

MONETARY POLICY REPORT

December 2012



MONETARY POLICY REPORT*/ December 2012



*/ 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.



CONTENTS*/

PREFACE	5
SUMMARY	7
MONETARY POLICY DECISIONS IN THE LAST THREE MONTHS	11
I. INTERNATIONAL SCENARIO	13
II. FINANCIAL MARKETS	17
III. DEMAND AND OUTPUT	21
IV. PRICES AND COSTS	27
V. INFLATION SCENARIOS	33
GLOSSARY AND ABBREVIATIONS	37
REFERENCES	41
BOXES	
Private consumption behavior	25
Inflation and output gaps	31

*/ The statistical cutoff date of this *Monetary Policy Report* was 13 December 2012.

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 tolerance range of plus or minus one percentage point. To meet this target, the Bank focuses its monetary policy on keeping projected inflation at 3% annually over a policy horizon of around two years. Controlling inflation is the means through which monetary policy contributes to the population's welfare. Low, stable inflation favors a better functioning of the economy and economic growth, while preventing the erosion of personal income. Moreover, focusing monetary policy on achieving the inflation target helps to moderate fluctuations in national employment and output.

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

The *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. A number of 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 of 14 December 2012 for presentation to the Senate's Finance Committee on 18 December 2011.

The Board

SUMMARY

The macroeconomic scenario facing the Chilean economy has not changed significantly since the last Monetary Policy Report. However, underlying risks do show some variation. In Chile, output, and especially domestic demand, has grown above expectations. Some progress has been made in the external scenario, but the inherent risks in the Eurozone are still present. In this context, headline inflation has fluctuated substantially in the past few months, due to one-time factors relating with supply shocks. Core inflation—discounting foodstuffs and energy—has declined slightly to near 2% y-o-y. The Board, continuing with what has been the tone throughout the year, held the monetary policy interest rate (MPR) at 5%.

As of November, y-o-y CPI inflation was 2.1%, after rising to almost 3% in October. Key determinants of this rise have been the fluctuations in the prices of fresh fruits and vegetables. Core inflation has dropped somewhat, despite stronger dynamism of output. Looking in more detail, the difference between the price evolution of goods and services persists, the latter increasing at around 4% annually. Y-o-y growth in nominal wages has remained roughly constant in the 6% to 7% range, albeit with differences across sectors. Higher growth in average labor productivity has helped moderate the rise in real labor costs. This couples with a compression of retail margins and a reduction in the dollar prices of imported goods. In any case, the possibly procyclical behavior of productivity and margins makes it difficult to elucidate whether these changes are temporary or permanent in nature, so the medium-term inflationary risks remain.

In the third quarter of 2012, output grew 5.7% y-o-y, the same as in the second quarter, but above expectations. August's Economic Expectations Survey (EES)—available at the closing of last Report—anticipated a growth rate of 4.6% y-o-y for the third quarter. This higher growth is explained by a better overall performance. All in all, in terms of its expansion velocity, output showed a deceleration, from 8.3% to 5.7%. In the baseline scenario, the Board estimates GDP will grow 5.5% this year.

On the domestic spending side, third quarter growth (i.e., 8.0% y-o-y) largely surpassed second-quarter figures, however swollen by some specific factors. While every component of expenditure posted higher increases, the large increase in machinery and equipment investment is worth noting: 19.9% y-o-y. One

**ECONOMIC GROWTH AND CURRENT ACCOUNT**

	2011	2012 (f)	2013 (f)
	(annual change, percent)		
GDP	6,0	5,5	4,25-5,25
National income	6,1	5,2	4,6
Domestic demand	9,4	6,6	5,7
Domestic demand (w/o inventory change)	10,2	6,8	6,0
Gross fixed capital formation	17,6	11,3	7,6
Total consumption	7,9	5,3	5,5
Goods and services exports	4,6	2,7	3,0
Goods and services imports	14,4	5,5	5,9
Current account (% of GDP)	-1,3	-3,8	-4,6
National savings (% of GDP)	23,4	22,0	21,6
GFCF (% of nominal GDP)	23,2	24,4	25,2
GFCF (% of real GDP)	26,2	27,7	28,4
	(millions of dollars)		
Current account	-3,221	-10,000	-12,950
Trade balance	10,792	2,350	-1,050
Exports	81,411	77,600	77,300
Imports	-70,619	-75,250	-78,350
Services	-2,417	-1,500	-1,500
Rent	-14,015	-12,750	-12,350
Current transfers	2,418	1,900	1,950

(f) Forecast.

Source: Central Bank of Chile.

determinant was imported transportation material, which by itself accounted for more than half the increase. The acceleration of domestic spending amplified the negative current account balance, which in the third quarter went to 2.9% of GDP accumulated in the last year. The baseline scenario assumes that it will end the year 2012 at 3.8% of GDP, exceeding September's forecast of 3.2%.

The Board pays close attention to the evolution of the current account deficit. Its level, persistence, composition and funding sources are all aspects that may affect the vulnerability of the Chilean economy, particularly if confronted with adverse external scenarios. Overall, today's deficit has many peculiarities that mitigate the associated risks. First, a significant part is explained by higher investment in a number of projects aimed at the production of exportable goods and services. Second, a major part of the deficit is being financed via foreign direct investment rather than external debt. Finally, the evolution of domestic and external credit is showing no signs of overborrowing by either households or firms. The evolution of private consumption does not divert far from what can be inferred from labor income, the low rate of unemployment and financial conditions. From a longer perspective, in nominal terms, the ratio between private consumption and private national disposable income is close to its historic average.

Towards 2013, the Board estimates that GDP growth will be in the range from 4.25% to 5.25%, above the September forecast. In this scenario, domestic demand will increase 5.7% y-o-y, further increasing the current account deficit to 4.6% of GDP. This projection supposes that macroeconomic conditions facing the Chilean economy will remain fairly unchanged in the near future, and that the economy will grow in line with trend rates, which the Board continues to estimate around 5%.

INTERNATIONAL BASELINE SCENARIO ASSUMPTIONS

	2011	2012 (f)	2013 (f)	2014 (f)
	(annual change, percent)			
Terms of trade	0.5	-5.0	-0.8	1.3
Trading partners' GDP (*)	4.2	3.3	3.5	4.0
World GDP at PPP (*)	3.8	3.0	3.3	3.8
World GDP at market exchange rates (*)	2.8	2.4	2.6	3.2
External prices (in US\$)	10.1	-0.4	0.0	0.4
	(levels)			
LME copper price (US\$/lb)	400	361	340	350
WTI oil price (US\$/barrel)	95	94	90	90
Brent oil price (US\$/barrel)	111	112	105	100
Gasoline parity price (US\$/m ³) (*)	803	825	741	700
Libor US\$ (nominal, 90 days)	0.3	0.4	0.4	0.5

(*) For a detailed definition, see glossary.

(f) Forecast.

Source: Central Bank of Chile.

Internationally, the baseline scenario foresees that in 2013 and 2014 the world economy and Chile's trading partners will grow by averages of 3.6% and 3.8%, respectively, not far from those of 2011-2012. As seen in previous reports, there are important differences between the performances of the developed world and the emerging world. The recession in the Eurozone has settled and is expected to last some more time. Worth noting is the further weakening of core Eurozone economies, which had been shielded to some extent from the hardships of the periphery. Expectations regarding the United States are that it will continue to recover at a slow pace, and that moderate adjustments to the fiscal policy will take place. The downgraded outlook for Japan needs mention, due to both its relation with the Eurozone and some fiscal adjustment measures appearing in the horizon. In the emerging world, incoming data from China suggest that the slowdown of most of 2012 may be reverting. Thus, again y-o-y growth rates around 8% are forecast for the Chinese economy for 2013 and 2014. Compared with last Report, growth prospects for Latin America are revised downward for this and the next two years. Most of the region's economies continue to grow, but some of them have shown signs of a slowdown.

In this scenario, commodity prices will not change much from forecasts a few months back. In the two-year period 2013-2014, the baseline scenario foresees average prices of US\$3.45 per pound of copper and US\$102 per Brent oil barrel. Accordingly, terms of trade estimates for Chile continue to be high, but lower than they were this year.

Volatility in external financial markets has diminished in recent months. However, there is still a long way to go in resolving the crisis of the Eurozone, and the steady worsening of the economy complicates the materialization of the much sought improvements in fiscal balances even more. Nevertheless, the commitment of various organizations to work out a solution seems to be bearing fruit in the market's evaluation. The baseline scenario again considers the possibility of new stress episodes in the world markets, yet not as severe as those of the latter part of 2011. Such calm has also reflected in stock markets and currency parities. In recent months, the U.S. dollar has depreciated slightly against the main currencies. The peso/dollar parity, with ups and downs, is somewhat lower than in the previous Report, while the real exchange rate (RER) has shown no significant variation. The Board continues to estimate that, with the prevailing nominal exchange rate and currency parities, the RER is in the lower part of the range of values consistent with its long-term fundamentals.

In the baseline scenario, y-o-y CPI inflation will stand below the tolerance range in the coming months, to start rising later and approach 3% by the end of 2013 and at the projection horizon, this time the last quarter of 2014. There are several factors explaining the lower figures foreseen for the near future, including the high basis for comparison of late 2011 and the turn of 2012. Core inflation will post y-o-y variations below 2% over most of 2013, then it will rise gradually to near 3% over the course of 2014. This path assumes that wages will grow in line with productivity and target inflation. In addition, it relies on the methodological assumption that, over the projection horizon, the RER will be fairly unchanged from its current values. Finally, the baseline scenario uses as a working assumption that the MPR trajectory will be stable, as suggested by the latest surveys available at the statistical closing of this Report.

The baseline scenario reflects those events that are believed to be the most likely with the information at hand at the closing of this Report. There are risk scenarios, however, which if materialized, may reshape the macroeconomic environment—in some cases, significantly—and therefore, may alter the course of monetary policy. On this opportunity, having evaluated the alternative scenarios, the Board estimates that the risk balance is unbiased for both output and inflation.

In the world economy, the main risk continues to be associated to the situation in the Eurozone. Although some advances have been made, the inherent risks are still present. On one hand are the difficulties in implementing agreements. On the other, as time has passed, the economic situation of the most affected countries has complicated further, while core European economies seem to be taking a turn for the worse. A sharper deceleration in Germany or France could aggravate the problems in the region and amplify pass-through channels to other economies. Neither can this analysis rule out episodes of volatility in the financial markets that could be more severe than the ones considered in the baseline scenario. And there is the ongoing discussion in the United States to ward off a sharp fiscal adjustment in 2013. Failure to reach an agreement could significantly hamper growth and increase market volatility.

In the emerging world, again the biggest risk comes from the pace of economic activity. On one hand, incoming data suggests that China has resumed stronger growth, but the weakening of Europe and pending discussions in the United

INFLATION

	2011	2012 (f) (2)	2013 (f)	2014 (f)
	(annual change, percent)			
Average CPI inflation	3,3	3,0	2,3	3,1
December CPI inflation	4,4	1,6	2,9	
CPI inflation in around 2 years (1)				3,0
Average CPIPEE inflation	1,3	2,2	1,7	2,7
December CPIPEE inflation	2,4	1,6	2,3	
CPIPEE inflation in around 2 years (1)				2,8

(f) Forecast.

(1) Inflation forecast at the fourth quarter of 2014.

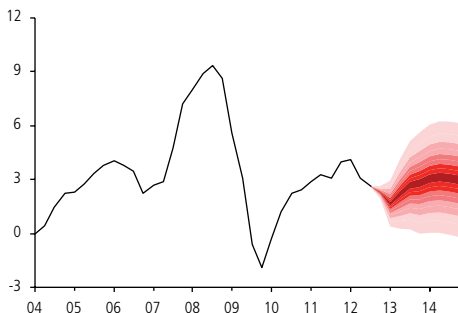
(2) For December 2012, the median of monthly inflation is considered, as forecast in the Economic Expectations Survey.

Source: Central Bank of Chile.



CPI INFLATION FORECAST (*)

(annual change, percent)

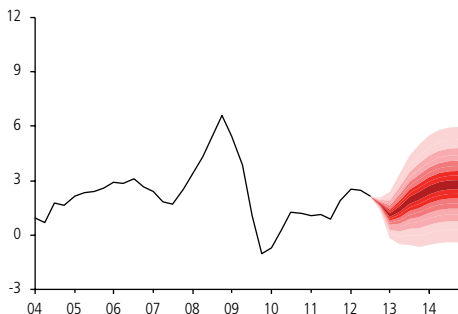


(*) The figure shows the confidence interval of the baseline projection base over the respective horizon (colored area). Confidence intervals of 10%, 30%, 50%, 70% and 90% around the baseline scenario are included. These intervals summarize the risk on future inflation as assessed by the Board. The baseline scenario uses as a working assumption that the MPR trajectory will be stable, as suggested by the latest surveys 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 base 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 risk on future inflation as assessed by the Board. The baseline scenario uses as a working assumption that the MPR trajectory will be stable, as suggested by the latest surveys available at the statistical closing of this Report.

Source: Central Bank of Chile.

States could affect the Chinese economy, and through it the rest of the emerging world. This could be particularly important to Chile because of its incidence in the copper price. On the other hand, the recent drop in world trade growth figures is cause for concern.

In Chile, capacity utilization is still intensive, and a strengthening of domestic demand could trigger inflationary pressures incompatible with the inflation target. So far, increased activity has not resulted in higher inflation, which can be explained by factors such as higher average labor productivity or compressed margins. However, figuring out whether these phenomena are permanent or temporary is a difficult task, so medium-term inflationary risks remain in place. Add to this the persistently tight conditions in the labor market.

A more dynamic domestic demand could amplify the current account deficit and increase the economy's external vulnerability, eventually confronting it with costly potential adjustments. In the past, most of the crises that the country endured were preceded by high and persistent current account deficits, an excessive increase in borrowing, and important currency mismatches. However, today's economic policy framework is more advanced, including a rule that governs fiscal policy and cushions the impact on public expenditure of both copper price fluctuations around its long-term trend and the ups and downs of the business cycle. It also includes a floating exchange rate regime that puts currency risks under the light allowing an early response to sudden changes in external conditions. It also contemplates proper financial regulation and supervision to prevent the incubation of excessive risk. Accordingly, the Board estimates that it is paramount to closely monitor those factors that are behind the current account deficit, in order to avoid the incubation of imbalances that may affect the future performance of the economy.

As has been said before, the current scenario depicts significant risks that call for policy responses in different directions. On one hand, although its effects on the Chilean economy have been mild, the external situation is fragile and its unfolding is still unclear. Major economies are showing signs of weakness and have historically expansionary monetary policies in place. Chile is a small economy, commercially and financially open, so it will not be immune to global developments. On the other hand, its solid domestic output and demand mean that medium-term inflationary risks are still present. The MPR is within the range of values considered neutral. The Board follows closely the evolution of the external and domestic macroeconomic scenarios and their implications on inflation, and reiterates its commitment to conduct monetary policy in such a way that projected inflation stands at 3% over the policy horizon.

MONETARY POLICY DECISIONS IN THE LAST THREE MONTHS

BACKGROUND: MONETARY POLICY REPORT OF SEPTEMBER 2012

In September, differences between the performances of the global and the local economy had deepened. On one hand, external conditions were still complex, and the growth outlook had weakened due primarily to a steeper than expected slowdown in the emerging world, particularly in Brazil, China and India. Several elements were behind this slowdown, of which the effects on their exports of the global deceleration—especially in Europe—stood out, as did more stringent policies than in the past. This had led to a visible deceleration of those countries' manufacturing industries. Developed economies were still performing poorly. In the United States, the overall evaluation continued to point at a slow recovery. In the Eurozone, GDP had decreased in the second quarter, after posting zero growth early in the year. A cause for concern was the weakness of some German indicators, particularly those for domestic consumption, compounded with weakened exporting and manufacturing sectors.

External financial markets had quieted down somewhat, thanks to, among other causes, the fact that announcements by the European Central Bank had been welcome by investors, leading to a widespread improvement in financial conditions in the Eurozone and around the world. These measures could be expected to provide some respite to advance in the structural reforms that were required to enhance fiscal and financial stability in the Eurozone. While acknowledging the progress made, its materialization presented great political difficulties, so risks in the Eurozone remained and a resurgence of financial stress was a possibility. There was also the decision of the Federal Reserve to amplify its asset purchase program and extend the period during which it would hold the monetary policy rate at its minimum level.

The external impulse to the Chilean economy would be somewhat milder than foreseen, because of downward revisions of trading partners' growth. Meanwhile, the terms of trade would be not as favorable as previously forecast. The price of oil and derivatives would be higher than estimated in June, due to supply-side problems and growing geopolitical risks in the Middle East. Also because of supply-side problems, the international prices of foodstuffs, especially grains, had risen. The copper price projection

was unchanged from June.

Domestic output and demand had outperformed second-quarter expectations and the effects of the debilitated external scenario on the local economy had been mild. Accordingly, installed capacity utilization had intensified. Nevertheless, headline inflation had been lower than expected and was in the lower part of the tolerance range, as were core inflation measures. Within the latter, however, goods inflation and services inflation were posting different performances. Services inflation had remained close to 5% annually, reflecting prevailing medium-term inflationary risks. Despite a slowdown in y-o-y growth in employment and nominal wages, the labor market was still tight. The peso/dollar parity had appreciated by 5.3% since June. The real exchange rate (RER) was estimated to be in the lower range of its values consistent with its long-term fundamentals.

The risk balance for both output and inflation was unbiased. The situation in the Eurozone was complex. Executing the announcements was no easy task and the passing of time would bring further problems to peripheral economies, so a severe aggravation of the financial crisis in the Eurozone could not be ruled out. This coupled with discussions in the United States to ward off fiscal adjustments in 2013. In the emerging world, the biggest risk was a deepening of signs of economic slowdown. Particularly worrisome was the performance of China, since a sharper deceleration would have the strongest impact on commodity exporting economies.

Medium-term inflationary risks were ongoing. Increases in the international prices of fuels and some foodstuffs could quickly be passed through to inflation, considering above all the narrow output gaps and tight labor market. In addition, if the dynamism of domestic output and demand persisted or increased, it could further intensify capacity utilization pressuring inflation away from the target. At the same time, it could amplify the current account deficit, making the economy more vulnerable in facing a complex global scenario.

MEETINGS IN SEPTEMBER, OCTOBER AND NOVEMBER

In September, the available data led the Research Division to propose as the relevant option to hold the monetary policy interest rate (MPR) at 5.0%. The option of raising it was discarded



in view of the outlook for the external scenario and its potential impact on the Chilean economy and inflation. Lowering it was also ruled out considering that the output gaps and the labor market were tight, posing a latent risk to medium-term inflation expectations. It was likely that the external slowdown would help to clear this risk in the coming months, but so far it had had only a mild effect. As for the option of keeping the policy rate unchanged, it was justified by the MPR being within a range of neutral values, which provided time and flexibility to wait and gather more information on the unfolding of external conditions and their effects on the Chilean economy. Accordingly, the Board decided to maintain the MPR at 5% annually.

In October, incoming news from both within and outside the country did not configure a very different situation from what had been analyzed in the latest monetary policy meeting and September's *Monetary Policy Report*. Internationally, while acknowledging the advances in the Eurozone, political and institutional arrangements to achieve a sustainable resolution of sovereign debt problems had still a long way to go in bargaining and implementation. In the United States there was some improvement in economic figures, but the risk of a drastic fiscal adjustment in early 2013 had not abated. China's growth deceleration showed some marginal signs of attenuation and its effects on commodity markets had been limited.

The domestic outlook continued to assume a slowdown in output and demand, given the lagged effects of higher external uncertainty and slower growth of trading partners. However, some indicators suggested that final demand could become stronger thanks to robust purchases of durable goods and strong machinery & equipment investment. This pattern was expected to result in a widening of the current account deficit. Meanwhile, inflation was expected to be at the lower end of the tolerance range due to adjustments in some specific prices, the effects of the exchange rate appreciation and the lower incidence of fuels.

Thus, one more time the Research Division proposed as the relevant option to hold the MPR at 5.0%. The option of increasing the MPR was discarded as incoming information revealed some deceleration of output, associated both with weak external demand and lower inventory accumulation, and that output growth, as well as employment growth, had become aligned with trend rates. Also, inflation indicators and private inflation expectations were still consistent with meeting the target. The option of lowering the MPR was ruled out, as the probability of occurrence of some of the external risk scenarios depicted in September's *Report* had not increased. Plus, figures showed that domestic demand and related indicators were still dynamic, while local financial conditions remained benign. Keeping the MPR unchanged was totally consistent with the monetary stimulus

needed to align the evolution of activity with its potential, as had been pointed out in the last *Monetary Policy Report*. The Board therefore decided to hold the MPR at 5% annually.

In November, developments in the last month did not modify significantly the external scenario outlined in September's *Monetary Policy Report*. World growth forecasts had not changed materially, although the decoupling of the Eurozone with the other regions had been exacerbated. Conditions were still fragile in the Eurozone, the risk of a severe fiscal adjustment in the United States persisted, and only in China were some more positive signs being observed, which however contrasted with the decline in commodity prices in the past few weeks.

Domestically, indicators showed an acceleration of the already dynamic domestic demand, due to a stronger impulse from private consumption and also from investment in machinery & equipment. This also reflected in higher output growth, although the latter also owed to natural resource related sectors. This growth pattern could result in a widening of the current account deficit. However, the slower growth of bank loans in the last two months was something to bear in mind.

The surprises of headline inflation of the past two months reflected the greater contribution of foodstuffs, although mostly perishables. In fact, core inflation, which excludes energy and foodstuffs, was 1.9% y-o-y at October. These surprisingly high prices of some goods had not affected medium-term inflation expectations.

Thus, the Research Division again presented as the relevant option to keep the MPR at 5.0%. Raising it was ruled out because indicators suggested that the acceleration of output growth, i.e., those sectors more closely linked with price dynamics, had been somewhat milder, contrasting with domestic expenditure. Additionally, actual and expected inflation indicators were still in a zone consistent with the target. The option of cutting down the MPR could be warranted as a preventive measure considering the risk of a sharper deceleration of economic growth and inflation. This could be the case if the external risk scenario described in the last *Monetary Policy Report* materialized. However, the probability of occurrence of these scenarios had not increased, and it could even be contended that the risks associated with a sharp slowdown of the Chinese economy had become milder. At the same time, indicators showed still dynamic domestic demand and related figures, together with still favorable local financial conditions, so no imminent deceleration of domestic demand could be foreseen. The option of keeping the MPR unchanged, within a range of neutral values, provided time to wait and accumulate new information about the evolution of the external situation and its impact on the Chilean economy. Accordingly, the Board decided to hold the MPR at 5% annually.

I. INTERNATIONAL SCENARIO

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

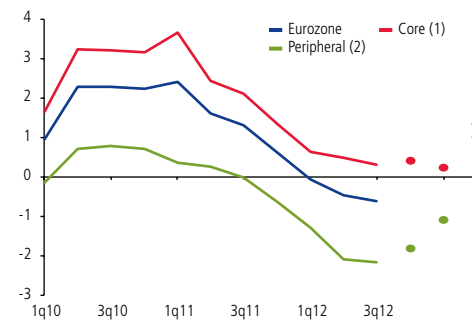
WORLD GROWTH

In the past few months, news on global growth has been mixed. In the emerging world, signs of slowdown in some of the large economies, such as China, have subsided. Meanwhile, news from developed countries is not so favorable and their economies are expected to continue weak for longer than was previously thought.

United States' figures suggest that the recovery continues, but at a slow pace. The unemployment rate is on the decline, but the jobs that were lost in the aftermath of the 2008 crisis are yet to be fully recovered, and growth in private consumption hinges on this. Still, consumer confidence is steadily improving. Surveys on the manufacturing and services sectors are consistent with its further growth while incoming real-estate figures show growing sales and a rebound of prices, which is also consistent with the high rates of housing investment in the third quarter. In any case, prospects for the U.S. economy are depending on the outcome of ongoing fiscal negotiations.

In the Eurozone, the third quarter's GDP contraction of 0.2% annualized quarterly (-0.6% annually), consolidated the projected scenario of recession in the region. A sharper than expected weakening of the stronger economies such as Germany and France added to the well-known drop in peripheral countries' activity. Peripheral economies continue to worsen with unemployment rates above 20% in some cases and output contraction ongoing for several quarters. In central Europe, a cause for concern is the evolution of some incoming indicators such as expectations, exports and manufacturing activity. Going forward, the baseline scenario of this Report foresees that the region will continue to be affected by fiscal and financial developments and that it will take even longer to bounce back. This, because market stress and bank funding difficulties are not helping credit. Add to this that the fiscal adjustment that is needed further weakens activity and deteriorates banks' assets. Finally, the complexity of the scenario is holding back investment and hiring decisions (figure I.1).

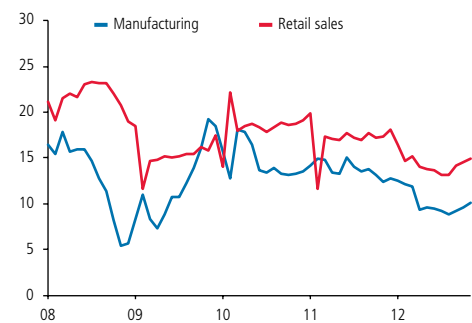
FIGURE I.1
GDP growth in the Eurozone (3)
(annual change, percent)



(1) Austria, Finland, France, Germany, Luxembourg, and the Netherlands.
(2) Belgium, Cyprus, Estonia, Greece, Ireland, Italy, Malta, Portugal, Slovakia, Slovenia and Spain.
(3) The dots indicate forecasts for 2012, 2013 and 2014.

Source: Central Bank of Chile based on a sample of investment banks, Consensus Forecasts and International Monetary Fund.

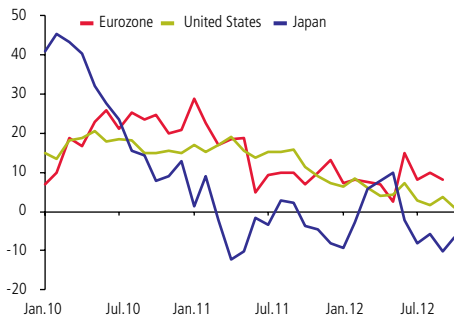
FIGURE I.2
China: Output indicators
(annual change, percent)



Source: Bloomberg



FIGURE I.3
Exports
(annual change, percent)



Source: Bloomberg.

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

	Avg. 90-99	Avg. 00-07	2011 (e)	2012 (f)	2013 (f)	2014 (f)
World at PPP	3.1	4.2	3.8	3.0	3.3	3.8
World at market exchange rates	2.7	3.2	2.8	2.4	2.6	3.2
Trading partners	3.1	3.6	4.2	3.3	3.5	4.0
United States	3.2	2.6	1.8	2.3	1.9	2.3
Eurozone	1.6	2.2	1.4	-0.5	-0.3	1.2
Japan	1.5	1.7	-0.6	1.9	0.5	0.9
China	10.0	10.5	9.3	7.7	8.0	8.2
India	5.6	7.1	6.5	5.6	6.6	6.4
Rest of Asia	5.6	5.1	4.2	3.5	4.3	4.7
Latin America (excl. Chile)	2.8	3.5	4.4	2.8	3.3	3.7
Commodity exporters	2.7	3.1	2.3	2.5	2.3	2.7

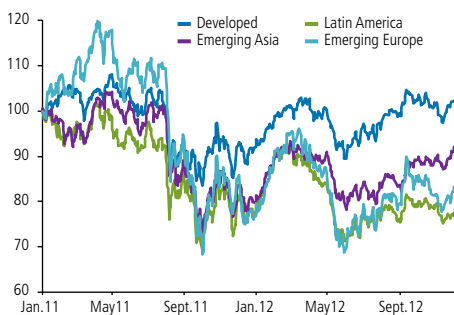
(e) Estimate.

(f) Forecast.

(*) See glossary for definitions.

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

FIGURE I.4
Stock market indicators
(index, 02/01/2011=100)



Source: Bloomberg.

The baseline scenario of this Report revises the growth forecast for Japan significantly down, taking note of its economy’s 3.5% q-o-q saar contraction in the third quarter, and also the corrections to historic GDP figures the country recently made. Prospects for the Japanese economy are also weak, as the reduction in shipments to the European market—the destination of a little over 10% of Japan’s total exports—compounds with a reduction in exports to China—nearly 20% of total exports—due to territorial conflicts between the two nations. Hence the worsening of output and manufacturing prospects. Going forward, there is also the effect on growth that the expected fiscal measures could have.

The emerging economies have had dissimilar behaviors. A number of them have seen a slowdown, but the weakness that some of the larger ones were enduring some months ago are now showing some signs of a reversal. In China, GDP dropped in the third quarter from y-o-y growth of 7.4%, from 7.6% and 8.1% the previous quarters and 9.3% in 2011. However, the most recent indicators suggest that the stimulus packages adopted by policy makers have been successful and have resulted in better exports, manufacturing production and retail sales indicators (figure I.2). In South Korea, despite a recent rebound of manufacturing, the exchange rate appreciation has eroded business expectations and the external sector is looking weak. In Brazil, third-quarter GDP posted an unexpected 0.9% y-o-y (2.4% q-o-q saar), mainly reflecting the contraction of gross fixed capital formation, which contrasts with still dynamic private consumption. Going forward a slow recovery is expected. In Colombia, the latest output indicators point to a slowdown. In Peru, GDP grew 6.5% y-o-y in the third quarter, despite a weak external sector. Argentina has also seen an important slowdown of activity and its local currency has depreciated nearly 13% in the year to date.

In the past few quarters, world growth has relied by stronger emerging economies. However, this scenario entails significant levels of risk, as the further weakening of the developed economies couples with decelerating world trade indicators (figure I.3). This puts a note of alert on growth sustainability of the emerging economies. However, the baseline scenario estimates that over the policy horizon, Chile’s trading partners will grow somewhat less than previously forecast (table I.1).

INTERNATIONAL FINANCIAL MARKETS

Our September Report warned of the existence of a series of events which, if taking a different direction than desired by economic agents, could trigger new episodes of significant stress. A number of these events showed a positive evolution, which added to the announcement made by the European Central Bank that it would launch the Outright Monetary Transaction (OMT) plan whereby it would purchase Eurozone government bonds and the agreement to create a single banking supervisor in the region. The situation in the Eurozone, however, continues to be very complex and its resolution hinges on thorny political and institutional negotiations, with conflicts and frictions, more so considering the growing social tensions that are being triggered by the debilitated growth and employment outlook. In addition, several peripheral

economies are facing strict debt-servicing calendars, which opens the door to new requests for help from the international financial community. Accordingly, new stress episodes can occur. All in all, the ECB's announcement, progress made in banking supervision and the recent agreement to release resources toward Greece is a sign that the authorities are willing to work out solutions.

On the other hand, fiscal issues being discussed in the United States are also a potential source of tension in the markets. The drastic conclusion of tax rebates and subsidies in early 2013 could hit the country's growth very hard if no agreement is arrived at on the subject, in a debate that was still ongoing at the closing of this Report. Most recently, the markets have reacted to news about how near or how distant is such an agreement. In addition, policy makers must look into the debt limit that will be reached again in early 2013.

Thus, financial indicators have continued to reflect the complexities of the situation and, while with some swings, the stock exchanges of developed economies, the markets' volatility and risk premiums are roughly where they were at the closing of our September Report (figures I.4 and I.5). Meanwhile, the dollar has appreciated slightly in the international financial markets.

Consistently with the poor growth outlook for developed economies, the interest rates on their government bonds are very near their historic lows, and no material change is foreseen in the medium term (figure I.6). Such a context favors capital flows into emerging markets—whose economic growth prospects are better and whose interest rates are higher than in the developed world—, a situation that has prevailed for some months now. Capital inflows have been invested in both stocks and bonds, mainly in emerging Asia (figure I.7). This phenomenon again entails difficulties in the accommodation of such flows in the aforesaid economies.

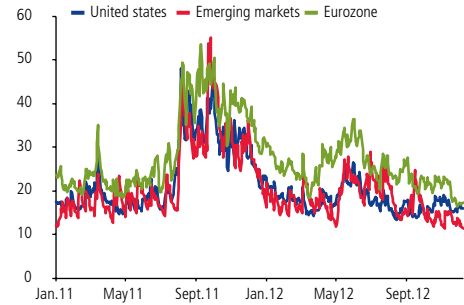
COMMODITIES

In the past few months, commodities have had dissimilar performances. Some prices have dropped responding, on one hand, to supply-side factors that affected them earlier. In some other cases, the perception of lower demand from developed economies has been behind price drops (figure I.8).

The copper price has fluctuated substantially since the last Report. After remaining fairly stable around US\$3.4 per pound for several months, in mid-September it rose to near US\$3.8, later to recede to earlier levels and resume a rising path towards the closing of this Report. The copper market is forecast to loosen somewhat because of the startup of new deposits and the extension of old ones. Accordingly, the average copper price forecast for 2013 does not change from September and will be lower than the 2012 average.

Fuel prices have fallen from the closing of the last Report. These movements respond largely to supply-side problems having been resolved in some refineries: the WTI oil price dropped close to 10%, while the gasoline price dropped by more than 20% since September. Not so steep was the drop in the Brent oil price (5% during the same period), relating with recent tensions in the Middle

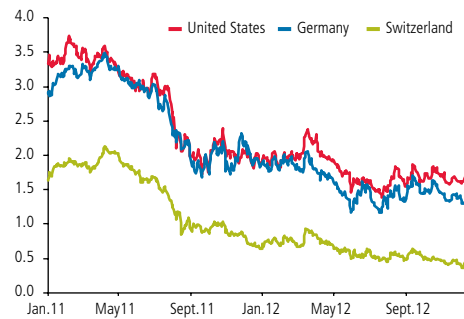
FIGURE I.5
Stock market volatility (*)
(percent)



(*) For the U.S., the VIX is used. For the Eurozone, Vstox. For emerging markets, an estimate of the historic volatility of the MSCI index denominated in dollars is used. See glossary for definition.

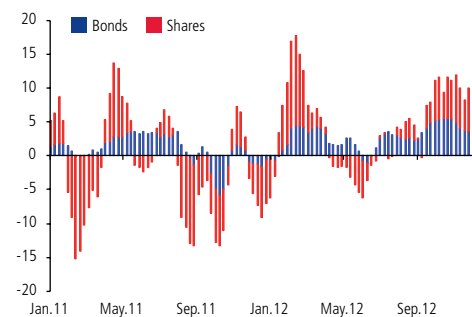
Source: Bloomberg.

FIGURE I.6
Interest rates on 10-year government bonds
(percent)



Source: Bloomberg.

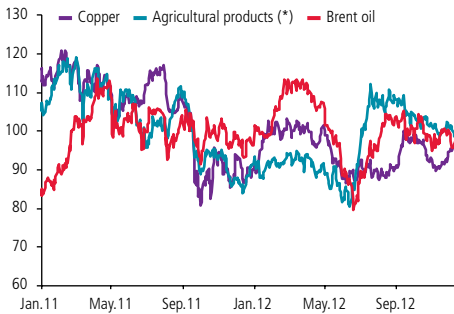
FIGURE I.7
Capital inflows to emerging economies
(billions of dollars, moving month)



Source: Emerging Portfolio Fund Research.

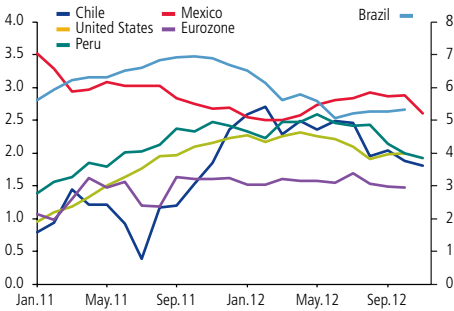


FIGURE I.8
Commodity prices
(index, period average=100)



(*) As per the Goldman Sachs aggregate index.
Source: Bloomberg.

FIGURE I.9
Core inflation
(annual change, percent)



Sources: Bloomberg, CEIC and statistics bureaus of respective country.

East. Reflecting the price drops of the past several months, futures contracts over the last ten working days before the closing of this Report, point at a fuel price trajectory not very different from the one foreseen last September.

Towards the closing of the last Report, emphasis was placed on the strong increase in foodstuff prices, especially for some grains. However, these have been declining due to expectations of better harvests. Still, the recent reductions are not enough to offset earlier increases: the wheat price rose by more than 40% between the Reports of June and September of this year, and after September it has receded by close to 5%.

INFLATION AND MONETARY POLICY

As regards inflation, although actual figures have shown a somewhat rising trend in several economies, this is the result of some pass through from food price increases some months ago in emerging economies. In the developed economies, the larger incidence has come from energy prices. Thus, core indicators show no major changes (figure I.9). In line with this scenario, for this year and next market consensus forecasts do not significantly vary from forecasts of a few months back.

In general, the central banks of emerging economies, as well as those of some developed ones have gradually continued with processes of monetary policy rate cuts. Meanwhile, the bigger developed economies have intensified their application of unconventional monetary policies to boost growth. In the United States, the Federal Reserve announced that it will buy long term Treasury bonds as well as its intention of holding the policy rate flat as long as the unemployment rate remains above 6.5% and some conditions for inflation expectations are met. The Japanese monetary authority expanded its asset purchases and the European Central Bank announced the implementation of a government bond purchase plan.

II. FINANCIAL MARKETS

This chapter reviews the recent evolution of the main local financial markets from a monetary policy perspective.

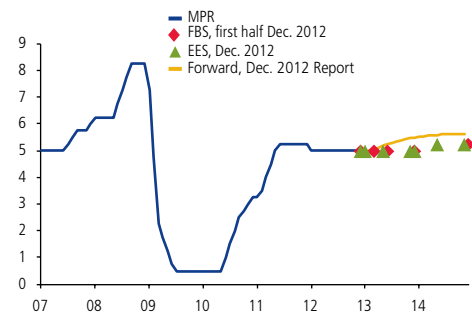
MONETARY POLICY

The macroeconomic scenario facing the Chilean economy has shown no big changes in the past several months. The external situation is still complex. Developed economies continue to show weak growth. The emerging world's growth outlook, despite some signs of recovery, remains uncertain. Risks prevail in the Eurozone and a resurgence of financial tensions in the coming months cannot be ruled out. The local scenario has exhibited stronger growth in output and demand. The Board has held the monetary policy rate (MPR) at 5% since the monetary policy meeting of January 2012, stating that any future changes to the policy rate will depend on the implications of domestic and external macroeconomic conditions on the inflation outlook.

At the statistical closing of this Report, the various measures of market expectations regarding the future of the MPR suggest that it should stay flat for many months. The December Economic Expectations Survey (EES) and the Financial Brokers Survey (FBS) of the first half of December anticipate a rise in the MPR of 25 basis points (bp) two years ahead, after remaining unchanged through December 2013. The expectations that can be inferred from financial prices also suggest an increase in the MPR, but sooner (figure II.1). Thus, considering the different measures of expectations one year ahead, the MPR would range between 5.0% y 5.5% (4.7% and 5.2% in December's Report) and for two years ahead, between 5.3% y 5.6%. (5.0% and 5.4% in September's Report) (table II.1). The baseline scenario of this Report uses as a working assumption that the MPR trajectory will be stable, as suggested by the latest surveys available at the statistical closing of this Report.

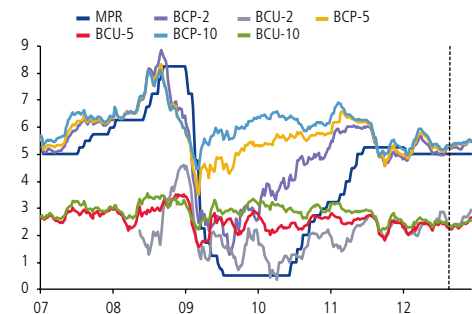
The interest rates on Central Bank and Treasury documents are higher than those in the previous Report, coinciding with higher output figures recently made available. However, this increase has been somewhat steeper for indexed rates than for non-indexed rates. As of the statistical closing of this Report, the latter are close to 5.5% for maturities between two and ten years. At the closing of this Report, BCU rates are in the 2.6% to 2.9% range for two-, five- and ten-year maturities. (figure II.2).

FIGURE II.1
MPR and expectations
(percent)



Source: Central Bank of Chile.

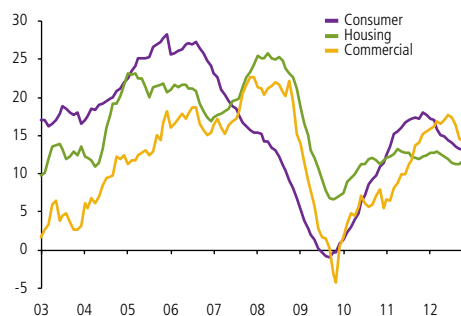
FIGURE II.2
MPR and interest rates on Central Bank of Chile documents (*)
(weekly averages, percent)



(*) Dotted vertical line indicates statistical cutoff date of the September 2012 Report.

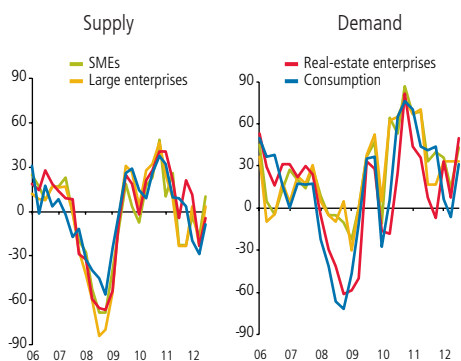
Source: Central Bank of Chile.

FIGURE II.3
Nominal loans by type of credit
(annual change, percent)



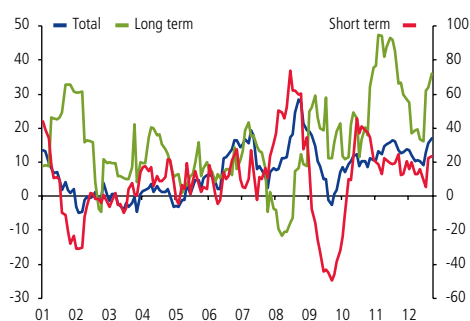
Sources: Central Bank of Chile and Superintendencia of Banks and Financial Institutions (SBIF).

FIGURE II.4
Bank Lending Survey (*)
(net responses, percent)



(*) Average responses per quarter. Negative (positive) value indicates more contractionary (expansionary) conditions than last quarter.
Source: Central Bank of Chile.

FIGURE II.5
Non-financial entities' gross external debt
(annual change, percent)



Source: Central Bank of Chile.

TABLE II.1
Expectations for the MPR
(percent)

	One year ahead		Two years ahead	
	September Report	December Report	September Report	December Report
EEE (1)	5.00	5.00	5.00	5.25
FBS (2)	5.00	5.00	5.00	5.25
Forward curve (3)	5.18	5.50	5.42	5.64
Swap contracts (4)	4.73	5.12	5.01	5.26

(1) Surveys of August and December 2012.
(2) Surveys of second half of August and first half of December 2012.
(3) Built using interest rates of swap contracts up to two years, and later BCP interest rates.
(4) Built using interest rates of swap contracts up to two years.

Source: Central Bank of Chile.

FINANCIAL CONDITIONS

The lending standards of local banks have been modified somewhat with respect to the first half of the year. The main change has been the sharper decline in y-o-y growth in lending during recent months (figure II.3). On the household's side, as of November its y-o-y growth rate dropped to 12.2% (13.7% in August). The interest rates on these loans, in the most important brackets (i.e., from 181 days to one year, and over three years) dropped between 120 and 230 bp since August. As regards housing loans, y-o-y growth and interest rates have not changed much in 2012 to date. According to the Bank Lending Survey (BLS) of the third quarter of 2012, banking institutions perceived a strengthening of the demand for both consumer and housing loans. However, on the supply side there was a tightening of the conditions to access consumer loans.

As for commercial loans, y-o-y growth dropped significantly from 16.4% in August to 13.9% in November. Their month-to-month velocity of expansion has also diminished. The same as with consumer loans, interest rates on these credits for the most significant durations, dropped by 60 bp to 70 bp between August and November.

Together with the slowdown of commercial loans, the BLS of the third quarter of this year showed more stringent standards for the approval of credit to some sectors, particularly building and real-estate firms, due to a perception of higher credit risk associated with real-estate clients (figure II.4). As was mentioned in our *Financial Stability Report* for the second half of 2012, risks in this sector stem from the time span going from the start up of the building works to the final sale, which, if a demand shock hits, could lead to a supply-demand mismatch. Moreover, business contacts across several regions of the country report that firms perceive that credit access conditions have tightened over the course of the third quarter and in the fourth quarter to date. The reason would be that credit profile reviews have become more rigorous in some regions and institutions. Meanwhile, demand has strengthened for every credit category.

As for other funding sources, the issuance of corporate bonds has been fairly stable in the past several months, where worth noting is the increase in issuances for the purpose of liability restructuring. Meanwhile, the gross external debt of non-financial entities shows an increase in the weight of long-term funding (figure II.5). Funding via leasing increased by 11% y-o-y at September of this year. As for external funding, the debt increased through bonds its y-o-y growth speeded up significantly, as it went from 19.0% in the second quarter to 24.2% in the third quarter of this year.

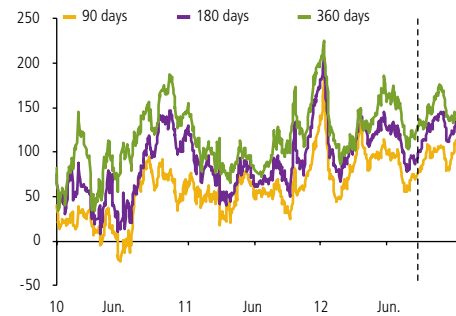
As for debt default indicators, as mentioned in our *Financial Stability Report*, the overall non-performing-loans (NPL) index remains stable and in line with the increase in household income, while the NPL of housing loans has declined in recent months, to settle below its historic average. Default indicators for consumer credit from banks and other consumer credit providers (i.e. department stores and cooperatives) have remained stable in the past few months; however, the latter have shown some deterioration.

Regarding interest rates in the money market in pesos, since the closing of the last Report the prime swap spreads at various maturities have shown fluctuations, particularly, the hike seen between September and October stands out. Accordingly, the Board announced on 8 November of this year a temporary program aimed at smoothing the management of peso liquidity in the financial system, with the purpose of taming possible tensions that could build up towards the end of the year. Under this program, the Central Bank of Chile offers a *repo* at a floating rate (i.e. the MPR plus 25 basis points) at 60- and 90-day terms. Said operations were offered until 18 December 2012. After the announcement of the aforesaid liquidity injection program, the prime-swap spreads dropped. Most recently, part of such drop has reversed. Since the closing of the last Report, they increased between 18 and 35 bp (figure II.6). The interest rates on peso deposits that trade in the stock exchange, and on dollar-denominated loans at 90 and 180 days, with their ups and downs, are somewhat above their levels shown in September's Report.

Beyond their usual daily volatility, international stock markets have risen since September (figure II.7). The stock markets of developed economies rose slightly and, measured by the MSCI indexes, increased 2.2% in local currency (2.8% in dollars), taking the last ten working days prior to the statistical closing of this and the last Report. The domestic stock market, affected by idiosyncratic factors, has performed not so favorably: -0.8% measured in pesos (0.1% in dollars). In the year so far, this indicator has risen by 11.3% in dollars (1.8% in local currency). Comparing this and the last Report, in their respective local currencies, the Latin American stock markets rose 2.2% (1.1% in dollars). The emerging Asian stock markets rose 6.4% in local currency (8.8% in dollars).

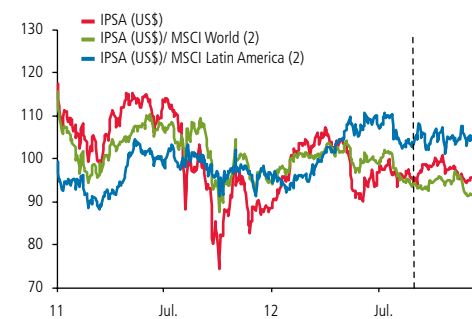
The y-o-y growth rate of nominal monetary aggregates has fallen in the past few months (figure II.8). According to information available at November, M1 increased 9.0% annually (12.5% in July); M2 and M3 rose by 13.8% and 11.0%, respectively (22.5% and 19.3% in July).

FIGURE II.6
Money market spread in pesos (1) (2)
(basis points)



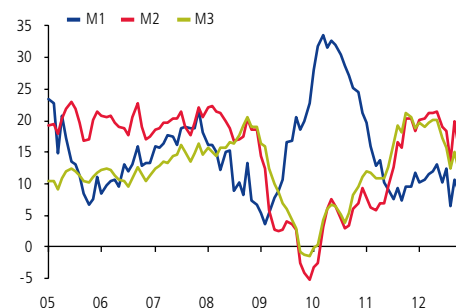
(1) Measured by prime-swap interbank spread. See glossary for definition.
(2) Dotted vertical line indicates statistical cutoff date of the September 2012 Report.
Source: Central Bank of Chile.

FIGURE II.7
Stock markets (1)
(index, 01/01/2011-12/13/2012=100)



(1) Dotted vertical line indicates statistical cutoff date of the September 2012 Report.
(2) Morgan Stanley Capital International stock indexes by region.
Source: Bloomberg.

FIGURE II.8
Monetary aggregates
(annual change, percent)

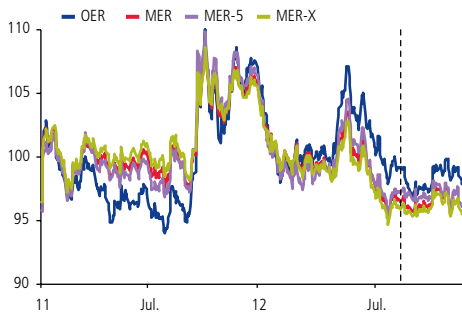


Source: Central Bank of Chile.



FIGURE II.9

Nominal exchange rate (1) (2)
(index, 01/03/2011-12/13/2012=100)



(1) See glossary for definition.
 (2) Dotted vertical line indicates statistical cutoff date of the September 2012 Report.
 Source: Central Bank of Chile.

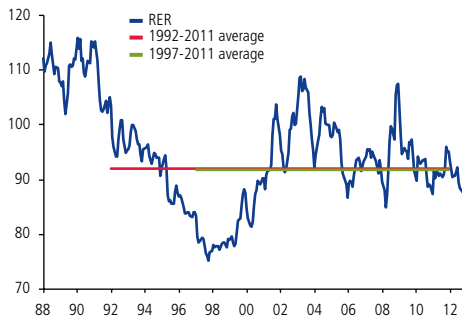
EXCHANGE RATE

In the past few months, the U.S. dollar depreciated slightly at the global level. Comparing the statistical closings of this and September’s Report, the multilateral dollar rose by 2%. The peso fluctuated, but overall the peso/dollar parity and the multilateral exchange rates changed little if at all between the two Reports. Thus, during the period the peso appreciated 0.8% against the dollar, and 0.2% against a currency basket (MER). At the statistical closing of this Report, the parity was \$475 pesos to the dollar. The behavior of the peso has been similar to that of the currencies of other commodity exporting economies and Latin America (figure II.9).

The real exchange rate (RER) has not changed much in the past few months. In November it was at 88.5 (88.4 in August). Considering the nominal exchange rate and the parities prevailing during the ten days prior to the statistical closing of this Report, the RER is near 88 (figure II.10). This figure is in the lower part of the range of values consistent with its long-term fundamentals. The baseline scenario of this Report uses as a working assumption that, over the projection horizon, the RER will remain around its recent indicators.

FIGURE II.10

Real exchange rate (*)
(index, 1986=100)



(*) December figure includes data up to 13 December 2012.
 Source: Central Bank of Chile.

III. DEMAND AND OUTPUT

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

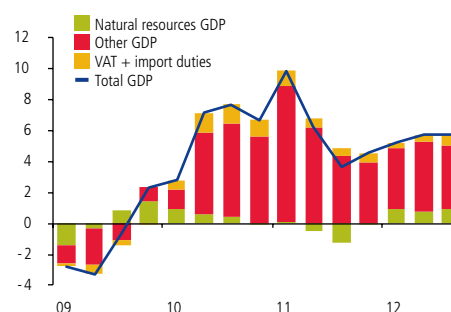
SECTORAL ACTIVITY

In the third quarter of 2012, output grew 5.7% y-o-y, the same as in the second quarter, but above expectations. August's Economic Expectations Survey (EES)—available at the closing of last Report—anticipated a growth rate of 4.6% y-o-y for the third quarter. This higher growth rate is explained by a better overall performance. Measured at factor cost, output's y-o-y growth was less than in the previous quarter: 5.7% in the third quarter (8.3% in the second). With respect to the previous quarter, output increased 5.7% y-o-y (8.3% in the second), a similar rate to that of the first quarter of 2012 (figure III.1).

By sectors, natural resources grew more than in the previous quarter in y-o-y terms. This better performance was primarily related to mining: 5.7% y-o-y (2.7% in the second quarter). This is partly explained by the low basis for comparing with the same period in 2011, but also by an increase in copper production in recent months thanks to access to deposits of higher grade ore, better operating conditions and the startup of new productive facilities. The volume of mining exports, contrasting with the second quarter, posted a drop in y-o-y terms: -2.4% (+0.1% in the previous quarter). This difference between volume produced and exported resulted in an accumulation of inventories that affected domestic demand, which has been gradually reversing with the recovery of copper shipments the months afterwards. The Electricity, gas & water (EGW) sector continued to decelerate: 6.4% y-o-y growth (13.1% in the second quarter). This owed mainly to lower value added in electric generation, because of hydric resources being replaced by carbon and gas. The fishing industry again posted a negative y-o-y growth rate, mainly due to reduced salmon culture production compared with a year before (table III.1).

In the third quarter, the other sectors' aggregate reduced its y-o-y expansion rate with respect to the second. Nevertheless, growth in this group continued to be driven by those branches linked to domestic demand and, to a lesser extent, the external sector. Financial services, construction and trade continued to lead this expansion, the latter two being somewhat more dynamic than in the previous quarter. Construction continued to grow in y-o-y terms around 8%, while trade rose to 8.6% (7.2% in the second quarter). Stronger growth in trade was particularly driven by retail sales of consumer goods and wholesale

FIGURE III.1
Contribution to annual GDP growth (*)
(real annual change, percentage points)



(*) See glossary for definition.

Source: Central Bank of Chile.

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

	Weight 2011	2010	2011	2012		
				I	II	III
Agriculture-forestry	2.8	2.3	11.2	-6.5	3.9	6.9
Fishing	0.4	2.2	17.1	-12.1	-2.1	-5.8
Mining	15.2	1.1	-4.8	3.0	2.7	5.7
Manufacturing	10.9	3.4	6.6	3.6	3.5	-0.3
EGW	2.4	10.7	12.5	24.1	13.1	6.4
Construction	7.4	1.7	11.1	9.2	8.2	7.9
Trade	7.9	17.5	12.1	7.0	7.2	8.6
Restaurants & hotels	1.6	8.9	9.7	4.1	4.4	2.2
Transportation	4.1	8.5	8.4	5.9	7.7	6.0
Communications	1.9	9.2	6.9	6.9	6.5	5.7
Financial services	4.2	6.1	9.3	8.0	9.1	9.5
Entrepreneurial services	13.0	7.4	8.2	8.2	6.8	5.5
Personal services (2)	10.6	5.3	7.0	6.3	6.9	6.7
Total GDP	100.0	6.1	6.0	5.2	5.7	5.7
GDP at factor costs (3)	91.7	5.5	5.8	5.3	5.8	5.5
Other GDP	73.8	6.0	7.9	5.3	6.2	5.6
Natural resources GDP	17.9	2.9	-2.3	5.4	4.0	5.5

(1) Preliminary figures.

(2) Includes education and healthcare—public and private—and other services.

(3) See glossary for definition.

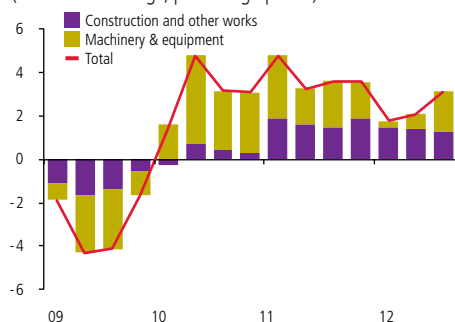
Source: Central Bank of Chile.

TABLE III.2
Domestic demand (*)
(weight in GDP; real annual change, percent)

	Weight 2011	2010			2011			2012		
		I	II	III	I	II	III	I	II	III
Domestic demand	96.7	14.8	9.4	4.6	6.8	8.0				
Domestic demand (w/o inventory change)	95.2	10.3	10.2	5.2	6.1	7.6				
Gross fixed capital formation	23.2	14.3	17.6	8.0	9.0	13.3				
Construction and other works	13.9	1.9	12.7	10.9	10.0	8.8				
Machinery & equipment	9.3	40.3	25.8	3.4	7.5	19.9				
Total consumption	72.0	9.0	7.9	4.4	5.1	5.9				
Private consumption	60.2	10.0	8.8	4.9	5.4	6.4				
Durable goods	5.8	35.4	23.6	14.2	11.5	12.8				
Non-durable goods	25.1	8.7	6.9	2.2	3.6	6.1				
Services	29.3	7.4	7.7	5.4	5.8	5.5				
Government consumption	11.8	3.9	3.9	1.1	3.6	2.9				
Inventory change (annual accum.)	1.5	2.0	1.3	1.2	1.3	1.5				
Exports of goods and services	38.1	1.4	4.6	5.7	0.9	-3.4				
Imports of goods and services	34.7	27.4	14.4	4.1	3.2	2.5				
Total GDP	100	6.1	6.0	5.2	5.7	5.7				

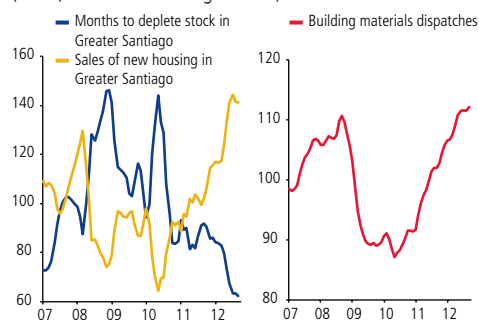
(*) Preliminary figures.
Source: Central Bank of Chile.

FIGURE III.2
Contribution to annual investment growth
(real annual change, percentage points)



Source: Central Bank of Chile.

FIGURE III.3
Real estate sector (*)
(index, 2007-2012 average = 100)



(*) Moving quarter. Seasonally-adjusted series. Figures at September in left-hand panel; figures at October in right-hand panel.

Source: Chilean Chamber of Construction (CChC).

sales mainly related to investment goods. Other sectors linked to domestic demand, such as entrepreneurial services, transport, communications, and restaurants & hotels reduced their y-o-y variation rates from the second quarter. Manufacturing production posted negative y-o-y variation: -0.3% (+3.5% in the second quarter), because of a one-time drop in diesel oil refining. Other branches associated with manufacturing production changed little from the second quarter. Meanwhile, manufacturing exports recorded reductions in volumes compared with the same quarter of 2011, especially in forestry, wood pulp and fishmeal, which were partly offset by increased shipments of wines and salmons.

Thus, total output accumulated 5.6% growth in the first three quarters of the year. In the baseline scenario, the Board estimates that the economy will grow 5.5% in 2012. This figure is above the September Report's forecast. Market expectations have the same forecast for the year and have also gradually adjusted upward their growth scenario over the past few months. In particular, the Economic Expectations Survey (EES) went from 4.9% in August to 5.5% in December. Towards 2013, the Board estimates that GDP growth will be in the range from 4.25% to 5.25%, above the September forecast. The December EES foresees GDP growing 4.8% (4.7% in August).

DOMESTIC DEMAND

In the third quarter, domestic demand accelerated its pace of expansion with respect to the previous quarter. This result was explained mainly by an increase in investment in machinery and equipment, added to a somewhat stronger impulse from private consumption and greater accumulation of mining inventories. In y-o-y terms, therefore, domestic demand grew 8.0% (6.8% in the second quarter). After discounting inventories, the increase becomes 7.6% (6.1% in the previous quarter) (table III.2 and figure III. 2).

As for investment, the machinery and equipment component grew 19.9% y-o-y during the third quarter (7.5% in the second). This higher growth is largely explained by imports of transportation materials, a factor that extended into October and November, our latest available data on foreign trade. Other capital goods imports showed no change in their behavior. Investment related with construction and other works remained strong. In y-o-y terms, it grew less than in the second quarter. The scenario for private investment has not changed significantly. The prospects are that it will continue to perform well in the coming quarters, particularly investment in mining and construction. The survey of the Capital Goods Corporation (CBC) of September revised upward the investment forecast for construction and engineering works in the period 2013-2015, due mainly to adjustments to mining and real-estate projects. The same survey, however, revised downward its forecast for investment in energy projects, which puts a note of caution, particularly regarding how this could affect the implementation of mining projects. In construction, dispatches of building materials regained strength in October, thanks to strong demand from

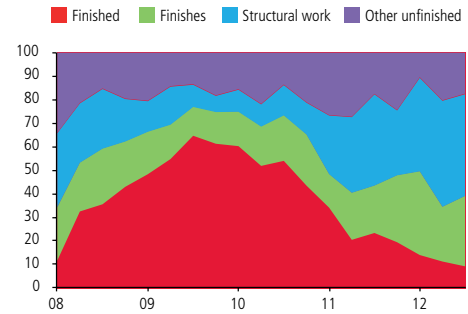
the housing market: third-quarter sales of new homes, by different measures (i.e., Collect and Chilean Chamber of Construction), remained high. Consulted business contacts report strong dynamism of catalogue sales. Also, as reported in our *Financial Stability Report* of the second half of 2012, in the residential sector, promises to purchase houses and apartments have risen above actual sales, with sustained rising of their prices. Nevertheless, labor costs and availability of labor force in some regions of the country, as reported by business contacts, have become a cause for concern and in some cases is hindering project execution. The Bank Lending Survey (BLS) of the third quarter showed more stringent standards for the approval of credit, particularly to building and real-estate firms, due to a perception of higher credit risk associated with their clients. However, no substantial changes are seen in related interest rates. Nevertheless, the BLS also reveals a strengthening of demand for mortgage loans, as well as for the other sectors (figure III.3) (figure III.4).

Private consumption performed somewhat better than in the previous quarter. Nevertheless, it is evolving in line with its fundamentals (Box III.1). In nominal terms, in the moving year ended in the third quarter, private consumption amounted to the equivalent of 61% of GDP and 64% of private gross national disposable income, that is, close to historic averages. Moreover, the determinants of private consumption are still favorable and have shown no substantial changes. The unemployment rate, measured by the National Statistics Institute and the University of Chile, has remained low, around 6.5%. The wage mass has remained dynamic, but with a change in composition: nominal wages moderated their y-o-y rate of expansion, while job creation in recent months increased for both the salaried sector and self-employment. Consumer confidence, measured by the economic perception index (IPEC), has remained in the expansion zone. Regarding financial conditions, interest rates on consumer loans in the most important segments, are lower than in September, while lending standards reported by the third quarter's BLS are somewhat tighter. However, the same survey reveals growing demand for credit (figure III.5) (figure III.6).

Stronger growth in private consumption during the quarter was particularly visible in non-durable goods. In y-o-y terms, it went to 6.1% in the third quarter (3.6% in the second). Durable consumption, meanwhile, increased 12.8% y-o-y (11.5% in the second quarter) (figure III.7).

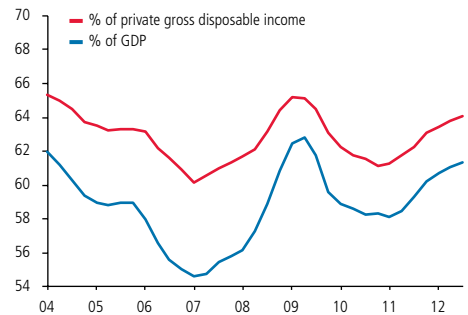
Inventories accumulated the equivalent of 1.5% of GDP in the last moving year ending in the third quarter. This level is not very different from the second quarter (1.3% of GDP). As already mentioned, a great part of the higher inventory buildup is explained by the intensified accumulation of copper inventories that was generated by a difference between copper production and exports. To a lesser extent, there was also some accumulation of manufacturing inventories. All considered, the increase in inventories in this quarter was substantially smaller than in the previous quarter.

FIGURE III.4
Housing sales by building status
(percentage of total)



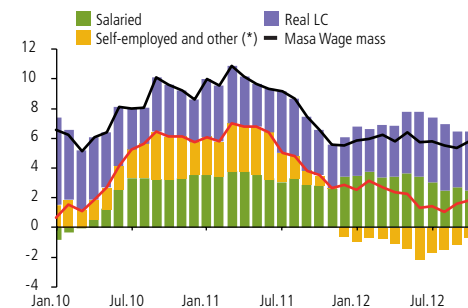
Source: Chilean Chamber of Construction (CChC).

FIGURE III.5
Nominal private consumption
(accumulated in a moving year)



Source: Central Bank of Chile.

FIGURE III.6
Wage mass
(annual change, percent)

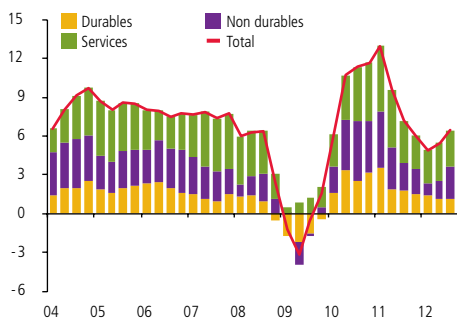


(*) Includes employers, service staff, non-remunerated family members, accounting for roughly 10% of total employment.

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

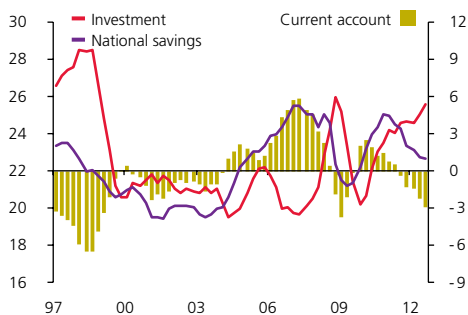


FIGURE III.7
Contribution to annual private consumption growth
(real annual change, percentage points)



Source: Central Bank of Chile.

FIGURE III.8
Current account, national savings and investment
(percentage of GDP, accumulated in a moving year)



Source: Central Bank of Chile.

CURRENT ACCOUNT

The current account of the balance of payments posted a deficit of US\$4,783 million in the third quarter, or 2.9% of GDP in the last moving year (2.3% in the second quarter). This deficit is larger by US\$1,784 million than it was in the same period of 2011. The difference is explained by the trade balance, which decreased by US\$2,089 million in the same time span. This was due to a decline in valued exports (US\$1,849 million) and an increase in imports (US\$240 million). The drop in exports was primarily associated with a decline in the copper price, which compounded with a drop in volume exports of copper. The change in imports was largely explained by volume imports of capital goods (23.8% y-o-y) (figure III.8). The baseline scenario of this Report assumes that the current account deficit will amount to 3.8% of GDP in 2012 and 4.6% of GDP in 2013.

The Board pays close attention to the evolution of the current account deficit. Its level, persistence and funding sources are all aspects that may affect the vulnerability of the Chilean economy, particularly if confronted with adverse external scenarios. Overall, today's deficit has many peculiarities that mitigate the associated risks. First, a significant part is explained by higher investment in a number of projects aimed at the production of exportable goods and services. Second, a major part of the deficit is being financed via foreign direct investment rather than external debt. Finally, the evolution of domestic and external credit is showing no signs of overborrowing by either households or firms. The evolution of private consumption does not divert far from what can be inferred from labor income, the low rate of unemployment and financial conditions. Furthermore, as was already noted, private consumption has been evolving in line with its fundamentals.

BOX III.1 PRIVATE CONSUMPTION BEHAVIOR

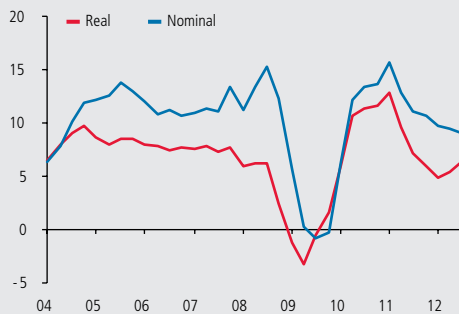
One aspect of the country's economic performance that has stood out in the past few quarters is the behavior of private consumption. The slowdown of this aggregate has not been as intensive as was foreseen in previous reports. This raises the question of why this increased dynamism has originated. This box looks into some indicators to answer the question.

To begin with, it is important to note that throughout 2012 private consumption has increased its y-o-y growth rate measured in real terms, in prices of the chained base year. The picture changes when it is measured in prices of the current year, that is, in nominal prices. Actually, in this latter measure, private consumption growth has remained on the downward trend it has been following since 2011 (figure III.9).

growth over the past several years (figure III.10). In fact, real y-o-y growth in private consumption has outperformed GDP most of the time in the last ten years (figure III.11).

The differences in the behavior of nominal and real ratios of private consumption to GDP originate in their respective deflators. Compared with GDP deflators, which include the effects of export prices, the relative prices of private consumer goods have been declining steadily since 2003 (figure III.12). In durable goods, this difference has been even bigger. Most noteworthy is the drop in the prices of electronic equipment in the last few years, followed by clothing. Factors such as the peso appreciation, fast technological obsolescence and the ever growing presence of low-cost imported goods have played a part in the trajectory of durable goods prices.

FIGURE III.9
Private consumption
(annual change, percent)



Source: Central Bank of Chile.

FIGURE III.10
Private consumption
(accumulated in a moving year)



Source: Central Bank of Chile.

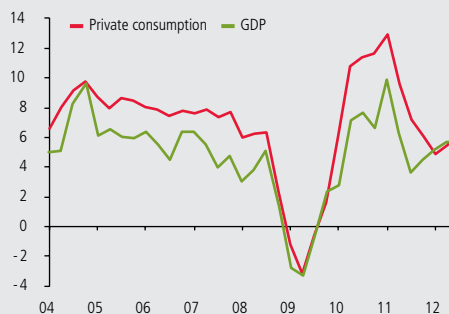
Secondly, when measured in terms of private disposable income or nominal GDP, the level of private consumption has risen in recent times, but is near its historic averages. In real terms, the ratio of private consumption to GDP does show sustained



Finally, behavior of private consumption has been consistent with personal income and financial conditions. On one hand, in the labor market, since the end of 2011, the unemployment rate has been around its fifteen-year lowest, and the wage mass has sustained y-o-y growth near 6%. On the other hand, financial conditions have remained favorable. In the most important segments (i.e., from 181 days to one year, and over three years) interest rates on consumer loans have remained constant for quite some time. This, within a context where demand, as inferred from the Bank Lending Survey (BLS), has expanded over the past year, and consumer credit standards have tightened somewhat only in the last quarter. Add to this that consumer confidence, measured by the economic perception index (IPEC), is again in the expansion zone since mid-2012, after a year and a half in pessimistic territory. It is worth noting the improved evaluation of conditions for household purchases by the survey's respondent. Last November, 51% of the respondents thought that the time was good to make such purchases, compared to 40% in midyear.

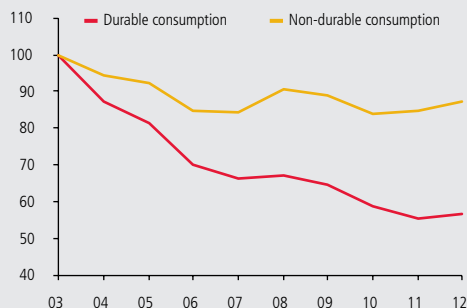
Although the behavior of private consumption has been consistent with the trajectory of its fundamentals, it is important to bear in mind that if the dynamism of private consumption intensifies, unwanted risks may arise, either because of the effects on inflation and the current account, or the possible incubation of financial imbalances. Sudden changes in macroeconomic conditions could trigger difficult adjustments in the national economy.

FIGURE III.11
Private consumption and output
(real annual change, percent)



Source: Central Bank of Chile.

FIGURE III.12
Private consumption deflators relative to GDP deflators
(index, 2003=100)



Source: Central Bank of Chile.

IV. PRICES AND COSTS

This chapter examines recent trends in the main components of inflation and costs, identifying different sources of existing inflationary pressures and their probable future behavior.

RECENT INFLATION TRENDS

Annual CPI inflation is lower than at the statistical closing of our previous Report, but it had significant swings during the period. After being at 2.5% in July, it rose to 2.9% in October and dropped to 2.1% in November (figure IV.1 and table IV.1). The prices of perishable foods (i.e., fresh fruits & vegetables) were decisive in this oscillating trajectory. Actually, from August to November inflation accumulated 1.1 percentage points (pp), with monthly inflation rates between 0.8% (September) and -0.5% (November). Meanwhile, y-o-y growth of the core measure that excludes foodstuffs and energy (CPIEFE) has been much less volatile, declining from 2.5% to 1.8% between July and November, despite output's dynamism. The preponderance of supply factors in the behavior of monthly inflation has been reflected in the stability of inflation expectations. Both one year ahead and towards the end of the projection horizon, said expectations have remained around 3.0%. Nevertheless, medium-term inflationary risks are still present, as domestic markets continue to be tight.

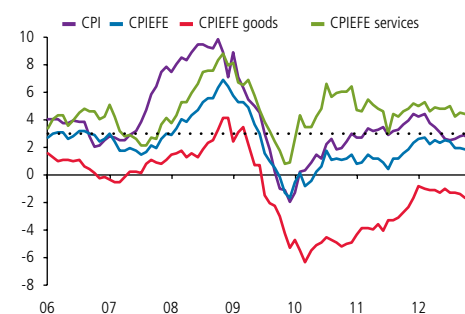
TABLE IV.1
Inflation indicators (*)
(annual change, percent)

	CPI	CPIX	CPIX1	CPI w/o foods and energy	CPI tradables	CPI non tradables	CPI goods	CPI services
2011 Jan.	2.7	2.0	0.5	0.8	1.2	4.8	1.0	4.8
Feb.	2.7	2.1	0.4	0.9	1.2	4.7	0.9	4.8
Mar.	3.4	2.4	0.7	1.4	1.8	5.5	1.6	5.6
Apr.	3.2	2.4	0.7	1.2	1.7	5.2	1.4	5.4
May.	3.3	2.5	1.1	1.2	1.8	5.2	1.7	5.2
Jun.	3.4	2.4	0.9	0.9	2.3	4.9	1.9	5.4
Jul.	2.9	1.9	1.4	0.4	2.5	3.4	2.0	4.0
Aug.	3.2	2.3	1.5	1.2	2.0	4.7	2.0	4.6
Sep.	3.3	2.1	1.5	1.2	2.5	4.3	2.4	4.3
Oct.	3.7	2.5	1.9	1.5	2.9	4.7	3.1	4.4
Nov.	3.9	2.8	2.0	1.9	3.2	4.8	3.4	4.5
Dec.	4.4	3.3	2.5	2.4	3.8	5.2	3.9	5.1
2012 Jan.	4.2	3.2	2.7	2.6	3.6	5.1	4.0	4.6
Feb.	4.4	3.5	2.8	2.7	3.6	5.4	4.0	4.9
Mar.	3.8	3.1	2.6	2.3	3.0	4.7	3.7	3.9
Apr.	3.5	2.6	2.7	2.5	2.4	5.0	3.5	3.5
May.	3.1	2.7	2.3	2.4	1.9	4.7	2.4	4.0
Jun.	2.7	2.5	2.3	2.5	1.0	4.8	1.8	3.6
Jul.	2.5	2.4	2.3	2.5	0.6	4.9	1.6	3.6
Aug.	2.6	2.0	1.9	2.0	1.3	4.2	2.2	3.0
Sep.	2.8	2.2	2.1	2.0	1.6	4.5	3.0	2.7
Oct.	2.9	2.1	2.0	1.9	1.8	4.4	2.9	3.0
Nov.	2.1	1.7	2.1	1.8	0.4	4.3	1.6	2.7

(*) See glossary for definition.

Source: National Statistics Institute (INE).

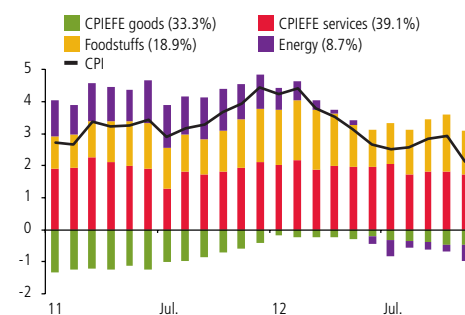
FIGURE IV.1
Inflation indicators (*)
(annual change, percent)



(*) See glossary for definition.

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

FIGURE IV.2
Contributions to annual CPI inflation (*)
(percentage points)



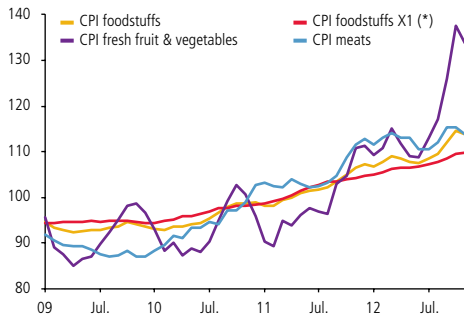
(*) In parentheses, shares in CPI basket.

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

FIGURE IV.3

Food prices

(index, Jan.2009-Nov.2012 average = 100)



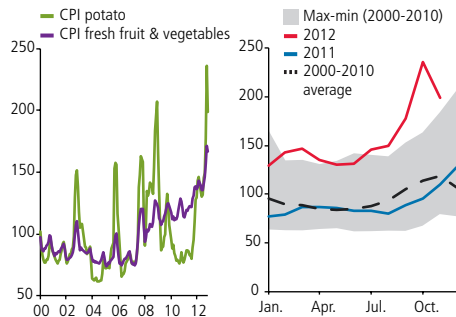
(*) See glossary for definition.

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

FIGURE IV.4

Potato price

(index, Jan. 2000-Nov.2012 average = 100)

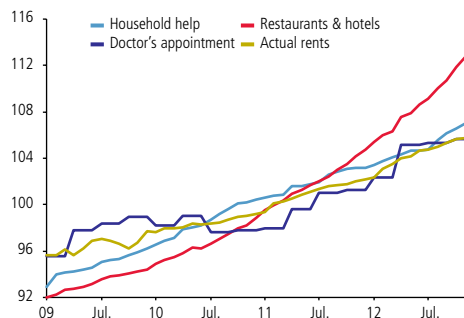


Sources: Central Bank of Chile and National Statistics Institute (INE).

FIGURE IV.5

Services prices

(index, 2009-2012=100)



Source: National Statistics Institute (INE).

Between August and November, as has been said, the CPI accumulated an increase of 1.1pp. This increase contrasts with the -0.2pp decline it accumulated between April and July. This is explained primarily by food prices, which contributed 1.0pp in the last few months. Energy contributed 0.05pp to accumulated inflation. By component, fuels contributed 0.26pp and electricity -0.21pp. Core inflation had virtually no weight (0.05pp) in the aggregate, but continued to show a divergence between the performances of goods and services inflation. The former contributed -0.11pp of inflation in the period, while the latter added 0.16pp. In y-o-y terms, foodstuffs and services continued to explain the positive y-o-y inflation rate. Energy and the CPIPEF's goods component continued to have a negative incidence in y-o-y inflation (figure IV.2).

As aforesaid, in the last few months the largest contributors to inflation were foodstuffs. By component, fresh fruits and vegetables stood out, with an accumulated incidence of 0.6pp between August and November (figure IV.3). Inside this category, the largest increase came from potatoes, which hit a record high in October, and contributed 0.21pp to monthly inflation between August and November (figure IV.4). Despite a decline last month, the price of potatoes is still high and remains, as it has throughout this year, above its average for 2000-2010 and 2011 figures. According to reports by the Agricultural Policy and Research Bureau (Odepa), the potato price increase is due to a reduction in supply. During the last several months, supply-side problems also affected the prices of other products such as tomatoes and pumpkins, which had a significant positive incidence, beyond seasonal effects.

The prices of non-perishable foodstuffs have shown no change in trajectory and have continued to have a positive incidence in monthly inflation. Thus, between August and November they added 0.4pp to inflation. The global increase in food prices, which was a preoccupying factor some months ago, has tended to subside most recently. For example, the prices of grains (e.g., wheat and corn) are slightly below those in the previous Report. In particular, the Goldman Sachs grain index has fallen around 9% since September. However, it is still high compared to the first half of the year (+30% since June, the month when it began to rise). At any rate, forecasts for these prices have been revised downward in the short term, as better harvests are expected. Two years ahead, however, they match the prices derived from market futures at September.

As for energy prices (i.e., fuels and electricity), their contribution to accumulated inflation between August and November was higher than it had been between April and July. This trend was determined mainly by the prices of fuels, which contributed 0.26pp in the same period, largely concentrated in August. This, because of the increase in the international prices of oil and derivatives that occurred at the time, mainly due to supply-side factors. However, in mid-September these prices dropped. Thus, the price of gasoline from the Gulf of Mexico is more than 20% below those seen at the statistical closing of last Report. Such declines reflected in the domestic market, mainly from October

onwards. The exchange rate had little to do with these price movements as the peso appreciated slightly since the last Report. However, in the projection horizon, the oil price forecast does not change significantly. It has been corrected downward for the short term, but two years ahead it will return to the levels foreseen in the September Report. The lower short-term prices are explained by greater supply and weaker demand than previously estimated. The gasoline price is revised downward for the whole projection horizon, as it couples with more refining expected. Conversely, the price of liquefied natural gas has been rising steadily since August. According to the National Statistics Institute (INE), this rise, particularly since November, is due to variations in the international benchmark indicators used in national prices. Meanwhile, the price of electricity continued to have a negative incidence, accumulating a contribution of -0.21pp in recent months. In y-o-y terms, energy prices continued to contribute negatively to inflation.

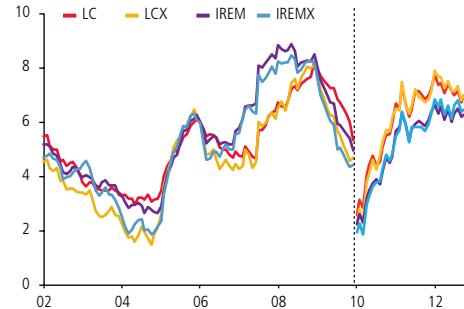
The CPI excluding foodstuffs and energy (CPIEFE) accumulated an increase of 0.1pp in the last four months, less than between April and July, despite a more dynamic economy. By component, services inflation increased a little over 0.4pp over the same time span, less than from April to July (1.5pp). Goods inflation dropped somewhat less than 0.4pp (-1.5pp between April and July).

The prices of goods in the CPIEFE are somewhat below those of July and showed a path less downward marked than in the first half of the year. Movements were determined by used car prices, technological products (computers and cell phones), clothing and household items. The prices of imported consumer goods, both in pesos and in dollars, declined in the third quarter.

The prices of services in the CPIEFE have continued on an upward path. From August to date, the biggest positive contribution to CPIEFE services inflation came from on-premise lunch services (0.1pp). Passenger transport by intercity bus, contrasting with the trend up to September, had the greatest negative incidence between August and November (-0.18pp). In y-o-y terms, CPIEFE services inflation reduced its growth rate from almost 5.0% to a little more than 4.0% between August and November. Nevertheless, the prices of most services, including health care, rent, education, restaurants and hotels, continued to have a positive incidence in y-o-y services inflation, and no change is foreseen in this trend (figure IV.5).

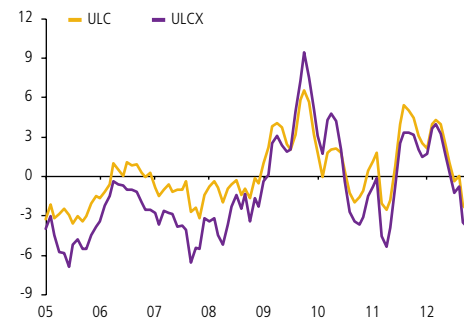
Nominal wages have continued to grow between 6% and 7% y-o-y in the past several months (figure IV.6). By productive sectors, the wages of mining and construction workers are on a high growth trend: 9% to 10% y-o-y, while manufacturing and trade show rates between 6% and 7%. It is worth noting that the stronger growth of mean labor productivity has helped to moderate annual growth in real labor costs (box IV.1). The growth rates of real wage indicators adjusted by mean labor productivity began to decline in the second quarter. Thus, in October its y-o-y variation was between -2.5% and -4%, depending on the metric used (figure IV.7). It should be noted, however, that mean labor productivity figures can be very procyclical, even though its trend

FIGURE IV.6
Nominal wages (1) (2)
(annual change, percent)



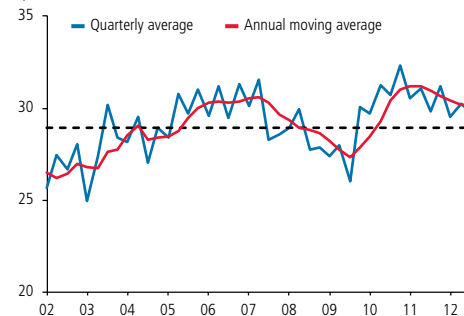
(1) As from January 2010 new indexes with annual base 2009=100 are used, so figures are not strictly comparable with earlier ones.
(2) See glossary for definition.
Sources: Central Bank of Chile and National Statistics Institute (INE).

FIGURE IV.7
Labor costs adjusted for productivity (*)
(annual change, percent)



(*) See glossary for definition.
Sources: Central Bank of Chile and National Statistics Institute (INE).

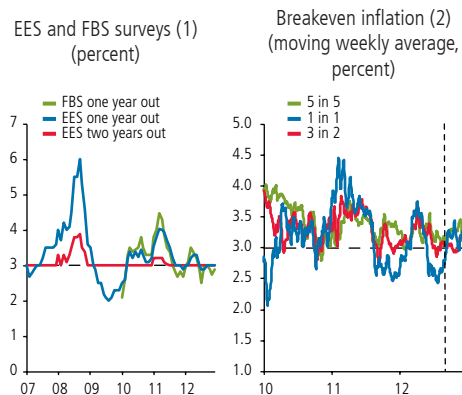
FIGURE IV.8
Sales operating margin (*)
(percent)



(*) Ratio of gross profit to sales income. Average of four enterprises with highest share in sales, weighted by sales income. Dotted line indicates 2001-2012 average.
Sources: Central Bank of Chile and Superintendencia of Securities and Insurance (SVS).



FIGURE IV.9
Inflation expectations



(1) FBS considers survey of first half of the month.
 (2) Forward breakeven inflation based on swap rates.
 Dotted vertical line indicates statistical cutoff date of the September 2012 Report.

Source: Central Bank of Chile

evolution can be smooth. In any case, the labor market continues to be tight with dynamic y-o-y growth in the wage mass. Business contacts report that the difficulties to find labor have intensified in some sectors and regions of the country, including mining, construction and agriculture. The outlook that is derived from the monthly index of entrepreneurial confidence (IMCE) also reflects a tight labor market. Accordingly, wage expectations are up from the September Report, especially for the construction and manufacturing industries.

Operating margins, specifically in the trade sector, have compressed during the year to near the 2001-2012 average (figure IV.8). Such compression could be caused by more permanent changes, but also by cycle-related temporary changes that may be reversed in the coming months.

INFLATION OUTLOOK

Despite the ups and downs of headline inflation in the past few months, inflation expectations for the end of the projection horizon remained unchanged at 3.0%. This suggests that inflationary surprises were due to specific supply-side factors, while the strengthening of the economy has not resulted in a rebound of core inflation indicators. One year ahead, although with dissimilar movements, they are also around 3.0%.

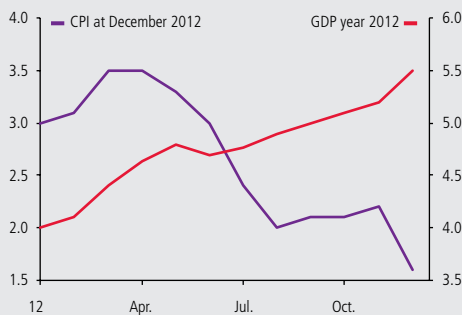
Private inflation expectations derived from the Economic Expectations Survey (EES) have stayed at 3.0% one and two years ahead. Expectations one year ahead derived from the Financial Brokers Survey (FBS) dropped, with fluctuations, and are now at 2.9% in the FBS of the first half of December (3.0% for the survey of the second half of August). Two years ahead they have remained at 3.0%. The IMCE continues to forecast inflation one year ahead around 3.2%. The percentage of respondents who think that inflation will rise "a lot" in the next twelve months, as measured by the economic perception index (IPEC), fluctuated between 51% and 58% since August; in particular, in November it was 54% (56% in the September Report). Inflation expectations derived from the breakeven inflation rates, at different terms, oscillated and are currently somewhat above those in the previous Report. However, they remain around 3.0% (figure IV.9).

In the baseline scenario, y-o-y CPI inflation will be below the tolerance range for some months and will later approach 3% at the end of 2013, the same as in the projection horizon, this time the fourth quarter of 2014.

BOX IV.1 INFLATION AND OUTPUT GAPS

Throughout 2012, both the forecasts in the Monetary Policy Report and private expectations have revised downward the outlook for inflation, and upward for GDP growth (figure IV.10). In March 2012, the Report estimated that inflation would average 4.0% in the year; this Report lowers such estimate to 3.0%. GDP growth forecast in March was in the 4% to 5% range, and is here raised to 5.5%. This has also coincided with an increase in the projection for y-o-y growth in domestic demand.

FIGURE IV.10
Projections in Economic Expectations Survey
(annual change projection in indicated month, percent)



Source: Central Bank of Chile

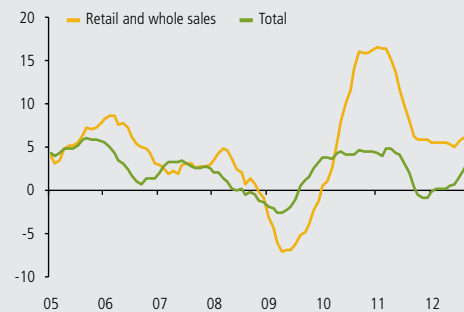
These changes in projections have come as a surprise, as increased activity has probably implied a more intensive utilization of installed capacity, but not an acceleration in the inflation trajectory. Actually, core inflation is today below 2% and its forecast for 2013 is also lower than was thought some months back. However, the difference in the behavior of core inflation of goods and services persists: while the former continues to post negative y-o-y rates, the latter is growing by around 4% (figure IV.1).

This box examines some of the hypotheses that might explain this pattern of higher economic growth and lower core inflation.

A first hypothesis refers to the possible gains of productivity that might allow stronger output growth without increasing price pressures. Recent data shows that y-o-y growth in mean labor

productivity has increased in the past few quarters, after the drop it experienced in 2011. This has driven it above the 2004-2011 average (figure IV.11). More striking is what occurs in the retail and whole sales sectors, where the increase in productivity was significant in 2010 and is now outperforming the economy's aggregate indicator.

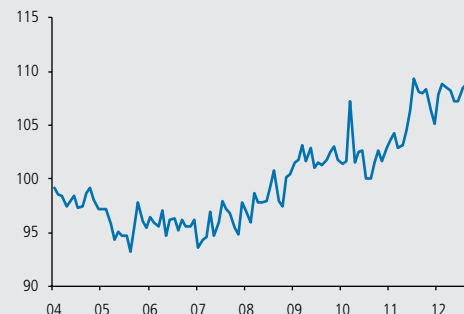
FIGURE IV.11
Price of consumer goods imports (IVUM)
(annual change, percent)



Source: Central Bank of Chile

The increase in productivity, despite sustained growth in wages, allows a moderation of unit labor costs, adjusted by hours worked (figure IV.12). This latter factor is one element that can explain the low inflationary pressures seen so far.

FIGURE IV.12
Unit labor costs
(Index, January 2004-September 2012 average=100)



Source: Central Bank of Chile



Along with this, it is important to underscore that despite increased employment and the consequent decline in unemployment, wage growth at the aggregate level has remained relatively bounded (figure IV.13). Employment growth has been accompanied by an increase in the labor force, especially women, whose participation is higher in sectors like retail and whole sales, where wages weigh heavily in costs. This, together with the aforesaid gains in productivity, could have allowed this sector to meet a growing demand without a substantial increase in costs. Accordingly, information provided by business contacts also suggest that the bigger wage pressures and shortages of labor are seen mainly in sectors such as agriculture, mining, and construction, but not in trade. Indeed, nominal wages of construction and mining workers show higher y-o-y increases than the average for all the other sectors.

FIGURE IV.13
Unemployment and wages
(index, Jan. 1992-Sep. 2012 average = 100)

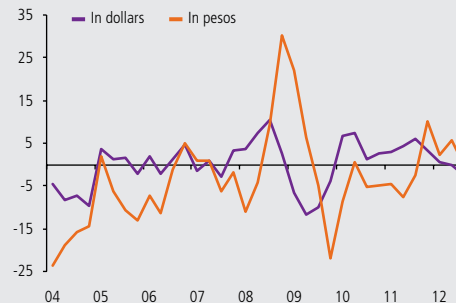


Sources: Central Bank of Chile and National Statistics Institute (INE).

A second hypothesis has to do with the value of imported goods included in the consumer basket. Partly because of the international cycle, but also due to the evolution of costs in the producing countries, the prices of imported goods have exhibited systematic decreases. Most recently, there is also the evolution of the exchange rate, which has also played a part in reining in import cost pressures (figure IV.14).

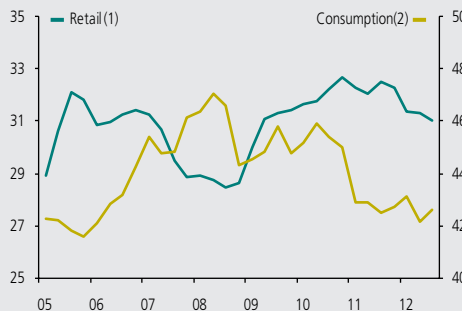
Finally, a third hypothesis points at a compression in margins that has helped contain inflation. Beyond the aforementioned favorable evolution of labor and import costs, some compression in margins has been observed. Their current levels, although stable in the past few quarters, are certainly smaller than they were some years ago (figure IV.15).

FIGURE IV.14
Price of consumer goods imports (IVUM)
(annual change, percent)



Source: Central Bank of Chile.

FIGURE IV.15
Operating margins
(seasonally-adjusted series, percent)



(1) Cencosud, Falabella, Ripley and Walmart.
(2) Andina, CCU, Concha y Toro, Embonor, Iansa and San Pedro.

Source: Central Bank of Chile based on uniform codified statistical form (FECU) applicable to listed companies.

Nevertheless, it is possible that the different hypotheses raised here respond to temporary rather than permanent movements. For example, productivity typically has a significantly procyclical behavior, although its trend follows a much smoother evolution. In the case of lower margins, this could be the result of structural changes in the economy, associated with higher competition among firms or commercial strategies aimed at gaining market share. However, it is also possible that they obey to cyclical movements that could be reversed in the future. For the same reason, the Board estimates that medium-term inflationary risks relating to the intensive utilization of installed capacity are still present and they are significant.

V. INFLATION SCENARIOS

This chapter presents the Board's assessment on the Chilean economic outlook over the next two years, including the analysis carried out until the monetary policy meeting of 13 December 2012. 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 base, the impulse that the Chilean economy will receive from abroad in the next two years will be milder than forecast in the previous Report (table V.1). Trading partners' lower growth than foreseen in September is behind this revision, as the projection for external financial conditions is similar and for the terms of trade is slightly better than assumed then, but lower than current levels.

For 2013 and 2014, trading partners' growth is revised down three tenths of a point each year, to 3.5% and 4.0%, respectively, primarily because of the expected downturn in the performances of the Eurozone and Japan. The Eurozone is expected to take longer to come out of the recession, and to recover at a slower pace. This change in the projection is grounded in the weakness of some of the core European economies and the protracted contractions of peripheral economies. This couples with the persistence of tightened financial conditions to accommodate the complex situation of the region. Plus, it is in line with recent revisions by some international institutions to growth estimates for the zone. The correction to Japan's growth takes into account the significant downward revision to historic GDP figures that Japan recently made, which largely explains the change in the outlook for 2012 and into 2013. It also considers the effect of the reduction in Japanese exports to two of its main trading partners—the Eurozone and China—on output and, in particular, its manufacturing industry. Toward 2014, there is also the expected impact of fiscal consolidation measures on growth. These adjustments will reflect in some deceleration in the rest of the world, although these corrections are smaller in magnitude.

The copper and oil price forecasts for 2013 and 2014 in the baseline scenario are fairly unchanged from projections in September. This, despite the fact that fuel prices have dropped in recent months as some supply-side problems have been resolved and the expected decline in the demand from the developed world. Also in the past few months copper traded at higher prices than foreseen in the last Report, prompting an upward revision of the copper price forecast for this year. Thus, considering the prices of futures contracts over the last ten working days before the closing of this Report, average prices of US\$ 105 and US\$ 100 per barrel of Brent oil

TABLE V.1
International baseline scenario assumptions

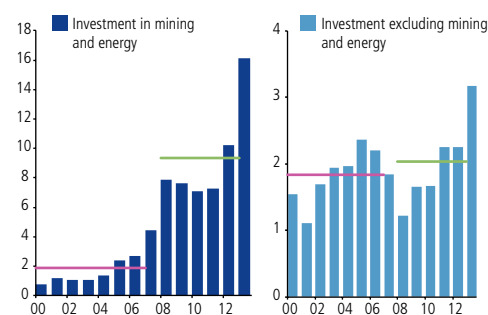
	2011	2012 (f)	2013 (f)	2014 (f)
	(annual change, percent)			
Terms of trade	0.5	-5.0	-0.8	1.3
Trading partners' GDP (*)	4.2	3.3	3.5	4.0
World GDP at PPP (*)	3.8	3.0	3.3	3.8
World GDP at market exchange rates (*)	2.8	2.4	2.6	3.2
External prices (in US\$)	10.1	-0.4	0.0	0.4
	(levels)			
LME copper price (US\$/cent/lb)	400	361	340	350
WTI oil price (US\$/barrel)	95	94	90	90
Brent oil price (US\$/barrel)	111	112	105	100
Gasoline parity price (US\$/m3) (*)	803	825	741	700
Libor US\$ (nominal, 90 days)	0.3	0.4	0.4	0.5

(*) For a detailed definition, see glossary.

(f) Forecast.

Source: Central Bank of Chile.

FIGURE V.1
Investment by sector (*)
(billions of dollars)



(*) Pink lines show the 2000-2007 average; green lines show 2008-2013 average.

Source: Capital Goods Corporation (CBC).

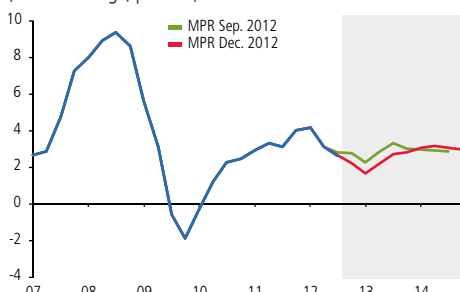
TABLE V.2
Economic growth and current account

	2011	2012 (f)	2013 (f)
	(annual change, percent)		
GDP	6,0	5,5	4,25-5,25
National income	6,1	5,2	4,6
Domestic demand	9,4	6,6	5,7
Domestic demand (w/o inventory change)	10,2	6,8	6,0
Gross fixed capital formation	17,6	11,3	7,6
Total consumption	7,9	5,3	5,5
Goods and services exports	4,6	2,7	3,0
Goods and services imports	14,4	5,5	5,9
Current account (% of GDP)	-1,3	-3,8	-4,6
National savings (% of GDP)	23,4	22,0	21,6
GFCF (% of nominal GDP)	23,2	24,4	25,2
GFCF (% of real GDP)	26,2	27,7	28,4
	(millions of dollars)		
Current account	-3,221	-10,000	-12,950
Trade balance	10,792	2,350	-1,050
Exports	81,411	77,600	77,300
Imports	-70,619	-75,250	-78,350
Services	-2,417	-1,500	-1,500
Rent	-14,015	-12,750	-12,350
Current transfers	2,418	1,900	1,950

(f) Forecast.

Source: Central Bank of Chile.

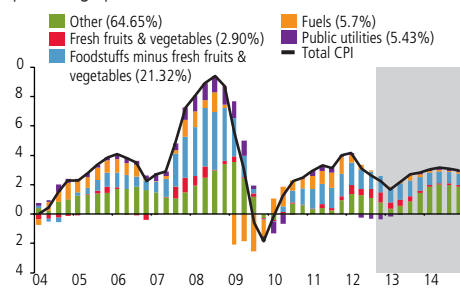
FIGURE V.2
CPI inflation forecast (1) (2)
(annual change, percent)



(1) Gray area, as from the fourth quarter of 2012, shows forecast.
(2) For December 2012, the median of monthly inflation is considered, as forecast in the Economic Expectations Survey.

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

FIGURE V.3
Contribution to annual CPI inflation (1) (2)
(percentage points)



(1) Gray area, as from the fourth quarter of 2012, shows breakdown of inflation forecast in the baseline scenario.

(2) In parentheses, shares in CPI basket.

(3) For December 2012, the median of monthly inflation is considered, as forecast in the Economic Expectations Survey.

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

are projected for 2013 and 2014, respectively. The copper forecast is maintained at an average of US\$3.45 per pound in the two-year period 2013-2014. The terms of trade will be better than forecast in September, but still lower than in 2012.

In Chile, domestic output and demand growth exceeded September's projections. The baseline scenario foresees GDP growth of 5.5% in 2012. For 2013, the baseline scenario assumes slower growth, in the range of 4.25% to 5.25%, influenced by the weaker external impulse in exports, but offset mainly by higher expected investment during the period. All considered, this forecast assumes that Chile's macroeconomic conditions will change little going forward and the economy will grow in line with the trend, which the Board continues to estimate at around 5%.

In the past few quarters, the dynamism of domestic demand has relied mainly on strong gross fixed capital formation (GFCF). In the third quarter, its strength owed largely to the significant increase of its machinery and equipment component, especially imports of transportation material. This couples with a significant impulse from investment in construction and infrastructure, which will continue to affect expenditure during several months of 2013. This will respond, on one hand, to the expected boost that mining investment will continue to provide (figure V.1), and, on the other hand, to the evolution of the real-estate sector. Today, catalog housing sales are high: 80% of third-quarter total sales, compared with the 2011 average of around 50%. This suggests that the activity of this part of investment and construction will be very strong in 2013. All this combination of factors will drive GFCF as a percentage of GDP to rise in 2013 to all-time high levels of 28.4% and 25.2% in real and nominal terms, respectively. In the baseline scenario, private consumption will continue to grow in line with its fundamentals, therefore remaining strong over the projection horizon (box III.1). Accordingly, the national saving rate will drop to 21.6% of GDP in 2013. Finally, in the baseline scenario, the structural fiscal deficit will remain at 1% of GDP, as announced by the authority.

The expansion of domestic expenditure above the September forecast, coupled with the weakening of the world economy and its effects on exports—visible primarily in 2013—will reflect in a current-account deficit that will exceed the September projections: 3.8% and 4.6% of GDP in 2012 and 2013, respectively. Considering that the higher current account deficit is mainly due to a change in quantities, measured in trend prices it will approach 6% of GDP in 2013^{1/}. The Board pays close attention to the evolution of the current account deficit. Its level, persistence, composition and funding sources are all aspects that may affect the vulnerability of the Chilean economy, particularly if confronted with adverse external scenarios (table V.2).

In the baseline scenario, y-o-y CPI inflation will stand below the tolerance range in the coming months, to start rising later and approach 3% by the end of 2013 and at the projection horizon, this time the last quarter of 2014. There are several factors explaining the lower figures foreseen for the near future, including the high basis for comparison of late 2011 and the turn of 2012. Core inflation will post y-o-y variations below 2% over most of 2013, then it will rise gradually to near 3% over the course of 2014 (figures V.2 and V.3) (table V.3).

^{1/} This calculation considers revisions to prices, not volumes. Long term prices of US\$2.8 per pound of copper and US\$80 per barrel of oil are assumed.

This path assumes that wages will grow in line with productivity and target inflation. In addition, it relies on the methodological assumption that, over the projection scenario, the RER will remain around its recent values. This reflects the fact that the Board continues to estimate that, with the prevailing nominal exchange rate and currency parities, the RER is in the lower part of the range consistent with its long-term fundamentals. Finally, the baseline scenario uses as a working assumption that the MPR trajectory will be stable, as suggested by the latest surveys available at the statistical closing of this Report (figure V.4).

RISK SCENARIOS

The baseline scenario reflects those events that are believed to be the most likely with the information at hand at the closing of this Report. There are risk scenarios, however, which if materialized, may reshape the macroeconomic environment—in some cases, significantly—and therefore, may alter the course of monetary policy. On this opportunity, having evaluated the alternative scenarios, the Board estimates that the risk balance is unbiased for both output and inflation (figures V.5, V.6 and V.7).

In the world economy, the main risk continues to be associated to the situation in the Eurozone. Although some advances have been made, the inherent risks are still present. On one hand are the difficulties in implementing agreements. On the other, as time has passed, the economic situation of the most affected countries has complicated further, while core European economies seem to be taking a turn for the worse. A sharper deceleration in Germany or France could aggravate the problems in the region and amplify pass-through channels to other economies. Neither can this analysis rule out episodes of volatility in the financial markets that could be more severe than the ones considered in the baseline scenario. And there is the ongoing discussion in the United States to ward off a sharp fiscal adjustment in 2013. Failure to reach an agreement could significantly hamper growth and increase market volatility.

In the emerging world, again the biggest risk comes from the pace of economic activity. On one hand, incoming data suggests that China has resumed stronger growth, but the weakening of Europe and pending discussions in the United States could affect the Chinese economy, and through it the rest of the emerging world. This could be particularly important to Chile because of its incidence in the copper price. On the other hand, the recent drop in world trade growth figures is cause for concern.

In Chile, capacity utilization is still intensive, and a strengthening of domestic demand could trigger inflationary pressures incompatible with the inflation target. So far, increased activity has not resulted in higher inflation, which can be explained by factors such as higher average labor productivity or compressed margins. However, figuring out whether these phenomena are permanent or temporary is a difficult task, so medium-term inflationary risks remain in place. Add to this the persistently tight conditions in the labor market.

A more dynamic domestic demand could amplify the current account deficit and increase the economy's external vulnerability, eventually confronting it with costly potential adjustments. In the past, most of the crises that the country endured were preceded by high and persistent current account deficits, an excessive increase

TABLE V.3

Inflation

	2011	2012 (f) (2)	2013 (f)	2014 (f)
	(annual change, percent)			
Average CPI inflation	3,3	3,0	2,3	3,1
December CPI inflation	4,4	1,6	2,9	
CPI inflation in around 2 years (1)				3,0
Average CPIPEE inflation	1,3	2,2	1,7	2,7
December CPIPEE inflation	2,4	1,6	2,3	
CPIPEE inflation in around 2 years (1)				2,8

(f) Forecast.

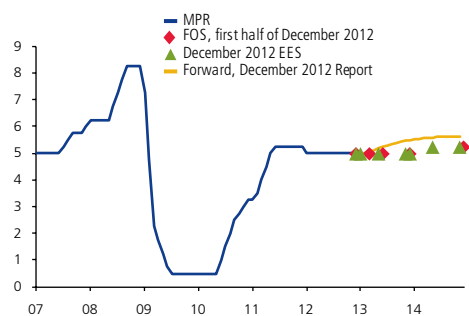
(1) Inflation forecast at the fourth quarter of 2014.

(2) For December 2012, the median of monthly inflation is considered, as forecast in the Economic Expectations Survey.

Source: Central Bank of Chile.

FIGURE V.4

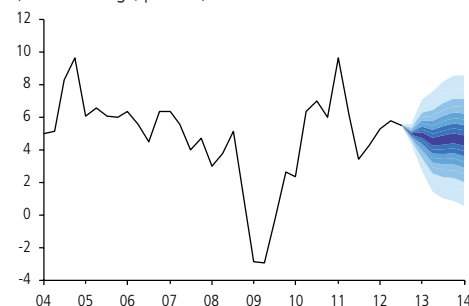
MPR and expectations (percent)



Source: Central Bank of Chile.

FIGURE V.5

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

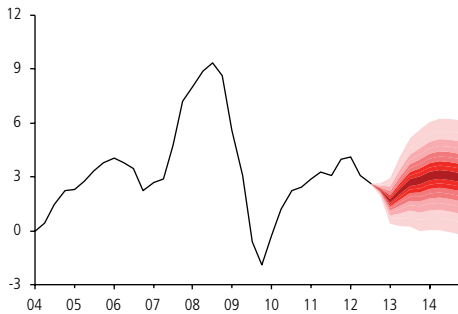


(*) The figure shows the confidence interval of the baseline projection base over the respective horizon (colored area). Confidence intervals of 10%, 30%, 50%, 70% and 90% around the baseline scenario are included. These intervals summarize the risk on growth as assessed by the Board. The baseline scenario uses as a working assumption that the MPR trajectory will be stable, as suggested by the latest surveys available at the statistical closing of this Report.

Source: Central Bank of Chile.



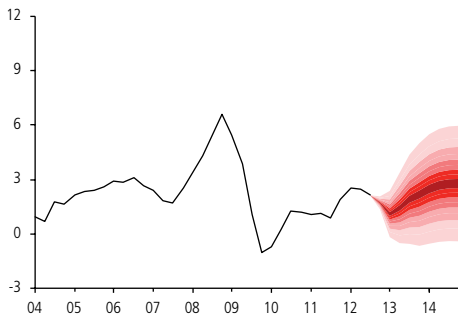
FIGURE V.6
CPI inflation forecast (*)
(annual change, percent)



(*) The figure shows the confidence interval of the baseline projection base 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 risk on future inflation as assessed by the Board. The baseline scenario uses as a working assumption that the MPR trajectory will be stable, as suggested by the latest surveys available at the statistical closing of this Report.

Source: Central Bank of Chile.

FIGURE V.7
CPIEFE inflation forecast (*)
(annual change, percent)



(*) The figure shows the confidence interval of the baseline projection base 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 risk on future inflation as assessed by the Board. The baseline scenario uses as a working assumption that the MPR trajectory will be stable, as suggested by the latest surveys available at the statistical closing of this Report.

Source: Central Bank of Chile.

in borrowing, and important currency mismatches. However, today's economic policy framework is more advanced, including a rule that governs fiscal policy and cushions the impact on public expenditure of both copper price fluctuations around its long-term trend and the ups and downs of the business cycle. It also includes a floating exchange rate regime that puts currency risks under the light allowing an early response to sudden changes in external conditions. It also contemplates proper financial regulation and supervision to prevent the incubation of excessive risk. Accordingly, the Board estimates that it is paramount to closely monitor those factors that are behind the current account deficit, in order to avoid the incubation of imbalances that may affect the future performance of the economy.

As has been said before, the current scenario depicts significant risks that call for policy responses in different directions. On one hand, although its effects on the Chilean economy have been mild, the external situation is fragile and its unfolding is still unclear. Major economies are showing signs of weakness and have historically expansionary monetary policies in place. Chile is a small economy, commercially and financially open, so it will not be immune to global developments. On the other hand, its solid domestic output and demand mean that medium-term inflationary risks are still present. The MPR is within the range of values considered neutral. The Board follows closely the evolution of the external and domestic macroeconomic scenarios and their implications on inflation, and reiterates its commitment to conduct monetary policy in such a way that projected inflation stands at 3% over the policy horizon.

GLOSSARY

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

Commodity exporters: Australia, Canada and New Zealand.

CPIEFE: CPI minus prices of foodstuffs and energy, leaving 72% of the total basket.

CPIX: Core consumer price index. CPI excluding fuels and fresh fruit and vegetables, leaving 91% of the total CPI basket.

CPIX1: CPIX excluding fresh meat and fish, regulated utility rates, indexed prices, and financial services, leaving 73% of the total CPI basket.

GDP at factor cost: Total GDP less net VAT revenue and import duties.

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

GDP, other: Includes the following industries: agriculture/livestock and forestry; manufacturing industry; construction; wholesale and retail trade; transport and communications; financial and entrepreneurial services; housing property; personal services; and public administration.

Growth of trading partners: Growth of Chile's main trading partners, weighted by their share in total exports during two moving years. Countries considered are the destination of 93% of total exports, in average, for the 1990-2011 period.

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

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

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

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

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

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

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

MER: Multilateral exchange rate. A measure of the nominal value of the peso against a broad basket of currencies, weighted as for the RER. For 2011: Argentina, Belgium, Brazil, Canada, China, Colombia, France, Germany, Italy, Japan, Mexico, the Netherlands, Paraguay, Peru, South Korea, Spain, Switzerland, Thailand, the United Kingdom and the United States.

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

Outright Monetary Transactions (OMT): A European Central Bank program consisting of the unlimited purchase of government bonds.

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

Repos: Repurchase (resale) agreements. Collateralized sale (purchase) with the pledge or commitment to repurchase (resell).

RER: Real exchange rate. A measure of the real value of the peso against a basket of currencies. It is constructed using the currencies making up the MER.

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

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

VIX: Estimated by the Chicago Board of Trade, is the most commonly used index to gauge general market volatility at the international level. It measures the implied volatility being negotiated in options over the S&P 500 index.

World growth at market exchange rate: Growth at market exchange rate. Each country is weighted by its GDP in dollars, as published by the IMF's World Economic Outlook (WEO, October 2012). The sample of

countries represents around 88% of world GDP. For the remaining 12%, average growth is estimated at 1.6% for the 2012-2014 period.

World growth: Regional growth weighted by shares in world GDP at PPP as published by the IMF's World Economic Outlook (WEO, October 2012). World growth projections for the 2012-2014 period are calculated from a sample of countries that account for about 85% of world GDP. For the remaining 15%, average growth is estimated at 3.2% for the 2012-2014 period.

ABBREVIATIONS

BCP: Central Bank bonds in pesos

BCU: Central Bank bonds in UFs

BLS: Bank Lending Survey

EES: Economic Expectations Survey

FBS: Financial Brokers Survey

IMCE: Monthly entrepreneurial confidence indicator

CPIG: Consumer price index for goods

CPINT: Consumer price index for non-tradables

CPIS: Consumer price index for services

CPIT: Consumer price index for tradables

CPIEFE: Consumer price index excluding foodstuffs and energy

IPEC: Economic perception index

MPR: Monetary policy rate

REFERENCES

- Barclays Capital. 2012. Global Economics Weekly. December.
- Central Bank of Chile. 2012. Financial Stability Report. Second half.
- Central Bank of Chile. Monetary Policy Report. Various issues.
- Congressional Budget Office. 2012. Economic effects of reducing the fiscal restraint that is scheduled to occur in 2013. May.
- Consensus Forecasts. 2012. A Digest of International Forecast. Various issues.
- CRU. 2012. Copper Quarterly Industry and Market Outlook. October.
- Deutsche Bank. 2012a. Asia Economics Monthly. November.
- Deutsche Bank. 2012b. Dollar Bloc Weekly. December.
- Deutsche Bank. 2012c. Emerging Markets Monthly. November.
- Deutsche Bank. 2012d. Focus Europe. November.
- Deutsche Bank. 2012e. Global Economic Perspectives. November.
- International Monetary Fund. 2012a. World Economic Outlook. October.
- International Monetary Fund. 2012b. Fiscal Monitor. April.
- JP Morgan Chase. 2012. Global Data Watch. November.

Alejandro Zurbuchen S.

LEGAL REPRESENTATIVE

CENTRAL BANK OF CHILE
Institutional Affairs Division
Publications Department
DECEMBER 2012

ISSN: 0716-2219
Santiago, Chile
Agustinas 1180, Santiago, Chile
P.O. Box 967, Santiago, Chile
Tel.: 56-2-2670 2000
Fax: 56-2-2670 2231
www.bcentral.cl
bcch@bcentral.cl

This publication is protected by Law 17336 on intellectual property. Reproduction is prohibited without express permission from the Central Bank of Chile, although parts of this document may be reproduced, provided that the source, title and author are fully cited.



BANCO CENTRAL
DE CHILE

MONETARY POLICY REPORT December 2012