MONETARY POLICY REPORT

September 2012

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

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*/ The statistical cutoff date of this Monetary Policy Report was 30 August 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 range of plus or minus one percentage point. To meet this target, the Bank focuses its monetary policy on keeping projected inflation at 3% annually over a policy horizon of around two years. Controlling inflation is the means through which monetary policy contributes to the population's welfare. Low, stable inflation promotes economic activity and growth while preventing the erosion of personal income. Moreover, focusing monetary policy on achieving the inflation target helps to moderate fluctuations in national employment and output.

The Monetary Policy serves three central objectives: (i) to inform and explain to the Senate, the Government, and the general public the Central Bank Board's views on recent and expected inflation trends and their consequences for the conduct of monetary policy; (ii) to publicize the Board's medium-term analytical framework used to formulate monetary policy; and (iii) to provide information that can help shape market participants' expectations on future inflation and output trends. In accordance with Article 80 of the Bank's Constitutional Charter, 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 the inflation trajectory, which include the international environment, financial conditions, the outlook for aggregate demand, output, and employment, and recent price and cost developments. The last chapter summarizes the results of this analysis in terms of the prospects and risks affecting inflation and economic growth over the next eight quarters. Some boxes are included to provide more detail on issues that are relevant for evaluating inflation and monetary policy.

This Report was approved at the Board's session on 3 September 2012 for presentation to the Senate on 5 September 2012.

The Board

SUMMARY

Over the past few months, the differences between the performance of the global and the domestic economy have deepened. On one hand, the external situation remains complex. The growth outlook has weakened somewhat, due mainly to a sharper-than-expected deceleration of the emerging world. The tensions in foreign financial markets have eased somewhat in recent weeks, but risks remain high. On the other hand, domestic output and demand grew more in the second quarter than previously forecast and the effects of the frail external scenario on the local economy have been mild. Thus, the utilization of installed capacity has intensified further. Still, headline inflation has been lower than expected and is currently at the lower part of the tolerance range, as are core measures. Within core inflation, however, the difference between the behavior of goods inflation and services inflation stands out. The latter, more closely associated with the state of the output gaps, has hovered around 5% annually, reflecting that medium-term inflation risks are still present. In this context, the Board has held the monetary policy interest rate (MPR) unchanged at 5% since last January.

Internationally, the biggest news has concentrated in the performance of the emerging world, shaping a scenario where deceleration exceeds forecasts. The reduced dynamism of Brazil, China and India stands out. Several elements are behind this slowdown, among which it is worth singling out the effects on their exports of the global deceleration, especially in Europe, and stringent policies applied in the past. This has resulted in a notorious deceleration of these countries' manufacturing industries.

The developed economies continue to post weak growth. In the United States, the overall evaluation is still of a slow recovery. The United Kingdom is in recession, affected by anemic external and internal demand, the latter influenced by tight credit conditions and policies aimed at fiscal consolidation. In the Eurozone, the GDP shrank in the second quarter, after being flat in the early part of the year. The performance of the zone continued to be marked by big differences between peripheral economies (with sharp falls) and central European economies (with modest increases), reflecting financial and fiscal vulnerabilities. However, the weakness of some incoming indicators from Germany is cause for concern, particularly domestic consumption compounded by the weak performance of its exports and manufactures.

Some calm has come to the external financial markets, originating, among other causes, in the announcements that steps will be taken towards a banking union and the statements by the governor of the European Central Bank regarding the possibility of shortly implementing a sovereign bond purchase plan, upon previous

INTERNATIONAL BASELINE SCENARIO ASSUMPTIONS

	2011 (e)	2012 (f)	2013 (f)	2014 (f)
	(annual change, percent)			
Terms of trade	0.5	-7.4	-2.6	1.3
Trading partners' GDP (*)	4.1	3.5	3.8	4.3
World GDP at PPP (*)	3.8	3.1	3.6	4.1
World GDP at market exchange rates (*)	2.8	2.5	2.8	3.4
External prices (in US$)	10.1	-0.9	1.3	2.8
	(levels)			
LME copper price (US$cent/pound)	400	355	340	350
WTI oil price (US$/barrel)	95	97	97	93
Brent oil price (US$/barril)	111	113	109	103
Gasoline parity price (US$/m3) (*)	803	843	796	753
Libor US$ (nominal, 90 days)	0.3	0.4	0.4	0.6

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

Source: Central Bank of Chile.

ECONOMIC GROWTH AND CURRENT ACCOUNT

	2010	2011	2012 (f)	2013 (f)
	(annual change, percent)			
GDP	6.1	6.0	4.75-5.25	4.0-5.0
National income	13.1	6.1	3.8	3.8
Domestic demand	14.8	9.4	5.6	5.5
Domestic demand (w/o inventory change)	10.2	10.2	5.5	5.8
Gross fixed capital formation	14.3	17.6	7.0	7.1
Total consumption	9.0	7.9	5.1	5.4
Goods and services exports	1.4	4.6	3.5	3.6
Goods and services imports	27.4	14.4	4.0	5.8
Current account (% of GDP)	1.5	-1.3	-3.2	-4.4
National saving (% of GDP)	25.1	23.4	22.0	21.2
GFCF (% of nominal GDP)	21.5	23.2	23.6	24.4
GFCF (% of real GDP)	23.,6	26.2	26.7	27.3
	(US$ million)			
Current account	3,269	-3,221	-8,500	-12,200
Trade balance	15,324	10,792	4,200	100
Exports	70,897	81,411	77,800	78,800
Imports	-55,572	-70,619	-73,600	-78,700
Services	-1,806	-2,417	-2,100	-2,100
Rent	-14,765	-14,015	-12,600	-12,300
Current transfers	4,515	2,418	2,000	2,100

(f) Forecast.

Source: Central Bank of Chile.

political agreement on a fiscal austerity program. Besides, no significant sovereign debt payments from peripheral economies have fallen due in the past several weeks. However, the region faces a tough path, because of considerable difficulties to carry out these actions. For example, how a banking union for the Eurozone could be materialized is unclear and, for the time being, there is no unanimous support from member countries. In addition, there is the negative outlook placed for Germany's and other central Eurozone economies' ratings. Plus, in the coming months, several events will occur that may revive market tensions. For September there is, among other developments, the evaluation of the tripartite group on the degree of compliance with agreed adjustments in Greece and the possibility of a new program, aside from the voting at the German constitutional tribunal on the legality of the ESM. For October, there is a strict calendar of debt maturities in Spain, which entails refinancing obligations in international markets.

The impulse from abroad on the Chilean economy will be somewhat milder than was foreseen a few months back. On one hand, in the baseline scenario our trading partners will grow 3.5% in 2012 and 3.8% in 2013, one tenth of a point less than forecast in June. This, as aforesaid, because of the downward revisions to emerging economies' growth. On the other hand, the terms of trade will be less favorable than projected then. The price of oil and fuels will be higher than assumed in June, because of supply-side problems and increasing geopolitical risks in the Middle East. On top of this is —also because of supply-side problems— the increase in food prices in the world markets, especially for grains. The copper price projection does not change from June. Finally, despite the observed calm, the baseline scenario considers new episodes of stress in global financial markets, similar of those of the past year. This, because of the events foreseen for the coming months and the difficulties of advancing towards a more long-lasting solution to the problems in the Eurozone.

In Chile, the greatest news is stronger-than-expected growth in output and demand in the second quarter of the year. Output owes its dynamism to sectors linked to domestic demand, such as construction, trade and services. The better result of the manufacturing industry is also worth noting, which, although growing less than aggregate GDP, still exceeded expectations, driven by the lines associated with demand, especially investment and specific export-oriented activities. On the expenditures side, inventory accumulation intensified with respect to previous months. This seems to respond to an attempt to rebuild inventory levels after the reduction of late 2011 and that, at the time, was linked to the expected negative effects of the external scenario on final sales. Also worth noting was the renewed strength of consumption and gross fixed capital formation. Consumption continues to rely on the evolution of the labor market and fairly stable financial conditions. Regarding investment, the contribution of construction and infrastructure works stands out, relating mainly to mining and energy projects, but also to a strengthened real-estate sector, which reflects on the performance of commercial loans.

The behavior of output, especially of sectors other than natural resources, and domestic demand intensified the utilization of installed capacity. Although y-o-y growth in employment and nominal wages has dropped, the labor market remains tight. However, the increased domestic demand, especially investment, together with lower copper prices compared with 2011, have led to a widening of the current account deficit. In the moving year ending the second quarter of 2012 this deficit rose to 2.7% of GDP, from 1.3% at the close of 2011.

In the past few months, y-o-y inflation has continued on a downward path, influenced by fuel prices. Core inflation, which excludes foodstuffs and energy (CPIEFE) has stabilized near 2.5%. The services component of the CPIEFE has hovered near 5%, while the goods component is still in negative territory, a behavior in which the appreciation of the peso has played a part most recently. The peso/dollar parity has appreciated 5.3% since June. Considering the current level of the nominal exchange rate and the currency parities prevailing at the statistical closing of this Report, the real exchange rate (RER) is estimated to be in the lower part of the range consistent with its long-term fundamentals.

The baseline scenario assumes that this year the Chilean economy will grow between 4.75% and 5.25%. The correction is explained mainly by actual data for the first half of the year and because the effects of the external situation on the Chilean economy will be milder than was forecast in June. However, the baseline scenario assumes that, during the second half of 2012 the GDP will post lower growth rates than in the first half, gradually leading to a normal usage of installed capacity. The Board continues to estimate trend GDP growth at around 5%. For 2013, the Board foresees GDP growing between 4% and 5%. In the baseline scenario, the current account deficit for this year is estimated at 3.2% of GDP. In 2013 it should widen to 4.4% as a reflection of strong domestic demand and, to a lesser extent, of a lower copper price.

As for inflation, the baseline scenario foresees that CPI inflation will end the year below June's projections, reaching 2.5%. Later, it will gradually approach 3%, where it will arrive in the second half of 2013 and will fluctuate nearby until the end of the projection horizon, this time the third quarter of 2014. The CPIEFE will converge to 3% at a slower pace than foreseen in June. This trajectory assumes that wages will be adjusted according to productivity and the inflation target. In addition, as a methodological assumption, it assumes that the RER will stay around its recent values during the forecast horizon. Finally, the baseline scenario uses as a working assumption that the MPR will remain stable over the short term.

The baseline scenario reflects the developments that the Board believes to be the most likely to occur with the information at hand at the statistical closing of the Report. However, there are risk scenarios that, if materialized, might change —significantly, in some cases— the macroeconomic outlook and, therefore, the course of monetary policy. On this occasion, after evaluating the alternative scenarios, the Board estimates that the risk balance for output and inflation is unbiased.

Abroad, the risks described during the past several quarters have not changed significantly. The situation of the Eurozone is complex. Carrying out the announced measures will not be easy and the passing of time will bring more problems to the economies of peripheral Europe, so a severe aggravation of the financial crisis in the Eurozone or even more extreme scenarios with systemic implications cannot be ruled out. Add to this the discussion in the United States to prevent

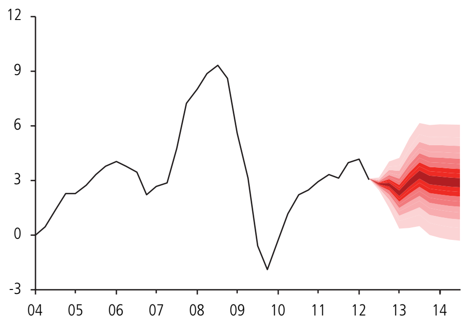
INFLATION

	2010	2011	2012 (f)	2013 (f)	2014 (f)
	(annual change, percent)				
Average CPI inflation	1.4	3.3	3.2	2.9	
December CPI inflation	3.0	4.4	2.5	3.0	
CPI inflation in around 2 years (1)					2.9
Average CPIEFE inflation (2)	0.5	1.3	2.5	2.6	
December CPIEFE inflation (2)	1.5	2.4	2.3	2.8	
CPIEFE inflation in around 2 years (1) (2)					2.8

(f) Forecast.
(1) Inflation forecast at the third quarter of 2014.
(2) The CPIEFE (CPI excluding food and energy) is the price index of the consumer basket excluding the prices of foodstuffs and energy. In most OECD economies this index is used as a core inflation measure.

Source: Central Bank of Chile.

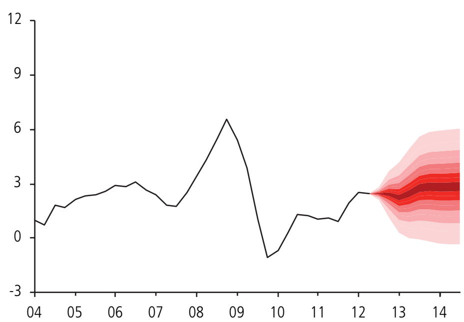
CPI INFLATION FORECAST (*)
(annual change, percent)



(*) The figure shows the confidence interval of the baseline projection over the respective horizon (colored area). Confidence intervals of 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 basline scenario uses as a working assumption that the MPR will remain stable over the short term.

Source: Central Bank of Chile.

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



(*) The figure shows the confidence interval of the baseline projection over the respective horizon (colored area). Confidence intervals of 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 basline scenario uses as a working assumption that the MPR will remain stable over the short term.

Source: Central Bank of Chile.

fiscal adjustments from being triggered in 2013. If attempts to reach agreements are unsuccessful, this economy's GDP growth could fall significantly and tensions could increase in financial markets.

In the emerging world, the biggest risk is a deepening of economic slowdown indicators. On aggregate, the world growth forecast does not divert from the average of the past 15 to 20 years, but this has been sustained by the expansion of the larger emerging economies. Particularly preoccupying is the performance of China, due to its weight in the world economy and its relevance in the evolution of the copper price. Should it post a sharper deceleration, global growth would weaken further, with intensified effects on commodity-exporting economies like Chile, which are still growing at high rates. Another possibility is for supply-side factors to intensify recent increases in the prices of some commodities, especially fuels and grains.

Locally, medium-term inflationary risks are still present. The recent increase in the world prices of fuels and some foodstuffs could rapidly pass through to inflation, all the more so considering the current state of output gaps. In addition, if domestic output and demand remain as dynamic, or even more so, they can further intensify the usage of installed capacity pressuring inflation away from the target. This could also result in a widening of the current account deficit that could create vulnerability factors in the economy in a complex global environment. This variable is important for the evolution of the conditions for accessing external financing. Sudden changes in the sources of credit and/or the terms of trade (e.g., a significant drop in the copper price), could trigger difficult adjustments in the domestic economy, with an impact on demand, employment, credit and the real exchange rate. In the past, most crises faced by the country were preceded by large, persistent deficits in the current account. However, the economic policy framework in force has advanced to include a rule that guides fiscal policy and shields public expenditure from the copper price over-increasing above its estimated long-term trend. It also considers a floating exchange rate policy that allows for early adjustments in order to deal with unexpected changes in external conditions. However, the Board believes that it is important to closely monitor the factors underlying the wrreat deficit, to prevent the incubation of imbalances that might affect future economic performance.

The current macroeconomic scenario poses significant risks demanding policy responses in different directions. On one hand, although so far its effects have been mild, the external situation is severe. Chile is a small economy, commercially and financially open, so it will not be immune to global developments. The probability of extreme events has not diminished, and their materialization could have very severe consequences on output around the world, including Chile. On the other hand, the strength of domestic demand and output, together with recent increases in some commodity prices, means that medium-term inflationary risks remain present. The MPR is within a range of values that are considered neutral, providing flexibility to wait for the concrete effects of such scenarios on the Chilean economy to become visible. The Board monitors closely the evolution of the external and internal macroeconomic scenario and its implications on inflation, and reiterates its commitment to conduct monetary policy so that projected inflation stands at 3% over the policy horizon.

MONETARY POLICY DECISIONS IN THE LAST THREE MONTHS

BACKGROUND: MEETING AND MONETARY POLICY REPORT OF JUNE 2012

Over the past few months, the differences between the evolution of the global and the Chilean economy had deepened. The external scenario had deteriorated, and risks had increased, with growing tensions in the financial markets, and a weakened global growth. Once again, the possibility of a disorderly outcome of the crisis in the Eurozone was being discussed. Thus, after having improved in the first quarter of the year, tensions in financial markets had aggravated to mimic or exceed those of December 2011. The economic and financial situation of Spain had worsened further and its risk premium had risen to record highs, despite the announced capitalization of its banking industry. In addition, doubts persisted over whether other countries would be needing similar action. Also worth noting was the substantial drop in commodity prices, especially oil. The main effects of these tensions on emerging economies, aside from lower commodity prices, had been a depreciation of their currencies, reduced stock prices, and higher risk premiums.

The feeble external outlook contrasted with the performance of domestic output and demand. GDP had expanded more than forecast, although in quarter-on-quarter terms, it had expanded at a rate similar to trend. So the Board estimated that output gaps were still tight. Although the labor market remained tight, the signs of this tightness had not intensified: employment had reduced its rate of expansion, the unemployment rate had stabilized at low levels, and y-o-y growth in wages, while still strong, had eased off.

Inflation had been less than forecast, a fact that, combined with lower international fuel prices, had reduced the risks for its short-term evolution. Nonetheless, medium-term inflationary risks were still latent because of the tight domestic markets. This was evidenced by the fact that the services component of inflation was the largest contributor to its increase.

The risk balance was biased downwards for output and unbiased for inflation. The greatest risk had its origin abroad, because of the situation in the Eurozone, which was very complex, and the developments of the recent months had revived the possibility of more extreme scenarios. The lack of clarity about the capitalization plan announced for Spanish banks, its difficulties to meet the fiscal targets given its gloomy growth outlook and its impact on its sovereign debt were still cause for concern. Similarly, apprehensions had increased about other countries in the region. Also possible was a reversal of current tensions, for instance if there were agreements favoring compliance with the adjustment measures agreed or new announcements of support by economic authorities. Doubts persisted in the U.S. about how the transition to a sustainable medium- and long-term debt trajectory would proceed. In the emerging world, a Chinese slowdown sharper and/or longer than forecast in the baseline scenario could not be ruled out, hindering growth in other economies due to its weight in the global economy, and affecting commodity prices significantly.

Medium-term risks for inflation were still present. The growth rate for domestic demand and output had dropped, albeit not as fast as expected. By the same token, domestic demand had outgrown GDP in the last two years, thus widening the current account deficit. If domestic demand became more dynamic, the current account deficit could expand. This could be risky in a scenario of weak world growth, lower copper price and costlier external financing.

For the June meeting, the available data led the Research Division to propose, as the relevant option for monetary policy, to hold the monetary policy rate (MPR) at 5%. The option of raising the MPR was discarded in view of the worsened international conditions and their possible impact on Chile. Moreover, because the output and employment growth rates were converging to trend rates, core inflation had decreased during the previous months, and the most recent performance of the more volatile components –fuels and food– also contributed to reduce inflationary levels. Holding the MPR at its current level was justified since it was within its neutral range; at the same time, the economy showed a closed-output gap situation and inflation close to target, which provided the necessary time and flexibility to wait and collect information on the evolution of the external situation and its impact on Chile. Consequently, the Board decided to keep the MPR at a y-o-y 5% level.

MEETINGS IN JULY AND AUGUST

In July, the available data did not vary greatly from the baseline scenario of the Monetary Policy Report. The global economy and its outlook showed a somewhat sharper slowdown. However, the monetary measures and the agreements reached in the Eurozone had contributed to slightly improve the international financial conditions. Additionally, commodity prices had stopped dropping.

Domestically, the output gap and the labor market remained tight, which implied that growth in the Chilean economy should align with its potential path. For the second half of 2012, the projections of the Monetary Policy Report included a slowdown in growth resulting from increased international uncertainty and a reduced external demand. So far, the signals of these effects were mild.

Headline and core inflation were below 3% annually. The reduction of total inflation had outperformed predictions, thereby reflecting the evolution of temporary factors, such as the more volatile components —energy and food—, as well as the incidence of the appreciation of the peso in the inflation of traded goods. On the other hand, indicators of core inflation —particularly its services component— and nominal wages remained stable and this validated the closed-output gap diagnosis, a factor that needed further monitoring.

Thus, the Research Division proposed as the relevant option to hold the MPR at 5.0%. The option of increasing it was discarded in view of the worsened international outlooks and their possible impact on the Chilean economy and inflation. Simultaneously, the output and employment growth rates were converging to trend rates, core inflation had decreased substantially during the previous months, and the described performance of the most volatile components had also contributed to reduce inflationary levels and market expectations. The option of lowering the MPR was also ruled out in view of the latent risk related to the medium-term inflationary outlook. Holding the MPR at its current level was justified since it was within its neutral range; at the same time, the economy showed a closed-output gap situation and an inflation close to target, which provided the necessary time and flexibility to wait and collect information on the evolution of the prevailing situation. The Board therefore decided to hold the MPR at 5.0%.

In August, the reported global output data evidenced a somewhat sharper slowdown of emerging economies, and a certain improvement of the international financial conditions. Even though some progress had been made in the Eurozone, its materialization was still faced with considerable politic hindrances; thus, risks in this region were still fully prevalent and the external scenario still presented the possibility that financial tensions could intensify in the following months. Besides, the risks of a sharper slowdown in China and other emerging economies had grown.

Domestically, the output gap and labor markets remained tight, which implied that growth should align with its potential path in order to avoid medium-term inflationary pressures. The new background data indicated that, in the year to date, growth in output and demand had been above this trend. In fact, recent growth figures revealed a dynamism that was, to some extent, somewhat surprising in a widespread international slowdown context. This was a factor that had to be further monitored in the following months.

Actual inflation and its core measures went on evolving below 3% y-o-y. Since the previous meeting, a reversal of international prices of grains and energy had been observed, which would probably have a positive effect on the evolution of the CPI in the following months. On the other hand, indicators of core inflation, particularly its services component, and nominal wages remained stable. However, news related to these prices were also factors to be monitored in the coming months.

Therefore, the Research Division proposed as the relevant option to hold the MPR at 5.0%. The option of increasing the MPR was discarded in view of the recent developments in the external scenario and their possible impact on the Chilean economy and inflation. Measurements of headline and core inflation remained at the lower part of the tolerance range; wages and inflation of services evolved on a stable basis, and two-year expectations were still around the target. The option of lowering the MPR was also discarded in view of the tightened labor market, which implied a latent risk related to the medium-term inflationary outlook. It was quite probable that the external slowdown would contribute to clear up this risk in the following months but, so far, these effects had been mild. Holding the MPR at its current level was still justified since it was within its neutral range; at the same time, the economy featured a closed gap and inflation close to target, which provided the necessary time and flexibility to wait and collect information on the evolution of the external situation and its impact on the Chilean economy. The Board therefore decided to hold the MPR at 5.0%.

I. INTERNATIONAL SCENARIO

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

WORLD GROWTH

World growth has not changed significantly on aggregate, as compared to June; however, its composition has changed somewhat. The most remarkable change is that large emerging economies are slowing down more markedly than expected, while developed economies have evolved as forecast, showing a meager and slow recovery. Accordingly, world growth projections are revised downward, but this time, the main adjustments come from the emerging world. Growth of our trading partners as well as of the PPP-weighted world for 2012 have been revised by one tenth of a point at 3.5 and 3.1%, respectively (table I.1).

The main emerging economies are now feeling the effects of the complex international scenario. The GDP of China grew 7.6% y-o-y in the second quarter of the year, as compared to the 8.1% of the first quarter and the 9.2% of 2011, which evidences the slowdown it is undergoing. The most recent indicators show that this slowdown has continued. Exports to the European market show a year-on-year drop, and retail sales and loans have also slowed down (figure I.1). This outlook has resulted in a sharp downward adjustment of growth projections in this country. While the projection included in the September Monetary Policy Report stated an 8.3% and 8.7% expansion of the Chinese economy in 2012 and 2013, respectively, this Report projects 7.8% and 8.1% for those same years (box I.1). Other Asian economies record increasingly lower y-o-y growth rates —even negative in some cases— greatly affected by the performance of their main trading partners, particularly, developed economies and other Asian countries. In India, the slowdown is also related to fiscal and energy problems, among other factors.

One distinctive aspect in the last few months in several developed and emerging economies has been the weak performance of their manufacturing industries. Surveys of purchasing managers in several of these countries indicate that this will extend into the following months (figure I.2).

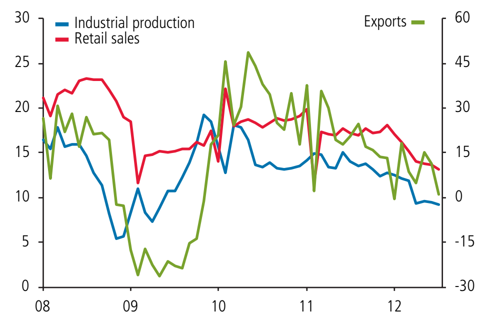
TABLE I.1
World growth (*)
(annual change, percent)

	Avg. 90-99	Avg. 00-07	2011 (e)	2012 (f)	2013 (f)	2014 (f)
World at PPP	3.0	4.2	3.8	3.1	3.6	4.1
World at market exchange rates	2.7	3.2	2.8	2.5	2.8	3.4
United States	3.2	2.6	1.8	2.2	2.0	2.4
Eurozone	1.6	2.2	1.5	-0.4	0.3	1.7
Japan	1.5	1.7	-0.8	2.7	1.3	1.4
China	10.0	10.5	9.2	7.8	8.1	8.3
India	5.6	7.1	6.5	5.8	7.1	7.3
Rest of Asia	5.6	5.1	4.2	3.5	4.5	4.8
Latin America (excl. Chile)	2.8	3.5	4.4	3.0	3.4	3.9
Commodity exporters	2.7	3.1	2.2	2.3	2.5	2.8
Trading partners	3.1	3.6	4.1	3.5	3.8	4.3

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

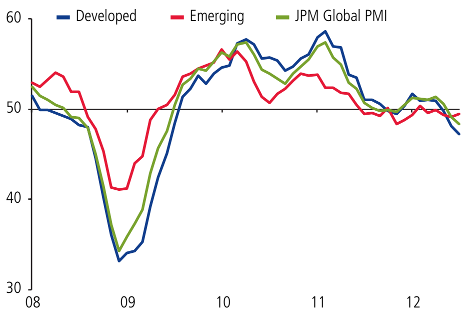
Sources: Central Bank of Chile based on a sample of investment banks, Consensus Forecasts, International Monetary Fund and statistics bureaus of respective countries.

FIGURE I.1
China: Output indicators
(annual change, percent)



Source: Bloomberg.

FIGURE I.2
Expectations for manufacturing sector: PMI (*)
(diffusion index)



(*) Value above (below) 50 indicates expansion (fall).

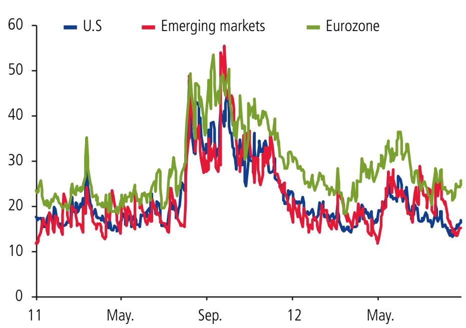
Source: Bloomberg.

TABLE I.2
GDP growth in Europe
(annualized q-o-q change, percent)

	III.2011	IV.2011	I.2012	II.2012
Spain	-0.2	-2.0	-1.3	-1.7
Italy	-0.9	-2.9	-3.3	-2.9
Portugal	-2.5	-5.2	-0.3	-4.7
Ireland	-4.4	2.8	-4.2	-
Netherlands	-1.4	-2.5	0.9	0.7
Greece (y/y)	-5.0	-7.5	-6.5	-6.2
Germany	1.5	-0.6	2.0	1.1
France	1.1	0.0	0.1	-0.2
Eurozone	0.4	-1.3	0.1	-0.7
United Kingdom	2.4	-1.4	-1.3	-1.8

Sources: Eurostat, National Statistics Institute of Portugal and Statistics Bureau of Greece.

FIGURE I.3
Stock market volatility (*)
(percent)



(*) VIX index for the U.S., Vstoxx index for the Eurozone and an estimate of the MSCI's historical volatility, denominated in dollars.

Sources: Central Bank of Chile and Bloomberg.

In Latin America, the outlook is still rather heterogeneous. The most remarkable fact is Brazil's significant slowdown, whose size largely accounts for the downward revision of the growth forecast for the region for this and next year. However, a recovery is expected going forward, resulting from the expansionary measures implemented by its authorities. These measures include the reduction of its monetary policy interest rate by 350 basis points in the year to date and a fiscal stimulus plan amounting to US$65 billion. Colombia and Argentina have also evidenced slowdown signs. However, other economies in the region, such as Peru and Mexico, are still growing strongly. Peru's growth is being driven by forces similar to those driving the Chilean economy and by an important effect of mining investments. In turn, Mexico's growth during the first half of the year exceeded expectations; however, the effects of its weakened external sector will become more clearly visible in the near future, which is now being suggested by the slowdown signs of its manufacturing industry.

The developed world is following a slow recovery path. In the United States, although some indicators from the real estate industry and the labor market show a somewhat more positive margin, the overall assessment continues to be fragile. Add to this the discussion to prevent fiscal adjustments from being triggered in 2013. The market estimates suggest that, if attempts to reach agreements are unsuccessful, the cuts in expenses that would be implemented could reduce the growth of this economy by more than two percentage points in 2013. Besides, the discussion is being hindered by the proximity of the elections. Although the growth projections for the United States for 2012 are revised slightly upwards, this results from a correction of historical figures that is habitually done at this time of the year, rather than from a more favorable outlook for this economy. The situation of the United Kingdom is also cause for concern, since its output fell for the third quarter running, as a result of a weakened external demand and a domestic demand that has been depleted by restrictive credit conditions and the fiscal consolidation program. In Japan, output in the last quarters has been favored by the reconstruction works, although more recent figures show degraded expectations.

In the Eurozone, output will continue to ail, with significant differences among its member countries. Peripheral economies have been contracting for several quarters now, while others, including Germany, are still growing (table I.2). However, the weakness of some recent indicators from Germany is cause for concern, particularly those related to domestic consumption, this compounded by the weak performance of its exports and manufactures, could imply a slowdown in the coming months. Nevertheless, some countries in the region have had to apply fiscal adjustment plans, credit conditions are still undergoing a continuing restriction, uncertainty restrains investment plans and, the deleveraging process also continues. The meager growth of this area weakens the intra-regional trade, but it helps to solve the imbalances within the region while exchange rate and wage rigidities persist.

INTERNATIONAL FINANCIAL MARKETS

These last few weeks have witnessed a somewhat less pessimistic international financial market. Among other causes, this arises from the announcements that steps will be taken towards a banking union, and the statements by the governor of the European Central Bank regarding the possibility of shortly implementing a sovereign bond purchase plan, upon previous political agreement on a fiscal austerity program. Besides, no significant sovereign debt payments from peripheral economies have fallen due in the past several weeks. Stock exchanges have risen, risk indicators have dropped, and the dollar has depreciated (figure I.3). However, the situation of markets is highly fragile: risk premiums are still high by historical standards, and stock exchanges are far from rebuilding the levels lost in the previous months. This mainly reflects that, although there are signs showing that the path is right, the implementation of the measures to solve structural problems of the region is faced with huge political difficulties and, besides, the next months will bring a series of critical events that may lead to new stress episodes in the markets. In September, for example, the European Union, the European Central Bank, and the International Monetary Fund will assess Greece's compliance with its adjustment commitments, the German constitutional court will vote on the lawfulness of the ESM, and the auditing companies will define the amount needed by Spanish banks to capitalize. For October, Spain has a strict calendar of debt maturities (figure I.4). Added to this is the above mentioned discussion that will take place in the U.S. Congress aiming at avoiding fiscal cuts. Since the fundamental problems have not yet been solved, any step taken in a direction other than that targeted by the economic agents in any of these regards will increase the edginess and volatility of markets. Therefore, the risk of a severe aggravation of the financial crisis in the Eurozone or even more extreme scenarios with systemic implications still persists.

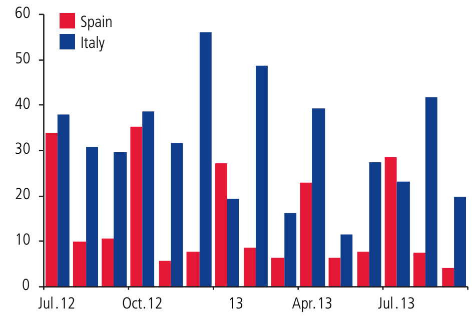
The emerging economies have also witnessed signs of the increased optimism of the international financial markets. Stock exchanges have risen, parities of economies have re-appreciated with respect to the dollar, and sovereign and corporate risk premiums show some reductions. Although a renewed capital inflow has been observed, they involve bonds, not stocks. This could reflect that the investors' recently increased appetite for risk is not fully consolidated.

COMMODITIES

In recent months, commodities have followed a dissimilar path. While the price of oil, its byproducts and some grains have risen again, the price of copper is similar to the one of the closing of the Monetary Policy Report of June (figure I.5). However, other industrial commodities other than copper, such as iron and steel, have undergone strong drops in prices and several mining companies have announced cuts in their expansion rates.

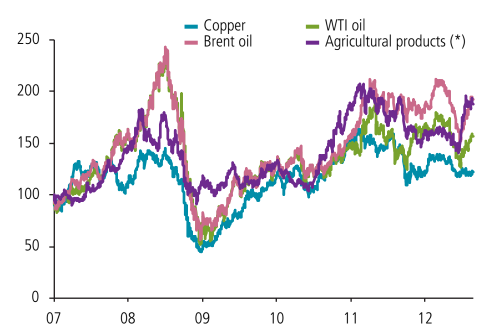
Regarding fuels, the price increase has resulted mainly from two factors. On one hand, the resurgence of geopolitical tensions in the Middle East. On the other hand, various restrictions on the supply side, including refinery problems in Mexico, which have raised the demand for fuel in the U.S. market. Thus, the

FIGURE I.4
Sovereign debt maturities (*)
(billions of euros)



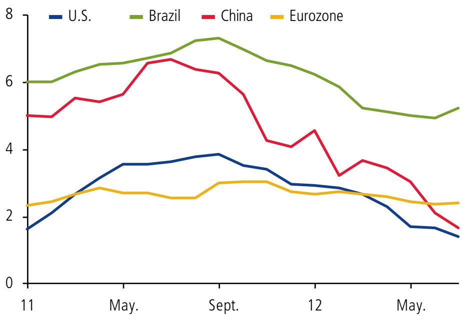
(*) Repayment of principal and interest.
Source: Bloomberg.

FIGURE I.5
Commodity prices
(index, 01/02/2007=100)



(*) Goldman Sachs aggregate index.
Source: Bloomberg.

FIGURE I.6
CPI inflation
(annual change, percent)



Source: Bloomberg.

TABLE I.3
World inflation
(average annual change in local currency, percent)

	Avg. 90-99	Avg. 00-07	2011	2012 (f)	2013 (f)	2014 (f)
United States	3.0	2.8	3.0	2.0	1.9	2.2
Eurozone	2.3	2.2	2.7	2.3	1.7	1.8
Japan	1.2	-0.3	-0.3	0.1	0.0	0.7
China	7.8	1.7	5.3	3.0	3.5	3.6
Australia	2.5	3.2	3.4	1.9	3.0	2.8
New Zealand	2.1	2.6	4.3	2.6	2.5	2.4
Brazil	854.8	7.3	6.5	5.6	5.1	5.1
Mexico	20.4	5.2	3.3	3.6	3.5	3.5

(f) Forecast.

Sources: Central Bank of Chile, Consensus Forecasts and International Monetary Fund.

price of oil has exceeded by 15% to 20% its value prevailing at the closing of the Report of June, for both the WTI and Brent prices. Consistently with the higher current prices, projections extracted from futures contracts estimate higher WTI and Brent average prices for 2012 and 2013.

Copper is currently trading at around US$3.4 per pound, almost unchanged from June. Although China's total imports have slowed down in recent months, the demand for copper in this country has remained solid, and this helps to sustain its price, as its copper imports account for 40% of the global demand for this metal. This demand is sustained, to a great extent, on the requirements for projects of investment in infrastructure. However, the contrast between the slowdown of the Chinese economy and its sustained dynamic demand for copper is worth noting, probably owing partly to stock-building of trade inventories. Price projections included in this Report are the same as those of June (US$3.55 and 3.40 per pound for 2012 and 2013, respectively).

In recent months the increase in the prices of some grains has also stood out. Particularly, wheat has risen over 40% in the last few months, due to severe supply problems. Expectations have it that harvests will stay far below forecast values, due to climatic factors in the main producers of the northern hemisphere. However, the price levels reached are far from those recorded halfway through 2008, when the upward path of these levels resulted mainly from demand considerations. Into the future, although the expectations contained in futures operations indicate that high prices will only be temporary, this will greatly depend on the results of the harvests in the southern hemisphere.

INFLATION AND MONETARY POLICY

Broadly, in the last few months, inflation records have started to ease, in both the developed and emerging economies (figure I.6). This mainly results from the reduced dynamism of output or the persistence of moderate growth figures. In China, y-o-y inflation continued to drop down to 1.8% in July, as compared to 4.1% in January this year. In this way, inflation projections have also decreased (figure I.3).

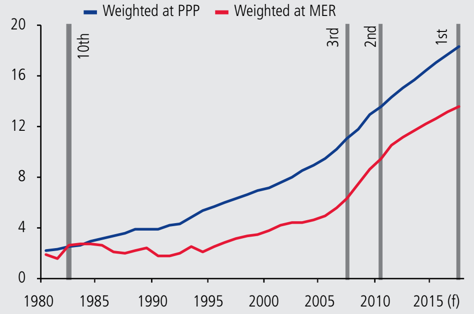
Monetary policy decisions in recent months have been greatly driven by the current effects of the weakened international outlook on local economies. Additionally, considering the space granted by the low inflation records and the milder price pressures, several emerging economies began or continued their ongoing reduction cycles of monetary policy rates. In China, the monetary authority lowered the monetary policy interest rate, and adopted administrative measures to reduce loan rates.

In developed economies, interest rates are still at record lows and additional measures have been announced, aiming at giving momentum to their output. In the United States, the communication by the authorities itself has led the market to internalize the possibility of additional monetary measures. In the United Kingdom, additional procurement of assets has been announced. In the Eurozone, the European Central Bank has reduced the interest rate down to 0.75% and the market expects that purchases of sovereign bonds will be resumed.

BOX I.1
CHINA: CURRENT SITUATION AND POSSIBLE EFFECTS ON THE GLOBAL ECONOMY

During the last decade, China has played a leading role in world trade and output (figure I.7). In this way, it has become the second largest economy in the world, the biggest investor in U.S. Treasury bonds, and the main business partner of several emerging economies and commodity exporters, including Chile. By 2010, China represented around 10% of global imports, absorbed 40% of the world copper output[1]/, over 11% of oil output[2]/, and between 15% and 30% of food output[3]/.

FIGURE I.7
Share of China in world GDP (*)
(percent)



(*) Vertical lines show moment in which the Chinese economy was (would be) the ith in the world, measured at PPP.
(f) Forecast.
Source: IMF (2012a).

China's growth was driven by net exports and investments, thereby becoming the largest manufacturing center in the world. In recent years, after the onset of the international financial crisis, the Government promoted a strong expansion of public investment, thereby succeeding in upkeeping a high growth rate. This contributed to the recovery of world activity and, particularly, to the recovery of commodity prices, benefitting countries such as Chile and other producers of these goods. Nowadays, there is concern about slowdown signs in China. This box analyzes the situation in this economy and the possible impacts of its further slowdown on world growth.

As indicated, in the last quarters, China has reduced the pace of its economic expansion. After having recorded annual growth rates of 10.4% and 9.2% in 2010 and 2011, respectively, in the second quarter of this year it grew just 7.6%. This slowdown is attributable to various factors, both local and external.

The first one has to do with the international cycle. China is exposed to the evolution of growth in developed economies through its international trade. Exports account for around 25% of its GDP. Their main destinations are the European Union (20%), USA (18%), Hong Kong (14%), and Japan (8%). Therefore, the weak performance of the developed world has an impact on the output of the exporting sector and of the economy at large.

The second factor refers to cyclical adjustments in the real-estate industry. In recent years, real-estate investment has become one of the main sources of growth in the Chinese economy, driven by a strong credit expansion. However, the authorities have implemented measures to moderate the performance of this industry, thereby avoiding the configuration of further financial imbalances. There is great concern regarding the worsening of the quality of real estate assets, which would adversely affect the financial situation of banks and could generate more durable echoes on the evolution of this industry. Concern about the financial situation of the real estate industry has also had an influence on the reduced willingness of authorities to act on a preventive basis in response to slowdown signs.

The third one arises from structural adjustments in the composition of the demand. The most recent Five-year Plan includes an increased share of private consumption over investment, to ensure sustainable growth. This transformation will require a series of adjustments to relative prices, including real wages, real exchange rate, credit cost, input prices —such as land and energy— apart from reforms to the social security system aimed at reducing the need for precautionary savings by consumers. Implementing these adjustments, however, could take a while, and could affect the profitability of the installed capacity during such process, thereby impacting negatively on China's economic growth.

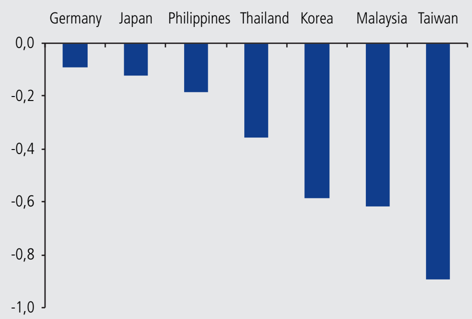
[1]/ CRU (2012).

[2]/ U.S. Energy Information Administration (2012).

[3]/ FAO (2012).

Given the relevance of the Chinese economy in the world spectrum, its lower growth rates of activity bear different degrees of impact on the rest of the world. Some exercises are carried out to quantify them: The first one is the one performed by the IMF[4]/, which assesses the consequences of a reduction in the Chinese real-estate investment. The scope would be determined by the interconnections of this industry with other areas of the Chinese economy, including durable consumer goods, construction, light manufacturing industry, and energy. In turn, these decreases compounded would have negative consequences on Chinese imports, thereby depressing the activity, the employment, and the domestic demand of its trading partners. The simulation shows that a 1% drop of the real estate investment, which accounts for 25% of the investment in fixed assets or a 12% of GDP in China, would reduce GDP growth by 0.2%. In turn, this would reduce the world growth by a 0.06%, which is equal to a one-third elasticity. A second exercise is obtained based on a global equilibrium model that simulates a one percentage point (pp) drop in the Chinese growth rate. In this exercise, this situation causes a 0.3pp decline in world growth, considering a particularly substantial slowdown in Asia and a milder one in Latin America[5]/. This is comparable with the results of the above mentioned analyses.

FIGURE I.8
Impact of a one-percentage-point fall in China's investment on main trade partners' growth
(percentage points)



Source: IMF (2012b).

Another exercise performed by the IMF assesses the potential effects of a one percentage point drop of the growth rate of total investment of China on the expansion of other economies. The most adversely affected countries would be its regional trading partners (figure I.8). The impact would also be relevant for commodity-exporting countries.

Another aspect to assess are the consequences of a lower Chinese output on commodity prices. The above mentioned report of the IMF shows the results of simulating a decrease in Chinese real estate investment. This would result in reductions of prices of metals and non-fuel commodities. For copper, the response elasticity would be around 1.5 as compared to the real estate investment, or 7.5 as compared to GDP growth in China. These elasticities are limited, because they are based on a transitory drop of real estate investment. The response elasticity to a more long-lasting decrease in investment in China or a more permanent slowdown of its growth rate should be greater. Simulation by using a global general equilibrium model shows that a 1% drop in China's growth leads to a 12.5% reduction in the average price of copper[6]/.

[4]/ IMF (2012b).

[5]/ These results derive from Carabenciov et al. (2012).

[6]/ These values have been obtained by using García and Medina's model (2009).

II. FINANCIAL MARKETS

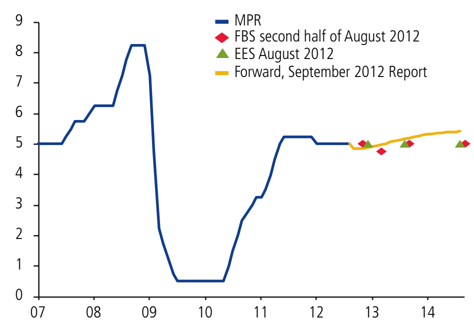
This chapter reviews the recent evolution of the main financial market variables from a monetary policy perspective.

MONETARY POLICY

Over the past few months, the differences between the domestic and the external scenarios have continued to deepen. On one hand, the global growth outlook is somewhat weaker; although tensions in the international financial markets have eased to some extent in recent weeks, risks remain high. On the other hand, domestic output and demand grew more than forecast in the second quarter and the effects of the frail external scenario on the local economy have been mild. The utilization of installed capacity has intensified even further. Still, headline inflation has been lower than expected and is currently at the lower part of the tolerance range, as are core measures. Within core inflation, however, the difference between the behavior of goods inflation and services inflation stands out. The latter, more closely associated with the state of the output gaps, has hovered around 5% annually, reflecting that medium-term inflation risks are still present. In this context, the Board has held the monetary policy interest rate (MPR) unchanged at 5% since last January.

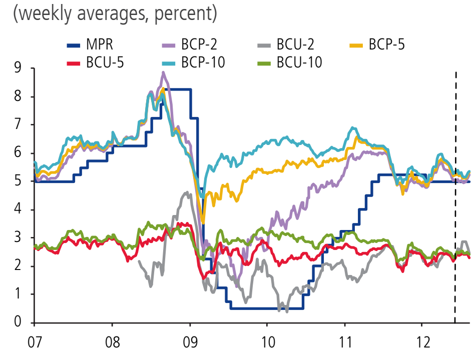
At the statistical closing of this Report, the different measures of market expectations regarding the evolution of the MPR reflect an extended stability, or transitory and limited reductions. Anyway, in the previous months, these expectations anticipated further reductions, which have increasingly subsided as international financial markets showed more calmness and the domestic output data were higher than expected. Thus, the median of the Economic Expectations Survey (EES) of August anticipates that the MPR will remain at 5% during the next two years. The median of the Financial Brokers Survey (FBS) of the second quarter of August forecasts that the MPR will drop 25 basis points (bp) in six months' time and rise again to 5% in twelve months' time. The expectations derived from financial prices are not so clear regarding the possibility of a reduction (figure II.1). Thus, depending on the different measures of expectations, the MPR would range from 4.7% to 5.2% for a one-year term (4.6 and 5.25% in June's Report), and from 5.0% to 5.4% for a two-year term (4.9 and 5.4% in June) (table II.1). The baseline scenario of this Report uses as a working assumption that the MPR path will remain stable over the short term.

FIGURE II.1
MPR and expectations
(percent)



Source: Central Bank of Chile.

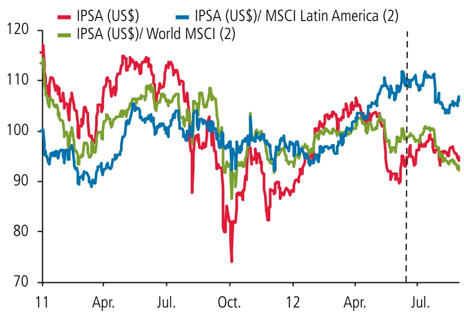
FIGURE II.2
MPR and interest rates on Central Bank of Chile documents (*)
(weekly averages, percent)



(*) Dotted vertical line shows statistical cutoff date of June 2012 Report.

Source: Central Bank of Chile.

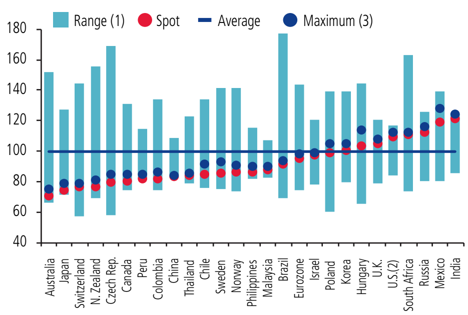
FIGURE II.3
Stock markets (1)
(index, 01/01/2011-08/30/2012=100)



(1) Dotted vertical line shows statistical cutoff date of June 2012 Report.
(2) Morgan Stanley Capital International's stock market indexes by region.

Sources: Central Bank of Chile and Bloomberg.

FIGURE II.4
Nominal exchange rates in the world
(index, 01/01/2000 - 08/30/2012=100)



(1) The range covers maximum and minimum values of the domestic currency in indicated period. (2) The broad index of the U.S. Federal Reserve. (3) Most depreciated value recorded in 2012.

Sources: Central Bank of Chile and Bloomberg.

FIGURE II.5
Nominal exchange rate (1) (2)
(index, 01/02/2011-08/30/2012=100)

(1) See glossary for definition.

(2) Dotted vertical line shows statistical cutoff date of June 2012 Report.

Source: Central Bank of Chile.

TABLE II.1
Expectations of the MPR
(percent)

	At December 2012		One year ahead		Two years ahead	
	June Report	Sept. Report	June Report	Sept. Report	June Report	Sept. Report
EES (1)	5.00	5.00	5.25	5.00	5.25	5.00
FBS (2)	4.75	5.00	4.75	5.00	5.00	5.00
Forward curve (3)	4.74	4.88	4.98	5.18	5.37	5.42
Swap contracts (4)	4.59	4.82	4.58	4.73	4.92	5.01

(1) Surveys from June 2012 and August of 2012.
(2) Surveys from first half of June 2012 and second half of August 2012 .
(3) Constructed using interest rates on swap contracts up to two years and then interest rates on BCPs.
(4) Constructed using interest rates on swap contracts up to ten years.

Source: Central Bank of Chile.

FINANCIAL AND MONEY MARKETS

In the last few months, the local monetary and interbank market has operated normally. As in previous months, the evolution of international financial markets has not had significant effects in local markets. As in other emerging economies, the largest impact of the external frictions has continued to be seen in the performance of fixed-income, stock and foreign exchange markets. However, most recently, idiosyncratic factors have impacted on the evolution of the local stock exchange as judged against comparable markets.

The rates of the Central Bank and Treasury instruments have remained at levels similar to those of the statistical closing of the previous Report. However, fluctuations were present in this period. The nominal rates showed a downward path until July, resulting from external events, and a subsequent reversal, determined by news on local activity. As of the statistical closing date of this Monetary Policy Report, they are between 5.2% and 5.3% for two- to ten-year terms. In turn, the surprises in inflationary levels and the effect on expected inflation of the local growth and of the increase in oil and food prices abroad have affected, to a greater degree, the evolution of the indexed rates of the Central Bank and the Treasury. The two-month term was the one which recorded the highest activity. As of the statistical closing date of this Monetary Policy Report, the BCU rates are around 2.3% and 2.4% for two-, five-, and ten-year terms (figure II.2).

The calmer scenario in the international financial markets has also caused a reduction in risk aversion, thereby improving the external financing conditions in the margin. In this way, sovereign and corporate spreads of emerging economies have decreased.

As mentioned above, the evolution of the local stock exchange has been marked by the relative calmness at external markets and, more recently, idiosyncratic factors. Thus, until late July, the local market showed fluctuations consistent with the activity at the main benchmark exchanges. In the first weeks of August, it had a less favorable performance, which coincided with the announcement of the capital increase by Enersis. Then, its behavior was once again similar to its external peers. At the statistical closing of this Report, the IPSA decreased by 2.5% in local currency as compared to the previous Report. As measured in dollars, this drop is reversed to a 2% increase, which is contrasted with the 6.5% and 8.5% increases of the Latin American and global MSCI indexes, respectively (figure II.3).

With regard to the foreign exchange market, the dollar has depreciated at a global level, though again with fluctuations. As to the Chilean peso, when comparing the statistical closing of this Report with the former one, the appreciation of this currency has been greater than the average of the emerging economies, but nevertheless similar to the levels observed in other commodity exporters (figure II.4). At the statistical closing of this Report, the currency traded around $480 to the dollar, after hitting $475 to the dollar during August. In this way, the peso appreciated 5.3% as from the statistical closing of June's Report. In turn, the currencies of Australia, Canada, and New Zealand appreciated between 4% and 5.5% in the same period. In the same period, the Mexican peso appreciated 6.4% relative to the U.S. dollar. As compared to the currency basket of the main trading partners —multilateral exchange rate—, the appreciation of the peso amounted to 4.7%. Leaving aside the U.S. dollar from this currency basket, the appreciation was smaller: 4.3% (figure II.5).

The real exchange rate (RER) has also decreased: 5.4% between June and August. Given the nominal exchange rate and the parities in the ten business days prior to the close of this Monetary Policy Report, the RER is around 87.5 (where 1986 = 100). Thus, the current level of the RER is below its average of the last 15 to 20 years and is estimated to be in the lower part of the range consistent with its long-term fundamentals (figure II.6). Consequently, the working assumption used in the baseline scenario of this Report is that the RER will remain around its recent levels in the forecast horizon.

FINANCIAL CONDITIONS

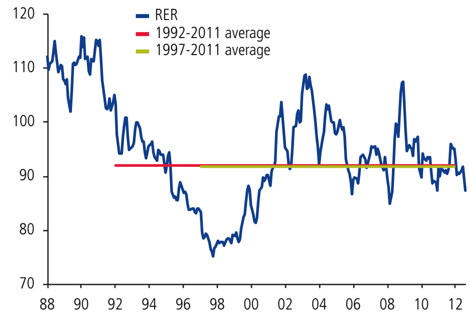
In general, the financial conditions have not shown significant changes in recent months. On the households side, the evolution has continued along the same trend of the first half of the year. Regarding interest rates, those that are applied on the lower-amount tranches have risen, but on average the change has not been substantial[1]/ (figure II.7). In particular, between May and July, the weighted average rate for consumer loans in pesos has remained around 28% annually. The annual growth of loans has decreased gradually (figure II.8).

With regard to mortgages, neither the annual growth rate nor the interest rates charged have changed substantially this year to date[2]/.

[1]/ Interest rates applicable to consumer loans for amounts between 0 and 200 UF have risen during this year, but their relevance on the total amount of these loans is relatively low.

[2]/ As described in the Financial Stability Report of the first quarter of 2012, the statistics on mortgages should be interpreted with caution, because the new subsidy policy, which reduces the share of the Banco Estado in total housing loans, affects historical comparisons.

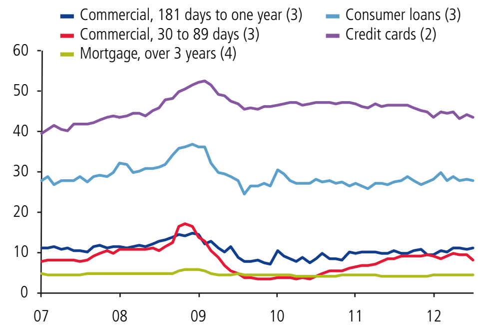
FIGURE II.6
Real exchange rate (*)
(index, 1986=100)



(*) August figure includes information up to 30 August 2012.

Source: Central Bank of Chile.

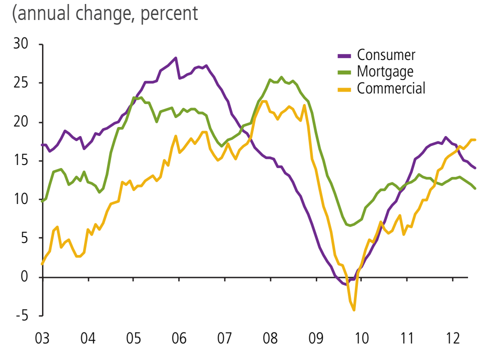
FIGURE II.7
Lending interest rates (1)
(percent)



(1) Weighted average rates of all operations performed in the month.
(2) For amounts up to UF200.
(3) Nominal rates.
(4) Rates in UF.

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

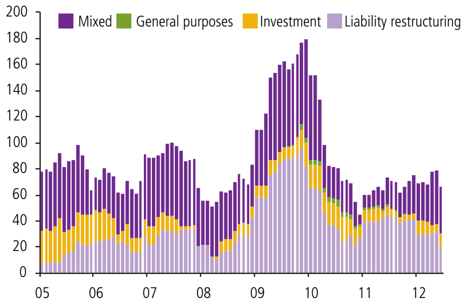
FIGURE II.8
Nominal loans by type of credit (*)
(annual change, percent



(*) Provisional data for July 2012.

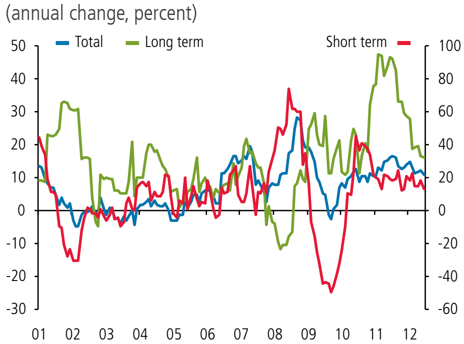
Sources: Central Bank of Chile and Superintendence of Banks and Financial Institutions (SBIF).

FIGURE II.9
Corporate bonds issued by objective
(millions of UF accumulated in twelve months)



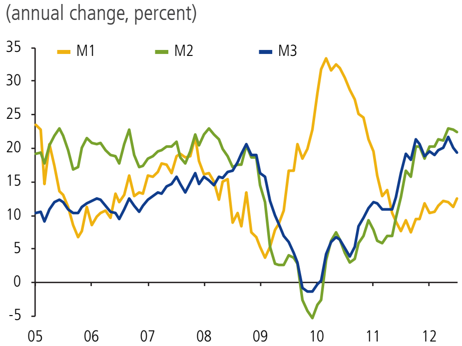
Sources: Central Bank of Chile and Superintendence of Securities and Insurance.

FIGURE II.10
Gross external debt of non-financial corporates
(annual change, percent)



Source: Central Bank of Chile.

FIGURE II.11
Monetary aggregates
(annual change, percent)



Source: Central Bank of Chile.

The Bank Lending Survey for the second quarter showed, for the second consecutive quarter, tighter consumer credit conditions. At the same time, and in contrast with the first quarter when consumer credit demand continued to gain strength, banking institutions perceived that such demand was less solid in this quarter. Nevertheless, financial conditions are still being considered as a factor supporting the consumption performance.

For businesses, lending conditions do not show any relevant changes either, but a sustained increase is indeed noticed in the annual growth of these loans. Business loans have continued to raise their annual growth rate, which reached 17.7% in July (17.1% in May; 15.6% in December 2011). Thus, they have risen back up to the 2005-2006 levels. Anyway, in monthly terms, throughout 2012 there have been no major changes in their expansion velocity, which is consistent with an annualized growth pace of around 18%. Regarding the interest rates of these loans, the term-weighted average decreased by 50 bp from May to July, and ending up at 9.4% in July. Anyway, differences were observed across maturities.

According to the Bank Lending Survey, the approval standards for business loans did not change on aggregate, and the demand for business financing kept on strengthening, except for construction companies, whose demand remained practically unchanged. Additionally, business-related sources of information show that the lending conditions have not undergone major changes over the course of the second quarter and in the third quarter to date.

Regarding other financing sources, the issuance of corporate bonds has shown a relative stability in recent months, most part of which were issued for mixed purposes rather than debt restructuring purposes (figure II.9). In turn, non-financial corporate gross external debt presents slightly decreasing annual variation rates in the last year and a half, due to the evolution of long-term liabilities (figure II.10).

As for nominal monetary aggregates, their annual growth rate rose slightly for M1, and dropped for M2 and M3. In particular, based on data available for July, M1 showed an annual variation of 12.5% (12% in May); while M2 and M3, one of 22.5 and 19.3%, respectively (24.4 and 22.5% in May) (figure II.11).

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

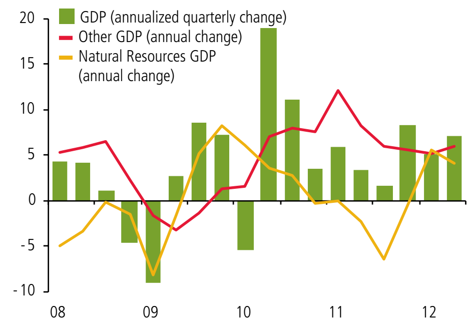
In the second quarter, output increased its expansion pace as compared to the previous quarter. In annual terms, GDP growth rose to 5.5% (5.3% in the first quarter) and, in quarterly terms, it rose to 1.7% (1.3% in the first quarter). The performance of the industries other than natural resources and more closely linked to domestic demand was key to this higher growth, particularly services. Additionally, trade and construction recorded once again annual expansion rates over 7% (figure III.1 and table III.1).

The natural resources industries had a lower annual expansion in the second quarter, which was mostly determined by the performance of electricity, gas and water (EGW) and, to a lesser extent, of the mining industry. In any case, y-o-y EGW growth continued to outperform the aggregate GDP rates: 13.1% (23.8% in the first quarter). The annual growth rate of the mining industry remained around 3% in the second quarter; however, the volume of mining exports recorded a reduced annual variation: 0.6% (5.6% in the previous quarter). The fishery industry showed increased growth, driven by the salmon farming activity.

In the rest of the sectors, the increase in annual growth as compared to the previous quarter was directly related to the performance of domestic demand. In turn, the external demand had a lesser incidence as compared to the previous period. By industrial sectors, the largest annual expansions were recorded in the trade, services, and construction industries. The performance of the manufacturing industry was higher than expected: 3.5% in the second quarter (3.6% in the first quarter). As to its composition, the increase in the industries related to manufacture of goods destined to investment, particularly construction, stood out (figure III.2). There were also specific increases in some productive subindustries, including tobacco and wine production. The industry's export-oriented lines continue to show relative stability. In terms of volume, the annual growth of the exports of this sector was lower than in the previous quarter.

Thus, in the first half of the year, the economy expanded by 5.4% in year-on-year terms. GDP growth in the second quarter exceeded the predictions of the Report of June. Considering these data, and the fact that the effects

FIGURE III.1
GDP growth
(percent)



Source: Central Bank of Chile.

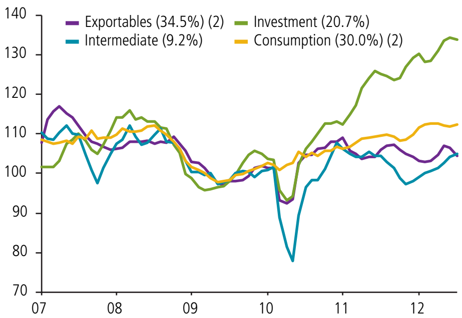
TABLE III.1
Gross domestic product (1)
(weight in GDP; real annual change, percent)

	Weighted 2011	2010	2011	2011 I	2011 II	2011 III	2011 IV	2012 I	2012 II
Agriculture-forestry	2.8	2.3	11.2	15.2	11.6	1.8	9.6	-7.2	2.4
Fishery	0.4	2.2	17.1	25.2	7.0	18.6	19.4	-6.8	2.8
Mining	12.0	1.1	-4.8	-2.5	-5.3	-9.6	-1.9	3.1	2.7
Manufacturing	10.6	3.4	6.6	12.7	8.3	5.6	0.4	3.6	3.5
EGW	3.4	10.7	12.5	14.1	13.9	11.6	10.7	23.8	13.1
Construction	7.1	1.7	11.1	13.4	9.8	9.4	11.7	8.7	7.3
Trade	9.3	17.5	12.1	22.7	11.1	9.0	7.8	7.2	7.1
Restaurants and hotels	1.4	8.9	9.7	17.9	11.9	5.7	5.0	4.1	5.1
Transport	4.5	8.5	8.4	20.6	9.2	2.3	4.0	5.7	6.6
Communications	2.2	9.2	6.9	7.6	6.8	6.7	6.5	6.7	6.1
Financial services	5.6	6.1	9.3	10.0	9.1	9.4	8.7	7.9	9.1
Entrepreneurial services	12.8	7.4	8.2	10.4	9.3	7.2	6.3	8.2	6.5
Personal services (2)	10.6	5.3	7.0	11.1	8.3	4.5	5.3	6.5	6.5
Total GDP		**6.1**	**6.0**	**9.9**	**6.3**	**3.7**	**4.5**	**5.3**	**5.5**
Other GDP		**6.0**	**7.9**	**12.1**	**8.3**	**5.9**	**5.5**	**5.2**	**6.0**
Natural resources GDP		**2.9**	**-2.3**	**0.0**	**-2.3**	**-6.4**	**-0.2**	**5.6**	**4.1**

(1) Preliminary figures.
(2) Includes education and health-care —public and private— and other services.

Source: Central Bank of Chile.

FIGURE III.2
Branches of manufacturing production (1)
(index, 2009=100)



(1) Seasonally-adjusted series. In parentheses, weights in total manufacturing basket.
(2) Excludes tobacco.

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

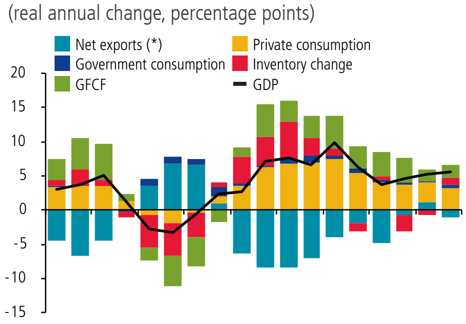
TABLE III.2
Domestic demand (*)
(real annual change, percent)

	2010	2011	2011				2012	
			I	II	III	IV	I	II
Domestic demand	**14.8**	**9.4**	**15.4**	**9.0**	**8.6**	**5.5**	**4.5**	**7.1**
Domestic demand (w/o inventory change)	10.2	10.2	14.5	10.3	8.7	8.1	5.2	5.9
Gross fixed capital formation	14.3	17.6	22.9	14.7	17.1	16.3	7.6	8.0
Construction and other works	1.9	12.7	13.4	11.7	11.0	14.6	10.4	9.1
Machinery & equipment	40.3	25.8	40.5	19.7	27.4	19.5	3.1	6.4
Total consumption	9.0	7.9	11.8	8.9	6.2	5.6	4.4	5.3
Private consumption	10.0	8.8	12.9	9.6	7.2	6.0	4.9	5.5
Durable goods	35.4	23.6	42.1	19.6	21.4	15.8	14.6	11.7
Non-durable goods	8.7	6.9	10.2	8.2	5.1	4.5	2.2	3.5
Services	7.4	7.7	10.3	8.9	6.6	5.5	5.4	5.9
Government consumption	3.9	3.9	6.1	5.7	1.2	3.3	1.1	4.2
Inventory change (annual accum.)	2.0	1.3	2.3	2.0	2.0	1.3	1.2	1.5
Goods and services exports	1.4	4.6	7.2	7.5	-0.7	4.9	5.6	1.2
Goods and services imports	27.4	14.4	23.3	15.9	13.0	7.2	3.6	5.2
Total GDP	**6.1**	**6.0**	**9.9**	**6.3**	**3.7**	**4.5**	**5.3**	**5.5**

(*) Preliminary figures.

Source: Central Bank of Chile.

FIGURE III.3
Contribution to annual GDP growth
(real annual change, percentage points)



(*) Exports minus import of goods and services.

Source: Central Bank of Chile.

of the external situation on Chile have been milder than foreseen, the Board estimates that growth expected for 2012 will be between 4.75% and 5.25%. Second quarter growth also exceeded market expectations, which were revised upwards in the projection for this year: 4.9% in the Economic Expectations Survey (EES) of August (4.7% in June).

For the rest of the year, the Board estimates that output will expand at annual rates lower than those of the first half of the year, thereby gradually driving capacity utilization back to normal levels. The Board continues to estimate trend growth at around 5%. However, in the immediate future, year-on-year output variation rates will show month-on-month substantial fluctuations. These movements will be influenced by the low basis for comparison arising from the strikes which affected the mining industry in 2011, and by the reduced number of business days in the third quarter of 2012.

DOMESTIC DEMAND

Domestic demand increased its expansion pace as compared to the previous quarter. As measured in annual terms, its growth rose to 7.1% (4.5% in the first quarter). Private consumption and investment showed annual increases also above the previous quarter's; however, it was the significant increase in inventory accumulation which generated the acceleration of domestic demand. In fact, excluding inventories, the annual growth of the domestic expenditure dropped: 5.9% annual (5.2% in the previous quarter) (figure III.3 and table III.2).

Inventory accumulation rose to 1.5% of GDP in the last moving year (1.2% in the first). In principle, this increase is estimated to be consistent with a desired inventory accumulation, after depletion in late 2011, which is related to the uncertainty surrounding the effects of the external scenario on the domestic economy. On one hand, the assessment of the industrial inventory level reported by the Monthly Indicator of Business Confidence (IMCE) shows that the perception of inventory surplus has decreased since the beginning of the year (figure III.4). On the other hand, imports of durable goods, particularly cars, had a steep drop in the last months of 2011. This has been largely recovered in recent months. Sources of information related to the automobile trade report that the drop and subsequent recovery is related to a change in the sales outlook in the country. Yet, estimations do not forecast inventory accumulation to keep adding increased momentum to the demand.

With regard to private consumption, its y-o-y variation rate rose again in the second quarter, as a consequence of the behavior of the consumption of non-durable goods and services (figure III.5). Consumption of durable goods, in turn, continued to reduce its y-o-y variation rate, as expected. In July, imports of consumption goods showed an annual growth rate lower than the average rate of the second quarter. Meanwhile, for the same month, retail sales of durable goods reported by the National Statistics Institute (INE) showed an annual expansion rate which exceeded the average rate recorded for the second quarter. Still, the recent real appreciation of the peso favors the consumption of these kinds of goods.

Expectations estimate that consumption will continue to grow at similar rates to the current ones. On one hand, the situation of labor income remains favorable, although employment and nominal wages have increased at rates which are lower than those of previous quarters. Additionally, the lower inflation of the last few months has led to higher real growth in such income. Regarding the labor market, and according to the data reported by the INE, the creation of employment at domestic level has been receding: an annual 1.4% in the moving quarter ended in July (2.7% in the moving quarter ended in March), although salaried employment remains dynamic (figure III.6). The unemployment rate, in turn, has remained at figures which are similar to the previous months: 6.5% (average 6.6% in 2012). Data published by the University of Chile for Greater Santiago also reflect a relatively stable unemployment rate: 7.1% in June, excluding seasonal variation (7.3% in March). In any case, business-related sources of information continue to express the difficulty to find and retain labor in some industries and regions of the country. This is particularly relevant in the northern area in the mining, construction, and agriculture related industries.

In turn, domestic financial conditions have not changed substantially. Interest rates of consumer credit lines that are applied to the lower-amount tranches have risen, but their average has not had relevant changes[1]/. At the same time, annual growth in nominal consumer loans has decreased gradually (figure II.8). The Bank Lending Survey for the second quarter showed tighter conditions applicable to granting of loans. It also showed that demand for loans has weakened. Expectations of consumers, as measured by the Economic Perception Index (IPEC), show improvements, particularly as related to the purchase of household appliances. For the first time in 16 months, the IPEC aggregate index rose up again into the optimistic area.

The annual growth rate of gross fixed capital formation (GFCF) also went up in the second quarter, as a result of the improved performance of the machinery and equipment component. The construction and other works component recorded an annual growth lower than in the previous quarter, somewhat under the first quarter's 10%.

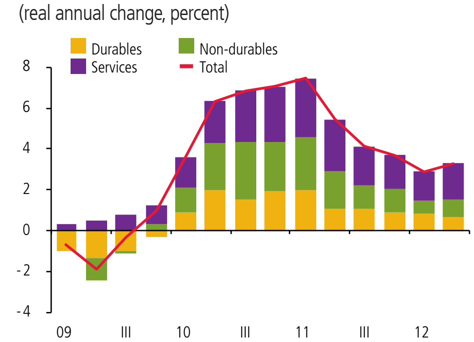
For the coming quarters, estimations continue to forecast that the construction component and other works will be the most dynamic within investment. The increase in housing sales reported for Greater Santiago, many of them off-plan transactions, and the evolution of indicators based on dispatches of building materials support this hypothesis (figure III.7). The same happens with the expected investment in mining and energy projects, which is obtained from the cadastre of the Capital Goods and Technological Development Corporation of June. Although it shows a downward correction for 2012, the estimation of mining, public works and energy projects for 2013-2014 is revised upwards. Regarding investment in machinery and equipment, imports of capital goods of July showed an increase in their annual expansion rates. Behavior of investment, the same as of consumption, is still supported by financial conditions. Commercial loans have shown increasing annual expansion rates for the last several months, and the term-weighted average of interest rates charged has remained stable.

[1]/ Interest rates applicable to consumer loans for amounts between 0 and 200 UF have risen during this year, but their relevance on the total amount of these loans is relatively low.

FIGURE III.4
Current inventory situation

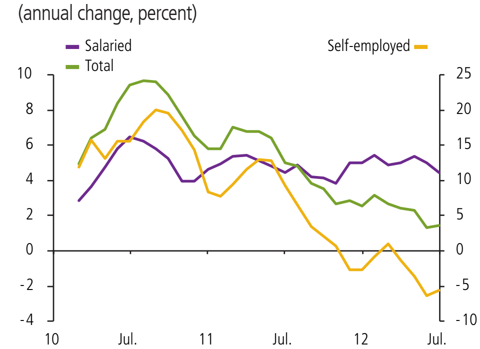
(1) IMCE: Value above (below) 50 points indicates more (less) than desired level.
(2) Seasonally-adjusted quarterly series.
Sources: Central Bank of Chile and Icare/Universidad Adolfo Ibáñez.

FIGURE III.5
Contribution to annual private consumption growth
(real annual change, percent)



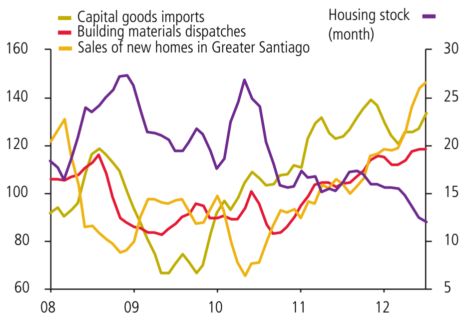
Source: Central Bank of Chile.

FIGURE III.6
Job creation
(annual change, percent)



Source: National Statistics Institute (INE).

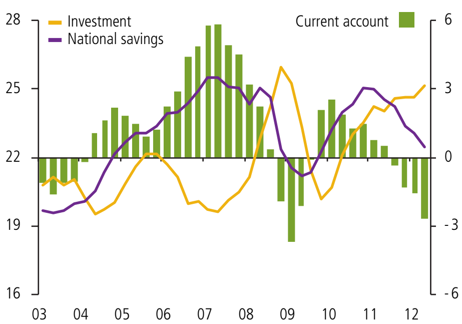
FIGURE III.7
Investment indicators (*)
(index, January 2007- July 2012 average = 100)



(*) Moving quarter. Seasonally-adjusted series.

Sources: Central Bank of Chile and Chilean Chamber of Construction.

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



Source: Central Bank of Chile.

CURRENT ACCOUNT

The current account of the balance of payments accumulated in the second quarter a deficit of US$2,442 million, equal to a 2.7% of GDP in the last moving year (1.6% in the first quarter). This deficit was US$2,036 million higher than the same period in 2011. The difference was attributable to the trade balance, which dropped by US$2,656 million in said period. This was due to a reduction in the value of exports (US$1,661 million) and an increase in imports (US$968 million). Regarding exports, this drop was mainly explained by the lower price of copper, since the volumes even rose. In turn, imports reflected the growth of the domestic demand.

In the baseline scenario of this Report, the current account deficit is estimated at 3.2% of GDP for 2012 and 4.4% of GDP for 2013 (figure III.8). The widening of the current account deficit, in a context of favorable terms of trade, results from the strong increase in investment and a decrease in national savings.

Regarding investment, its increase is mainly related to investment in mining, in view of the price levels forecast for copper. Information from different sources shows that the investment in projects related to the mining sector will reach record levels during the years to come.

As regards savings level, it arises from a lower level of both public and private savings. On one hand, public savings were substantially reduced by the countercyclical fiscal policy implemented in 2009[2]/. In recent years, such savings partially recovered, but they are still below the levels that preceded the international recession. Private savings, on the other hand, have decreased as a result of the sustained dynamism of consumption.

The current account measured at trend prices, which is adjusted by the volatile elements of the terms of trade (box V.2), would post, for 2012, a 4.6% deficit of GDP, which would probably rise to 5.2% of GDP in 2013.

[2]/ See Box III.2 in Monetary Policy Report of June 2012.

IV. PRICES AND COSTS

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

RECENT INFLATION TRENDS

In the past few months, y-o-y inflation of the CPI has continued on a downward path, and is now at the lower part of the tolerance range. In turn, core inflation, which excludes food and energy (CPIEFE)[1]/ has stabilized its growth near 2.5% y-o-y. The inflation accumulated in the last two months has been lower than forecast in the Report of June. However, medium-term risks for inflation still persist, particularly because the utilization of installed capacity has intensified further. This can be seen in the fact that, excluding food and energy, the services inflation —more closely associated with the state of the output gaps—, has remained around an annual 5.0%, with no major differences as compared to June (figure IV.1 and table IV.1).

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

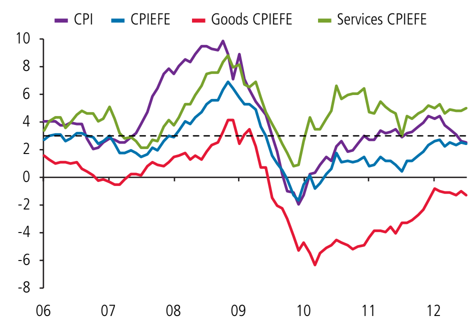
	CPI	CPIX	CPIX1	CPIEFE	CPI tradables	CPI non-tradables	CPI goods	CPI services
2011 Jan.	2.7	2.0	0.5	0.8	1.2	4.8	1.0	4.8
Feb.	2.7	2.1	0.4	0.9	1.2	4.7	0.9	4.8
Mar.	3.4	2.4	0.7	1.4	1.8	5.5	1.6	5.6
Apr.	3.2	2.4	0.7	1.2	1.7	5.2	1.4	5.4
May.	3.3	2.5	1.1	1.2	1.8	5.2	1.7	5.2
Jun.	3.4	2.4	0.9	0.9	2.3	4.9	1.9	5.4
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

(*) See glossary for definition.

Source: National Statistics Institute (INE).

[1]/ The CPIEFE (CPI excluding food and energy) is the price index of the consumer basket excluding the prices of foodstuffs and energy. In most OECD economies this index is used as a core inflation measure.

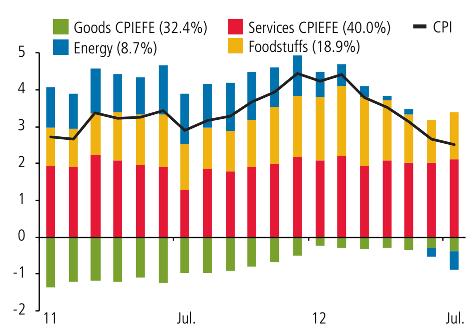
FIGURE IV.1
Inflation indicators (*)
(annual change, percent)



(*) See glossary for definition.

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

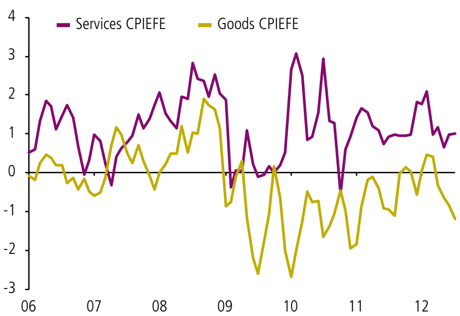
FIGURE IV.2
Contribution to annual CPI inflation (*)
(percentage points)



(*) In parentheses, shares in CPI basket.

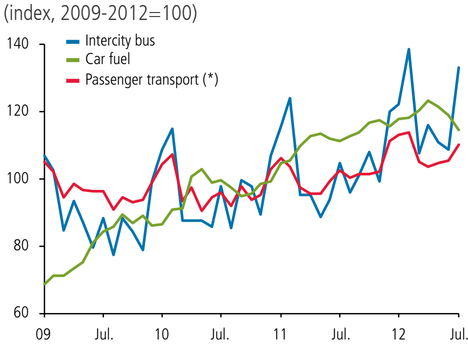
Sources: Central Bank of Chile and National Statistics Institute (INE).

FIGURE IV.3
Core inflation
(accumulated in three months, percent)



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

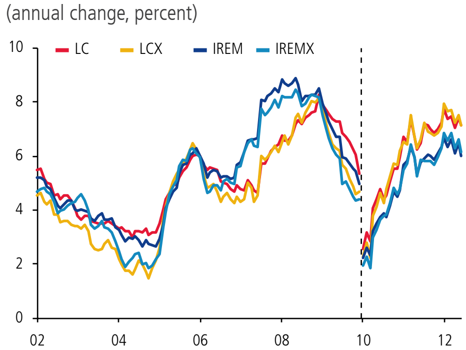
FIGURE IV.4
Transport fares
(index, 2009-2012=100)



(*) Average prices of railroad, urban, highway and air transport services.

Source: National Statistics Institute (INE).

FIGURE IV.5
Nominal wages (1) (2)
(annual change, percent)



(1) As from January 2010, the new indexes with annual base 2009=100 are used, so they are not strictly comparable with previous figures.
(2) See glossary for definition.

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

The lower records of headline CPI are mainly attributable to a larger-than-forecast decrease in fuel prices —in response to the global drop in fuel prices until mid-July— and in prices of goods. Most recently, the appreciation of the exchange rate has also contributed to this result.

Thus, in the last three months, the CPI totaled -0.3%, (0.2% in the three months previous to the statistical closing of the June Report). This result is mainly explained by the behavior of the goods component of the CPIEFE and of fuel prices, whose decreases could not be offset by the rises in the prices of foodstuffs, particularly fresh fruit and vegetables, and services. These differences in the monthly inflation also appear in annual terms. Thus, in June and July, energy showed a negative incidence in annual inflation, unlike its behavior before May. Food and services continued to be behind the positive annual inflation (figure IV.2).

The CPI excluding food and energy accumulated a 0.1% increase in the last three months (0.1% in the Report of June). The determining condition continued to be inflation of services which, from May to July, rose by 1% since the closing of the previous Report (0.7%). The inflation of goods has continued to bear a negative influence on the CPIEFE, thereby accumulating a 1.2% reduction, which exceeded its decrease in the Report of June (figure IV.3).

In services, the greatest incidence comes from transport, particularly the interurban passenger branch (0.15 percent points —pp— between May and July) (figure IV.4). Health-care, rent, and education and recreation also continued to contribute to the increase in services inflation.

The pressures on services inflation, which arise from the cost of labor, are quite similar to those of the previous Report. Although growth in nominal wages remains high, it has stabilized between 6% and 7% annually, thereby decreasing its expansion velocity as compared to April (figure IV.5). The annual growth of nominal unit labor costs, adjusted for productivity, has dropped as compared to the previous Report. Thus, as of June, its y-o-y variation is between 0.5 and 1.5%, depending on the measurement (figure IV.6). Although the labor market remains tight, the annual nominal growth of the wage mass has decreased from previous months. This is due to the lower job creation as compared to previous quarters and to the above mentioned stabilization of nominal wage growth. In any case, according to business-related sources of information, the difficulty to find labor has remained stable or has even intensified in certain regions and sectors of the country, including mining, construction, and agriculture.

Inflation of goods in the CPIEFE, as mentioned above, continued to show negative monthly rates, although higher than those recorded between March and May this year. Its evolution was mainly determined by the movements in the prices of clothes, which underwent a substantial drop in July, reflecting the end of the Autumn-Winter season sales. The prices of household equipment also decreased in recent months, but in the year to date, they have stabilized as compared to the marked downward trend of the last few years (figure IV.7). Between June and July, the prices of these goods had smaller negative monthly variations than those recorded until the previous Report. This is consistent with the fact that the prices in pesos of the consumption goods imported in the second quarter reversed part of the decrease observed in the first quarter of the year.

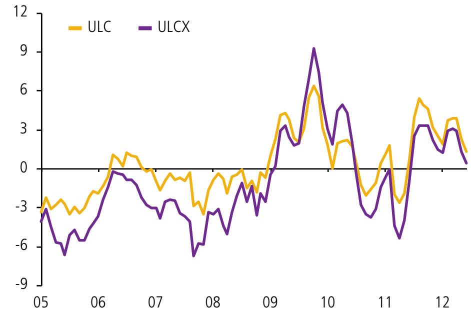
Data collected since the last Report show that food prices had a positive incidence on monthly inflation, particularly in July. This was mainly due to an increase in the fresh fruit and vegetables component resulting from the habitual seasonal variation of some products, such as vegetables, and transitory supply problems in other products, including potato and avocado. In the immediate term, prices are expected to stabilize or decrease as the supply-side factors normalize. However, the drought affecting some regions of the country could impact the vegetable prices in the coming months, particularly towards year's end and early next year.

In June and July, when new data was collected since the previous Report, non-perishable food prices have also had a positive effect on total inflation, particularly in July. International prices of agricultural products rose. Particularly, the price of grains, as measured by the Goldman Sachs index, rose by 40% since the June Report. Market expectations, as reflected in the downward path for the futures of these prices, show that the recent increase is due to supply problems, such as the drought in the Northern hemisphere, whose effects would revert to some extent in the following months. According to sources of information related to this industry, the recent increases in the international prices of products such as wheat have been passed through only partially to the prices of the domestic market. This may be attributable to the appreciation of the peso and to the fact that food margins, although they have dropped quite recently, still remain high. Thus, the relationship between food prices obtained from the CPI and its international prices has diminished. This suggests that the ability to cushion cost increases has decreased in this industry.

As mentioned above, the price of energy has had monthly and annual negative incidences in the last months. This occurred mainly because of the drop observed until July of the international benchmark price of oil and its byproducts. However, as from mid-July, the international price of oil has risen, mainly because of geopolitical tensions in the Middle East and also because of some supply-side problems. Specifically, the prices of Brent oil and gasoline in the Gulf of Mexico rose between 15 and 20%, respectively, as from the statistical closing of the previous Report. These increases have started to be visible in the domestic market (figure IV.8). The outlook of these prices has also been adjusted upwards, although at two-year terms they reach levels which are similar to those projected in the previous Report.

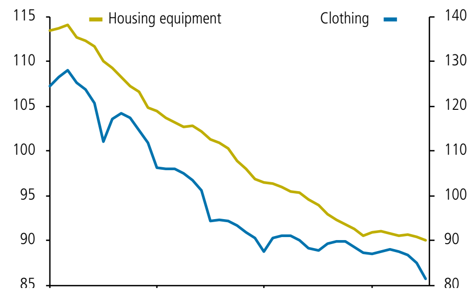
It is important to point out that the above described rises in the prices of some foodstuffs and of oil at international markets suggest that monthly inflation records will be higher in the coming months. Additionally, they represent a risk in the current juncture, in which the utilization of installed capacity has intensified further.

FIGURE IV.6
Labor costs adjusted for productivity (*)
(annual change, percent)



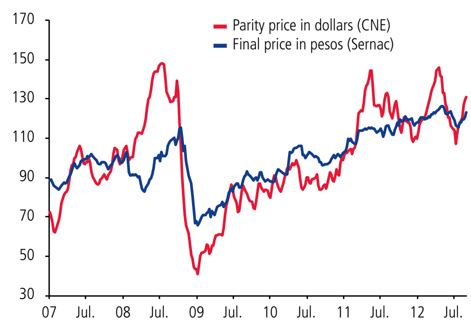
(*) See glossary for definition.
Source: Central Bank of Chile.

FIGURE IV.7
Goods prices
(index, 2009-2012=100)



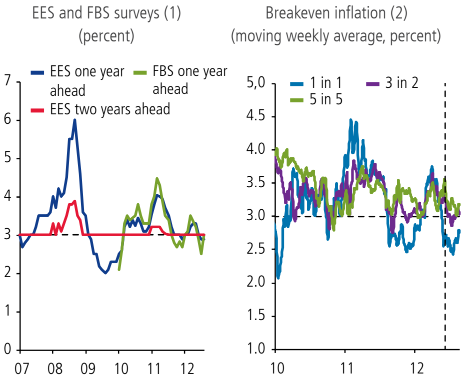
Source: National Statistics Institute (INE).

FIGURE IV.8
Weekly gasoline prices
(index, 2007-2012=100)



Sources: National Energy Committee (CNE) and National Consumers' Service (Sernac).

FIGURE IV.9
Inflation expectations



(1) FBS considers the survey of the first half of the month, except for August, which uses the second half.
(2) Forward breakeven inflation based on swap rates. Dotted vertical line shows statistical cutoff date of June 2012 Report.

Source: Central Bank of Chile.

OUTLOOK FOR INFLATION

The short-term outlook for inflation is down from June. This was mainly caused by the reduced headline inflation in the last few months. In particular, for December this year, private expectations anticipate that the CPI will be below 3%, the same as in the baseline scenario of this Report. Towards the end of the projection horizon, expectations have remained close to the target.

Private inflation expectations derived from the Economic Expectations Survey (EES) of August dropped to 2.0% for December this year (3.0% in June). Expectations one year ahead are at 2.9% (3.0% in June). For the same term, the Financial Brokers Survey (FBS) of the second half of August released 3.0% (2.9% for the survey in the first half of June). Expectations derived from surveys to consumers and companies also show reductions. One-year inflation perspectives of the Monthly Business Confidence Index (IMCE) decreased to 3.2% in July (3.7% in May). The percentage of people who think that inflation will rise "a lot" in the next twelve months, as measured by the Economic Perceptions Index (IPEC), was 56% in July (57% in May). Inflation expectations derived from the breakeven inflationary rates, at different terms, also showed a downward trend as compared to the previous Report. In the breakeven inflationary rates 1 on 1 and 3 on 2 derived from average interbank swap contracts, this trend started to reverse by late July. Accordingly, at the statistical closing of this Report, they are near the levels of June, (i.e., around 3.0%) (figure IV.9).

In the baseline scenario, the Board anticipates that CPI inflation will end the year below June's projections, reaching 2.5%. It will then return gradually to 3% by the second half of 2013, to stay in the neighborhood until the end of the projection horizon, this time the third quarter of 2014.

V. INFLATION SCENARIOS

This chapter presents the Board's assessment on the Chilean economic outlook over the next two years. Projections are presented of the most likely inflation and growth trajectories. These are conditional on the assumptions in the baseline scenario, thus the Board's assessment of the risk balance for output and inflation is also provided.

BASELINE PROJECTION SCENARIO

In the baseline scenario, the external impulse on the Chilean economy over the next two years will be somewhat weaker than assumed in the last Monetary Policy Report (table V.1). The world growth forecast does not differ much from that of June: trading partners will grow 3.5% in 2012. The main factor behind our revisions is the performance of emerging economies, affected by a debilitated external demand. Partial third-quarter indicators such as exports, manufacturing output and expectations suggest that such weakness has continued. Toward 2013, as the stimulative policies implemented in recent months begin bearing fruit, the emerging world should post a higher growth rate that should result in the trading partners growing by 3.8%.

Growth projections for the developed economies are fairly unchanged from June. Adjustments in the United States and the Eurozone respond to actual first-half data being a little better than thought earlier, not to a better evaluation of their future performance. Both economies continue to reflect the ongoing deleveraging process of households, firms and governments. Meanwhile, their weak labor markets work against a significant recovery of private consumption, while widespread uncertainty, particularly in the Eurozone, hinders investment plans. Accordingly, these economies are forecast to grow substantially below their averages for the past 15 to 20 years.

In the baseline scenario, commodity prices will drop from their current levels, primarily because recent rises originate in supply-side factors: climatic for some grains and mainly geopolitical risks in the case of oil and derivatives. The Brent oil price is forecast at US$113 and $109 per barrel in 2012 and 2013, respectively. With mild fluctuations, copper has hovered around US$3.4 per pound since June, so its price forecast is unchanged. Over the projection horizon, the terms of trade will be lower than foreseen in June (figure V.1).

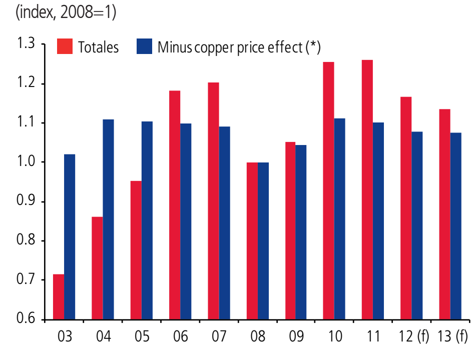
TABLE V.1
International baseline scenario assumptions

	2011 (e)	2012 (f)	2013 (f)	2014 (f)
	(annual change, percent)			
Terms of trade	0.5	-7.4	-2.6	1.3
Trading partners' GDP (*)	4.1	3.5	3.8	4.3
World GDP at PPP (*)	3.8	3.1	3.6	4.1
World GDP at market exchange rates (*)	2.8	2.5	2.8	3.4
External prices (in US$)	10.1	-0.9	1.3	2.8
	(levels)			
LME copper price (US$cent/pound)	400	355	340	350
WTI oil price (US$/barrel)	95	97	97	93
Brent oil price (US$/barril)	111	113	109	103
Gasoline parity price (US$/m3) (*)	803	843	796	753
Libor US$ (nominal, 90 days)	0.3	0.4	0.4	0.6

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

Source: Central Bank of Chile.

FIGURE V.1
Terms of trade
(index, 2008=1)



(f) Forecast.

(*) Estimates use as benchmark the 2008 average price at the London Metal Exchange. No other potential effects on price or quantity are considered. For the period 2003-2007 provisional calculations are made using balance of payments data.

Source: Central Bank of Chile.

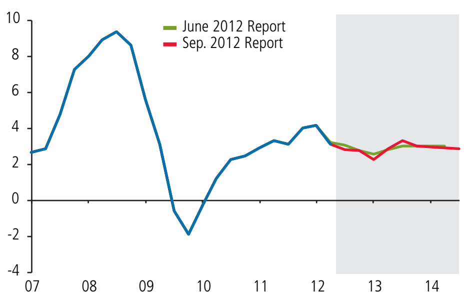
TABLE V.2
Economic growth and current account

	2010	2011	2012 (f)	2013 (f)
	(annual change, percent)			
GDP	6.1	6.0	4.75-5.25	4.0-5.0
National income	13.1	6.1	3.8	3.8
Domestic demand	14.8	9.4	5.6	5.5
Domestic demand (w/o inventory change)	10.2	10.2	5.5	5.8
Gross fixed capital formation	14.3	17.6	7.0	7.1
Total consumption	9.0	7.9	5.1	5.4
Goods and services exports	1.4	4.6	3.5	3.6
Goods and services imports	27.4	14.4	4.0	5.8
Current account (% of GDP)	1.5	-1.3	-3.2	-4.4
National saving (% of GDP)	25.1	23.4	22.0	21.2
GFCF (% of nominal GDP)	21.5	23.2	23.6	24.4
GFCF (% of real GDP)	23.,6	26.2	26.7	27.3
	(US$ million)			
Current account	3,269	-3,221	-8,500	-12,200
Trade balance	15,324	10,792	4,200	100
Exports	70,897	81,411	77,800	78,800
Imports	-55,572	-70,619	-73,600	-78,700
Services	-1,806	-2,417	-2,100	-2,100
Rent	-14,765	-14,015	-12,600	-12,300
Current transfers	4,515	2,418	2,000	2,100

(f) Forecast.

Source: Central Bank of Chile.

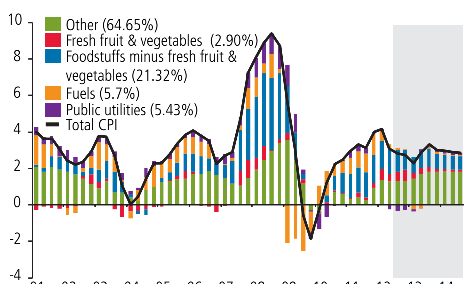
FIGURE V.2
CPI inflation forecast (*)
(annual change, percent)



(*) Gray area, as from the third quarter of 2012, shows forecast.

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 third quarter of 2012, shows breakdown of inflation forecast in the baseline scenario.
(2) In parentheses, shares in CPI basket.

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

World inflation forecasts are adjusted downward with respect to June, reflecting that, in general, inflation figures have dropped responding to weaker output.

The baseline scenario assumes that new stress episodes will arise in international financial markets, mainly because of difficulties to resolve fundamental problems in the Eurozone. This will drive several measures of risk premiums to be, on average, above their historic figures.

In Chile, the baseline scenario revises the growth range forecast for 2012 upward, placing it between 4.75 and 5.25% (table V.2). The main reason behind this change is that in the second quarter output exceeded June's projections, as the effects of the external scenario have been milder than forecast. Going forward, these effects will be smaller and slower than was thought before, to become more clearly visible towards the end of the second half. This, combined with the evolution of actual data, underlies the downward correction of our forecasts for goods and services exports. In the second half of 2012, GDP will reduce its growth rate compared with the first half, gradually leading to a normal usage of installed capacity. In the immediate future, y-o-y output growth figures will be more volatile than usual. Mining figures for August will be influenced by the low basis of comparison due to strikes and climatic problems in major mines in 2011. September will be affected by the fact that it comes with four business days less than did September of last year.

In 2013, the economy will grow less than in 2012. In the baseline scenario, it will be between 4 and 5% y-o-y, owing to slower GDP growth of natural resources and other products. This, primarily because of the necessary convergence towards rates of expansion that help decompress installed capacity utilization.

In 2012 and 2013, domestic demand will outperform GDP growth in annual terms, reflecting the sustained strength of expenditure. This is related to the increase in household income deriving from a dynamic labor market, with continuing favorable financial conditions and the momentum that the economy, and especially investment, will continue to receive from several mining projects under way. The strong inventory accumulation observed in the second quarter of this year will not be repeated. In 2013, consumption and gross fixed capital formation will exceed the growth rates foreseen for this year. In the latter case, the postponement of projects from 2012 to 2013 or 2014 as shown in the CBC survey reflects in the stronger increase of the construction and infrastructure works component. Machinery and equipment will also grow more in 2013, considering the effects of the exchange rate appreciation on imports of these goods. Thus, in real terms, gross fixed capital formation will reach 26.7% of GDP in 2012, and 27.3% in 2013.

The current account deficit estimated for 2012 is 3.2% of GDP and 4.4% for 2013. Next year, the trade balance will be near zero, mainly because of higher imports than in 2012, reflecting the foreseen evolution of consumption and investment. To a lesser extent, it will respond to the effects on valued exports of a lower copper price. The current account measured at trend prices will also post a larger deficit in 2013 than in 2012, going from 4.6% of GDP to 5.2%[1]/[2]/ (box V.1). This reflects the fact that the wider current account deficit obeys largely to the stronger dynamism that is expected for domestic expenditure.

The baseline scenario assumes that the structural fiscal deficit will converge to 1% of GDP towards the end of the current Administration, as announced by the authority and in conformity with the Fiscal Responsibility Law.

As for inflation, the baseline scenario foresees that CPI inflation will end the year below June's projections, reaching 2.5%. It will then return gradually to 3% by the second half of 2013, to stay in the neighborhood until the end of the projection horizon, this time the third quarter of 2014. The CPIEFE will converge to 3% later than foreseen in June, partly because of lower external inflation. Considering the higher world prices of grains and fuels, the domestic prices of foodstuffs and energy are revised upward from June (figures V.2 and V.3) (table V.3).

As working assumptions, the inflation trajectory assumes that wages will be adjusted according to productivity and the inflation target. Other working assumptions are that the RER will remain around its recent figures during the forecast horizon. In addition, it is assumed that the MPR will remain stable over the short term (figure V.4).

RISK SCENARIOS

The baseline scenario reflects the developments that the Board believes to be the most likely to occur with the information at hand at the statistical closing of the Report. However, there are risk scenarios that, if materialized, might change —significantly, in some cases— the macroeconomic outlook and, therefore, the course of monetary policy. On this occasion, after evaluating the alternative scenarios, the Board estimates that the risk balance for output and inflation is unbiased (figures V.5, V.6 and V.7).

Abroad, the risks described during the past several quarters have not changed significantly. The situation of the Eurozone is complex. The materialization of the announcements will not be easy and the passing of time will bring more problems to the economies of peripheral Europe, so a severe aggravation of the financial crisis in the Eurozone or even more extreme scenarios with systemic implications cannot be ruled out. Add to this the discussion in the United States to prevent fiscal adjustments from being triggered in 2013. If attempts to reach agreements are unsuccessful, this economy's GDP growth could fall significantly and tensions could increase in financial markets.

[1]/ This estimate considers corrections to prices, not volumes. Long-term prices of US$2.8 per pound of copper and US$80 per barrel of oil are projected.
[2]/ These figures are below the ones published before due to adjustments in its calculation method.

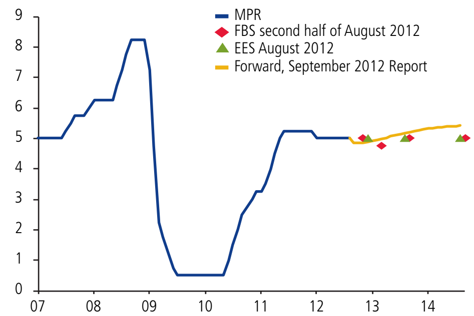
TABLE V.3
Inflation

	2010	2011	2012 (f)	2013 (f)	2014 (f)
	(annual change, percent)				
Average CPI inflation	1.4	3.3	3.2	2.9	
December CPI inflation	3.0	4.4	2.5	3.0	
CPI inflation in around 2 years (1)					2.9
Average CPIEFE inflation (2)	0.5	1.3	2.5	2.6	
December CPIEFE inflation (2)	1.5	2.4	2.3	2.8	
CPIEFE inflation in around 2 years (1) (2)					2.8

(f) Forecast.
(1) Inflation forecast at the third quarter of 2014.
(2) The CPIEFE (CPI excluding food and energy) is the price index of the consumer basket excluding the prices of foodstuffs and energy. In most OECD economies this index is used as a core inflation measure.

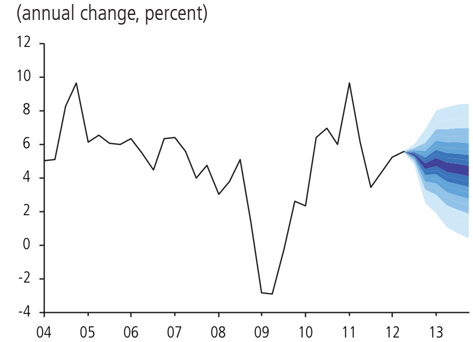
Source: Central Bank of Chile.

FIGURE V.4
MPR and expectations
(percent)



Source: Central Bank of Chile.

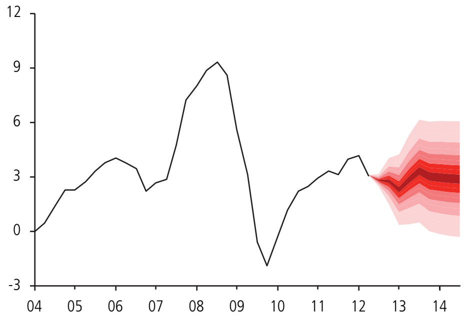
FIGURE V.5
Quarterly GDP growth scenarios (*)
(annual change, percent)



(*) The figure shows the confidence interval of the baseline projection over the respective horizon (colored area). Confidence intervals of 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 basline scenario uses as a working assumption that the MPR will remain stable over the short term.

Source: Central Bank of Chile.

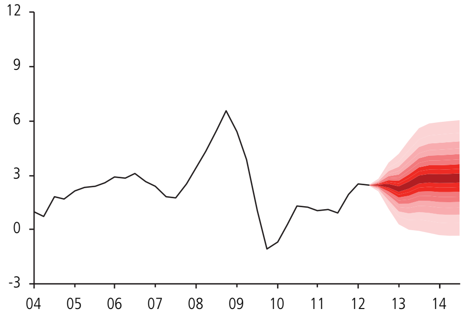
FIGURE V.6
CPI inflation forecast (*)
(annual change, percent)



(*) The figure shows the confidence interval of the baseline projection over the respective horizon (colored area). Confidence intervals of 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 basline scenario uses as a working assumption that the MPR will remain stable over the short term.

Source: Central Bank of Chile.

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



(*) The figure shows the confidence interval of the baseline projection over the respective horizon (colored area). Confidence intervals of 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 basline scenario uses as a working assumption that the MPR will remain stable over the short term.

Source: Central Bank of Chile.

In the emerging world, the biggest risk is a deepening of signs of economic slowdown. On aggregate, the world growth forecast does not divert from the average of the past 15 to 20 years, but this has been sustained by the expansion of the larger emerging economies. Particularly preoccupying is the performance of China, due to its weight in the world economy and its relevance in the evolution of the prices of copper and other commodities. Should it post a sharper deceleration, global growth would weaken further, with intensified effects on commodity exporting economies like Chile, which are still growing at high rates. Another possibility is for supply-side factors to intensify recent increases in the prices of some commodities, especially fuels and grains.

Locally, medium-term inflationary risks are still present. The recent increase in the world prices of fuels and some foodstuffs could rapidly pass through to inflation, all the more so considering the current state of output gaps. In addition, if domestic output and demand remain as dynamic even or more so, they can further intensify the usage of installed capacity pressuring inflation away from the target. This could also could result in a widening of the current account deficit that could create vulnerability factors in the economy in a complex global environment. This variable is important for the evolution of the conditions for accessing external financing. Sudden changes in the sources of credit and/or the terms of trade (e.g., a significant drop in the copper price) could trigger difficult adjustments in the domestic economy, with an impact on demand, employment, credit and the real exchange rate. In the past, most crises faced by the country were preceded by large, persistent deficits in the current account. However, the economic policy framework in force has advanced to include a rule that guides fiscal policy and shields public expenditure from copper prices over-increasing above their estimated long-term trend. It also considers a floating exchange rate policy that allows early adjustments to deal with unexpected changes in external conditions. However, the Board believes that it is important to closely monitor the factors underlying the current deficit, in order to prevent the incubation of imbalances affecting future economic performance.

The current macroeconomic scenario poses significant risks demanding policy responses in different directions. On one hand, although so far its effects have been mild, the external situation is severe. Chile is a small economy, commercially and financially open, so it will not be immune to global developments. The probability of extreme events has not diminished and their materialization would have very severe consequences on output around the world, including Chile. On the other hand, the strength of domestic demand and output, together with recent increases in some commodity prices, means that medium-term inflationary risks remain present. The MPR is within a range of values that are considered neutral, providing flexibility to wait for the concrete effects of such scenarios on the Chilean economy to become visible. The Board monitors closely the evolution of the external and internal macroeconomic scenario and its implications on inflation, and reiterates its commitment to conduct monetary policy so that projected inflation stands at 3% over the policy horizon.

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

The macroeconomic scenario facing the Chilean economy has oscillated between two opposing forces in the past year. On one hand is the gradually deteriorating external scenario, and, on the other, stronger-than-forecast growth in domestic output and demand, with milder-than-expected effects from the complex external scenario. Inflation has fluctuated significantly. At the end of 2011 and the turn of 2012, inflation rose to more than 4% y-o-y, reflecting the increase in world fuel prices and supply-side shocks that affected the prices of some perishable goods. Later on, over the course of this year, it has descended to less than 3%, due to the reversal in the fuel price increase and, primarily, because the goods component of core inflation (CPIEFE) has remained low. The exchange rate appreciation that began in late 2011 contributed to this result. In any case, medium-term inflationary risks have been present throughout the year, as higher growth has intensified the use of productive resources. This box reviews the main changes occurred in the baseline scenario since September 2011.

The world economic outlook has deteriorated in the past twelve months. The growth scenario foreseen for the developed world has posted the biggest change, going from weak growth to recession in several European economies. Financial stress has further tightened credit constraints, while at the same time the substantial fiscal adjustments needed particularly in peripheral Europe have hindered growth. In other developed economies, the scenario of low growth and slow recovery has been validated. In the emerging world, the effects of the global situation have become apparent, with a more marked slowdown in growth in recent months. Worth noting are developments in large economies, like China, Brazil and India. Thus, in the past year, the growth outlook for the world and Chile's trading partners have been revised downward by around one percentage point for 2012 and 2013 (table V.4).

Tensions in world financial markets peaked in the last quarter of 2011 and mid-2012. However, announcements made and measures taken by European policy makers helped bring some calm to the markets, although risks are still high. Among the steps taken by Eurozone authorities it is worth noting the three-year loans granted by the European Central Bank (ECB), the delivery of the second rescue package for Greece, its debt swap with the private sector and the announced capitalization of the Spanish banking system. There is also the announced attempts to advance towards a banking union and statements by the ECB governor regarding the possibility of shortly implementing a sovereign bond purchase plan, upon political agreement on a fiscal adjustment plan. These measures have helped improve global financial conditions and particularly the Eurozone's. Similarly, sovereign risks have fallen, stock markets have recovered part of their value after the sharp drops of the second half of 2011; volatility, as measured by the VIX, has receded.

In emerging economies, the greater impact of external tensions has reflected on the performance of their fixed-income, stock, and currency markets. In Chile, some temporary frictions were observed in late 2011 in the money market. After that, the local market has operated normally. Still, the baseline scenario continues to assume that international financial markets will continue to fluctuate, and increased stress is not ruled out.

TABLE V.4
Main international scenario assumptions

	Sept. 11	Dec.11	Mar.12	Jun.12	Sept.12
World GDP at PPP (annual change, percent)					
2012	4.0	3.5	3.3	3.2	3.1
2013	4.5	4.1	3.9	3.6	3.6
Trading partners' GDP (annual change, percent)					
2012	4.3	3.8	3.8	3.6	3.5
2013	4.6	4.2	4.2	3.9	3.8
Brent oil price (US$/barrel)					
2012	108	107	121	107	113
2013	106	102	115	97	109
WTI oil price (US$/barrel)					
2012	89	100	107	92	97
2013	91	96	106	87	97
LME copper price (US$cent/pound)					
2012	370	350	370	355	355
2013	350	340	360	340	340
Terms of trade (annual change, percent)					
2012	-5.3	-6.7	-5.3	-6.9	-7.4
2013	-2.6	-3.5	-0.1	-1.5	-2.6
External prices, in US$ (annual change , percent)					
2012	2.9	1.3	1.9	0.6	-0.9
2013	2.1	2.1	3.3	2.4	1.3

Source: Central Bank of Chile.

Beyond the weakened global economic scenario, some commodities have been affected by supply-side problems. Foods, due to droughts in the main producing countries. Oil, by the intensification of conflicts in the Middle East, which drove the Brent oil price to fluctuate between US$89 and US$126 per barrel in the last year. The copper price was more stable than other natural resources, hovering around US$3.5 per pound in 2012 so far. Forecasts for the Brent crude oil price in 2013 place it somewhat higher than it was in September 2011. Accordingly, the terms of trade are revised downward for this and next year from projections a year ago, although they are still high by historic standards.

Globally, inflation and short-term expectations indicators rose in the first quarter, owing mainly to the higher price of crude oil. However, the subsequent evolution of the oil price and, especially, the weakness of the world economic scenario eased concerns. Actually, monetary policy makers have either sustained or boosted the monetary stimulus in the past year.

TABLE V.5

Economic growth and current account in 2012

	Sept. 11	Dec.11	Mar.12	Jun.12	Sept.12
	(annual change, percent)				
GDP	4.25-5.25	3.75-4.75	4.0-5.0	4.0-5.0	4.75-5.25
Output risk balance	downward bias	downward bias	unbiased	downward bias	unbiased
Domestic demand	4.5	3.7	5.3	5.2	5.6
Total consumption	4.9	4.5	4.8	4.8	5.1
Gross fixed capital formation	7.1	5.8	8.9	7.4	7.0
	(percentage of GDP)				
Current account	-2.1	-3.3	-3.4	-3.1	-3.2

Source: Central Bank of Chile.

Domestically, the range for growth in 2012 was gradually revised to include the economic developments abroad and their effects in Chile. In December of 2011, the growth range was revised downward, due to the deteriorated external scenario and its potential consequences for domestic demand. However, over the course of 2012 so far said revision was reversed as domestic demand behaved more strongly than foreseen. The forecast for domestic expenditure was changed from 4.5% to 5.6% y-o-y in the last year (table V.5).

The current account deficit forecast for the year has also increased, responding mainly to the aforesaid increased dynamism of domestic demand, but also because of the lower copper price foreseen in 2012. Thus, the current account deficit foreseen for the year is raised by just over one percentage point with respect to September 2011.

Inflation forecasts fluctuated during the past year, up in late 2011 and early 2012, and down in the following months, reflecting the evolution of the oil price and the drop in actual inflation indicators (table V.6).

TABLE V.6

Changes in 2012 average CPI inflation forecast

	Dec. 11	May.11	Jun.12	Sept.12
Initial forecast (1)	2.8	3.2	4.0	3.3
Fuels	0.37	-0.13	-0.07	-0.09
Foodstuffs minus fresh fruit & vegetables	-0.50	0.36	-0.08	-0.06
Fresh fruit & vegetables	0.01	0.41	-0.04	0.04
Public utilities	0.00	-0.37	-0.05	-0.05
Other products	0.56	0.47	-0.42	0.07
Final forecast (2)	3,2	4,0	3,3	3,2

(1) Forecast included in previous Monetary Policy Report.
(2) Forecast included in respective Monetary Policy Report.

Source: Central Bank of Chile.

From September to December of 2011, the Board decided to hold the monetary policy interest rate (MPR) at 5.25% annually. Also, in the last two monetary policy meetings of 2011 they added an expansionary bias, stating that the sharper-than-expected weakening of the external scenario could probably have an impact on domestic growth and inflation, as well as on the orientation of monetary policy. At the meeting of January 2012, the Board lowered the MPR by 25 basis points, and has kept it unchanged since then. The market's forecasts of the MPR trajectory have been quite volatile. While in late 2011 they predicted further cuts, in March 2012 they changed to an increase. Afterwards, they turned to declines, and in recent months they have gradually assumed a flat MPR trajectory for some time. The baseline scenario uses as a working assumption that the MPR will remain stable over the short term.

BOX V.2
THE CURRENT ACCOUNT AT TREND PRICES

A country's current account measures the difference between domestic investment and savings. It is thus an indicator of how much the country is contributing to finance investment overseas, in case there is a surplus, or how much external savings is needed to finance domestic investment. In this latter case, the current account balance may be an indicator of the country's external vulnerability, as the materialization of part of the investment relies on the availability of external funds.

For commodity-exporting economies, having a surplus or deficit in the current account depends largely on fluctuations of the terms of trade (ToT). In Chile, for instance, the copper price level has a strong impact on the current account balance. Being this price highly volatile, the effective current account balance will not necessarily be the best indicator to assess its underlying situation.

For example, the current account can post a surplus at a time where the copper price is particularly high and above its long-term trend. However, a price correction may quickly result in a deficit. Likewise, fluctuations in the oil price —one of the major imports of our country— may mislead the evaluation of the economy's external position.

Therefore, a measurement of the current account that corrects for temporary movements in the main commodity prices affecting the external accounts, may supplement the evaluation of the potential vulnerabilities from abroad, combined with other indicators such as the level of international reserves, the size of the external debt and the composition of external credit. This measure is known as the *current account at trend prices*.

This box presents the methodology used by the Central Bank of Chile to estimate the current account at trend prices included in the *Monetary Policy Report.* Basically, it adjusts the values of mining exports and fuel imports taking the deviations of the prices of copper and oil away from their long-term trends into account. It does the same with the rents and transfers associated with copper exports. Other exports and imports are valued using current prices. This measure does not correct any possible changes in quantities exported or imported due to movements in the prices of copper or oil[1].

The first adjustment is made to the trade balance. For mining exports (*XCu*) and fuel imports (*MCom*), adjusted or trend values are calculated thus:

$$\overline{XCu} = XCu\,\frac{\overline{PCu}}{PCu}\,, \qquad \overline{MCom} = MCom\,\frac{\overline{PCom}}{PCom}$$

where *XCu* denotes mining exports, *MCom* is fuel imports; *PCu* and $\overline{PCu}$ are the actual and long-term prices of copper, respectively, and $\overline{PCom}$ and PCom are the actual and long-term prices of fuels.

The second adjustment is made to the rent component. This is so because a significant fraction of copper production and exports is carried out by foreign companies, whose profits are included in income paid to other countries. Thus, adjusted or trend income can be written as:

$$\overline{R} = R + \overline{R^{cu}} - R^{cu}$$

[1] It is worth mentioning that the current account at trend prices is not the current account to which the economy will converge in trend if the prices of copper and oil return to their long-term values.

where R is total income, R^{cu} is income associated with foreign copper-producing companies, and $\overline{R^{cu}}$ is income of foreign companies measured at trend prices. For the latter, only deviations of the copper price from its long-term value are considered, and no adjustments are made to production costs. Accordingly, if QCu is total copper exports, α is the share of foreign mining companies in total production/exports, and τ_R is income tax plus the mining company's royalty, then the adjustment to actual income necessary to obtain a trend measure is:

$$\overline{R^{cu}} - R^{cu} = R^{cu} - R^{cu}\, \alpha QCu\, (\overline{PCu} - PCu)(1 - \tau_R)$$

Thus, trend income can be written as:

$$\overline{R} = R + \alpha QCu\, (\overline{PCu} - PCu)(1 - \tau_R)$$

A third adjustment is done to transfers, because a large part of the transfers into the country come from the remnant of taxes on profits remitted abroad, paid by direct investment companies, particularly mining corporations. This adjustment is similar to the adjustment to income, so trend transfers, $\overline{TR}$, become:

$$\overline{TR} = TR + \alpha QCu\, (\overline{PCu} - PCu)\, \tau_R$$

where TR stands for actual transfers and where τ_R is the surcharge, net of income taxes, paid by foreign companies on profit remittances.

For the long-term prices, as a methodological working assumption, prices of US$2.80 per pound of copper and US$80 per barrel of oil are used. These are the prices, in today's currency, to which the prices of copper and oil are expected to converge over the long run, and are determined by their respective long-term marginal costs.

Other assumptions are that the share of foreign companies in total copper production is 67%; that the average corporate tax plus royalty is 24%; and that the surcharge, net of corporate tax, is 15%.

For the calculation of the current account balance as a percentage of nominal GDP, the latter is also corrected by adjusting the deflator through the long-term copper price.

With this methodology and these assumptions, in 2011, the current account measured at trend prices would have posted a deficit of 4.4% of GDP, which would increase to 4.6% in 2012. In 2013, the deficit at trend prices would equal 5.2% of GDP.

The current account at trend prices included in earlier showed somewhat bigger deficits. The changes respond exclusively to a modification to the formerly used calculation methodology. Before, adjustments were made to the prices of other exported and imported products with respect to their trends. These adjustments have been eliminated, both to simplify the methodology and because of the difficulties of estimating trend prices of these goods.

APPENDIX A:
The Central Bank of Chile's balance sheet

This appendix presents and analyzes the position and projections of the main entries on the Central Bank of Chile's financial statements. It begins with a brief review of the evolution of the balance sheet in the first half of 2012 and then presents asset and liability forecasts for year-end 2012 and 2013.

The movements in any balance sheet account can be explained by (a) flows, which are related to settled liabilities and new transactions, (b) profits, which correspond to interest earned, and (c) adjustments, that is, earnings or losses associated with accounts indexed to the exchange rate or inflation. Because around 91% of its assets are international reserves and 66% of its liabilities are policy instruments and promissory notes (debt), the Central Bank is a net debtor in domestic currency and a net creditor in foreign currency. Therefore, the bottom line of the balance sheet is determined by the evolution of the differential between international interest rates (profitability of reserves) and the domestic interest rate or cost of the debt. In turn, since the reserves are made up primarily of dollars and euros (48% dollars and 22% euros in the comparator), earnings and losses depend primarily on the variation of the peso against these currencies.

THE BALANCE SHEET EVOLUTION IN THE FIRST HALF OF 2012

In the first half of 2012, the evolution of the balance sheet was marked by the reduced size of assets and liabilities. This coupled with a deterioration in equity, mainly because of foreign exchange losses owing to the appreciation of the peso —0.6% of GDP— and the differential of interest rates and inflation —0.2% of GDP.

Between 31 December 2011 and 30 June 2012, the size of the balance decreased by Ch$2,318 billion, going from 20.7% to 18.3% of GDP. Part of this change was due to unusually high entries at the close of 2011.

On the assets side, at 30 June international reserves were down by Ch$1,326 billion, due to reduced deposits in dollars from commercial banks and the State, and also because of the appreciation of the peso against the foreign currencies that make up the reserves. In addition, the use of Repo operations dropped by Ch$952 billion.

On the liabilities side, there was a reduction in the use of liquidity deposit (LD) operations and the standing deposit facility by Ch$1,771 billion. In turn, the deposits from domestic banks and the State dropped by Ch$698 billion.

In terms of flows, and consistently with the above, during the first half the changes in the balance sheet explain a reduction of the monetary base by Ch$455 billion (table A.1).

The Bank's net worth dropped from the close of the previous year. According to the books, equity went from -Ch$2,354 billion at 31 December 2011 (-2.0% of GDP) to -Ch$3,374 billion at 30 June 2012 (-2.7% of GDP). This was due mainly to losses coming from the international reserves, associated with the appreciation of the peso with respect to the currencies that make them up by Ch$711 billion, and by the differential between interest rates and inflation paid over the debt and received from investments abroad, equivalent to Ch$283 billion.

BALANCE SHEET PROJECTIONS FOR 2012 AND 2013

The main assumptions underlying the forecast are: (i) no forex operations will be performed over the forecast period; (ii) the standing deposit facility will remain around the equivalent to the average level of the first half of 2012; (iii) the balance of monetary policy instruments, mainly repos and the liquidity line, will remain unused; (iv) Treasury deposits will remain at their levels in effect at 30 June 2012; (v) the evolution of the monetary base will be consistent with growth in output and inflation; and (vi) in 2012, long-term debt operations (BCU, BCP) are forecast to conform to the debt plan announced in December 2011. For 2013, the renewal of maturities and coupons paid over the period is assumed. PDBC operations are expected to be used as an adjustment variable to accommodate a deficit or a surplus of funds.

The baseline scenario assumes that in the remainder of 2012 and during 2013 the differential between domestic and external interest rates will be unchanged from the end of the first half. Moreover, in 2012 and 2013 international reserves are expected to post lower profitability from its foreign currencies than what they earned from capital gains associated with interest rate drops in 2011. With these assumptions, under the concept of net interests, a loss in net worth of 0.4% of GDP is foreseen in 2012 and again in 2013 (table A.2).

As for inflation, the baseline scenario of this Report foresees that the CPI variation will be lower than 3% towards the end of this year, and will hover around 3% in 2013. Accordingly, the indexed debt —mainly bonds— will generate losses during the year, equivalent to 0.1% of GDP in 2012 and 0.2% in 2013.

For the Bank's balance sheet forecast, a nominal exchange rate trajectory is assumed that, considering the projected evolution of domestic and world inflation, is consistent with a real exchange rate that, in the projection horizon, will remain around its present values. For the rest of the currencies, parities are assumed that will move in line with market survey responses. Under these assumptions, losses are forecast for 2012 associated to changes in valuation for 1.2% of GDP. For 2013, earnings are foreseen from foreign exchange variation for the equivalent of 0.1% of GDP.

With all the assumptions described, in 2012 a reduction in the balance sheet size of 3.7% of GDP is foreseen. In 2013, the reduction will amount to 1.0% of GDP. Meanwhile, the net worth will drop by 1.7% of GDP in 2012 and 0.5% of GDP in 2013.

TABLE A.1

Central Bank of Chile balance sheet flows (1)

(billions of pesos)

	2008	2009	2010	2011	Jun.12	2012 (f)	2013 (f)
1. Net international reserves	2,691	701	1,306	6,771	-671	-671	0
2. Policy instruments in domestic currency (DC)	-2,223	354	1,030	-4,363	-345	-275	1,201
2a of which: indexed to the exchange rate	196	3	0	0	0	0	0
3. CBCh's promissory notes in dollars	0	0	0	0	0	0	0
4. Other operations in DC except monetary base (2)	-90	-18	-98	-105	-111	-111	-136
5. Other operations in foreign currency (3)	180	-684	-1,295	-977	672	672	0
Monetary base (Variation = 1+2+3+4+5)	558	352	943	1,326	-455	-386	1,065
Memorandum							
Position paid in foreign currency (forex operations =1+3+5)	2,871	16	11	5,794	1	1	0
Valued position in foreign currency (= 1+2a+3+5)	3,067	19	11	5,794	1	1	0

(1) Trade flows. The corresponding balances are affected also, and if applicable, by interest, monetary correction, and price changes.
(2) Service of fiscal promissory notes in UF, subordinate debt service and other operations in domestic currency.
(3) Fiscal and banking deposits, and other operations in foreign currency.
(f) Forecast.
Source: Central Bank of Chile.

TABLE A.2

Central Bank of Chile balance sheet: summarized balances and results

(percent of GDP)

	2008	2009	2010	2011	Jun.12	2012 (f)	2013 (f)
ASSETS	**19.4**	**19.2**	**13.7**	**20.7**	**18.3**	**17.0**	**16.0**
International reserves	15.5	13.3	11.8	18.2	16.6	15.5	14.7
Fiscal promissory notes and other loans to the government	0.9	0.9	0.8	0.8	0.8	0.8	0.8
Monetary policy instruments	1.7	3.9	0.1	0.8	0.1	0.1	0.1
Other assets	1.3	1.1	0.9	0.8	0.7	0.7	0.5
LIABILITIES	**18.8**	**21.3**	**16.8**	**22.7**	**21.0**	**20.6**	**19.8**
Promissory notes with secondary market	11.3	12.0	8.1	11.0	12.0	12.4	11.3
Policy instrument with banks	2.3	3.2	2.4	4.0	2.0	1.1	1.1
Other liabilities with banks	0.3	0.3	0.4	0.7	0.8	1.0	1.0
Other liabilities except monetary base	0.4	1.1	1.0	1.3	1.1	1.0	1.0
Monetary base	4.5	4.7	5.0	5.7	5.2	5.1	5.5
EQUITY (A+B+C)	**0.7**	**-2.0**	**-3.1**	**-2.0**	**-2.7**	**-3.6**	**-3.8**
A. Initial equity	-2.5	0.8	-1.8	-2.9	-1.9	-1.8	-3.3
B. Net non-financial result	2.7	-2.9	-1.3	0.9	-0.8	-1.7	-0.5
No financieros	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	-0.1
Net interest	-0.5	-0.1	-0.1	-0.3	-0.1	-0.4	-0.4
UF variation	0.0	0.2	-0.1	-0.2	-0.1	-0.1	-0.2
Exchange rate variation	0.0	-2.8	-1.1	1.4	-0.6	-1.2	0.1
Capital revaluation	0.2	0.0	0.0	0.0	0.0	0.0	0.0
C. Capital contribution	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Paid position in foreign currency (1)	15.4	12.6	10.1	15.7	14.8	14.4	13.7
Valued position in foreign currency (2)	15.4	12.6	10.1	15.7	14.8	14.4	13.7

(1) Assets minus liabilities payable in foreign currency.
(2) Position in foreign currency minus domestic currency liabilities indexed to the exchange rate.
(f) Forecast.
Source: Central Bank of Chile.

APPENDIX B:
International reserves management

International reserves are the liquid assets in foreign currency held by the Central Bank of Chile (the Bank) to back its monetary and exchange rate policy. Its management seeks to provide, in an efficient fashion, secure access to international liquidity, safeguarding the Bank's financial net worth, in conformity with the legal framework as defined in article 38, Title III, of its Basic Constitutional Act.

For its international reserves management, the Bank has separated responsibilities across hierarchical levels, that comply with relevant international recommendations and have been assessed by the IMF. Also, on a regular basis, internal and external audit exercises are performed to international reserves management, through which the different investment processes are reviewed. This guarantees that the decision-making and management assessment processes inside the Bank are well defined and have limited risk exposure.

In the administration of international reserves, function segregation principles are applied. The International Markets Division participates in the definition of the Investment Policy approved by the Board, and is responsible for implementing defined strategies of investment, execution and follow-up. In turn, the Financial Services Division is responsible of carrying out the investment operations, meaning the recording, accounting and generation of all payment and/or fund movement instructions that ensure compliance with formal obligations.

To monitor compliance with investment guidelines and parameters defined by the Board on a daily basis, the Bank has a Financial Risk Evaluation and Management Department that hierarchically reports to the Bank's General Management.

To manage credit risk associated with investing international reserves, that is, to determine the eligibility of and maximum exposure allowed to countries, supranationals, commercial banks and agencies, variables such as the risk rating, net worth, market size, debt ratios, and explicit guarantees of the institutions are used, among others.

Moreover, the international markets department has developed a number of additional indicators that allow better follow-up to the various managed positions, through daily positioning reports, implicit risk ratings, early warning models and hedging cost follow-up in case of default (CDS).

As for information systems, the Bank has continued to make improvements to its technological platforms, reinforcing the operational continuity of processes and implementing mechanisms of high availability.

Also, during the first half of 2012 the investment policy was subjected to a review originating in the increase in the level of reserves under the currency purchase program implemented in 2011, plus the changes observed in the macroeconomic and financial environment of international markets, and the Bank's adequacy policies to best international practices[1]/. Based on this review, a new investment policy was generated for reserves management, which was approved by the Board in February this year.

In the new policy, the management objectives are those of the former policy: (i) to hold the international reserves in high-liquidity instruments, meaning that they can be cashed in the least time possible, without incurrent significant transaction costs. This liquidity objective relates to the hedging of short-term residual internal debt; (ii) that said instruments entail limited risks so the possibility of causing a capital loss is minimized; and (iii) that the asset composition allows minimizing the volatility that is generated in the Bank's net worth due to changes in the peso-parities of the different currencies where the reserves are invested. This objective is associated with the Bank's balance-sheet hedging principle.

Notwithstanding, the new policy explicitly incorporated the objective of reducing, at the margin, the cost of holding the reserves. This objective is achieved by incorporating oriented at obtaining, over the long run, higher absolute returns. The

[1]/ These best practices were defined on the basis of the conclusions of the Workshop "Policy objectives in Reserves Management," that took place in 2010. This event brought together various international counterparties from both the public sector (central banks and supranational entities) and the private sector (external administrators and investment banks).

inclusion of this new objective responds to the increased level of available reserves.

The new benchmark structure defines three investment portfolios: (a) Short-term liquidity portfolio (24%); (b) Medium-term liquidity portfolio (61%); and (c) Diversification portfolio (15%). These portfolios make up the Portfolio of International Reserves Investment (table B.1). Said portfolio, added to the Cash Portfolio (current-account balances held by the Treasury, public enterprises and banks) and the Other Assets Portfolio (the IMF's special drawing rights, SDRs, certified gold and others), make up the International Reserves Portfolio.

The new benchmark structure of the investment portfolio considers a reduction in the share of U.S. dollars and euros, and a higher share of other currencies, as follows: United States dollar (39.90%), euro (31.95%)[2]/, Canadian dollar (9.15%), Australian dollar (6.10%), Japanese yen (2.55%), Swiss franc (2.10%), pound sterling (1.95%), Korean won (1.95%), New Zealand dollar (1.50%), Singapore dollar (0.90%) and Chinese renminbi (1.95%) (table B.2).

As for credit risk, the new benchmark contemplates 98.05% in sovereign risk and 1.95% in banking risk, with the latter being only in deposits denominated in Chinese renminbi. The global interest rate of the Investment Portfolio, as measured by modified duration, is of roughly 23 months.

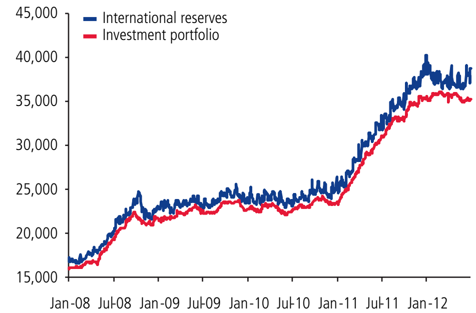
TABLE B.1
Benchmark structure of international reserves' investment portfolio by type of risk and comparators

Structure	Credit risk	Current share	Benchmark comparator
Short-term liquidity portfolio	Sovereign, Agency and Supranational	24%	Index, Barclays Capital Global Aggregate: Treasury Bond Index (unhedged) Duration 0 - 1 year (USD, EUR)
Medium-term liquidity portfolio	Sovereign	61%	Barclays Capital Global Aggregate index: Treasury Bond Index (unhedged) Duration 1 - 3 years (90%) Duration 3 - 5 years (10%) (USD, EUR, CAD, AUD)
Diversification portfolio	Sovereign, Agency, Supranational and and Banking	15%	Index, Barclays Capital Global Aggregate: Treasury Bond Index (unhedged) Duration 5 - 7 years (75%) Duration 7 - 10 years (10%) (JPY, KRW, SGD, CHF, NZD, GBP, EUR) Bloomberg index, DPZ 3M CNH (15%)
Total portfolio		100%	

Source: Central Bank of Chile.

[2]/ On 5 July, with the approval of the Board, this proportion was lowered to 21.96%, while the U.S. dollar's share rose to near 50%. Thus the benchmark currency structure was modified as from that date.

FIGURE B.1
International reserves (*)
(millions of U.S. dollars)



(*) Excludes other assets.
Source: Central Bank of Chile.

As a complement to internal management, since 1995 the Bank uses external management programs for a fraction of the reserves. The purpose of this is to rely on an active comparator to assess internal management, add economic value and facilitate the transfer of know-how and technology.

At the closing of the first half of 2012, a portion of the investment portfolio (2.86%) was managed independently by two external managers (Pimco and Goldman Sachs Asset Management). As part of regular turnover exercise, Goldman Sachs became an external manager in December 2011, replacing Wellington Management Co.

In the first half of 2012, the annualized return on managed international reserves was -0.35%, measured in U.S. dollars. The differential return of the management was -28 basis points[3]/ (table B.3).

At 30 June 2012, international reserves amounted to a total of US$40,344.3 million, US$1,635 million less than at the close of 2011. Of total reserves, US$34,967 million belonged to the investment portfolio and US$3,467.5 million to the Cash portfolio (figure B.1). Of total reserves, 46.8% were invested in U.S. dollars; 25.5% in euros, and 27.7% in other currencies (table B.4).

[3]/ Because the change in the investment structure was made during the course of the second quarter, for the purposes of the differential return a composite of two benchmark was used.

TABLE B.2

Currency, term and duration structure of internally managed benchmark portfolio

		Dollar U.S.		Euros		Dollar Australia		Dollar Canadá		Franco Switzerland		United Kingdom pound	
		Share	Duration	Share	Duration	Share	Duration	Share	Duration	Share	Duration	Share	Duration
Short-term liquidity portfolio	Sovereign, Agency and Supranational												
	0-1 years	22.2%	2.9	2.5%	4.5								
	Subtotal LCP	**22.2%**	**2.9**	**2.5%**	**4.5**								
Medium-term liquidity portfolio	Nominal bonds												
	Duration												
	1-3 years	16.9%	22.3	25.4%	21.1	5.7%	24.6	8.5%	19.9				
	3-5 years	1.9%	47.1	2.8%	44.1	0.6%	44.4	0.9%	42.0				
	Subtotal LMP	**18.8%**	**24.8**	**28.2%**	**23.4**	**6.3%**	**26.6**	**9.4%**	**22.1**				
Diversification portfolio	Nominal bonds												
	Duration												
	5-7 years			1.6%	62.9					1.6%	64.1	1.5%	63.3
	7-10 years			0.2%	90.1					0.2%	97.2	0.2%	87.9
	Banking												
	0-1 years												
	Sub Diversification			**1.8%**	**66.0**					**1.8%**	**67.9**	**1.6%**	**66.2**
Total portfolio		**41.0%**	**12.9**	**32.5%**	**24.3**	**6.3%**	**26.6**	**9.4%**	**22.1**	**1.8%**	**67.9**	**1.6%**	**66.2**

		Japan yen		S. Korea won		N.Zealand dollar		China renminbi		Singapore dollar		Total	
		Share	Duration	Share	Duration	Share	Duration	Share	Duration	Share	Duration	Share	Duration
Short-term liquidity portfolio	Sovereign, Agency and Supranational												
	0-1 years												
	Subtotal STL											**24.7%**	**3.1**
Medium-term liquidity portfolio	Nominal bonds												
	Duration												
	1-3 years												
	3-5 years												
	Subtotal MTL											**62.7%**	**23.9**
Diversification portfolio	Nominal bonds												
	Duration												
	5-7 years	1.9%	67.5	1.5%	59.6	1.1%	62.2			0.7%	66.0		
	7-10 years	0.3%	96.5	0.2%	84.2	0.1%	85.5			0.1%	85.1		
	Banking												
	0-1 years							1.6%	1.5				
	Sub. Diversification	**2.1%**	**70.9**	**1.6%**	**62.5**	**1.3%**	**64.8**	**1.6%**	**1.5**	**0.8%**	**68.3**	**12.6%**	**58.3**
Total portfolio		**2.1%**	**70.9**	**1.6%**	**62.5**	**1.3%**	**64.8**	**1.6%**	**1.5**	**0.8%**	**68.3**	**100.0%**	**23.1**

Source: Central Bank of Chile.

TABLE B.3

International reserves' absolute returns, benchmark and differential returns

(percent)

	In foreign currency		In dollars		
Period	I. Reserves	BMK	I. Reserves	BMK	Differential
2012 (1)	0.25	0.54	-0.35	-0.07	-0.28
2011	2.43	2.41	1.22	1.20	0.02
2010 (2)	2.09	2.19	-0.15	-0.06	-0.09
2009	2.15	1.65	3.34	2.84	0.50
2008	5.70	5.37	4.14	3.81	0.33
2007	4.81	4.78	8.86	8.83	0.03
2006	2.45	2.39	6.84	6.78	0.06
2005	2.90	2.85	-1.72	-1.77	0.05
2004	1.84	1.95	4.08	4.20	-0.11
2003	2.31	1.78	6.64	6.12	0.53
2002	5.25	4.69	9.34	8.78	0.57
2001	5.57	5.27	3.90	3.60	0.30
2000	6.88	6.65	4.84	4.61	0.22

(1) Annual returns of first half.
(2) Foreign-currency figures revised from previous publication.

Source: Central Bank of Chile.

TABLE B.4

Composition of international reserves (*)

(millions of dollars)

		2011		2012	
Portfolio	Currencies	Dec.	%	Jun.	%
Investment portfolios		**35,329.0**	**84.2%**	**34,967.0**	**86.7%**
Currencies and deposits	dollar	807.0	1.9%	640.3	1.6%
	Euro	1,027.0	2.4%	6.6	0.0%
	Other	1,888.2	4.5%	977.4	2.4%
Securities	dollar	16,457.2	39.2%	14,718.9	36.5%
	Euro	11,628.6	27.7%	10,278.5	25.5%
	Other	3,521.1	8.4%	8,345.3	20.7%
Totales	dollar	17,264.1	41.1%	15,359.3	38.1%
	Euro	12,655.6	30.1%	10,285.0	25.5%
	Other	5,409.2	12.9%	9,322.7	23.1%
Cash portfolio		**4,786.6**	**11.4%**	**3,467.5**	**8.6%**
Currencies and deposits	dollar	4,786.6	11.4%	3,467.5	8.6%
	Euro	0.0	0.0%	0.0	0.0%
	Other	0.0	0.0%	0.0	0.0%
Securities	dollar				
Totales	dollar	4,786.6	11.4%	3,467.5	8.6%
	Euro	0.0	0.0%	0.0	0.0%
	Other	0.0	0.0%	0.0	0.0%
Other assets		**1,863.7**	**4.4%**	**1,909.8**	**4.7%**
Monetary gold	Other	12.2	0.0%	12.4	0.0%
SDR, IMF	Other	1,214.4	2.9%	1,192.7	3.0%
IMF Reserves position	Other	601.3	1.4%	663.0	1.6%
Reciprocal credit agreements	dollar	35.9	0.1%	41.7	0.1%
TOTAL INTERNATIONAL RESERVES		**41,979.3**	**100.0%**	**40,344.3**	**100.0%**
Total	dollar	22,086.6	52.6%	18,868.5	46.8%
	Euro	12,655.6	30.1%	10,285.0	25.5%
	Other	7,237.1	17.2%	11,190.8	27.7%

(*) 2012 data is presented for comparison purposes only. The portfolio structure of the international reserves changed during 2012.

Source: Central Bank of Chile.

At June 2012, bank deposit investments in the investment portfolio added up to US$1,624.3 million, that is, US$2,097.9 million less than at year-end 2011. Te lower bank risk responded to a new investment policy being implemented, that contemplates lower exposure to said risk.

Securities investments in the investment portfolio increased by US$1,735.8 million with respect to the close of 2011, to US$33,342.7 million at the end of the first half 2012. The cash portfolio ended the period with US$3,467.5 million, a balance reduction of US$1,319.1 million from the close of 2011. Such reduction reflects movements in the account balances and deposits held by the banking system in the Bank.

As for the exposure of the internally managed investment portfolio by type of risk and by country, at the close of this Report there existed appropriate degrees of diversification for the various types of risks where the international reserves were invested. Investments in sovereign risk were largely in the United States and Germany, for a combined 73.91% of the total. At the end of June, banking risk investments were mainly in banks of the United Kingdom, the Netherlands, Australia and Sweden (table B.5).

TABLE B.5

Internally managed portfolio: investments by country and type of risk

(millions of dollars)

Country	Sovereign (1)	Banking	Agency (2)	Supranational	Total
United States	14,194		620		**14,814**
Germany	10,064				**10,064**
Canada	3,257				**3,257**
Australia	2,045	132			**2,176**
Japan	1,332	20			**1,352**
United Kingdom	444	366			**811**
Switzerland	601	42			**642**
New Zealand	453				**453**
Singapore	260	32			**291**
Netherlands	14	260			**274**
Austria	156				**156**
Sweden		110			**110**
Finland		7			**7**
Total	**32,819**	**969**	**620**	**0**	**34,408**

(1) Sovereign exposure includes the following institutions that have explicit sovereign guarantee: KFW (Germany, USD 31 million), Oesterreichische Kontrollbank (Austria, US$156 million). Sovereign exposure in the United States includes an overnight deposit in the Federal Reserve for US$630 million.
(2) Of Agencies' exposure in the United States, US$358 million correspond to investments in Freddie Mac and US$262 million in Fannie Mae.

Source: Central Bank of Chile.

The internally managed investment portfolio's breakdown by currencies was thus at 30 June 2012: 43.67% in U.S. dollars, 29.16% in euros, 9.53% in Canadian dollars, and 6.63% in Australian dollars. The remaining 11.02% was invested in pounds sterling, Swiss francs, Singapore dollars, New Zealand dollars, Chinese renminbi and Japanese yen (table B.6).

TABLE B.6

Internally managed portfolio: investments by currency

Currency	Share
United States dollar	43.67%
Euro	29.16%
Canadian dollar	9.53%
Australian dollar	6.63%
Japanese yen	3.94%
Swiss franc	1.75%
Chinese renminbi	1.64%
Sterling pound	1.62%
New Zealand dollar	1.32%
Singapore dollar	0.76%
Total	**100%**

Source: Central Bank of Chile.

Finally, in the case of the externally managed portfolio, the largest exposure comes from sovereign risks. The United States and Germany posted the higher shares. Banking risk was marginal, while the Agency risk came mainly from MBSs (table B.7).

TABLE B.7

Externally managed portfolio: investments by country and type of risk

(millions of US$)

Country	Sovereign (1)	Banking(2)	Agencies (3)	Supranationals (4)	Total
United States	352	-17	87		421
Germany	265	20	5		290
Canada	16	5			21
United Kingdom	12	6			18
Italy	9				9
Australia		8			8
Japan	9				9
Austria	36				36
France	63				63
New Zealand	10	-9			1
Belgium	14				14
Finland	8				8
Netherlands	34				34
Denmark	10				10
Slovenia	6				6
Supranational				58	58
Total	**843**	**14**	**91**	**58**	**1,007**

(1) Sovereign exposure includes the following institutions that have explicit sovereign guarantee.
(2) Includes forwards, cash and Jumbo Pfandbriefes bonds (Germany).
(3) Exposure to United States Agencies corresponds to investments in MBS and TBA. In Germany, to the Rentenbank Agency.
(4) Exposure in Supranationals includes the following eligible issuers: African Development Bank, World Bank (International Bank for Reconstruction and Development: IBRD), Eurofima, Council of Europe Development Bank, Inter-American Development Bank, European Investment Bank.

Sources: Central Bank of Chile and reports from independent administrators.

APPENDIX C:
Main measures taken by the Central Bank of Chile in 2012

JANUARY

2 The Central Bank of Chile (CBCh) informed that the Board approved by Agreement N°1651-07 of 29 December 2011 the annual tender offer program contemplated for 2012. This program entailed the habitual renewal of debt falling due during the current year, for an amount of US$ 3 billion, which is added to US$ 1 billion of PDBC falling due that will be gradually moved to long-term debt during the year.

The detail of the bonds to be issued from January to December is shown below:

a) Two-year bonds in pesos (BCP-2): 250 billion pesos.

b) Five-year bonds in pesos (BCP-5): 350 billion pesos.

c) Ten-year bonds in pesos (BCP-10): 350 billion pesos.

d) Five-year bonds in UF (BCU-5): 25 million UF.

f) Ten-year bonds in UF (BCU-10): 23 million UF.

In addition, it was noted at the time that these bonds will be issued in conformity with stipulations in article 104 of the Income Tax Law.

Similarly, it was made explicit that this tender offer program might be subjected to amendments in case of significant changes in market conditions.

5 By Resolution N°1652-01-120105, published in the Official Gazette of 7 January 2012, the Board of the CBCh decided to accept the retribution to which the Bank will be entitled in its capacity as Fiscal Agency, relating to the administration of the resources of the Economic and Social Stabilization Fund for the period ranging from March 2012 to February 2013, in accordance with Official Letter N°1.880, of the Ministry of Finance, dated 27 December 2011.

12 At its monthly monetary policy meeting, the Board of the CBCh decided to lower the monetary policy interest rate by 25 basis points, to 5.0% annual.

19 By Resolution N°1654-02-120119, published in the Official Gazette of 28 January 2012, the Board of the CBCh, with the authority granted it by the Law of Defense of Free Competition, agreed to convene a Public Auction aimed at appointing an attorney at law Regular Minister and an economist Regular Minister for the Defense of Free Competition Tribunal, due to the partial renewal of its members, considering the legal term for which were appointed, respectively, Mr. Javier Velozo Alcaide and Mr. Julio Peña Torres, and which concludes on 12 May 2012.

FEBRUARY

2 By Resolution N°1656-01-120202, published in the Official Gazette of 17 February 2012, the Bank accepted the Fiscal Agency entrusted it by Supreme Decree N°1839 of 28 December 2011, del Ministry of Finance, published in the Official Gazette of 27 January 2012, to represent and act on the name and on the account of the Treasury in the placement and administration of the bonds referred to in said act, in accordance with the terms and conditions set forth therein.

9 By Resolution N°1657-05-120209, the Board of the CBCh decided to accept the amendments communicated by the Minister of Finance by Official Letter N°248 dated 7 February 2012, with respect to the Guidelines on Custody and other matters relating with the management of the Social and Economic Stabilization Fund and the Pension Reserve Fund managed by the Fiscal Agent, contained in Official Letter N°133 of the Ministry of Finance, dated 8 February 2007.

By virtue of the same resolution, it was noted that the amendments to the Custody Guidelines do not require modifying the agreed retribution with respect to the management of the Social and Economic Stabilization Fund and the Pension Reserve Fund for the period from March 2012 to February 2013.

14 At its monthly monetary policy meeting, the Board of the CBCh decided to maintain the monetary policy interest rate at 5% annual.

14 By Resolution N°1658E-01-120214 published in the Official Gazette of 17 February 2012, the Board of the CBCh agreed unanimously to reelect Board member Mr. José Manuel Marfán Lewis as the Vice-Governor of the CBCh, a position he has held since 7 January 2010.

21 By Resolution N°1687-04 adopted on 21 June 2012, the Board, pursuant to stipulations in letter c) of article 10 of Law N°18.634, established that the interest rate that will be accrued by deferred payments of customs duties during the six months ending 31 December 2012, will be 6% annually, in U.S. dollars.

21 By Resolution N°1687-03-120621, the Board, pursuant to stipulations in the final item of article 83 of the General Banking Act, and bearing in mind the statements made of the Superintendence of Banks and Financial Institutions in Official Letter N°2.200, dated 20 June 2012, agreed to deliver its preliminary report in favor of the amendments proposed by said Superintendence in said communication, to its general rule contained in Chapter 12-15 of the Updated Compilation of Regulations of said Superintendence. These amendments are intended to incorporate demand deposits in the calculation of individual limits set forth in the aforesaid rule concerning deposits that banking institutions may hold abroad, as well as for the establishment of an overall limit applicable to the sum of all deposits, whether demand or term, that said banking institutions may hold with related financial institutions abroad.

Said Resolution was notified to the Superintendent of Banks and Financial Institutions with the purpose that the Superintendence would disseminate said proposed regulation for public consultation through the website.

23 By Resolution N°1660-02-120223, published in the Official Gazette of 27 February 2012, the Board of the CBCh decided to accept the amendments notified by the Minister of Finance by Official Letter N°192 dated 31 January 2012, with respect to the Guidelines on Execution of the Pension Reserve Fund managed by the Fiscal Agent, contained in Official Letter N°1637 of the Ministry of Finance, dated 18 November 2011.

23 By Resolution N°1660-03-120223, the Board of the CBCh approved a new Investment Policy applicable to the administration of International reserves, with the same objectives regarding liquidity, preservation of capital, hedging the Bank's balance sheet and, in the margin, profitability. Among the most significant elements of the new policy, the creation of three sub-portfolios stands out, associated with which is the achievement of the objectives just defined: i) Short-term Liquidity Portfolio; ii) Medium-Term Liquidity Portfolio; and; iii) Diversification Portfolio. Unlike the former investment policy, the new one included a larger number of currencies in the benchmark comparator, increased the exposure to sovereign risk against banking risk, and raised the credit rating requisite for the eligibility of sovereign risk. Additionally, the overall duration of the reserves portfolio was increased from 17 to 25 months, with the purpose of providing proper balance sheet hedging. The overall composition by currencies became: 39.90% in United States dollars, 31.95% in euros, 9.15% in Canadian dollars, 6.10% in Australian dollars, 2.55% in Japanese yen, 2.10% in Swiss francs, 1.95% in pounds sterling, 1.95% in Korean won, 1.95% in Chinese renminbi, 1.50% in New Zealand dollars, and 0.90% in Singapore dollars.

MARCH

12 The CBCh and the Superintendence of Banks and Financial Institutions submitted to public consultation the new regulations on mortgage bonds. Thus, amendments of MKIII were made to the General Banking Law with respect to mortgage bonds. These bonds shall be issued by banking issues with the purpose of using the resources obtained to finance mortgage loans for housing. This new instrument is granted special treatment in case of insolvency or forced liquidation of the issuing bank, because in such case the loan portfolio associated with the mortgage bond may be auctioned jointly with the respective liabilities, which implies a lesser risk for investors. The CBCh regulation refers specifically to aspects relating with mortgage credit, investment in fixed-income instruments during the time span from the bond issuance, the granting of the credits and requisites of public disclosure. This measure was approved at Board session N°1663-05 of 8 March 2012.

12 By Resolution N°1663-03-120308, published in the Official Gazette of 13 March 2012, the Board decided to place on record the adoption, for the sole purpose of compliance with the CBCh's statistical function, of the definition of Foreign Direct Investment suggested to adopt in the technical recommendations contained in the sixth edition of the International Monetary Fund's Balance of Payments Manual and in the fourth edition of the OECD's Benchmark Definition of Foreign Direct Investment.

15 At its monthly monetary policy meeting, the Board of the CBCh decided to maintain the monetary policy interest rate at 5% annual.

27 By Resolution N°1666E-01-120327 and with respect to the decision of capitalizing via an issuance of shares free of payment 30% of the profits of the year obtained by the Banco de Chile during 2011, adopted at the Banco de Chile shareholders' meetings of 22 March 2012, the Board of the CBCh decided to opt for the total of profits or surpluses to which it is entitled under its role of creditor of the subordinated obligation, being repaid in cash. The Board adopted this decision in accordance with stipulations in letter b) of article 31 of Law N°19.396 on subordinated obligations.

APRIL

2 By Board Resolution N°1667-02 of 29 March 2012, the CBCh decided the publication of the draft of Part One of the New Compendium of Monetary and Financial Regulation (CNMF), with the purpose of gleaning comments from interested parties and the general public, during the month of April.

It was placed on record that this initiative to rearrange and systematize does not modify the policies already adopted by the Bank in order to regulate the quantity of money in circulation and credit, although some provisions and chapters of the Compendium of Financial Regulation (CNF) were repealed, that refer to matters that have been rendered obsolete or inapplicable.

17 At its monthly monetary policy meeting, the Board of the CBCh decided to maintain the monetary policy interest rate at 5% annual.

19 By Board Resolution N°1672-01-120419, the stock broker firm Cruz del Sur Corredora de Bolsa S.A. was authorized to operate in the formal foreign exchange market as a regulated nonbank entity forming part of the aforesaid regulated market undertaking foreign exchange operations, in accordance with the stipulations of article 41 of the CBCh's Constitutional Organic Act and Chapter III of the Compendium of Foreign Exchange Regulations.

26 By Resolution N°1673-01-120426, the Board of the CBCh decided to accept the retribution to which the Bank will be entitled in its capacity as Fiscal Agency, relating to the administration of the resources of the Strategic Contingency Fund for the period ranging from May 2012 to April 2013, in accordance with Official Letter N°859 of the Ministry of Finance, dated 24 April 2012.

MAY

3 By Resolution N°1677E-01-02-120503 the Board of the CBCh agreed to designate as members of the Defense of Free Competition Tribunal Ms María de la Luz Domper Rodríguez in the position of economist Regular Minister and Mr. Enrique Vergara Vial in the position of attorney-at-law Regular Minister.

The respective designations were made for the six-year period, by reason of the completion of the legal term of Mr. Julio Peña Torres as economist Regular Minister, and Mr. Javier Velozo Alcaide as attorney-at-law Regular Minister, and in accordance with stipulations in articles 6, 7 and 12 of D.L. 211, of 1973, that sets forth the regulations aimed at promoting and defending free competition in the markets.

9 The CBCh and the Superintendence of Banks and Financial Institutions published for public consultation the proposed rules that amend the regulations governing the Clearing House of checks and other documents in domestic currency in the country. This measure was approved at Board session N°1676 of 3 May 2012.

14 By Resolution N°1679E-01-120514, the Board of the CBCh, in exercise of the authorities granted it under article 168, Title XVI of D.L. 3.500 of 1980 on social security reform within the pension system, appointed a regular member and an alternate member of the Technical Investment Board.

Regular member was appointed Mr. Luis Felipe Céspedes Cifuentes for a term of four years, to replace Mr. Guillermo Le Fort Varela, upon completion of his designated term. Alternate member was appointed Mr. Luis Antonio Ahumada Contreras for the same term, placing on record that this designation corresponds to a renewal for a new term, as set forth in the aforesaid article 168.

17 At its monthly monetary policy meeting, the Board of the CBCh decided to maintain the monetary policy interest rate at 5% annual.

17 By Resolution 1680-03-120517, published in the Official Gazette of 19 May 2012, the Board of the CBCh delivered a favorable prior report to the proposal of the Superintendence of Pensions referring to the concept of foreign exchange hedging and the ceilings to investments in foreign currency with no foreign exchange hedge applicable to Pensions Funds and Unemployment Funds, contained in the respective investment schemes that must be approved by said Superintendence. The new regulation

distinguishes ranges of foreign exchange hedge for investment-grade debt instruments, low-investment-grade debt instruments, and variable-income assets. For the first, the hedge range was set between 50% and 100% of funds invested in said instruments; for the second, the range was set between 0% and 70%; finally, for variable income, the range was set between 0% and 50%. Said favorable prior report was amended and complemented by Board Resolution N°1687-02-120621, published in the Official Gazette of 26 June 2012, considering the modifications informed by the Superintendence of Pensions with respect of the aforesaid proposal, after submission thereof to a process of public consultation.

By the same above-cited Resolution N°1680-03, the CBCh amended chapters III.F.4 on pension fund investment and III.F.7 containing the financial regulation applicable to the unemployment fund managing institution, both of the Compendium of Financial Regulations.

In this regard, limits were modified to foreign-currency investments without foreign exchange hedge allowed to pension fund and unemployment fund managing institutions. The prevailing definition of foreign exchange hedge was adjusted. Also, limits were modified to investments in the instruments identified in numbers 1, 2, 3, 4, 5, 6, and 7 of the twenty-first item of article 45 of D.L. N°3.500, of 1980, in the case of pension funds, and limits were modified to investments in the instruments identified in numbers 1, 2, 3, 4, 5, 6, and 7 of item 2 of article 58C of Law N°19728, in the cases of the Unemployment Fund and the Solidarity Unemployment Fund.

The above was done by reason of amendments to Law N°20552 with respect to D.L. 3500 of 1980, and Law 19728; and the regulatory proposal submitted by the Superintendence with respect to the new limits to foreign-currency investments without foreign exchange hedge and the concept of foreign exchange hedge applicable, as well as the reports delivered by reason of the amendments made to the Compendium of Financial Regulations.

24 By Board Resolution N°1681-01-120524, published in the Official Gazette of 28 May 2012, Part One of the CNMF was approved, referring to the Regulations on Monetary Operations formerly contained in the CNF, in effect as from Monday 27 August 2012.

As from the aforesaid date, it was agreed to repeal the following chapters of the CNF:

Part One, on Funding Systems, letter B, with respect to chapters:

a) II.B.1 on Liquidity Facility and Liquidity Credit Line to banking institutions;

b) II.B.1.1 on Standing Liquidity Facility and Liquidity Credit Lines, in domestic currency, to banking institutions;

c) II.B.1.2 on Liquidity Credit Line in United States dollars, to banking institutions;

d) II.B.2.2 on Short-term credit to banks;

e) II.B.2.3 on Short-term credit line regulation to banks;

f) II.B.4 on Medium-term credit line;

g) II.B.4.1 on Medium-term credit line regulation;

h) II.B.5 on Intraday Liquidity Facility of the CBCh to participants in the RTGS system.

It was placed on record that Chapter II.B.3 of said letter B remains unchanged.

Part Two, on Operating Regulation, Intermediation and Control of Financial System and Capital Market, with respect to the chapters in letter A, on reserve requirement:

a) III.A.1 on Reserve requirement regulations for banking institutions and savings & loans cooperatives;

b) III.A.2 on Interests paid by reserve requirement of deposits in domestic currency, and

c) III.A.4 on Technical reserve regulations.

Part Three, on CBCh operations with financial instruments, with respect to all the chapters of its letters:

a) on Operations with financial instruments payable in domestic currency;

b) on CBCh operations with financial instruments payable in foreign currency;

c) on Auctions of CBCh promissory notes purchase;

d) on Swaps; and

e) on Bonds.

It was placed on record that the same Resolution updates the reference made in the CNF Supreme Decree N°1220 of the Ministry of Finance, of 2009, which established the list of debt instruments that may benefit from the provisions in article 104 of the Income Tax Law, as amended by Supreme Decree N°414 of the Ministry of Finance, of 2012.

24 By Resolution N°1681-02-120524, the Board granted Corpbanca the prior authorization referred to in article 76 of the General Banking Law, with respect to the acquisition of shares of a banking institution and other subsidiaries incorporated abroad, draws wherefrom are among those allowed under articles 70 et seq. of said legislation.

JUNE

14 At its monthly monetary policy meeting, the Board of the CBCh decided to maintain the monetary policy interest rate at 5% annual.

18 The Board of the CBCh, in exercise of the authority granted it by articles 6 and 12 of the Law of Defense of Free Competition, agreed to convene a Public Auction to conform a list of three candidates to be submitted to H.E. the President of the Republic for him to designate the economist deputy Minister for the Defense of Free Competition Tribunal, to replace Ms María de la Luz Domper Rodríguez by reason of her voluntary resignation to said position, for the remainder of the term for which she was appointed, that is, until 12 May 2014. Resolution N°1686E-01-120618, adopted by the Board of the Central Bank of Chile was published in the Official Gazette of 22 June 2012.

21 The CBCh adopted a Favorable Prior Agreement to allow publishing, for the public opinion, new regulation established by the Superintendence of Banks and Financial Institutions on limits to banking exposure with financial entities abroad. The improvements are focused on strengthening the existing limits on bank deposits established in Chile in entities abroad, incorporating demand deposits in the individual limit to demand deposits and setting a new overall limit for demand and term deposits. With these amendments, the domestic regulation converges to the best international banking standards.

JULY

12 At its monthly monetary policy meeting, the Board of the CBCh decided to maintain the monetary policy interest rate at 5% annual.

13 By Circular Letter dated 13 July 2012 from the Domestic Market Director of the CBCh was released to the banks, pension fund administrators, unemployment fund administrators, insurance companies, mutual fund administrators, stock brokers and securities agents, the Manual of Operating Procedures of Part One of CNMF, approved by said Director in accordance with Resolution N°1681-01- 120524. Said regulations were set to become effective as from 27 August 2012.

26 By Board Resolution N°1695-01-120726, published in the Official Gazette of 31 July 2012, the CBCh amended Chapter III.H.1 of its Compendium of Financial Regulations about "Clearing House for checks and other documents in local currency in the country" to allow materializing the initiative of "Early release of funds" proposed to the Bank by the guild Association of Banks and Financial Institutions. This initiative aims at permitting holders of banking current accounts to dispose of their withheld funds from checks and other documents valued in domestic currency, as from 9:00 A.M. of the business day following their current account deposit, instead of 13:30 hours as was the practice to date.

In this regard, it should be noted that the proposal made by said guild association relates to the establishment of a procedure for accepting the checks and other documents submitted for collection through the House and will allow, in conjunction with the corresponding regulations to be enacted by the Superintendence of Banks and Financial Institutions for such purposes, to reduce the period currently in force for the release of the respective clients funds. The process of acceptance of these documents will operate on a deferred basis, according to the adjustment proposal on the matter presented by the Association of Banks and Financial Institutions, bearing in mind that said modality will be applicable until December 2013, when the regulation established by the Bank will be revised in order to have a single stage in the release of funds.

Such amendment was based on a previous report by the said Superintendence and was subjected to public consultation during the month of May, as aforesaid.

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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 tariffs, indexed prices, and financial services, leaving 73% of the total CPI basket.

EPI: External price index relevant to Chile. It is calculated using the wholesale price index (WPI) —or CPI, as available—, and is expressed in dollars of the countries considered in computing the MER and weighted according to their share in Chilean trade, excluding oil and copper.

Gasoline parity price: Reference cost of gasoline imports, calculated on the basis of quotes for similar conditions to Chile, in relevant markets (America, Europe, and Asia). It includes maritime shipping, insurance rate, tariffs, and other 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 business services; dwelling services; 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.

MER-X: MER excluding US dollar.

RER: Real exchange rate. A measure of the nominal 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.

ULC: Considers total nominal labor cost, actual salaried hours worked, salaried employment, and total GDP.

ULCX: ULC considering only salaried employment and wages and GDP excluding sectors relating to natural resources.

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, April 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, April 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

EES: Economic Expectations Survey

FBS: Financial Brokers Survey

CPIG: Consumer price index for goods

CPINT: Consumer price index for non-tradables

CPIS: Consumer price index for services

CPIEFE: Consumer price index excluding foods and energy

CPIT: Consumer price index for tradables

IVUM: Unit price of imports index

MPR: Monetary policy rate

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