued to wane for all sectors except mining (figure III.8). Commercial loans have been growing at a slower annual rate since mid-2013, despite the reduction in the cost of credit. This reflects more cautious behavior on both the supply and demand sides: the Bank Lending Survey for the second quarter reveals not only that lending conditions have tightened for commercial loans, but also that demand has rapidly weakened (figure II.6).

CURRENT ACCOUNT

The evolution of domestic spending has resulted in a rapid adjustment in the current account deficit. In the second quarter, the current account balance in the last moving year was –2.4% of GDP. This compares with a deficit of –4.1% one year ago (figure III.9). The sharp contraction in imports, the weak consumption and investment, and firms' perception that inventories are too high are the main factors behind this adjustment. Thus, the total value of imports accumulated in the last moving year dropped from over US$77 billion in mid-2013 to US$71 billion in mid-2014. In the same period, the total value of exports decreased from US$77 billion to US$76 billion. Therefore, the baseline scenario for this *Report* considers that the current account deficit will be 1.8% of GDP in 2014 (2.5% in the June *Report*). The revision to the current account deficit measured in trend prices was of a similar magnitude for 2014, because the adjustments mainly reflect changes in quantity and not in prices. Thus, for this year, the current account measured in trend prices is expected to have a deficit of 1.9% (2.2% in June).

[1]/ See box III.1, "Recent Dynamics of Investment," *Monetary Policy Report*, June 2014.

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

After increasing since late 2013, annual CPI inflation declined slightly in the last two months. Moreover, there have not been more of the upward surprises seen in month-on-month inflation early in the year, such that total inflation has been in line with the forecast in the last *Monetary Policy Report.* Core inflation (the CPIEFE, defined as the CPI excluding food and energy prices) has been somewhat lower than projected, due in part to the weakening of output and domestic demand. Thus, in July annual CPI growth was 4.5% and CPIEFE, 3.7% (versus 4.7 and 3.8%, respectively, in the last *Report*) (figure IV.1 and table IV.1). The baseline scenario used in this *Report* assumes that the current high inflation will be temporary and will return to the target range in the coming quarters. Inflation expectations one and two years out have not changed significantly, remaining around 3%.

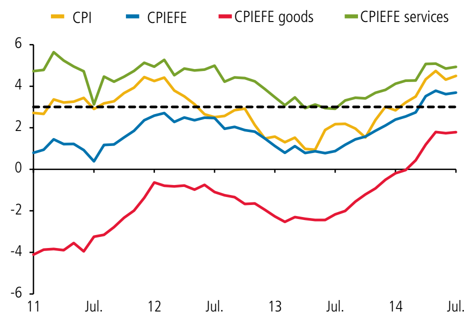
TABLA IV.1
Inflation indicators (1) (2)
(annual change, percent)

	CPI	CPIEFE	Tradable CPI	Non-tradable CPI	Goods CPI	Services CPI
2012 Average	3.0	2.2	1.7	4.7	2.6	3.5
2013 Jan.	1.6	1.1	0.0	3.6	0.9	2.4
Feb.	1.3	0.8	-0.2	3.2	0.6	2.2
Mar.	1.5	1.1	-0.1	3.6	0.5	2.8
Apr.	1.0	0.8	-0.7	3.1	-0.2	2.4
May	0.9	0.9	-1.0	3.3	0.3	1.7
Jun.	1.9	0.8	0.9	3.1	1.5	2.3
Jul.	2.2	0.9	1.5	3.0	1.9	2.5
Ago.	2.2	1.2	1.2	3.4	1.7	2.8
Sept.	2.0	1.4	0.7	3.5	0.6	3.5
Oct.	1.5	1.6	0.0	3.5	0.2	3.2
Nov.	2.4	1.8	1.3	3.7	1.4	3.5
Dic.	3.0	2.1	2.4	3.8	2.5	3.7
2014 Jan.	2.8	2.4	1.9	4.1	2.0	3.7
Feb.	3.2	2.5	2.4	4.3	2.6	3.9
Mar.	3.5	2.7	2.9	4.3	2.9	4.1
Apr.	4.3	3.5	3.8	5.1	3.7	5.0
May	4.7	3.8	4.5	5.1	4.5	5.0
Jun.	4.3	3.6	3.9	4.9	3.8	4.8
Jul.	4.5	3.7	4.2	4.9	4.2	4.9

(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).

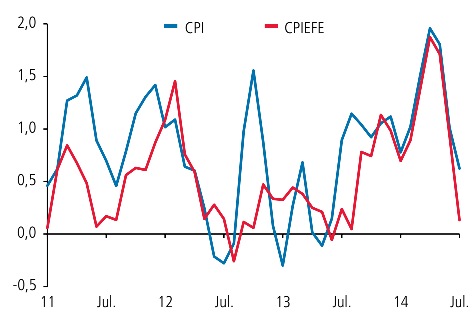
FIGURE IV.1
Inflation indicators (1) (2)
(annual change, percent)



(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).

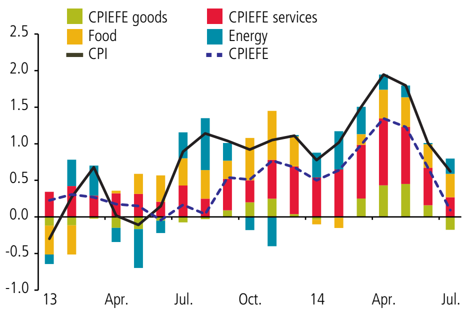
FIGURE IV.2
Monthly inflation (*)
(accrued in a three-month moving window, percentage points)



(*) 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).

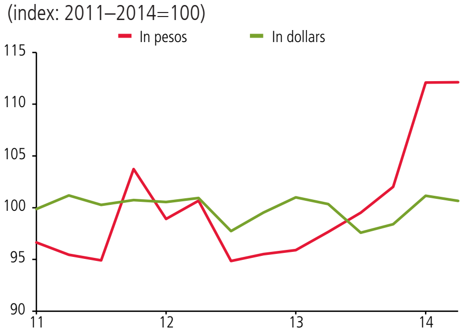
FIGURE IV.3
Contribution to monthly CPI inflation (*)
(accrued in a three-month moving window, percentage points)



(*) 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.

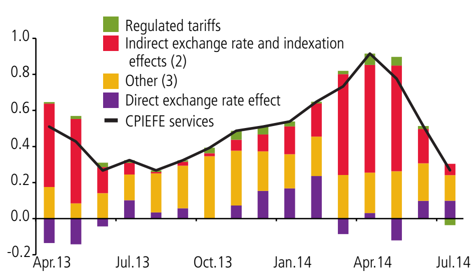
Sources: Central Bank of Chile and National Statistics Institute (INE).

FIGURE IV.4
Price of imported consumer goods
(index: 2011–2014=100)



Source: Central Bank of Chile.

FIGURE IV.5
Contribution of CPIEFE services to monthly CPI inflation (1)
(accrued in a three-month moving window, percentage points)



(1) Calculations are based on the new indices with base year 2013=100.
(2) Education, health, rent, tolls, insurance and vehicle technical inspection.
(3) Food, recreation, financial services, clothing, personal care, housing and other.

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

In contrast to the beginning of the year, monthly CPI inflation has fallen significantly, posting an average of 0.2% between May and July compared with an average of 0.6% between March and May. The CPIEFE followed the same trend, declining from an average of 0.6 to 0.04% in the same period. In the last three months, the CPI grew 0.6 percentage points, which is significantly lower than in the quarter ending in May (+1.8 percentage points). In the same period, the CPIEFE increased a mere 0.13 percentage points (1.7 points in May) (figure IV.2). Price increases have generally been lower for goods and services in the CPIEFE, whereas the contribution of energy prices was stable and food goods decreased (figure IV.3).

The main factor behind the lower inflation in the last three months has been the behavior of goods and services prices in the CPIEFE. By component, CPIEFE goods inflation accumulated a negative contribution in the last three months, compared with a positive contribution between March and May of this year. Notably, new car prices rose early in the year as a direct result of the depreciation of the peso, whereas their recent decline coincides with a strong contraction in the volume of sales. In general, sales indicators for durable and semi-durable goods have recorded the largest drops over the course of 2014. The easing of pressure from the rising exchange rate throughout the second quarter was also reflected in the fact that the price in pesos of imported consumer goods stopped rising relative to the previous quarter (figure IV.4).

The external prices relevant to the Chilean economy (the external price index, or EPI, and the EPI-5) peaked in July and April, respectively. The latter started a downward trend in May, in line with the global appreciation of the dollar. The baseline scenario assumes that annual EPI inflation will be lower than estimated in June, in that the dollar appreciation will more than offset the higher real inflation, especially in Latin America.

CPIEFE services inflation, which is usually more tied to the degree of excess capacity, was also lower between March and May. Highligts the lower contribution of services prices that are directly or indirectly linked to the exchange rate (namely, transport services) and services that are indexed to past inflation (such as education and health services). The sum of these items explains almost all of the reduction in CPIEFE services inflation (figure IV.5).

The contribution of energy prices (fuels and electricity) to total inflation in the last three months has continued to follow a downward trend, mainly due to the reduction in the external price of gasoline (figure IV.6). The inflation contribution in the moving quarter ending in July was similar to the previous quarter. In particular, the Gulf of Mexico gasoline price fell 1.7% in July relative to May of this year. Based on average oil futures prices in the world market in the last ten business days prior to the close of this *Report*, the forecast for the gasoline price was revised slightly downward for this year; this reflects the increased supply deriving from better climatic conditions in the Gulf of Mexico and the United States. The price of electricity, in turn, continued to follow a flat trend in the past three months.

With regard to food prices, their contribution to accumulated inflation has fallen slightly in the last three months. This was largely due to lower inflation in fresh fruits and vegetables, thanks to more favorable harvests. In contrast, the rest of food prices recorded an increase in inflation in the quarter ending in May (figure IV.7). Within this group, price increases were sharpest for bread and meat, in relation to the peso depreciation. In the international market, however, grain prices have fallen since June, after favorable climatic conditions resulted in better harvests. This was reflected in grain futures prices, which fell at the two-year horizon, while other agricultural products did not change significantly at that horizon relative to the last *Report*.

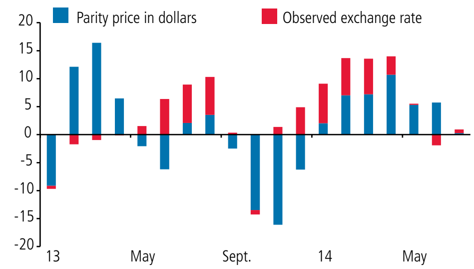
Disaggregated by group, the contribution of food and goods and services CPIEFE to annual CPI inflation was similar to the level at the close of the last *Report*, while energy declined (figure IV.8). The sum of all these factors resulted in a decrease in annual CPI inflation. CPIEFE services inflation fell from 5.1 in May of this year to 4.9% in July, while CPIEFE goods inflation was stable at 1.8% in the same period.

Labor costs continued to rise in the last three months: the annual growth rate of nominal wages in June was between 6.6 and 7.1% depending on the measure (between 6.3 and 6.8% in the June *Report*). Real wages increased, in line with the lower annual inflation recorded in the most recent period, with annual growth rates between 1.8 and 2.2% (1.2 to 1.7% in the June *Report*). This came after several successive months of decreases, however (figure IV.9). Information collected for the August *Business Perception Report* points to job losses, both in the firms contacted and in other companies in their sectors, mainly in the central and northern regions of the country. With exceptions in the agricultural sector and in the south, the firms report a greater availability of labor and lower wage pressure. Real unit labor costs have thus continued along a downward trend, with some fluctuation.

With regard to margins, different measures point to a compression. The ratio between the CPIEFE and unit labor costs adjusted for productivity continued to shrink. The ratio between CPIEFE goods prices and the exchange rate remains lower than early in the year.

FIGURE IV.6

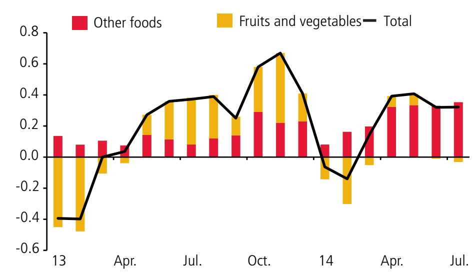
Gasoline price and exchange rate fluctuation
(accrued in three months, percentage points)



Sources: Central Bank of Chile and National Energy Commission (CNE).

FIGURE IV.7

Contribution of food goods to monthly CPI inflation (*)
(accrued in a three-month moving window, percentage points)

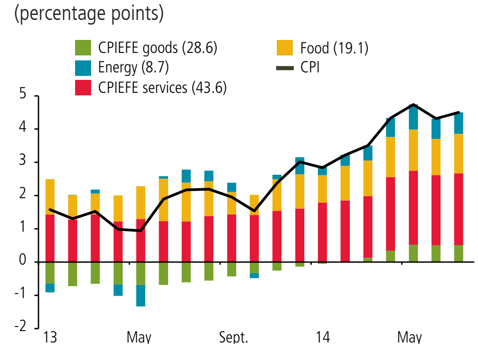


(*) Starting in January 2014, calculations are based on the new indices with base year 2013=100, so they may not be strictly comparable with earlier figures.

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

FIGURE IV.8

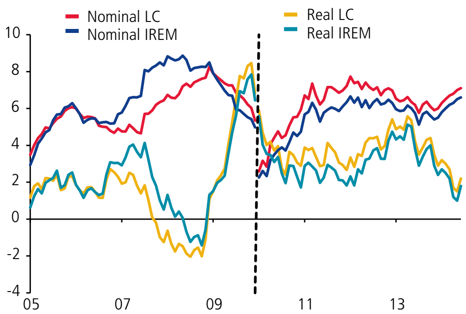
Contribution to annual CPI inflation (1) (2)
(percentage points)



(1) The shares in the new CPI basket are in parentheses.
(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).

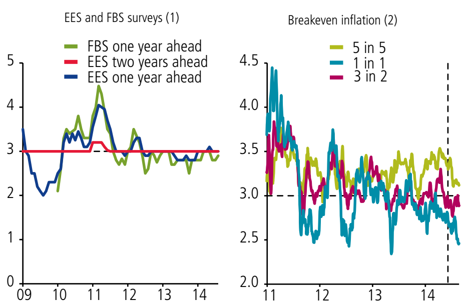
FIGURE IV.9
Wages (1) (2)
(annual change, percent)



(1) 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.
(2) See glossary for definitions.

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

FIGURE IV.10
Inflation expectations
(percent)



(1) The FBS corresponds to the survey for the first half of the month, except for August 2014, which corresponds to the second half.
(2) Forward breakeven inflation based on swap rates considering a weekly moving average. The vertical dashed line indicates the statistical dashed date of the June 2014 *Monetary Policy Report.*

Source: Central Bank of Chile.

INFLATION OUTLOOK

In this context, one- and two-year inflation expectations have not changed significantly since the last *Monetary Policy Report.* Thus, inflation expectations toward the end of the forecast horizon remain around the target of 3% (figure IV.10).

Private expectations for two-year inflation, derived from the August Economic Expectations Survey (EES) and the Financial Brokers Survey (FBS) for the second half of the same month, also remain around 3%. In the EES, private expectations for the end of this year and one year ahead stayed at 3.8 and 3.0%, respectively. For the same period, expectations in the FBS increased from 2.8 to 2.9% between the first half of June and the second half of August.

Expectations extracted from the breakeven inflation rate are similar to the close of the last *Report*. In particular, the three-year forward two-year breakeven inflation rate was stable at 2.9%, albeit with fluctuations. The one-year forward one-year rate and the five-year forward five-year rate, extracted from average interbank swap rates, fell slightly relative to the close of the last *Report*, from 2.8 and 3.3% to 2.5 and 3.1%, respectively.

In the baseline scenario, the Board estimates that annual CPI inflation will remain above 4% for the rest of 2014, due to the impact of the high monthly inflation at the start of the year and the direct effects of the recent depreciation of the peso. In 2015, inflationary pressures will ease as a result of the evolution of the economic cycle and the high basis for comparison, and annual CPI and CPIEFE inflation will thus rapidly converge to 3%. Both measures will then fluctuate around that level through the end of forecast horizon, which is currently the third quarter of 2016.

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

In the baseline scenario, the global context is fairly unchanged from June, with somewhat lower growth, somewhat better terms of trade, and still favorable international financial conditions (table V.1).

About the world economy, estimates remain that the developed world is recovering while emerging markets have lost strength. Thus, our trading partner's growth forecast is revised slightly downward, although with increasing expansion rates: two tenths of one point more for this year and one for next year, to 3.4% and 3.8%, respectively. Lower growth is expected in the United States this year, based mainly on actual data. However, its economic recovery is maintained, yielding an average annual growth estimate for 2015-2016 of 3.1%, a good comparison with its average of 2.7% in 2000-2007. Downward revisions are made to the Eurozone, following the downturn of output and expectations in recent months, and to Japan, due to the volatility of domestic demand caused by tax adjustments implemented in the first half of the year. In any case, towards 2015 and 2016 the outlook that these economies will grow more than this year on average, that is, a 1 percentage point (pp) increase in the Eurozone, and 0.4pp in Japan, is maintained.

In the emerging economies, corrections for this and next year show more dispersion. In China, government measures have stabilized the growth rate. The baseline scenario holds on to its growth estimates of 7.3% for 2014 and 7.2% for 2015. Again, the largest downward revision is for Latin America: 1.7% and 2.6% in 2014 and 2015, respectively (2.0% and 3.0% in June). Despite some heterogeneity, a number of economies in the region have shown more intense and persistent weakness than expected, mainly associated with investment-related sectors.

The baseline scenario assumes that the terms of trade will be slightly higher than forecast in June's *Report*, mainly reflecting a higher copper price, based on the actual increases seen since June, and no major variations in fundamentals.

TABLE V.1
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	0.0	-0.8	-0.5
Trading partners GDP (*)	3.6	4.6	3.5	3.4	3.8	3.9
World GDP at PPP (*)	4.2	4.0	3.1	3.2	3.7	4.1
World GDP at market exchange rate (*)	3.3	3.1	2.4	2.6	3.1	3.3
Developed economies' GDP at PPP (*)	2.6	1.8	1.3	1.7	2.4	2.5
Emerging economies ' GDP at PPP (*)	7.4	5.9	4.6	4.5	4.8	5.0
External prices (in US$*)	4.6	5.2	0.3	0.9	1.2	1.3
	(levels)					
LME copper price (US¢/lb)	154	367	332	315	305	300
WTI oil price (US$/barrel)	44	90	98	98	92	89
Brent oil price (US$/barrel)	42	101	109	106	104	101
Gasoline parity price (US$/$m^3$) (*)	367	742	785	779	753	732
Libor US$ (nominal, 90 días)	3.6	0.4	0.3	0.2	0.7	1.6

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

Source: Central Bank of Chile.

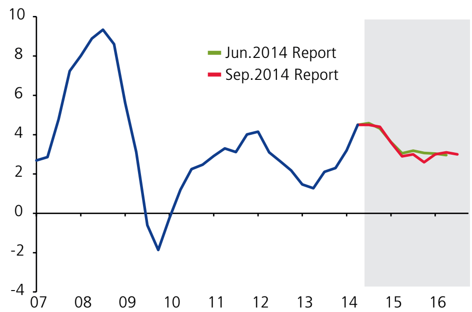
TABLE V.2
Economic growth and current account

	2013	2014 (f)	2015 (f)
	(annual change. percent)		
GDP	4.1	1.75-2.25	3.0-4.0
National income	3.4	2.0	3.2
Domestic demand	3.4	0.1	3.4
Domestic demand (w/o inventory change)	4.2	1.0	3.2
Gross fixed capital formation	0.4	-4.1	1.8
Total consumption	5.4	2.6	3.6
Goods and services exports	4.3	2.4	3.8
Goods and services imports	2.2	-3.9	4.0
Current account (% of GDP)	-3.4	-1.8	-2.2
Gross national saving (% of GDP)	20.5	19.8	19.7
Gross national investment (% of GDP)	23.9	21.6	21.9
GFCF (% of nominal GDP)	23.6	22.0	21.6
GFCF (% of real GDP)	25.8	24.3	23.9
	(US$ million)		
Current account	-9.485	-4.600	-5.880
Trade balance	2.117	7.850	6.750
Exports	76.684	77.450	79.650
Imports	-74.568	-69.600	-72.900
Services	-2.908	-3.060	-3.150
Rent	-11.102	-11.790	-11.930
Current transfers	2.408	2.400	2.450

(f) Forecast.

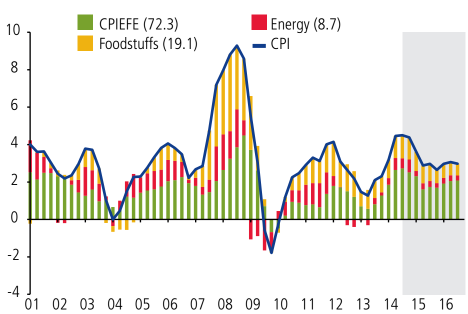
Source: Central Bank of Chile.

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



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

Our copper price forecast sets it at US$3.15 per pound in 2014 and US$3.05 in 2015. For oil, the estimated average between WTI and Brent is fairly the same, at US$103 for this year and US$99 in 2015.

External inflation relevant for Chile (IPE) is revised downwards for this and next year, mainly because of the appreciation of the U.S. dollar in international markets.

In the baseline scenario, Chile's GDP will grow between 1.75% and 2.25% in 2014, less than projected in June (table V.2). This correction is explained by weaker spending in the second quarter, a phenomenon that will presumably persist. Thus, economic growth will stay longer below its trend rate, which the Board estimates between 4% and 4.5%. The assumed medium-term growth of the economy is lower than previously envisaged, given the downward revisions to growth in total factor productivity and the capital stock, which partly reflect the natural convergence of an economy that has reached higher levels of per capita income[1]/.

Domestic demand growth in 2014, excluding inventories, is also adjusted downward: 1.0% annually (2.4% in June). This is explained by a sharper than expected decrease in investment in the second quarter and a more marked slowdown in consumption. The correction to total domestic demand is somewhat bigger: 0.1% annually (1.7% in June), because of lower inventory build-up, consistent with the behavior of expenditure and how some sectors evaluate their current inventory levels.

The downward revision to private consumption is grounded both in lower-than-expected second quarter figures and in still weak partial data of the third quarter, including consumer goods imports and car sales. Also in the deterioration of a large part of its fundamentals. The decline in consumer expectations, which are now in pessimistic territory, is worth noting. Annual employment growth dropped further, salaried employment ceased to grow and job vacancies have continued to decrease. Annual expansion of real labor income has fallen with respect to the beginning of the year, affected to some extent by higher inflation. Still, the unemployment rate remained low by historic standards and nominal wages increased further in annual terms.

Investment is the spending component with the biggest adjustment in 2014. Thus, the annual variation rate of gross fixed capital formation (GFCF) is lowered to -4.1% for this year (-0.7% in June; +0.8% in March). This implies a contraction of both the machinery and equipment component (-11.2% annually) and construction and other works (-0.1% annually). These adjustments are based on lower actual data and downward revisions to engineering and construction projects according to the survey of the Capital Goods Corporation (CBC). In addition, third-quarter conjunctural data such as capital goods imports are still weak and business expectations, excluding mining, have worsened further and are in the pessimistic zone. In contrast, a stronger boost is expected from public investment, with which GFCF should amount to 22% of nominal GDP (23.6% in 2013).

[1]/ Medium Term Growth Box

In 2015, GDP growth is forecast to stand between 3.0% and 4.0%, still below its trend rate. Domestic demand excluding inventories will have an estimated annual expansion of 3.2%, and total domestic demand, 3.4%. This projection considers a small expansion in investment: 1.8% annually. Total annual consumption will grow 3.6%, less than its average for the 2010-2013 period. Aside from the low basis of comparison this year and a limited dynamism of the economy, the mild recovery forecast for 2015 rests on a stronger monetary impulse and lower market interest rates, a greater fiscal stimulus; further impulse from trading partners' growth and the peso depreciation in real terms; and improved private expectations. In addition, some increase is expected in investment in construction and engineering works, according to the CBC's survey.

The revision to expenditure narrows the current account deficit foreseen for this year, both at current prices and at trend prices. At the trade balance level, this reflects mainly in reduced imports. Thus, the current account deficit will be an estimated 1.8% of GDP in 2014 and 2.2% of GDP in 2015. Measured at trend prices[2]/ the current account deficit should be 1.9% of GDP this year and 2.4% of GDP in 2015.

Annual CPI inflation, still affected by the high monthly variations early in the year and the direct effects of the recent depreciation of the peso, will stay above 4% throughout the remainder of this year. By 2015, because of lower inflationary pressures derived from the cyclic evolution of the economy and the high basis for comparison, annual CPI and CPIEFE inflation will show a rapid decline to 3%. Then, they will hover around 3% until the end of the projection horizon, this time the third quarter of 2016. (figures V.1 and V2, and table V.3).

This inflation trajectory considers that the indirect effects of nominal and real peso depreciation of the last months will be more than offset by the state of output gaps within the projection period. The Board evaluates the current level of the real exchange rate (RER) to be consistent with the state of the economic cycle and with domestic and external financial conditions, although it is slightly above its estimated range of long-term values. As a methodological assumption, the exchange rate is forecast to have a slight real appreciation in the long term, in line with the normalization of cyclical conditions of the economy. Regarding the MPR, the change in the local macroeconomic scenario has reduced its expected level from June. As a working assumption, the MPR is projected to follow a path comparable to what can be inferred from the various measures of expectations available at the statistical closing of this *Report* (figure V.3).

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 materialized, may reshape the macroeconomic outlook and, therefore, may alter the course of monetary policy. On this opportunity, having evaluated the alternative scenarios, the Board estimates that the risk balance for inflation is unbiased, and for output it is unbiased in 2014 and downward biased in 2015 (figures V.4, V.5 and V.6).

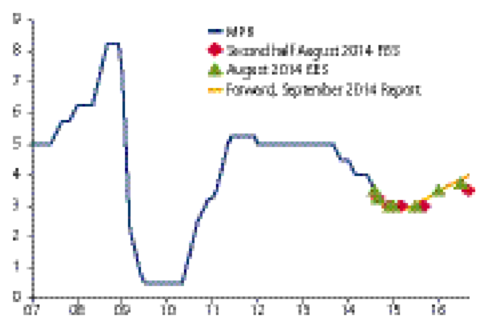
[2]/ The calculation at trend prices considers revisions to prices, not volumes. Long-term prices of US$2.85 per pound of copper and US$85 per barrel of oil are assumed.

TABLE V.3
Inflation

	2013	2014 (f)	2015 (f)	2016 (f)
	(annual change, percent)			
Average CPI inflation	1.8	4.1	3.0	
December CPI inflation	3.0	4.1	2.8	
CPI inflation in around 2 years (*)				3.0
Average CPIEFE inflation	1.2	3.4	2.6	
December CPIEFE inflation	2.1	3.4	2.5	
CPIEFE inflation in around 2 years (*)				2.9

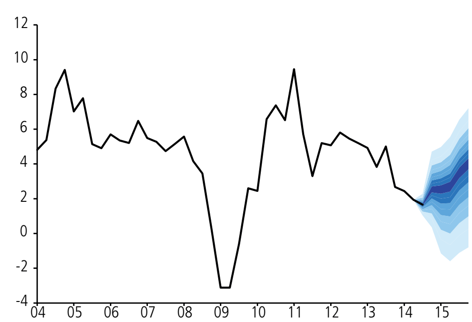
(f) Forecast.
(*) Inflation forecast at the third quarter of 2016.
Source: Central Bank of Chile.

FIGURE V.3
MPR and expectations
(percent)



Source: Central Bank of Chile.

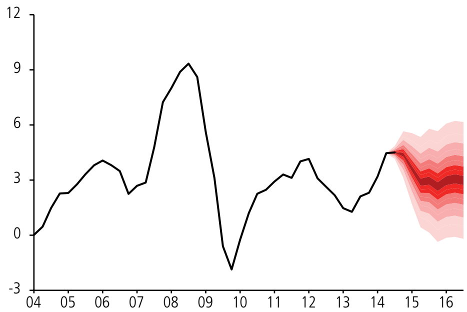
FIGURE V.4
GDP growth (*)
(annual change, percent)



(*) 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 methodological assumption that the policy rate will follow a path comparable to the one that can be inferred from the various measures of expectations available at the statistical closing of this *Report*.

Source: Central Bank of Chile.

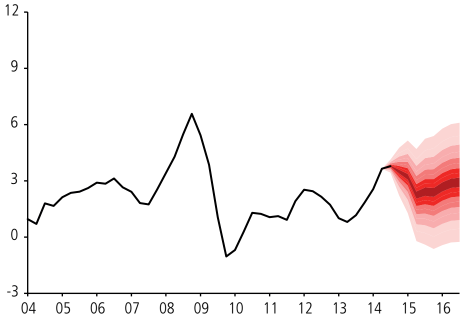
FIGURE V.5
CPI inflation forecast (*)
(annual change, percent)



(*) 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 methodological assumption that the policy rate will follow a path comparable to the one that can be inferred from the various measures of expectations available at the statistical closing of this *Report.*

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 inflation as assessed by the Board. The baseline scenario uses as a methodological assumption that the policy rate will follow a path comparable to the one that can be inferred from the various measures of expectations available at the statistical closing of this *Report.*

Source: Central Bank of Chile.

Abroad, the risks mentioned in previous *Reports* remain. Although growth in China and its outlook have stabilized most recently, its future performance is still a risk factor, in particular because of the uncertainty about its financial system and real estate sector. Also, it cannot be ruled out that the vulnerabilities in other emerging economies could generate new episodes of volatility. In the Eurozone, the macro-financial situation remains an element of uncertainty, which is compounded with the geopolitical tensions in the continent and aggravates the risks of a slower recovery in the region. In the United States, the withdrawal of unconventional monetary stimulus has proceeded as expected, but financial markets could suffer major episodes of stress when facing events that anticipate the moment when the Fed Funds rate will begin to rise. In particular, in the current context of low long-term interest rates and limited sovereign premiums, abrupt reversals could occur with significant stress. This could affect the cost of external financing and currency parities, with significant effects on emerging economies. However, it is most likely that a better performance of the U.S. economy will provide a stronger external impulse and a more favorable medium-term scenario.

In the local economy, one risk is growth in domestic output and demand being less than projected. As indicated, the weakening of these variables has been more intense than expected, coinciding with a widespread worsening of expectations. The baseline scenario assumes that such deterioration will be gradually reversed, which explains to some extent the consumption and investment growth forecasts for 2015. However, if such reversal does not occur, it is likely that a faster and more intense adjustment will be observed in the labor market, taking a toll on consumption and output. Moreover, worsening of business expectations would result in a sharper adjustment in investment. Such a scenario could also trigger greater rebalancing towards the tradable sector and mitigate the economic slowdown to some point. On the other hand, although a weaker economy could widen output gaps and ease inflationary pressures, it cannot be ruled out that the resulting effects on the exchange rate could offset its effects on prices, at least temporarily, thus delaying the convergence of inflation.

In the past few months, domestic output and demand have shown greater and more persistent weakness than expected. As from mid-2013, the Board began to communicate that monetary policy would be more expansionary to prevent the wider gaps in the economy from jeopardizing the achievement of the inflation target. Accordingly, it has lowered the MPR by 150bp in the last year and the interest rate structure has been adjusted significantly, adding a significant monetary stimulus to the economy. Also, the Board has stressed that it will consider the possibility of making additional cuts to the monetary policy rate in line with the evolution of domestic and external macroeconomic conditions and its implications on the inflationary outlook. At the same time, the Board reiterates its commitment to conduct monetary policy with flexibility, so that projected inflation stands at 3% over the policy horizon.

BOX V.1
CHANGES IN THE BASELINE FORECAST SCENARIO IN THE LAST YEAR

In the past year, output and demand in Chile have slowed more than expected, which has generated significant changes in the GDP growth range projected for this year. Moreover, the adjustment in the current account deficit was faster than expected, due to the evolution of spending. The inflation forecast for 2014 was also revised, but upward, mainly to account for the effect of the peso depreciation on prices. The international scenario continued to hinge on the gradual recovery of the developed economies, while the emerging economies continued to slow down. Consequently, the growth forecast for Chile's trading partners was revised slightly downward.

The assumption of high investment growth rates has been declining since mid-2013 and into 2014, which has been reflected in the *Monetary Policy Reports* of the past year. The slowdown in this component of spending was explained by the mining investment cycle, which was coming to a close, and the high basis of comparison deriving from the strong investment rates associated with transport materials imports in late 2012 and early 2013. This demand component was therefore expected to gradually adjust downward. Over the course of the year, however, real data began to reveal a faster deceleration, which cannot be fully explained by the usual determinants of investment.[1] The drop in investment has coincided with a significant deterioration in expectations indicators. Consequently, the annual growth rate of gross fixed capital formation fell from an average of nearly 9% in the first half of 2013 to –8.1% in the second quarter of 2014, with the resulting impact on the forecast (table V.4).

Consumption took longer to start slowing down, mainly propped up by a tight labor market. Around mid-2014, weak output and demand began to affect consumption through declining expectations, the sluggish activity passed through to the labor market (with a contraction of wage employment and a reduction in job vacancies) and higher inflation has undermined the growth of real wages. At first, durable goods consumption was hardest hit, which probably also reflected the peso depreciation, but more recently non-durables have begun to slow, as well. Thus, whereas a year ago consumption was expected to grow at 5.0% in 2014, this *Report* assumes an annual growth rate of just 2.6%.

TABLE V.4
Economic growth and current account for 2014

	Sept. 13	Dec. 13	Mar. 14	Jun. 14	Sept. 14
	(annual change, percent)				
GDP	4.0-5.0	3.75-4.75	3.0-4.0	2.5-3.5	1.75-2.25
Risk balance, output	biased downward	balanced	biased downward	balanced	balanced
Domestic demand	4.9	4.8	3.3	1.7	0.1
Domestic demand (excl. change in inventories)	4.8	4.5	3.3	2.4	1.0
Total consumption	5.0	4.7	4.1	3.4	2.6
Gross fixed capital formation	4.5	4.1	0.8	-0.7	-4.1
	(percent of GDP)				
Current account	-4.8	-3.7	-3.6	-2.5	-1.8

Source: Central Bank of Chile.

The current account deficit was a concern throughout much of 2013, given the possibility that it would stay high or continue expanding. In September of that year, the forecast for 2014 was for a deficit of 4.8% of GDP. However, the sharp downturn in spending and the exchange rate depreciation caused the current account to adjust sooner than expected. The baseline scenario for this *Report* thus estimates that the current account balance will be –1.8% of GDP this year. Measured at trend prices, the projected deficit for this year decreased from 4.6 to 1.9% of GDP, which again reflects the sharp adjustment in spending.

A year ago, annual inflation had returned to the target range, after several months below 2%, although the core measure (CPIEFE) remained around 1%. The forecast was for annual CPI inflation to continue rising gradually until reaching 3% in the first half of 2014. However, the peso depreciation that started in the first half of 2013 and intensified toward the end of that year, combined with the increase in international fuel prices, caused inflation to rise much faster, and it exceeded the target ceiling in the second quarter of 2014. This led to significant revisions in the forecast,

[1]/ See box III.1, "Recent Dynamics of Investment," *Monetary Policy Report*, June 2014.

but inflation is expected to only temporarily exceed 4%. Thus, the annual inflation forecast for 2014 rose from 2.8% in September 2013 to 4.1% in this *Report* (table V.5). The assumption that the higher inflation will be transitory is consistent with inflation expectations and with the 2015 forecast, which has stayed around 3% throughout the past year.

TABLE V.5
Changes in the forecast of average annual CPI inflation for 2014
(percentage points)

	Dec.13	Mar.14	Jun.14	Sept.14
Initial forecast (1)	2.8	2.6	3.4	4.1
Fuels	-0.07	0.43	0.06	-0.01
Foods, excl. fresh fruits and vegetables	-0.01	0.11	0.11	0.11
Fresh fruits and vegetables	-0.09	0.12	-0.03	-0.05
Public services	-0.06	-0.04	0.01	0.05
Other products	0.06	0.12	0.61	-0.12
Final forecast (2)	2.6	3.4	4.1	4.1

(1) Forecast included in the last Monetary Policy Report.
(2) Forecast included in the corresponding Monetary Policy Report.
Source: Central Bank of Chile.

Over the course of the year, the expected trends in the international scenario have been consolidated. Thus, growth rates are still expected to increase between 2014 and 2015, but starting from a lower level than projected in September 2013. In the United States, over and above the poor GDP data in the first quarter of 2014 due to climatic factors, the most recent information confirms that the recovery is still on course and that the growth rate of this economy will continue to rise. In the Eurozone and Japan, the outlook has deteriorated slightly, but these economies are still expected to record higher growth rates in 2015. The emerging economies have continued to slow down, a process that has been sharper than forecast a year ago, especially in Latin America. In China, there are ongoing concerns about the financial system and the real estate sector, but there is less possibility of a sharp dive in the economy's growth rate deriving from the realignment of the sources of growth toward higher consumption. While the growth estimates for this economy are now 7.3% for the two-year period 2014-2015 (versus 7.5% a year ago), they have stabilized in the past few months. Thus, the world growth forecast has been revised slightly downward since September 2013 (table V.6).

During the year, the news in the international financial markets was mostly related to the potential effects of the withdrawal of the monetary stimulus measures in the United States. One of the risks present in the forecast scenarios was that the speed of the withdrawal would change, provoking episodes of volatility in the financial markets. Over the course of the year, and in line with expectations, the U.S. Federal Reserve has gradually reduced its asset purchases without triggering a lot of tension in the markets. The emerging economies experienced capital outflows, but these have been reversed in recent months. Emerging market spreads are lower than a year ago, and volatility has not spiked. Finally, the dollar has appreciated across the board in international markets.

Commodity prices have fluctuated somewhat, but the copper and oil forecasts are both implicitly following a decreasing trend. The oil forecast is moderately higher than a year ago, given the higher real prices in response to geopolitical tensions and the harsh winter in the northern hemisphere. For copper, concerns of a steeper downturn in China were offset by signs of a recovery in demand in the developed world. Subsequently, the stabilization of growth in China and the tighter supply supported higher prices, such that the price forecast for the two-year period 2014–2015 today is about 4% higher than a year ago.

TABLE V.6
Main assumptions for the international scenario

	Sept.13	Dec.13	Mar.14	Jun.14	Sept.14
World GDP at PPP (annual change, percent)					
2014	3.5	3.5	3.5	3.3	3.2
2015	3.9	3.7	3.8	3.7	3.7
GDP trading partners (annual change, percent)					
2014	3.6	3.6	3.7	3.6	3.4
2015	4.0	3.8	3.9	3.9	3.8
Brent oil price (US$/barrel)					
2014	104	106	106	108	106
2015	97	100	101	103	104
WTI oil price (US$/barrel)					
2014	96	93	96	100	98
2015	89	88	88	93	92
LME copper price (US¢/lb)					
2014	305	310	300	310	315
2015	290	290	285	290	305
Terms of trade (annual change, percent)					
2014	0.1	0.2	-0.9	-0.5	0.0
2015	-1.2	-1.5	-1.1	-1.5	-0.8
External prices, in US$ (annual change, percent)					
2014	-1.5	-0.4	0.3	1.0	0.9
2015	0.2	0.0	0.7	1.3	1.2

Source: Central Bank of Chile.

In this context, the Board, after having announced the need for monetary policy adjustments in mid-2013, began to gradually reduce the monetary policy rate (MPR). The process started with cuts of 25 basis points in October and November 2013. In 2014, the MPR was cut in February, March, July and August, for a total of 150 basis points in the past year. The interest rate structure has also been adjusted significantly, which has provided a strong monetary stimulus for the economy. The Board has signaled that it will evaluate the possibility of introducing additional cuts depending on the evolution of internal and external macroeconomic conditions and the implications for the inflation outlook.

Appendix A: The Central Bank of Chile's Balance Sheet

This appendix presents and analyzes the position and projections of the main items on the Central Bank of Chile's financial statements. It starts with a brief review of the evolution of the balance sheet in the first half of 2014 and then presents asset and liability forecasts for year-end 2014 and 2015.

The movements in any balance sheet account can be explained by (a) flows, which are related to settled liabilities and new transactions; (b) profits, which correspond to interest earned; and (c) adjustments, which are earnings and losses associated with accounts indexed to movements in the exchange rate or inflation. Because around 92% of its assets are international reserves and 64% of its liabilities are policy instruments and promissory notes (debt), the Central Bank is a net debtor in domestic currency and a net creditor in foreign currency. Therefore, the bottom line of the balance sheet is determined by the evolution of the differential between international interest rates (profitability of reserves) and domestic interest rates or the cost of debt. Earnings and losses also depend on changes in the exchange rate of the peso against the currencies that make up the international reserves. Currently, the currency benchmark primarily comprises U.S. dollars (47.8%), euros (22.0%) and other currencies such as the pound sterling, Swiss franc, Chinese renminbi, South Korean won, Australian dollar, New Zealand dollar and Singapore dollar.

EVOLUTION OF THE BALANCE SHEET IN THE FIRST HALF OF 2014

In the first half of 2014, the size of the Central Bank's assets increased, while the equity deficit shrank, mainly due to foreign exchange earnings deriving from the depreciation of the peso and the appreciation of other currencies against the dollar. The size of liabilities was fairly constant, although there was a reduction in GDP terms (table A.1).

Between 31 December 2013 and 30 June 2014, the size of the balance sheet grew Ch$1.048 trillion, increasing from 17.2 to 17,3% of GDP in the period.

TABLE A.1
The Central Bank's balance sheet: summary of accounts and balances
(percent of GDP)

	2011	2012	2013	Jun.14	2014 (f)	2015 (f)
Assets	**20.5**	**17.7**	**17.2**	**17.3**	**17.5**	**16.8**
International reserves	18.0	15.3	15.7	15.9	16.1	15.5
Treasury promissory notes and other government loans	0.8	0.8	0.8	0.8	0.8	0.9
Monetary policy instruments	0.8	0.9	0.1	0.1	0.0	0.0
Other assets	0.8	0.7	0.6	0.5	0.5	0.4
Liabilities	**22.4**	**21.1**	**20.0**	**19.5**	**19.4**	**18.7**
Promissory notes traded in secondary markets	10.9	9.9	9.5	10.5	9.8	9.1
Policy instruments with banks	3.9	3.7	2.6	2.1	2.0	1.9
Other liabilities with banks	0.7	0.4	0.6	0.4	0.4	0.4
Other liabilities excl. the monetary base	1.3	1.1	0.8	1.3	1.2	1.2
Monetary base	5.6	6.0	6.4	5.3	5.8	6.0
Equity (A+B+C)	**-1.9**	**-3.4**	**-2.8**	**-2.2**	**-1.8**	**-1.8**
A. Initial equity	-2.8	-1.8	-3.3	-2.7	-2.1	-1.7
B. Net balance	0.9	-1.6	0.5	0.5	0.8	-0.1
Nonfinancial	-0.1	-0.1	-0.1	0.0	-0.1	-0.1
Net interest	-0.3	-0.3	-0.2	-0.1	-0.2	-0.1
From exchange rate and UF fluctuations	1.2	-1.3	0.8	0.6	1.1	0.1
C. Capital contributions	0.0	0.0	0.0	0.0	0.0	0.0
Position payable in foreign currency (*)	15.5	13.5	13.6	14.0	14.1	13.6

(*) Assets minus liabilities payable in foreign currency.
(f) Forecast.
Source: Central Bank of Chile.

On the asset side, as of 30 June, international reserves had expanded Ch$1.100 trillion, due to the depreciation of the peso against the currencies that make up the reserves. The other asset accounts, related to commercial banks and the government, did not change substantially.

On the liability side, PDBC issues increased Ch$2.202 trillion, and Treasury deposits grew Ch$606 billion. The use of the standing deposit facility decreased Ch$670 billion, and long-term debt contracted Ch$366 billion.

In terms of flows, the balance sheet changes described above explained the reduction in the monetary base of Ch$1.232 trillion in the first half (table A.2).

TABLE A.2
The Central Bank's balance sheet flows (1)
(Ch$ billion)

	2011	2012	2013	Jun.14	2014 (f)	2015 (f)
1. Net international reserves	6,771	-539	-127	-263	-292	-50
2. Policy instruments in local currency	-4,363	1,133	997	-608	361	920
3. Central Bank promissory notes in dollars	0	0	0	0	0	0
4. Other operations in local currency excluding the monetary base	-105	-100	-136	-626	-579	-52
5. Other operations in foreign currency (3)	-977	546	130	265	294	50
Monetary base (change = 1+2+3+4+5)	1,326	1,039	864	-1,232	-216	868
Position payable in foreign currency (forex operations=1+3+5)	5,794	6	3	2	2	0

(1) Foreign exchange flows. Where applicable, the balances are also affected by interests, inflation indexation, and price changes.
(2) Debt service on UF-denominated Treasury promissory notes, subordinate debt service, and other operations in local currency.
(3) Treasury and bank deposits, and other operations in foreign currency.
(f) Forecast.
Source: Central Bank of Chile.

The Bank's equity position improved relative to the close of the last *Report*. Based on the usual accounting procedures, the Central Bank of Chile's equity rose from –Ch$3.820 trillion on 31 December 2013 (–2.8% of GDP) to –Ch$3.105 trillion on 30 June 2014 (–2.2% of GDP). This was mainly due to earnings associated with the depreciation of the peso against the reserve currencies (Ch$1.067 trillion); losses from interest rates and inflation adjustments paid on debt (Ch$487 billion); earnings from international investment rates (Ch$167 billion); and administrative expenses plus the costs of issuing and distributing banknotes and currencies (Ch$31 billion).

BALANCE SHEET PROJECTIONS FOR 2014 AND 2015

The main working assumptions underlying the forecast are the following: (i) there will be no foreign exchange operations during the forecast period; (ii) the standing deposit facility will remain around the levels recorded at the close of the first half of 2014; (iii) the balance of monetary policy instruments, mainly repos and the liquidity line, will remain unused; (iv) Treasury deposits will remain at the level recorded on 30 June 2014; (v) the evolution of the monetary base will be consistent with the growth of the economy and inflation; and (vi) in 2014, there will be no issues of long-term debt (BCUs, BCPs), in accordance with the debt plan published in January 2014. In 2015, the debt plan contemplates maturity rollovers and coupons paid in the period, with the expected growth of the monetary base. PDBC operations are expected to be used to adjust for a deficit or surplus of funds.

The baseline forecast scenario assumes that the differential between local and international interest rates will hold at the level recorded in the first half of this year. As a result, equity losses are expected from net interest, with projections of 0.2 and 0.1% of GDP for 2014 and 2015, respectively.

The balance sheet projections assume that parities will move in accordance with forward values at the close of this *Monetary Policy Report.*

The baseline scenario projects that inflation will be 4.1% in December 2014 and 2.8% in December 2015.

Based on these assumptions, earnings from valuation changes are expected to be 1.1% of GDP in 2014 and 0.1% of GDP in 2015.

Appendix B: International reserve management

International reserves are the liquid assets in foreign currency that are held by the Central Bank of Chile to support its monetary and foreign exchange policies. Reserves are managed so as to provide efficient and secure access to international liquidity and to safeguard the financial equity of the Bank. Reserve management is based on the legal framework defined in Section 38, Title III, of the Basic Constitutional Act of the Central Bank.

The management objectives for the international reserves are as follows: (i) to hold foreign exchange reserves in highly liquid instruments, which can be called in the briefest period possible without incurring significant transaction costs, so as to be able to cover residual short-term external debt if necessary (the liquidity objective); (ii) to invest in instruments that present limited financial risks, in order to limit the risk of generating capital losses (the capital preservation objective); (iii) to minimize the volatility of the value of the Bank's equity as a result of changes in the exchange rates of the investment currencies vis-à-vis the peso (the balance sheet coverage objective); and (iv) to reduce the cost of holding reserves at the margin so as to maximize long-term absolute returns (the return-on-investment objective).

In carrying out its international reserve management, the Central Bank maintains a clear separation of responsibilities at the hierarchical level, in line with international recommendations in this area and in accordance with external evaluations by the IMF. The Bank also undergoes periodic internal and external audits of its international reserve management, including a review of the different processes in the investment cycle. This ensures that the decision-making process and management assessment within the Bank remain clearly defined and that the risks are mitigated.

The principle of separation of functions is applied to international reserve management. The International Markets Management participates in the definition of the investment policy, which is approved by the Board, and is responsible for implementing the policy in terms of defining, executing and monitoring investment strategies. The Financial Services Management is responsible for improving investment operations, including the maintenance of the registry, the accounting and the generation of all payment instructions and/or fund movements to ensure compliance with all contractual liabilities. Both managements answer to the Financial Operations Division.

The daily monitoring of compliance with the investment guidelines and parameters defined by the Board is carried out by the Financial Risk Assessment and Administrative Management. In contrast to the above managements, this one reports directly to the Central Bank's General Manager.

The credit risk associated with the investment of international reserves is managed through the definition of eligibility criteria and maximum exposure to countries, supranational entities, commercial banks and agencies (that is, external financial institutions). The variables used to monitor this risk include risk rating, institutional equity, market size, debt ratios and explicit guarantees.

TABLE B.1
Benchmark structure of the international reserve investment portfolio, by type of risk and comparator

Structure	Credit risk	Share (%)	Comparator
Short-term liquidity portfolio	Sovereign	24	Merrill Lynch index: Treasury Bills Index (unhedged) for 0–1 year segments (USD)
Medium-term liquidity portfolio	Sovereign	61	Barclays Capital Global Aggregate Index: Treasury Bond Index (unhedged) for 1–3 year segments (90%) for 3–5 year segments (10%) (USD, EUR, CAD, AUD)
Diversification portfolio	Sovereign and bank	15	Barclays Capital Global Aggregate Index: Treasury Bond Index (unhedged) for 5–7 year segments (75%) for 7–10 year segments (10%) (JPY, KRW, SGD, CHF, NZD, GBP) Bloomberg CGDRC index: Customized for CNH deposits (15%)
Total portfolio		100	

Source: Central Bank of Chile.

To achieve the management objectives, the benchmark structure defines three investment portfolios: (a) the short-term liquidity portfolio (24% of the total reserve investment portfolio); (b) the medium-term liquidity portfolio (61%); and (c) the diversification portfolio (15%). Together, these three funds make up the foreign exchange investment portfolio (table B.1). The international reserves portfolio further comprises the cash portfolio (transaction account balances held by the Treasury, public companies and banks) and the other assets portfolio (IMF special drawing rights, certified gold and other assets).

The benchmark structure of the investment portfolio includes a total of eleven currencies: U.S. dollars (47.79%), euros (21.96%), Canadian dollars (9.15%), Australian dollars (6.10%), Japanese yen (3.00%), Swiss francs (2.40%), English pounds sterling (2.25%), South Korean won (2.25%), New Zealand dollars (1.80%), Singapore dollars (1.05%) and Chinese renminbi (2.25%).

With regard to credit risk, the benchmark considers 97.75% in sovereign risk and 2.25% in bank risk, with the latter limited exclusively to deposits denominated in Chinese renminbi. The total interest rate risk of the investment portfolio, measured through modified duration, is approximately 23 months (table B.2).

TABLE B.2

Currency, maturity, and duration structure of the internally managed benchmark portfolio

		USD		EUR		AUD		CAD		CHF		GBP	
		Share (%)	Duration (months)	Share (%)	Duration (months)	Share (%)	Duration (months)	Share (%)	Duration (months)	Share (%)	Duration (months)	Share (%)	Duration (months)
Short-term liquidity portfolio (STL)	Sovereign												
	0-1 year	24.7	4.0										
	Subtotal STL	**24.7**	**4.0**										
Medium-term liquidity portfolio (MTL)	Sovereign												
	Maturity segment												
	1-3 years	22.0	22.5	20.3	21.1	5.7	23.1	8.5	20.1				
	3-5 years	2.5	46.1	2.3	44.7	0.6	41.7	0.9	42.7				
	Subtotal MTL	**24.5**	**24.9**	**22.6**	**23.5**	**6.3**	**25.0**	**9.4**	**22.3**				
Diversification portfolio (DP)	Sovereign												
	Maturity segment												
	5-7 years									1.8	72.2	1.7	60.6
	7-10 years									0.2	90.4	0.2	82.5
	Bank												
	0-1 year												
	Subtotal DP									**2.0**	**74.4**	**1.9**	**63.1**
Total portfolio		**49.2**	**14.4**	**22.6**	**23.5**	**6.3**	**25.0**	**9.4**	**22.3**	**2.0**	**74.4**	**1.9**	**63.1**

		JPY		KRW		NZD		CNY		SGD		Total	
		Share (%)	Duration (months)	Share (%)	Duration (months)	Share (%)	Duration (months)	Share (%)	Duration (months)	Share (%)	Duration (months)	Share (%)	Duration (months)
Short-term liquidity portfolio (STL)	Sovereign												
	0-1 year												
	Subtotal STL											**24.7**	**4.0**
Medium-term liquidity portfolio (MTL)	Sovereign												
	Maturity segment												
	1-3 years												
	3-5 years												
	Subtotal MTL											**62.7**	**24.0**
Diversification portfolio (DP)	Sovereign												
	Maturity segment												
	5-7 years	2.2	68.2	1.7	62.0	1.3	66.7			0.8	60.8		
	7-10 years	0.3	97.7	0.2	83.8	0.2	84.0			0.1	84.8		
	Bank												
	0-1 year							1.9	1.5				
	Subtotal DP	**2.5**	**71.6**	**1.9**	**64.6**	**1.5**	**68.7**	**1.9**	**1.5**	**0.9**	**63.6**	**12.6**	**58.3**
Total portfolio		**2.5**	**71.6**	**1.9**	**64.6**	**1.5**	**68.7**	**1.9**	**1.5**	**0.9**	**63.6**	**100.0**	**23.4**

Sources: Central Bank of Chile, Barclays and Merrill Lynch, as of 30 June 2014.

To complement internal international reserve management, the Bank has had external management programs for a share of the reserves since 1995. The objectives of these programs are to provide an active benchmark for evaluating internal management, to add economic value and to facilitate the transfer of knowledge and technology.

At the end of the first half of 2014, a share of the investment portfolio (2.87%) was under the management of two independent external companies (Pacific Investment Management Company and Goldman Sachs Asset Management).

In the first half of 2014, the annualized return from the internal international reserve management program was 1.43% measured in foreign currency. Expressed in U.S. dollars, the return was 2.66% (table B.3). The absolute returns in the period are explained by exchange rate trends and the return on the assets in which the reserves are invested: on one hand, the basket of relevant currencies appreciated against the U.S. dollar (figure B.1); on the other, the yield on fixed-income assets fell. These two trends translated into an increase in the market value of these assets. The differential return attributable to reserve management was –3 basis points.

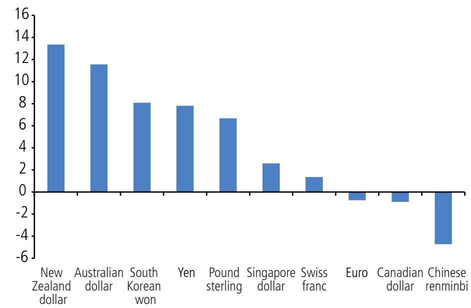
TABLE B.3
Absolute and differential returns on internally managed international reserves
(percent)

Period	In forex		In U.S. dollars		Differential
	International reserves	Benchmark	International reserves	Benchmark	
2014 (*)	1.43	1.46	2.66	2.69	-0.03
2013	0.26	0.21	-0.71	-0.77	0.05
2012	0.66	1.01	1.43	1.77	-0.35
2011	2.43	2.41	1.22	1.20	0.02
2010	2.10	2.19	-0.15	-0.06	-0.09
2009	2.15	1.65	3.34	2.85	0.50
2008	5.70	5.37	4.14	3.81	0.33
2007	4.81	4.78	8.86	8.83	0.03
2006	2.45	2.39	6.84	6.78	0.06
2005	2.90	2.85	-1.72	-1.77	0.05
2004	1.84	1.95	4.08	4.20	-0.11

(*) Annualized returns in the first half.
Source: Central Bank of Chile.

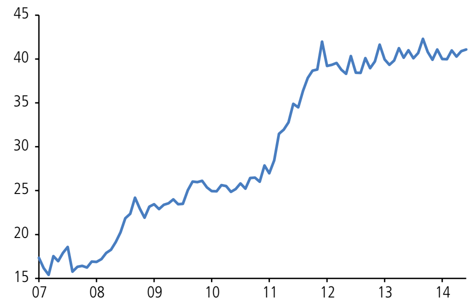
On 30 June 2014, international reserves totaled US$41.0876 billion (figure B.2). Of the total, US$35.9915 billion were allocated to the investment portfolio, US$3.2518 billion to the cash portfolio and US$1.8442 billion to other assets. With regard to the currency composition, 50.0% of the total is invested in U.S. dollars; 18.8% in euros and 31.2% in other currencies (table B.4).

FIGURE B.1
Currency fluctuations against the U.S. dollar (1) (2)
(percent)



(1) Annualized change in the currencies in the first half.
(2) A negative (positive) sign represents an appreciation (depreciation) of the U.S. dollar relative to a given currency.
Source: Bloomberg.

FIGURE B.2
International reserves
(stock, US$ million)



Source: Central Bank of Chile.

On 30 June 2014, the total value of international reserves was US$6.1 million less than at year-end 2013. This reflects reductions in other assets (–US$86.6 million) and the cash portfolio (–US$436.2 million), due to changes in the stock of deposits and account balances held at the Central Bank by the financial system, which was partially offset by an increase in the investment portfolio (US$516.7 million), explained by earnings from interest and exchange rates.

TABLE B.4

Composition of international reserves

(US$ million)

Type of portfolio	Currency	2013 Dec.	%	2014 Jun.	%
Investment portfolio		**35,474.8**	**86.3**	**35,991.5**	**87.6**
Currency and deposits	U.S. dollar	4.5	0.0	611.8	1.5
	Euro	0.8	0.0	2.6	0.0
	Canadian dollar	0.5	0.0	0.2	0.0
	Australian dollar	0.4	0.0	0.6	0.0
	Other currencies	826.2	2.0	784.6	1.9
Securities	U.S. dollar	16,794.3	40.9	16,624.3	40.5
	Euro	7,713.2	18.8	7,733.0	18.8
	Canadian dollar	3,244.7	7.9	3,317.4	8.1
	Australian dollar	2,408.0	5.9	2,370.8	5.8
	Other currencies	4,482.3	10.9	4,546.3	11.1
Total	U.S. dollar	16,798.8	40.9	17,236.1	41.9
	Euro	7,714.0	18.8	7,735.6	18.8
	Canadian dollar	3,245.2	7.9	3,317.6	8.1
	Australian dollar	2,408.4	5.9	2,371.4	5.8
	Other currencies	5,308.5	12.9	5,330.9	13.0
Cash portfolio		**3,688.0**	**9.0**	**3,251.8**	**7.9**
Currency and deposits	U.S. dollar	3,688.0	9.0	3,251.8	7.9
Other assets		**1,930.8**	**4.7**	**1,844.2**	**4.5**
Monetary gold	Other currencies	9.6	0.0	10.5	0.0
IMF SDRs	Other currencies	1,147.1	2.8	1,151.6	2.8
IMF reserve position	Other currencies	640.7	1.6	626.2	1.5
Reciprocal credit agreements	U.S. dollar	133.3	0.3	56.0	0.1
Total International Reserves		**41,093.7**	**100.0**	**41,087.6**	**100.0**
	U.S. dollar	20,620.2	50.2	20,543.9	50.0
	Euro	7,714.0	18.8	7,735.6	18.8
	Canadian dollar	3,245.2	7.9	3,317.6	8.1
	Australian dollar	2,408.4	5.9	2,371.4	5.8
	Other currencies	7,106.0	17.3	7,119.1	17.3

Source: Central Bank of Chile.

TABLE B.5

Internally managed portfolio: investments by country and type of risk

(US$ million)

Country	Sovereign (1)	Bank	Agency (2)	Supranational(3)	Total
United States	12,964		100		**13,064**
Germany	9,459	133			**9,592**
Canada	3,708				**3,708**
Australia	2,336	42			**2,378**
United Kingdom	747	432			**1,179**
Japan	776	348			**1,124**
South Korea	687				**687**
Switzerland	505				**505**
New Zealand	537				**537**
Singapore	301				**301**
Netherlands		33			**33**
Sweden		50			**50**
Denmark		33			**33**
Belgium	183				**183**
Austria	577				**577**
China	135	177			**312**
Supranational				686	**686**
Various (cash)		9			**9**
TOTAL	**32,915**	**1,257**	**100**	**686**	**34,958**

(1) Sovereign exposure includes the following institutions with an explicit sovereign guarantee: Kreditanstalt für Wiederaufbau (KFW / Germany: 1.9361 billion), Export Development Canada (EDC / Canada: 391.0 million) and Oesterreichische Kontrollbank (OKB / Austria: 576.6 million). Sovereign exposure in the United States includes an overnight deposit at the New York Federal Reserve of US$ 0.6 million. Sovereign exposure to China comprises US$100 million in the BISIP-CNY instrument, which is directly managed by the BIS.

(2) Agency exposure includes the following issuers in the United States: Federal National Mortgage Association (Fannie Mae: US$ 69.7 million) and Federal Home Loan Mortgage Corporation (Freddie Mac: US$ 30.6 million).

(3) Supranational exposure includes the following eligible issuers: European Investment Bank (EIB: US$ 131.0 million), International Bank for Reconstruction and Development (IBRD - US$ 480.0 million) and International Finance Corporation (IFC: US$ 75.0 million).

Source: Central Bank of Chile.

With regard to the exposure of the internally managed investment portfolio by type of risk and country, at the close of this *Report,* there was an appropriate degree of diversification of the different types of risk in which the international reserves are invested. At the end of June, investment in sovereign risk represented 94.2% of the internally managed investment portfolio, and it was concentrated in the United States (37.1%) and Germany (27.1%). At the close of the period, investment in supranational risk represented 2.0% and agency risk 0.3%. Bank risk, which represented 3.6% of the total internally managed portfolio, included banks in Germany, Australia, the United Kingdom, Japan, the Netherlands, Sweden, Denmark and China (table B.5). The portfolio was also exposed to a BIS Investment Pool (BISIP) denominated in renminbi (equivalent to US$100 million), which is managed directly by the Bank for International Settlements (BIS). This instrument provides exposure to the Chinese onshore fixed-income market.

On 30 June 2014, the currency composition of the internally managed investment portfolio was as follows: 49.3% in U.S. dollars, 22.7% in euros, 9.5% in Canadian dollars and 6.8% in Australian dollars. The remaining 11.7% was invested in English pounds sterling, Swiss francs, Singapore dollars, New Zealand dollars, Chinese renminbi, South Korean won and Japanese yen (table B.6).

At the end of June, the external management companies managed US$1.0330 billion, which was allocated to the diversification portfolio. Of the total, 85.0% was invested in sovereign risk (table B.7).

TABLE B.6
Internally managed portfolio: investments by currency
(percent)

Currency	Share
U.S. dollar	49.3
Euro	22.7
Canadian dollar	9.5
Australian dollar	6.8
Pound sterling	2.3
South Korean won	2.0
Japanese yen	1.9
Chinese renminbi	1.9
New Zealand dollar	1.6
Swiss franc	1.1
Singapore dollar	0.9
TOTAL	**100.0**

Source: Central Bank of Chile.

TABLE B.7
Internally managed portfolio: investments by country and type of risk
(US$ million)

Country	Sovereign (1)	Bank	Agency (2)	Supranational	Total
United States	21	10	12		43
Germany	10				10
United Kingdom	142	32			174
Japan	179				179
South Korea	162				162
Switzerland	147				147
New Zealand	129				129
Singapore	67	39			106
Holland		25			25
France		27			27
China	21				21
Various (cash)		10		0	10
TOTAL	**878**	**143**	**12**	**0**	**1.033**

(1) Sovereign exposure includes the following institutions with an explicit sovereign guarantee: Kreditanstalt für Wiederaufbau (KFW / Germany: 9.6 million).

(2) Agency exposure includes the following issuers in the United States: Federal National Mortgage Association (Fannie Mae: US$4.9 million) and Federal Home Loan Mortgage Corporation (Freddie Mac: US$6.7 million).

Source: Central Bank of Chile.

Appendix C: Main measures taken by the Central Bank of Chile in 2014

JANUARY

3 Through Board Resolution 1796-03-140102, the Board decided to publish for public consultation, open to market agents and the general public, the proposal to authorize the trading and payment in local currency of foreign securities eligible to be listed in the local market, in accordance with the stipulations of Article 184 of Law 18,045, on the Securities Market.

7 The Central Bank of Chile reported that in the Board meeting held on 28 November 2013, the Board approved the 2014 Debt Plan, under which the Bank will not issue or place debt instruments in the primary market at maturities of two years or longer during the period.

The Board further indicated that this plan could be subject to modifications in the event of significant changes in market conditions.

16 At its monthly monetary policy meeting, the Board decided to hold the monetary policy interest rate at 4.5% in annual terms.

FEBRUARY

18 At its monthly monetary policy meeting, the Board decided to reduce the monetary policy interest rate by 25 basis points, to 4.25% in annual terms.

MARCH

13 At its monthly monetary policy meeting, the Board decided to reduce the monetary policy interest rate by 25 basis points, to 4% in annual terms.

20 Through Resolution 1810-01-140320, the Board modified Chapter VI of the *Compendium of Foreign Exchange Regulations*, incorporating the charging of commissions on reimbursement requests routed by the Central Bank of Chile to local "Authorized Institutions" and defining the instruments that are eligible to be channeled under the *Aladi* Agreement on Reciprocal Payments and Credits. It was further established that the new provisions will enter into effect thirty consecutive days after the publication of the Resolution in the *Official Gazette,* scheduled for 24 March 2014.

APRIL

10 Through Resolution 1816-01-140410, the Board accepted the fiscal agency granted to the Central Bank of Chile through Executive Decree N° 38, dated 16 January 2014, by the Ministry of Finance, to represent and act in the name and on the account of the Treasury in the placement and management of the bonds and notes identified in the decree.

17 At its monthly monetary policy meeting, the Board decided to hold the monetary policy interest rate at 4.25% in annual terms.

24 Through Resolution 1818-03-140424, in accordance with the provisions of Law 20,712 on the Management of Third-Party Funds and Individual Portfolios, published in the *Official Gazette* on 7 January 2014, in which Article 3 incorporates modifications to the Income Tax Law (ITL) contained in Article 1 of Decree Law 824 of 1974, effective 1 May 2014, the Board determined to put on record the following:

"With regard to bonds issued by the Central Bank of Chile, henceforth "the Bank", in accordance with Chapter 1.1 of Part One of the *Compendium of Monetary and Financial Regulations* or the former Chapter IV.E.1 of the *Compendium of Financial Regulations* of the Central Bank, which are covered under the provisions of Article 104 of the ITL which is to be replaced by Law 20,712, let it be put on record with regard to the stipulations of the relevant regulations included in number 6 of the aforementioned Chapter 1.1 and former Chapter IV.E.1, that the Bank will comply, when the situation arises, with the withholding obligation applicable to bond issuers under Article 74 N°7 of the current ITL, a legal regulation that will be replaced by Law 20,712 effective 1 May 2014, which stipulates that the annual declaration and payment of the aforementioned withholding tax must be carried out by the issuer in accordance with Article 79 of the ITL, solely in relation to the period in 2014 during which Article 74 N°7 is effective.

For this purpose, in accordance with the modifications that are to be incorporated into the aforementioned Article 74 N° 7, and taking into account the relevant issue conditions, with regard to the indicated debt instruments the Bank will deduct, at the time of payment of the first half-yearly coupon due immediately after 30 April 2014, the part corresponding to 4% of the interest accrued by the bonds in the 2014 period covered under the application of Article 74 N° 7 which is to be replaced, that is, through 30 April 2014 inclusive. With this deduction, the payment obligation associated with that coupon, to which the Bank is subject in its role as issuer of the bonds, is understood as paid in full and on time. With regard to the redemption of the bonds, the collection and payment of the corresponding half-yearly coupon will include the deduction of the aforementioned interest.

Notwithstanding the foregoing, and also in accordance with the provisions of the aforementioned issue conditions and with the stipulations of the third paragraph of Article 20 N° 2, which will be in force through 30 April 2014, in relation to Article 79 of the ITL, during the month of January 2015 the Bank will disclose to investors who are not subject to the withholding tax established in Article 74 N° 7 of the ITL, which will be in force until the application of Law N° 20,712 enters into effect, the part corresponding to 4% of the interest accrued by the bonds in the period in 2014, during which the bonds have been the property of the respective investor and which is subject to the application of the ITL precepts cited above, that is, through 30 April 2014, inclusive. The foregoing is subject to the condition that the investors in question have expressly petitioned the Bank in writing, via notarized statement as established in the second paragraph of N° 7 of Article 74 of the aforementioned Law, presented in the form and at the time indicated by the Chilean Internal Revenue Service, together with other documents required by the Bank in order to verify the period in which the instruments have been in the possession of the investor.

To determine the amount to be disclosed, the Bank will use the value, on 31 December 2014, of the *Unidad de Fomento* (an inflation-indexed unit of account) or the value of the exchange rate stipulated in the second paragraph of Article 44 of the Basic Constitutional Act, as applicable for BCU or BCD bonds, respectively. The Central Bank of Chile will ensure timely compliance with the legal obligations established in Article 74 N° 7 of the ITL, in relation to Article 79, as well as all other tax obligations established for issuers of debt instruments covered under the provisions of Article 104 cited above as of 1 May 2014, for which purpose investors must provide the information that, in a given case, the aforementioned Revenue Service requires from the investor in relation to the corresponding tax code."

29 Through Resolution 1818-04-140424, the Board modified Chapter III.F.4 of the *Compendium of Financial Regulations* to incorporate Dominion Bond Rating Services Ltd., DBRS, on the list of international rating agencies that the Central Bank of Chile considers when investing its own resources, for the purposes of Decree Law 3500 of 1980; and updated the appendix to Chapter III.F.5 of the same *Compendium*.

MAY

5 Through Resolution 1820-03-140430, the Board granted the authorization stipulated in the third paragraph of Article 184 of Law 18,045 on the Securities Market, for the trading and payment in local currency of foreign securities contained in that authorization, for the purposes of listing the securities in the country, in accordance with the requirements and conditions contained in the appendix to the Resolution.

In granting this authorization, the Board considers that it should facilitate the development of a broader spectrum of investment alternatives and also allow the transactions to be cleared and settled through the central clearing houses. The established conditions include the following: (i) the instruments must be eligible to be listed in the securities market of the issuing country or other markets; (ii) the issuer must be incorporated in a country that is a member of the Financial Action Task Force (FATF) or an equivalent organization for combating money laundering and terrorist financing, and that is not on any list of non-cooperative countries or tax havens; (iii) the instruments must be registered in the Foreign Securities Registry maintained by the Superintendence of Securities and Insurance; and (iv) the instruments must be traded on the exchange.

8 Through Resolution 1823-03-140508, the Board modified the *Compendium of Monetary and Financial Regulations* in relation to the provisions of Law 20.712, especially with regard to the tax code applicable to bonds issued or to be issued by the Central Bank of Chile, covered under Article 104 of the Income Tax Law.

9 Through Resolution 1823-02-140508, the Board determined to open for public consultation the proposal to modify Chapter III.B.2 of the *Compendium of Financial Regulations* of the Central Bank of Chile, on Regulations on the Ratio of Asset and Liability Operations of Banks, in order to receive commentary on the proposal from interested parties and the general public during a period of 120 consecutive days from the date of its publication on the institutional website.

This regulation has the following objectives: (i) to strengthen the liquidity risk management policies of banking institutions, by giving more responsibility to the board of directors and management and establishing minimum guidelines for the development of stress tests and contingency plans; (ii) to increase the quantity and quality of information available to the supervisor and the market, thorough the inclusion of new monitoring variables, such as the Basel III liquidity coverage ratio (LCR) and net stable funding ratio (NSFR), and variables for monitoring liquid assets of different quality and the concentration of financing sources; and (iii) to improve the current regulatory requirements, by adding overall requirements on maturity mismatches, which are complementary to the individual requirements, and establishing guidelines on the treatment of overseas bank affiliates. In addition, adjustments have been incorporated to allow the standardization of criteria on the use of internal models (adjusted basis), so that similar flows will be treated similarly across all banks.

Beyond these improvements, the actual regulatory limits are not being incorporated at this time. Once the new regulation enters into effect, the Superintendence of Banks and Financial Institutions and the Central Bank will be able to more precisely estimate the LCR and NSFR. In addition to better and more frequent information on, for example, high-quality liquid assets (HQLA) and sources of financing, the information captured in the observation period (around a year) will allow the authorities to make the necessary adjustments and calibrations that will enable, through a new modification to the regulation, the adoption of the LCR as a regulatory requirement, for example, and the implementation of further improvements to the current limits.

15 At its monthly monetary policy meeting, the Board decided to hold the monetary policy interest rate at 4% in annual terms.

JUNE

6 Through Resolution 1830-04-140605, the Board determined to publish for public comment the proposed modifications to the regulations established in Chapter III.J.3 of the *Compendium of Financial Regulations*, on the Issue and Operation of Prepaid Payment Cards. The objective of these modifications is to adjust or update regulatory requirements that could be inhibiting the development of this means of payment, without introducing additional risks for the retail payment system.

12 At its monthly monetary policy meeting, the Board decided to hold the monetary policy interest rate at 4% in annual terms.

JULY

15 At its monthly monetary policy meeting, the Board decided to reduce the monetary policy interest rate by 25 basis points, to 3.75% in annual terms.

AUGUST

14 At its monthly monetary policy meeting, the Board decided to reduce the monetary policy interest rate by 25 basis points, to 3.5% in annual terms.

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 (14% of nominal GDP in 2013).

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 (77% of nominal GDP in 2013).

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.

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

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.

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.

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

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, April 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 2013–2015.

World growth at PPP: Regional growth weighted by its share in world GDP at PPP, published in the IMF's *World Economic Outlook* (WEO, April 2014). World growth projections for 2012–2015 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 2013–2015.

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.

ABBREVIATIONS

BCP: Central Bank bonds denominated in pesos.

BCU: Central Bank bonds denominated in UFs.

ECB: European Central Bank.

EES: Economic Expectations Survey

FBS: Financial Brokers Survey.

IMCE: Monthly Business Confidence Index

CPIEFE: CPI excluding food and energy

IPEC: Economic Perceptions Index

MPR: Monetary Policy Report.

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