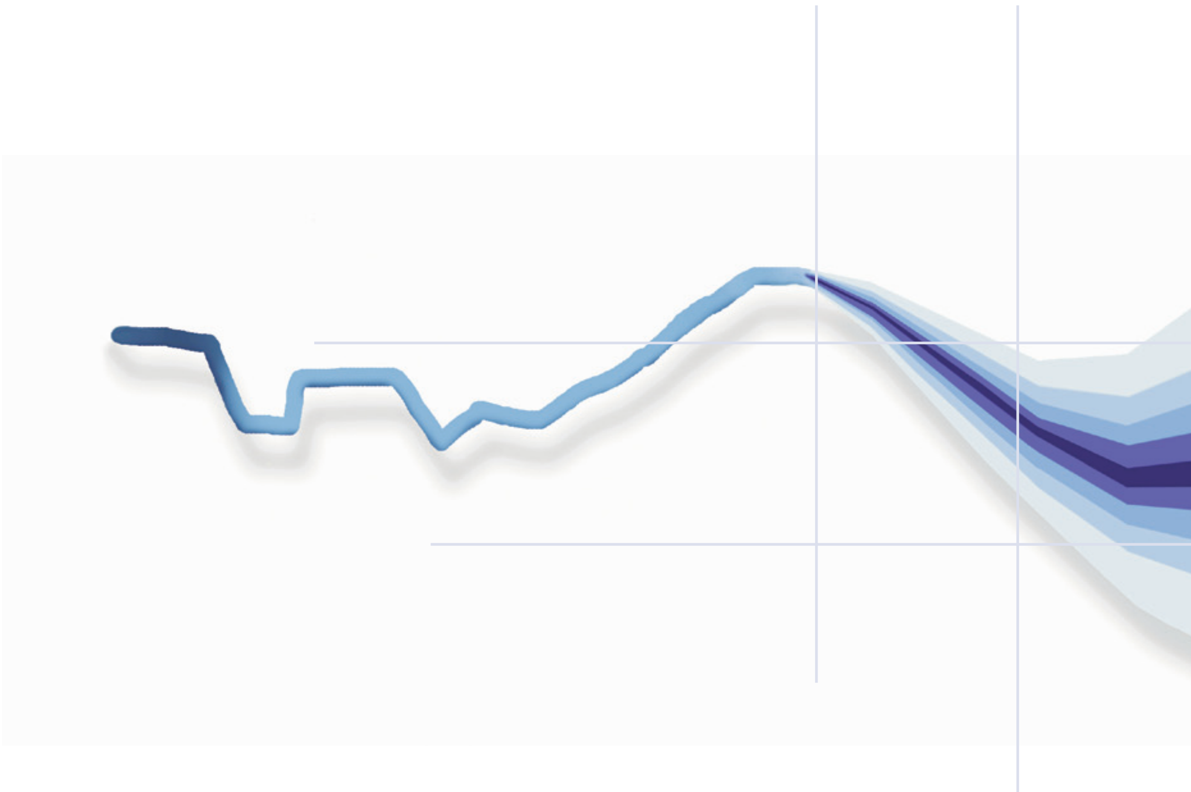
IPoM 2011

2011
JUNE

Monetary Policy Report



BANCO CENTRAL DE CHILE

Monetary Policy Report*

JUNE 2011

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DE CHILE

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

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*/ The statistical closing date of this *Monetary Policy Report* was 14 June 2011.

Preface

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

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

The *Monetary Policy Report* is published four times a year, in March, June, September and December. It analyzes the main factors influencing inflation, which include the international environment, financial conditions, the outlook for aggregate demand, output, and employment, and recent price and cost developments. The last chapter summarizes the results of this analysis in terms of the prospects and risks affecting inflation and economic growth over the next eight quarters. A number of boxes are included to provide more detail on issues that are relevant for evaluating inflation and monetary policy.

This *Report* was approved at the Board's session of 15 June 2011 for presentation before the Senate's Finance Committee on 20 June 2011.

The Board

Summary

Annual headline inflation has hovered around 3%, while core inflation, although on an upward trend, have remained contained, both below March's forecasts. The most outstanding development of the past few months has been the attenuation of some of the inflationary risks identified in March. Global commodity prices ceased to grow at the pace they were showing between mid-2010 and early 2011, but are still high. At the same time, the propagation of specific price shocks has been bounded, in line with projections. This and the monetary policy decisions adopted by the Board have contributed to moderate the concerns about an acceleration of inflation that were noticed in March. Accordingly, private inflation expectations show some marginal reversals.

First-quarter data showed a fast expansion of domestic output and demand, exceeding March's expectations. Partial indicators for the second quarter reflect an economy that continues to grow strongly but shows some moderation in the latest indicators. Worth noting is the strong dynamism of private consumption and, to a lesser extent, the machinery and equipments component of investment. Private consumption evolves consistently with fundamentals, particularly with the increase in household income, given that both employment and wages continue on the rise. Financial conditions are still favorable.

The baseline scenario assumes that GDP growth for this year will hit the upper part of the range foreseen in March, increasing between 6% and 7%, consistently with the upward bias then identified. This higher growth forecast for 2011 is based on actual first-quarter figures that exceeded estimates. For the rest of the year, the pace of expansion of total activity and demand will moderate as forecast in March. In particular, the speed of growth in the GDP of sectors other than natural resources will quickly approach the trend rate, which is still estimated at 5%. This scenario assumes that, on average, output gaps will remain closed throughout the projection horizon.

A significant part of the performance expected for the economy in the coming quarters will come from monetary policy adjustment. From June 2010 to date, the monetary policy interest rate (MPR) has been raised 475 basis points, of which 200 concentrated in this year. Any change in monetary policy is transmitted to output and inflation with a lag, normally taking in the range of two to eight quarters. In the baseline scenario, the full transmission of the monetary stimulus withdrawal will moderate the current dynamism of the economy and will stabilize it at a rate close to trend growth, simultaneously helping inflation to stand at 3% over the projection horizon.

International baseline scenario assumptions

	2009	2010	2011 (f)	2012 (f)
	(annual change, percent)			
Terms of trade	4.6	23.8	-1.6	-2.1
Trading partners' GDP (*)	-0.3	5.9	4.3	4.7
World GDP at PPP (*)	-0.6	4.9	4.1	4.5
World GDP at market exchange rate (*)	-2.1	3.8	3.2	3.8
External prices (in US$)	-6.2	5.8	9.0	2.8
	(levels)			
LME copper price (US¢/lb)	234	342	415	400
WTI oil price (US$/barrel)	62	79	99	103
Gasoline parity price (US$/m^3) (*)	471	598	825	832
Libor US$ (nominal, 90 days %)	0.7	0.3	0.3	0.9

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

Source: Central Bank of Chile.

Economic growth and current account

	2009	2010	2011 (f)
	(annual change, percent)		
GDP	-1.7	5.2	6.0 - 7.0
National income	-1.9	15.7	6.9
Domestic demand	-5.9	16.4	8.5
Domestic demand (w/o inventory change)	-2.9	11.5	9.2
Gross fixed capital formation	-15.9	18.8	11.9
Total consumption	1.9	9.3	8.3
Goods and services exports	-6.4	1.9	7.1
Goods and services imports	-14.6	29.5	11.0
Current account (percent of GDP)	1.6	1.9	0.0
	(US$ million)		
Current account	2,570	3,802	0
Trade balance	14,117	15,855	15,000
Exports	54,004	71,028	85,300
Imports	-39,888	-55,174	-70,300
Services	-1,444	-1,019	-1,900
Rent	-11,666	-15,424	-15,100
Current transfers	1,563	4,390	2,000

(f) Forecast.

Source: Central Bank of Chile.

Global conditions, particularly the terms of trade, trading partners' growth and external financing, are still favorable to Chile, but negative risks have intensified. On one hand, the dichotomy between developed and emerging economies has widened in terms of growth prospects and interest rates. On the other hand, inflation figures have increased further in several countries, but, as in Chile, the widespread concerns seen early this year over the future of the inflation scenario have eased.

For the external scenario, unlike previous *Reports*, this time projections match market consensus, because the latter were revised downward. On aggregate, world growth forecasts for the next two years are unchanged from March. However, there are significant changes in its breakdown. World GDP will grow slightly more than 4% in the 2011-2012 period, with a milder expansion of the United States —as inferred from recent output indicators and uncertainty regarding its approach to the fiscal deficit— and Japan— because the final effects of the earthquake have turned out stronger than initially estimated. This is offset by somewhat faster growth in emerging economies. Worth highlighting is the heterogeneity of economic activity within the Eurozone, where Germany and France have posted surprisingly strong growth, while peripheral Europe declines in its GDP.

Perceived weakness in the developed world has affected commodity prices, which stopped increasing as fast as they had since mid 2010, and there have been some revisions in the margin. They are still in record highs, however, mainly obeying to strong demand in emerging economies and some supply-side problems. The WTI oil barrel hit US$114 in late April, then it fell, and at the closing of this *Report* it is somewhat below US$100. Food prices, according to the FAO aggregate index, peaked in February, and have fluctuated around that level since. The baseline scenario assumes that the price of the WTI oil barrel will average around US$100 the next two years and foodstuff prices will remain fairly constant.

The interest rate differential between developed and emerging economies has continued to widen at all maturities. The dollar has depreciated further and emerging currencies have appreciated accordingly. The peso/dollar parity has not escaped this trend, although in its case it has been milder. The real exchange rate has depreciated marginally and is within the range considered to be consistent with its long-term fundamentals. The baseline scenario uses as a working assumption that it will remain at these values over the next several quarters.

In the past few months, inflation data have continued to be dominated by increases in prices of foodstuffs and fuels. Nearly two thirds of inflation accumulated between March and May stems from these two combined factors. Core inflation, particularly the CPIX1 variation is still bounded, not showing any unusual propagation of these shocks.

The baseline scenario foresees that the increase in headline inflation will be somewhat less than estimated in March. CPI inflation is expected to end the year in 4.0% and will remain fairly unchanged for some months. In 2012 it should converge to 3% and stay near the target until the end of the projection horizon, this time the second quarter of 2013. Core inflation will rise further to gradually converge to 3%. This forecast is based on the economy having, on average, closed output gaps throughout the projection

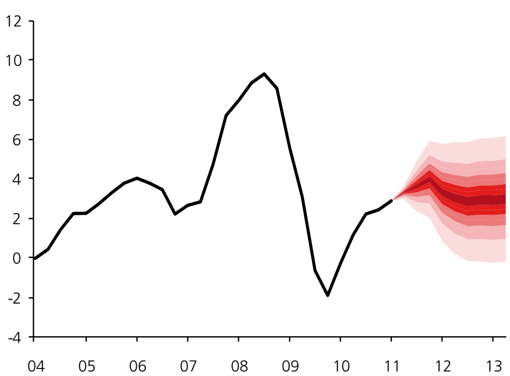
Inflation

	2009	2010	2011 (f)	2012 (f)	2013 (f)
	(annual change, percent)				
Average CPI inflation	1.6	1.4	3.5	3.1	
December CPI inflation	-1.4	3.0	4.0	3.0	
CPI inflation in 2 more years (*)					3.0
Average CPIX inflation	2.8	0.5	2.6	3.2	
December CPIX inflation	-1.8	2.5	3.5	3.1	
CPIX inflation in 2 more years (*)					3.1
Average CPIX1 inflation	2.7	-0.7	1.4	2.9	
December CPIX1 inflation	-1.1	0.1	2.7	3.0	
CPIX1 inflation in 2 more years (*)					3.1

(f) Forecast.
(*) Inflation forecast at the second quarter of 2013.

Source: Central Bank of Chile.

CPI inflation forecast (*)
(annual change, percent)



(*) The figure shows the confidence interval of the baseline projection over the respective horizon (colored area). Confidence intervals of 10%, 30%, 50%, 70% and 90% around the baseline scenario are included. These intervals summarize the risks on future inflation as assessed by the Board. The baseline scenario uses as a working assumption that the MPR will follow a path comparable to the one that can be inferred from the various expectations measures.

Source: Central Bank of Chile.

horizon and the propagation of specific price shocks being in line with the historic average, as in the last few months. Private projections are consistent with this scenario of less inflation.

As usual, there are risks that may shape a different macroeconomic scenario than the one described here. On this occasion, the Board estimates that risks for inflation and output are balanced.

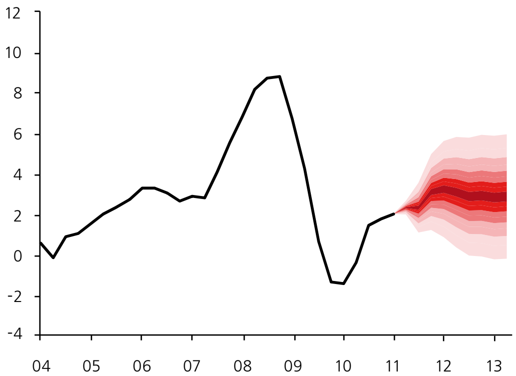
Although less intense than in March, one important risk is the persistence and propagation of the specific price shock of the past several quarters. Although a relative stability of commodity prices is estimated in external markets, a scenario of higher prices cannot be ruled out. Its effects on domestic inflation could be substantial due to the status of output gaps. On one hand, the labor market is showing significant strength. The rate of unemployment is low by historical standards and, combined with a significant increase in employment, various sources of information confirm the difficulties in hiring labor in some regions and economic sectors. The y-o-y increase in wages is greater than it was at the end of 2010 (box III.2). However, the combination of increased employment, higher wages and economic growth have allowed unit labor costs to post variation rates in line with the inflation target, at the same time that retailers' operating margins are above those of 2010. However, the behavior of the labor market must be closely monitored in order to prevent the incubation of inflationary pressures affecting the normal convergence of inflation to 3%.

The evolution of output and demand are also important in this setting. Should they continue to grow at the pace they showed in the first quarter, this could lead to an over-utilization of installed capacity, triggering greater inflationary pressures. Special attention has been given to consumption. However, it is unlikely that the current dynamism can be sustained very long. In a longer perspective, the recent boost in consumption reflects a recovery in the aftermath of the 2008-2009 crisis and the earthquake and tsunami of February 2010. Estimates of the ratio between actual and trend consumption do not show a significant difference (box III.1). In addition, the components of consumption showing the larger increases (i.e., durables and clothing) have a largely imported origin, so a lower exchange rate favors demand and replacement, particularly considering that its depreciation may have accelerated in tandem with technological changes. This is complemented with the low prices of these goods in dollars. Finally, growth in consumer credit, although showing higher velocity in the margin, is smaller than it has been in previous expansion phases or is observed in other emerging economies.

Internationally, the recent behavior of economic indicators, especially in developed economies, could be signaling a more protracted weakening of growth there. Such a scenario must be analyzed carefully, because other temporary factors related with the disruptive effects of the Japanese earthquake and the oil price increase may have played a role in recent developments. If the risk of this weakening of developed economies materializes, the decoupling of the growth pace between them and emerging markets would be aggravated. This would exacerbate the interest rate differentials in the world, intensifying capital flows toward emerging economies and exchange rate tensions, difficulting the implementation of macroeconomic policies. Add to this that in some European economies

CPIX inflation forecast (*)

(annual change, percent)



(*) The figure shows the confidence interval of the baseline projection over the respective horizon (colored area). Confidence intervals of 10%, 30%, 50%, 70% and 90% around the baseline scenario are included. These intervals summarize the risks on inflation as assessed by the Board. The baseline scenario uses as a working assumption that the MPR will follow a path comparable to the one that can be inferred from the various expectations measures.

Source: Central Bank of Chile.

financial tensions persist and global imbalances are far from over. It is also unclear how the major adjustments for fiscal consolidation in parts of Europe and in the U.S. will proceed. And it becomes even more uncertain when considering the setting of weak private demand and unsolved banking problems where these adjustments must take place.

Also far from over are the concerns about the way in which monetary policy makers in emerging economies will continue to deal with inflationary pressures. This is especially relevant in Asia, where some economies show signs of narrowing output gaps and growth rates above the trend. The possibility of a sharper adjustment in these economies' growth rates, particularly in China, would impact world GDP and commodity prices.

Summing up, in the baseline scenario, the Chilean economy is facing a favorable context. Still, important risks persist that must be closely monitored as they might jeopardize the achievement of the inflation target. As a working assumption, forecasts assume that the MPR will follow a trend comparable to the one that can be inferred from the various expectations measures. The Board estimates that, in the most likely scenario, further increases in the MPR will be necessary, the timing of which will depend on the unfolding of domestic and external macroeconomic conditions. Accordingly, it reiterates that it will continue to use its policies with flexibility so that projected inflation stands at 3% over the policy horizon.

Monetary policy decisions in the past three months

Background: Monetary policy meeting and *Report* of March 2011

The main development at the beginning of the year was increased inflationary risks. Rising prices of commodities—particularly oil and foodstuffs—had configured a scenario of higher inflationary pressures. Accordingly, short-term inflation expectations had increased. In the baseline scenario of the March *Monetary Policy Report*, headline inflation was expected to go above the upper boundary of the target range for several quarters, largely because of the effects of the higher prices of oil and oil derivatives. Y-o-y CPI inflation would be above 4% the entire second half of this year and into the turn of 2012. For December 2011, an annual CPI increase of 4.3% was forecast, an upward correction of one percentage point from December.

Domestically, output was still very dynamic. The strong growth of domestic demand had been crucial in this phenomenon. Thus, GDP was forecast to grow in the range of 5.5-6.5% in 2011. This scenario was consistent with output gaps remaining closed throughout the projection horizon. Labor market gaps had narrowed, with fast growth in employment and increased wages, largely owing to the boost from monetary policy to domestic expenditure and the world economic recovery.

World growth presented a somewhat improved outlook. The March *Report*'s baseline scenario assumed higher world economic growth than the December *Report*. Developed economies' activity, particularly in the U.S., had exceeded expectations and market consensus forecasts had been revised upward. Financial stress due to the situation at some European economies was still present. In emerging economies, growth proceeded as forecast, in a context of increasing foreign exchange tensions and rising commodity prices.

The balance of risks for both inflation and output was biased upward. The main risk had to do with the size, persistence and propagation of the commodity price shock, especially with oil. The baseline scenario assumed a fairly stable, though high, oil price. However, if political turmoil in some oil exporting countries intensified, the oil price could rise further. Domestically, to the extent that internal demand was stronger than projected, further inflationary pressures could incubate and favor a greater propagation of commodity price shocks to internal prices. Also, wage pressures had intensified reflecting the tight labor market.

As for March's monetary policy decision, the proposed options were an increase of either 25 or 50 basis points (bp) in the monetary policy interest rate (MPR). Both options were consistent with the contractionary bias of monetary policy. Although headline and core inflation remained within the tolerance range and the nominal exchange rate was appreciated, the strong growth in domestic output, greater inflationary pressures and the resulting increase in short-term inflation expectations posed the need for the Bank to give a powerful sign of its commitment with price stability. Hence, the Board decided to rise the MPR by 50bp to 4.0% annually.

Going forward, the Board would act to prevent the incubation of inflationary pressures that could favor the shocks' persistence and propagation to other prices. The baseline scenario of the March *Report* assumed that the withdrawal of the monetary stimulus would proceed at a pace comparable to the one that could be derived from the various expectations surveys.

Meetings of April and May

In April, the international scenario was marked by high financial risks in the Eurozone, specifically in Portugal, and the new rise in commodity prices, especially of oil. In that sense, the oil price increase associated to tensions in the Middle East and North Africa was an important risk factor because of its effects on world output and inflation expectations. Global growth was fairly positive while developed economies' output and employment continued to recover, albeit with large output gaps. Meanwhile, emerging economies continued with their marked dynamism. Domestically, actual data showed that output continued to grow vigorously. Domestic demand was growing strongly, driven by consumption which had remained high. This fast growth in output was also reflected in a tighter labor market. Actually, labor cost and remunerations indicators showed labor market constraints and the potential cost pressures on domestic prices. Inflation, especially in core indicators, was normalizing. March's CPI had been consistent with market expectations and core inflation indicators remained contained, particularly the CPIX1, which was still posting y-o-y variations of less than 1%, indicating that domestic inflation was being driven primarily by foodstuffs and fuels. Short-term inflation expectations were still slightly over the upper limit of the tolerance range, and somewhat above the target in the projection horizon. Data gathered since the previous meeting justified proposing as the relevant policy options increases in the MPR of either 25 or 50bp. A rise of 25bp was warranted solely under the assumption that the international scenario would continue with the moderate recovery of developed economies and expectations of a gradual normalization of trend inflation in Chile. However, the rationale behind March's decision had not changed. The increase in the oil price and the magnitude of its direct and indirect impact on Chilean inflation, combined with the possibility of even stronger domestic output and labor market, confirmed the need to further withdraw the monetary stimulus at the same pace as determined in the previous meeting and to act preventively to contain second-round effects. Moreover, the MPR was still below its neutral level. For these reasons, rising the MPR by 50bp was consistent with the risk-minimizing strategy. In the end, the Board decided to increase the MPR by 50bp to 4.5% annually.

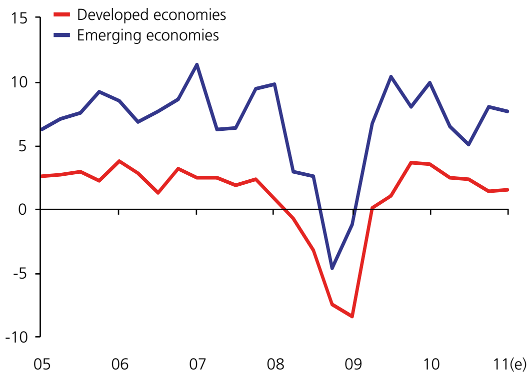
For May's meeting, the international context brought more uncertainty about the strength of world recovery. The differences between the prospects for developed and emerging economies suggested that the two-speed world economic recovery would persist. In some economies, inflation was close to or above the target range, although the degree of transmission of these pressures was less than in the past because of the appreciation of their currencies and the presence of output gaps in some of them. Commodity prices were still high, but more volatile now. Recent declines, particularly in the oil price, were largely explained by the world growth scenario. The domestic situation was marked by strong output and demand, combined with the recent increase in credit. Meanwhile, the labor market was still dynamic and, accordingly, y-o-y wage variation had been rising for some months. This scenario confirmed the risks of faster growth identified in the March *Report* which, if materialized, could augment inflationary pressures and call for a more aggressive monetary policy. As for prices, figures showed that inflation had been below market expectations. In this sense, monetary policy decisions and lower commodity prices had helped to reduce inflation expectations at different terms. This, unlike output, reduced the probability of occurrence of the upward-biased inflation scenario described in the March *Report*. In light of these developments, the normalization process of monetary policy had to continue. The data at hand indicated that increases of 25 or 50bp were totally feasible alternatives this time and were consistent with the strategy of reducing the monetary stimulus. The magnitude of the previous adjustment and the drop in commodity prices warranted an increase of 25bp in the MPR. Domestic inflationary pressures remained, however. Thus, an increase of 50bp would consolidate the policy trajectory followed so far and would send a strong signal of the Bank's commitment with target inflation while bringing the MPR closer to a range considered more neutral at the same time. The Board decided to raise the MPR by 50bp, taking it to 5.0% annually.

I. International scenario

Figure I.1

World output (*)

(annualized quarterly change, percent)



(*) Regions weighted at PPP. Developed economies include Australia, Canada, Denmark, the Eurozone, Japan, New Zealand, Sweden, Switzerland, the U.K. and the U.S. Emerging economies include Argentina, Brazil, Bulgaria, Chile, China, Colombia, the Czech Republic, India, Indonesia, Israel, Latvia, Malaysia, Mexico, Peru, the Philippines, Russia, Singapore, South Africa, South Korea, Thailand, Taiwan, Turkey and Venezuela.

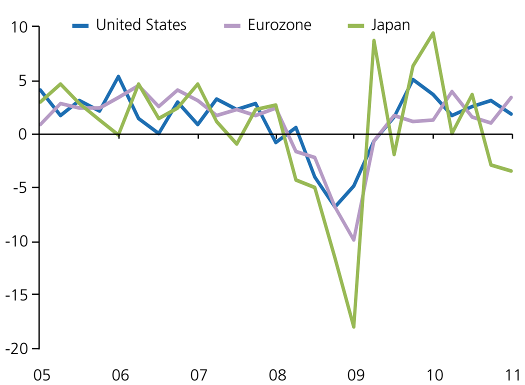
(e) Estimate.

Sources: Central Bank of Chile based on Bloomberg, the IMF and respective statistics bureaus.

Figure I.2

Growth in developed economies

(annualized quarterly change, percent)



Sources: Bloomberg and respective statistics bureaus.

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 relevant to the Chilean economy, as well as the main risks.

Baseline scenario

Generally, the international macroeconomic scenario has performed in line with March's projections and is still favorable for the Chilean economy, albeit important risks remain. The differences between economic growth in emerging and developed economies have widened further. Most recently, there is a reduction in consensus estimates for some developed economies. Although in the baseline scenario growth prospects for 2011 and 2012 show no significant changes in the aggregate, a weaker performance of the U.S. and Japan stands out, while emerging Asia shows faster growth. Inflation numbers have continued to rise in several countries, but the widespread preoccupation about its evolution seen earlier this year has dissipated. Although market consensus forecasts for inflation—that are released with a lag—have risen since the beginning of 2011, the expectations indicators that gather more recent information, such as breakeven inflation, show declines. This has coincided with commodity prices ceasing to rise with the strength they showed between mid-2010 and early 2011, although they are still high. This, plus the monetary policy actions adopted by various central banks and the deteriorated perception regarding growth of developed economies, has helped to moderate the fears of a bigger increase in inflation at the global level.

World growth

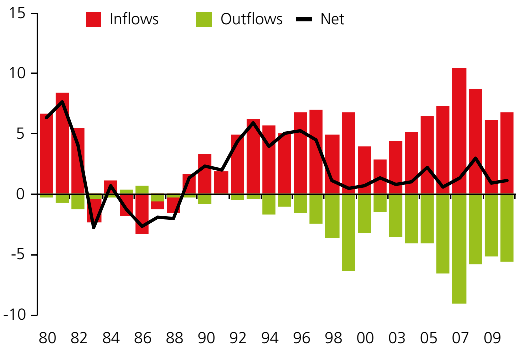
World activity is still proceeding in two speeds, with emerging markets growing strongly and developed economies failing to consolidate a recovery path (figure I.1). Most developed economies are still having wide output gaps (figure I.2). In the United States and Japan, first-quarter growth fell short of expectations. Their labor markets are still depressed, with no clear signs of improvement. Besides, recent surveys to purchasing managers anticipate a slowdown in these economies' growth trajectory. Likewise, stock exchanges have been sensitive to incoming information.

In contrast, emerging economies continue to grow strongly, near or somewhat above their potential and with closed output gaps in many of them. Some economies show lower unemployment rates than their historic averages, an acceleration of credit growth and larger current-account

Figure I.3

Average capital flows of emerging economies (1) (2)

(percent of GDP)



(1) Simple average of the following countries: Brazil, Chile, China, Colombia, Egypt, Hungary, India, Indonesia, Israel, Malaysia, Morocco, Mexico, Peru, the Philippines, Poland, South Korea, Russia, South Africa, Thailand, Taiwan and Turkey.

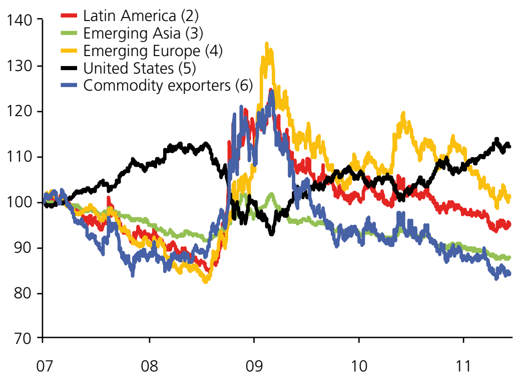
(2) Latest data show flows accumulated up to third quarter of 2010.

Source: Central Bank of Chile based on IMF figures.

Figure I.4

Currency parities (1)

(index 02.Jan.07=100, local currency units per dollar)



(1) Weighted average at PPP for each region. An increase indicates depreciation.

(2) Includes Argentina, Brazil, Chile and Mexico.

(3) Includes China, Indonesia, Malaysia, South Korea and Thailand.

(4) Includes the Czech Republic, Hungary, Poland and Russia.

(5) Dollar with respect to a basket of currencies from the U.S.'s main trading partners. An increase indicates a depreciation of the dollar.

(6) Includes Australia, Canada and New Zealand.

Sources: Bloomberg and International Monetary Fund.

Table I.1

World growth (*)

(annual change, percent)

	Avg. 90-99	Avg. 00-08	2009	2010 (e)	2011 (f)	2012 (f)
World at PPP	3.1	4.0	-0.6	4.9	4.1	4.5
World at market exchange rate	2.7	3.1	-2.1	3.8	3.2	3.8
United States	3.2	2.3	-2.6	2.9	2.7	3.2
Eurozone	2.2	2.0	-4.1	1.7	1.7	1.5
Japan	1.5	1.4	-6.3	4.0	-0.6	3.1
China	10.0	10.4	9.2	10.3	8.9	8.6
Rest of Asia	5.6	4.9	0.1	7.7	4.8	4.9
Latin America (excl. Chile)	2.8	3.6	-2.0	6.4	4.2	4.3
Commodity exporters	2.8	2.9	-1.0	2.9	2.7	3.0
Trading partners	3.1	3.5	-0.3	5.9	4.3	4.7

(e) Estimate.

(f) Forecast.

(*) For definitions, see glossary.

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

deficits associated to their dynamic domestic demands. These economies have continued receiving substantial capital inflows, although with some moderation from the second half of 2010. Unlike previous episodes of large capital inflows like those seen in the 1990s, today capital outflows from emerging economies are substantially larger, so the net balance has been smaller (figure I.3). The difference in the pace of growth and the favorable terms of trade have caused further appreciations of the currencies of most emerging countries (figure I.4). The dollar has depreciated nearly 2% since March against the basket of currencies of its main trading partners and is at its weakest point. Some economies have intensified measures to rein in the appreciation of their currencies, including Brazil, Colombia, Peru and South Korea.

The outlook for world economic growth in the baseline scenario is similar to the one in the March *Report*, but with changes in composition owing largely to the incorporation of actual first-quarter figures and partial indicators for the second quarter (table I.1). The projection is thus revised downward for the U.S. and Japan. In contrast, it is adjusted upward for the Eurozone to accommodate the greater actual GDP of the first quarter of the year, which is mainly explained by the exports-driven dynamism of Germany and France. Still, in these latter economies output should moderate in line with the withdrawal of fiscal stimulus packages applied during the financial crisis. In peripheral Europe, prospects for growth are more on the negative side, considering the bulkier fiscal adjustments required and the necessary deleveraging of households and firms. This is compounded with a more complex situation in the labor front: in Spain and Greece unemployment rates have practically doubled pre-crisis levels, while Germany exhibits the lowest rate in almost 20 years. The worsened evaluation of growth in developed economies has reflected in the drop in their long-term interest rates and in expectations of a more protracted expansionary monetary policy stance.

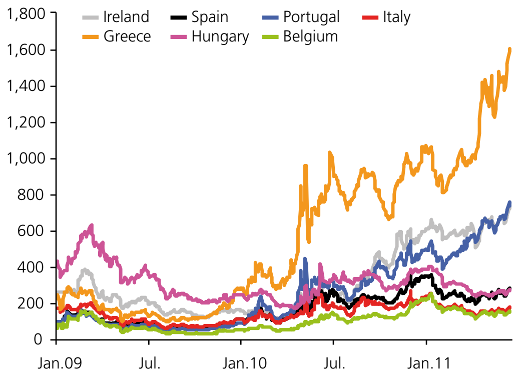
Growth projections for some emerging economies are slightly revised upward for 2011 and generally maintained for 2012. The data for the first part of the year have been higher than forecast, but are expected to slow down in line with the withdrawal of the monetary stimulus in several countries.

Risks for world growth are still present. The recent behavior of economic indicators, especially in the developed economies, has increased the probability of activity continuing to be weak for a longer period, reflecting their fragile fiscal and financial situation. Household indebtedness is still high and in some countries the public debt and the fiscal deficit are in record highs, raising doubts about their fiscal sustainability. Additionally, the adjustments needed to resolve this situation must be made in a context of weak domestic demands that cannot add any impulse. This situation has intensified pressures on credit markets in the past few months. Moreover, credit-risk-rating agencies have put several countries on a negative outlook,

Figure I.5

Sovereign risk premiums (*)

(basis points)



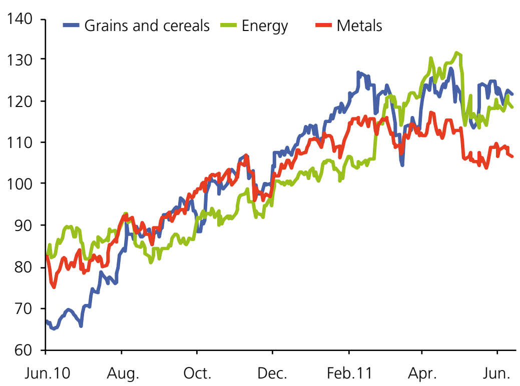
(*) Measured by 5-year-CDS premiums. For definition, see glossary.

Source: Bloomberg.

Figure I.6

Commodity prices (*)

(index, May 2010-June 2011=100)



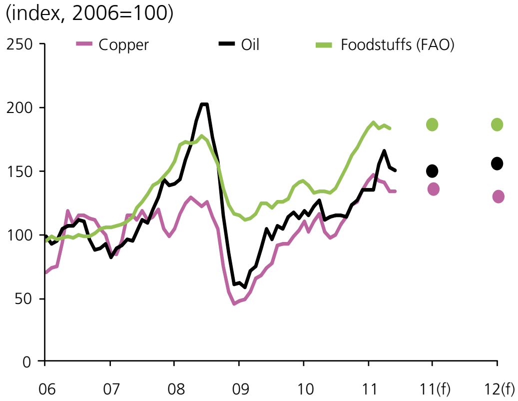
(*) From the S&P GSCI aggregate index.

Source: Bloomberg.

Figure I.7

Commodity prices (*)

(index, 2006=100)



(*) Foodstuffs include actual data up to May 2011; copper and oil include actual data up to June 2011.
(f) Dots show average prices forecast to 2011 and 2012.

Sources: Central Bank of Chile and Bloomberg.

including the United States, and downgraded others such as Japan and peripheral European economies. Sovereign risk premiums of banks and firms in some European countries increased substantially. In Ireland, Portugal and Greece, sovereign risk premiums hit new record highs since March, with increases of more than 500 basis points in Greece (figure I.5). Although Greece announced new austerity measures to cut down its fiscal deficit in order to qualify for funding by international organizations, the way in which it will be bailed out and the role of the private sector are yet to be figured out. However, the events of higher uncertainty with respect to the fiscal and financial situation in these economies have still not propagated to other markets the way they did in the second half of 2010.

Should the risk of further weakening of developed economies materialize, the decoupling with emerging markets in terms of their paces of growth would widen. The implications of such a scenario on interest rate differentials could exacerbate capital flows into emerging economies, increasing pressures on the exchange rate and obstructing the implementation of macroeconomic policies. Global imbalances persist.

Commodities

During the second quarter of this year, commodity prices ceased to increase as strongly as they had since the middle of 2010 (figure I.6). At present, they are high by historic standards, and are forecast to remain fairly stable during the coming quarters (figure I.7). The behavior of commodity prices in the past few weeks has been related, in part, to the perception that developed economies have weakened further. This is compounded with the impact of the restrictive measures that the Chinese government has adopted to slow down economic growth in China.

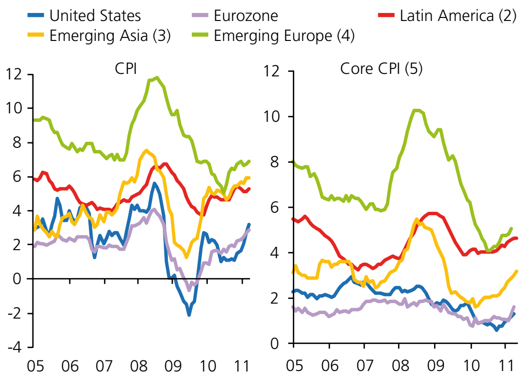
At the statistical cutoff date of this *Report*, the price of the oil barrel was slightly under US$100, and copper was trading at around US$4.0 per pound, down by 2% to 5% from the March *Report*. Price projections for the pound of copper are practically maintained at US$4.15 in 2011 and US$4.0 in 2012. For WTI oil, forecasts based on the average of futures contracts of the last ten business days place the price at an average of US$99 per barrel in 2011 and US$103 per barrel in 2012 (US$102 and US$103 in March, respectively). Meanwhile, the price of gasoline is at levels similar to the ones in March, due to refinery problems in the United States.

As for foodstuff prices, the FAO aggregate index is at its record high of February. It is worth noting that cereals—i.e., wheat, corn and rice—and meats are near their all-time highs. In contrast, sugar, dairy products and oils have decreased from their high first-quarter levels. Futures contracts suggest that food prices will stay where they are, with the exception of cereals. This, mainly because of bad climatic conditions driving the wheat price further up.

Figure I.8

Inflation (1)

(annual change, percent)



(1) Regions weighted at PPP.
(2) CPI includes Argentina, Brazil, Chile, Colombia, Mexico and Peru. Core CPI excludes Argentina.
(3) CPI includes China, India, Indonesia, Malaysia, South Korea, Thailand and Taiwan. Core CPI excludes China and India.
(4) CPI includes the Czech Republic, Hungary, Poland, Russia and Turkey.
(5) As per each country's definition.

Sources: Central Bank of Chile, Bloomberg and CEIC Data.

Table I.2

World inflation

(average annual change in local currency, percent)

	Avg. 90-99	Avg. 00-07	2010	2011 (f)	2012 (f)
United States	3.0	2.8	1.6	2.7	2.1
Eurozone	2.3	2.2	1.6	2.4	1.8
Japan	1.2	-0.3	-0.7	0.2	0.2
China	7.8	1.7	3.4	4.6	3.7
Australia	2.5	3.2	2.8	3.1	2.8
New Zealand	2.1	2.6	2.3	4.4	2.7
Brazil	854.8	7.3	5.0	6.5	5.4
Mexico	20.4	5.2	4.2	3.8	3.8
EPI (*)	1.8	4.6	5.8	9.0	2.8
IPL (*)	27.2	5.2	4.8	5.4	3.5

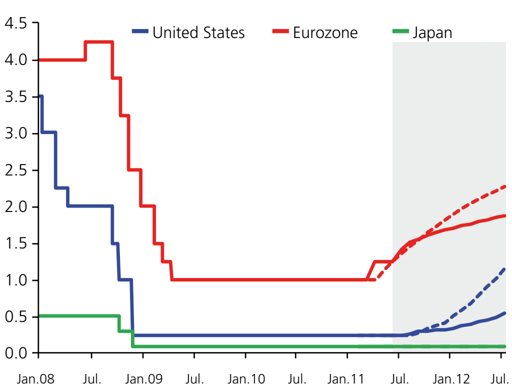
(*) For definitions, see glossary.
(f) Forecast.

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

Figure I.9

MPR and expectations (*)

(percent)



(*) Gray area shows trajectory implicit in futures contracts. Dashed line shows projections in March 2011's *Monetary Policy Report.*

Sources: Respective country's Central Bank and Bloomberg.

World inflation and monetary policy

Inflation has been increasing globally (figure I.8). The transmission of the price hikes of fuels and foodstuffs to local inflations has been determinant in this result. In the emerging world, this has been compounded with dynamic domestic demands. The changes in the currencies' valuation has affected the developed and emerging economies in opposite ways. While in the latter the appreciation has helped to cushion the external price shocks, in some developed ones, like the U.S., Japan and the U.K., the depreciation of their currencies has increased inflation.

The higher figures for actual inflation and the increase in commodity prices in the first quarter of the year triggered steady increases in market inflation expectations. In May, expected inflation for 2011 in the different regions was in the range of half to one percentage point higher than it was at the beginning of the year. Nonetheless, the expectations indicators that gather later information have posted declines in the past several weeks, coinciding with the shift in the trajectory of commodity prices and the perception of lower inflationary risk. The baseline scenario, which is configured using consensus forecasts for the local inflation of different economies, foresees that in 2011 external inflation relevant to Chile (measured by the external price index EPI) will be higher than foreseen in March (table I.2). This, because of a slightly more depreciated dollar trend and higher figures for actual inflation during the first quarter of the year.

The central banks of emerging economies have continued normalizing their reference rates, although at different speeds. In China, policy makers have shown concerns about the strength of growth and the increase in inflation—which went from 4.6% in December to 5.5% in its latest reading—and about the strength of the real estate market, which has been accompanied by an expansion of credit. Accordingly, the Chinese Central Bank has raised the monetary policy rate four times since October, after holding it constant for almost two years. In addition, it has increased reserve requirements to an all-time high of 21.5%. In any case, the way in which the monetary authorities of emerging economies will continue to deal with inflationary pressures is a risk, because more aggressive monetary policy responses—especially in some economies with signs of capacity over-utilization—might cause a slowdown in growth and a drop in commodity prices.

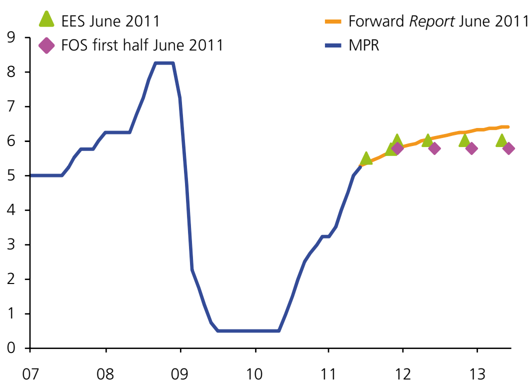
In the developed economies, monetary policy is still on an extraordinarily expansionary instance. Recent data and statements by the monetary authorities of some countries have given way to expectations that interest rates will stay low for longer than previously forecast (figure I.9). Still, some advanced economies are in a more accelerated normalization cycle, such as, for example, Sweden and Norway.

II. Financial markets

Figure II.1

MPR and expectations

(percent)



Source: Central Bank of Chile.

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

Monetary policy

In the first months of the year, inflationary risks intensified because of the sharp increase in commodity prices in international markets. The possibility of the propagation of these shocks to other prices being higher than usual, within a context where domestic output and demand were growing strongly, raised inflation forecasts and inflationary risks. The Board, in order to prevent the occurrence of a negative inflationary scenario, sped up the normalization of the monetary policy rate (MPR), raising it by a total of 150 basis points (bp) between March and May. This increase was faster than the market had anticipated. In June's meeting, the Board decided to raise the MPR by 25bp to 5.25%. In addition, it communicated that, in the most likely scenario, further increases would be necessary, the timing of which would depend on the unfolding of domestic and external macroeconomic conditions.

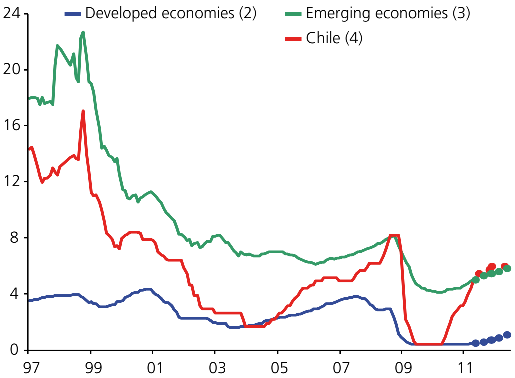
A significant factor in the behavior that is expected from the Chilean economy in the coming quarters is the withdrawal of the monetary impulse in the last year. Since June 2010, the Central Bank has raised the MPR by 475bp, nearly half of which in 2011. The lag—usually of two to eight quarters—with which the impact of changes in monetary policy are transmitted to output and inflation means that the data at hand does not fully reflect such withdrawal. In any case, the risks in the inflation scenario have eased, because of both the changes in the macroeconomic environment and the monetary policy actions themselves.

Market expectations, consistently with the perception of reduced inflationary risks, have brought down the forecast level of the MPR one and two years ahead. Those deduced from the Financial Brokers Survey (FBS) of the first half of June and the swap and forward contracts curve, have adjusted the MPR by up to 40bp since March, especially for the two-year horizon. Expectations one year ahead are between 5.7% and 5.97% (between 5.87% and 6.0% in March) and two years ahead, between 5.75% and 6.3% (6% to 6.7% in March) (table II.1). The expectations that are derived from June's Economic Expectations Survey (EES) at the same horizons have remained at 6%. However, the distribution has been shifting to the left, with a greater number of respondents foreseeing the MPR around 5.75% and a smaller share placing it above 6%. The baseline scenario of this *Report* uses as a working assumption that the MPR will follow a path comparable to the one that can be inferred from the various expectations measures (figure II.1).

Figure II.2

Actual and expected monetary policy rate in the world (1)

(percent)



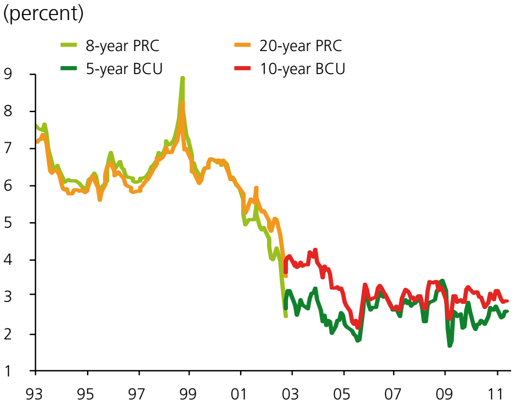
(1) Solid lines depict simple average of reference rates of each group of countries. For regions, dots indicate the median of Bloomberg's analysts survey about the expected MPR at June 2011, September 2011, December 2011, March 2012 and June 2012. For Chile, June's EES is used for the expected MPR at July 2011, November 2011, December 2011 and May 2012.
(2) Includes, the Eurozone, Japan, the U.S. and the U.K.
(3) Includes Brazil, China, Colombia, the Czech Republic, Hungary, Mexico, Peru, Poland, South Korea and South Africa.
(4) Data before the nominalization of the reference rate (August 2001) consider the real interbank overnight interest rate plus CPI inflation.

Sources: Central Bank of Chile, respective country's central bank, Bloomberg and International Monetary Fund.

Figure II.3

Long-term real interest rates (*)

(percent)



(*) Indexed promissory notes with coupon payments (PRC) were in effect until 8 August 2002 and are used in this figure as a proxy for BCUs.

Source: Central Bank of Chile.

Table II.1

MPR expectations

(percent)

	At December 2011		In one year		In two years	
	March *Report*	June *Report*	March *Report*	June *Report*	March *Report*	June *Report*
EES (1)	5.75	6.00	6.00	6.00	6.00	6.00
EOF (2)	--	5.75	6.00	5.75	6.00	5.75
Forward curve (3)	5.72	5.66	6.08	5.97	6.72	6.36
Swap contracts (4)	5.64	5.53	5.87	5.72	6.25	5.93

(1) Surveys of March and June 2011.
(2) Surveys of second half of March and first half of June 2011.
(3) Built using interest rates on swap contracts up to two years and then interest rates on BCPs.
(4) Built using interest rates on swap contracts up to two years.

Source: Central Bank of Chile.

The economy has recovered strongly from the recession of 2009, and the different variables are beginning to converge to their estimated equilibrium levels. Therefore, the monetary policy rate should be at a level where it neither strengthens nor weakens the impulse to aggregate demand with respect to the trend.

With the trajectory assumed in the baseline scenario, the MPR will be within the range of values historically considered neutral. It must be kept in mind, however, that there is a high degree of uncertainty about the true level of the neutral interest rate in the short term. The performance of the domestic and external economic scenarios in recent years may have modified previously estimated ranges[1]/. On one hand, low interest rates in the developed world—with projections that, at least for two more years, they will remain below their historic average—make it likely for the neutral short-term interest rate to fall slightly short of earlier estimates (figure II.2). For reference purposes, in the past few years market consensus forecasts for the real interest rate expected on average for the next ten years have been adjusted downward for a group of countries. In the United States, for example, it was changed from around 2.5% in 2006-2007 to a little less than 0.5% in 2010. On the other hand, the neutral real interest rate can also depend on changes in the cyclical phase of the economy, its medium-term growth prospects and changes in internal and external financing conditions, as well as changes in fiscal policy. As a reference, in Chile, the long-term real interest rates have fallen in the last decade from nearly 7% in the year 2000 to figures in the range of 2% to 3% in the last five years (figure II.3).

Financial conditions

Conditions in financial markets remain favorable for firms and persons, and present no big changes with respect to the scenario described in the March *Report*.

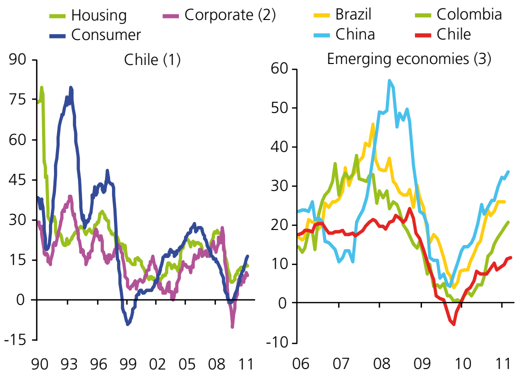
Most recently, the stock of banking consumer loans posted increased velocity in the margin, although it is still growing less than in previous expansionary cycles. In terms of y-o-y variation, it increased 17% in May

[1]/ Fuentes and Gredig (2008).

Figure II.4

Credit growth

(annual change, percent)



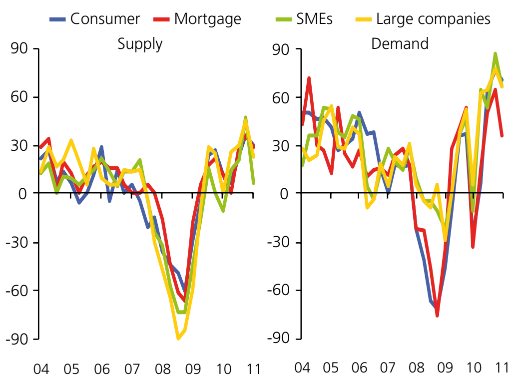
(1) Preliminary for May 2011.
(2) Commercial loans and foreign trade loans added together.
(3) For Brazil, figures cover up to February 2011; for China and Colombia, up to March 2011.

Sources: Central Bank of Chile, International Monetary Fund and Superintendence of Banks and Financial Institutions.

Figure II.5

Bank lending survey (*)

(net responses, percent)



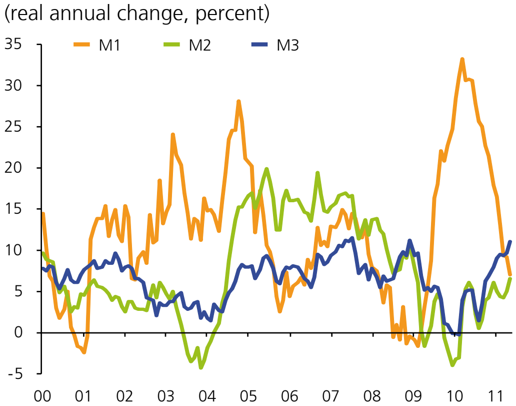
(*) Average responses by quarter. Negative (positive) values indicate tighter (looser) conditions than in previous quarter.

Source: Central Bank of Chile.

Figure II.6

Monetary aggregates (*)

(real annual change, percent)



(*) For definition, see glossary.

Source: Central Bank of Chile.

(14% in February). The stock of commercial and housing loans month to month continued to increase, but not as fast as consumer loans. Housing loans continued to grow at about 13% annually, while commercial loans rose to 9% (7% in February). Other financing sources have also shown a recovery in the past year. In the case of consumer credit, it is worth noting the increased share of loans from department stores, although their growth rate is still smaller than credits of banks. In the case of firms, external commercial credits and bond issues have shown significant dynamism this year to date[2]/. Nevertheless, credit growth is slower in Chile than in other emerging countries (figure II.4).

Considering the most relevant brackets, the interest rates applied by the banks have posted no material variations in the past few months (table II.2). The spread between lending rates and deposit rates has been narrowing since the beginning of this year, particularly at 30- and 90-day maturities. As for credit access conditions, the Bank Lending Survey of the first quarter showed that most banks continued to further loosen their lending standards, in terms of larger amounts and longer maturities for loans to every sector (figure II.5).

Table II.2

Interest rates of the financial system by type of loan (1)

(percent)

		Consumer 181 days to one year (2) (29.5%)	Consumer over 3 years (2) (43.9%)	Commercial 30 to 89 days (2) (23.3%)	Commercial 181 days to one year (2) (19.6%)	Housing over 3 years (3) (99.0%)
2002-2009 Average		32.2	25.6	7.6	10.2	4.9
2010	QI Average	35.9	27.0	3.8	9.4	4.5
	QII Average	34.9	25.1	3.5	8.0	4.1
	QIII Average	35.5	25.6	4.8	8.9	4.0
	QIV Average	35.2	24.9	5.7	8.9	4.3
2011	Jan.	34.3	26.1	6.4	9.8	4.3
	Feb.	35.9	25.2	6.9	10.3	4.4
	Mar.	34.9	24.2	6.9	10.1	4.4
	Apr.	36.3	25.1	7.2	10.3	4.3
	May	36.0	25.3	7.7	9.9	4.2

(1) Weighted average rates of all operations performed in the month. In parentheses, shares in total loans by type of credit in 2010.
(2) Non-indexed rates.
(3) UF-indexed rates.

Source: Central Bank of Chile.

The interest rates on long-term Central Bank and Treasury documents in pesos declined since March, partly following the interest rate trajectory of international markets. Thus, since the statistical cutoff date of the last *Report*, rates at 5 and 10 years regressed by around 20bp, which compares with the 40bp decline experienced by the U.S. government bond. At shorter maturities, the interest rates in pesos remained almost constant. As for rates denominated in UFs, the 2-year BCU rose around 70bp since the closing of the previous *Report*, probably reflecting lower inflation forecasts. The 5-year BCU rose 20bp, while the 10-year document is fairly unchanged from March.

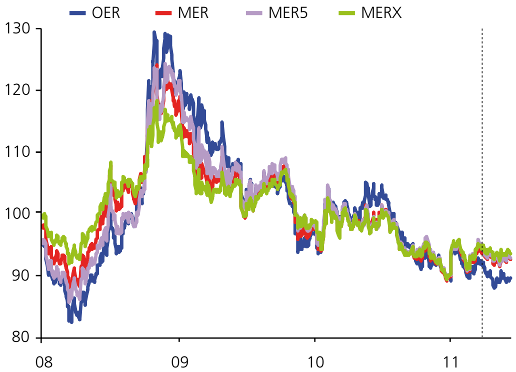
As for monetary aggregates, M1, made up primarily of non-remunerated assets, continued to reduce its rate of annual growth, in line with the current monetary policy cycle. Thus, by May it had increased at a real annual rate of

[2]/ *Financial Stability Report*, first half (2011).

Figure II.7

Nominal exchange rate (1) (2)

(index, 02.Jan.2008-14.Jun.2011=100)



(1) For definition, see glossary.

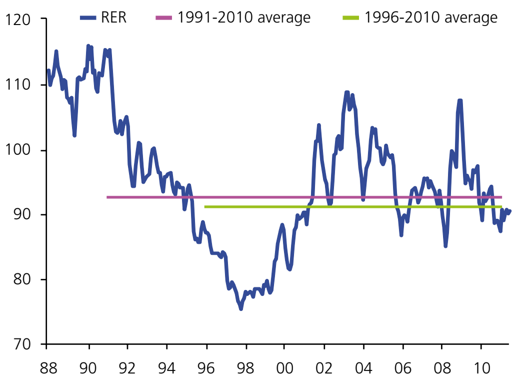
(2) Vertical dotted line shows date of publication of March 2011's *Monetary Policy Report.*

Source: Central Bank of Chile.

Figure II.8

Real exchange rate (*)

(index, 1986=100)



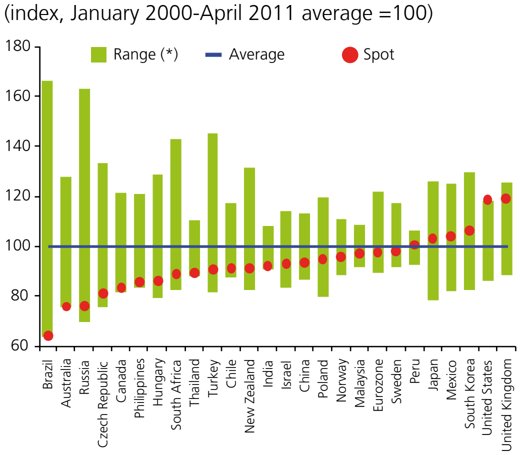
(*) Information at 14 June 2011.

Source: Central Bank of Chile.

Figure II.9

Real exchange rates in the world

(index, January 2000-April 2011 average =100)



(*) The range shows maximum and minimum values of respective local currency during indicated period.

Sources: Central Bank of Chile and Bank for International Settlements (BIS).

7% (13% in February). M2 held on to its real annual rate of 5%, while M3 is approaching an 11% real annual rate (9% in February), that is, similar to the values of late 2008. Since November 2010 there has been a shift in composition from highly liquid instruments that make up M1, toward longer-term instruments, which are part of M3 (figure II.6).

The world stock markets showed fluctuations since the statistical closing of the March *Report*. At first, the majority rose. Then, facing the further weakened indicators of developed economies, part of this movement reversed, most notably in emerging economies. The Chilean stock exchange, measured by the IPSA, rose 6% in local currency (9% in dollars) considering the ten business days before the statistical closing of this and the previous *Report*. A few days before the statistical closing there was increased volatility in the local market, reflecting the difficulties being experienced by a listed retail company.

Exchange rate

The dissimilar scenario of global growth, the continued weakness of the U.S. dollar and the high terms of trade have further appreciated the currencies of most emerging economies and commodity exporters. There have also been significant capital inflows into emerging economies. In 2010, these amounted to about 7% of GDP on average, considering a group of emerging markets (figure I.3). However, unlike previous episodes of large capital flows, like in the 1990s, today capital outflow from emerging economies is larger, so the net balance is smaller.

In the last month, reflecting the worsened output indicators in developed economies and financial stress in Europe, part of the exchange rate movements reversed. The Chilean peso has been no exception. During April, the peso-dollar parity continued to appreciate to levels around $460. After that, the peso depreciated, standing now close to $470. In multilateral terms, the parity was more stable (figure II.7). Comparing the last ten business days before the statistical cutoff date for the *Reports* of March and June, the peso appreciated 3.1%. In multilateral terms, the change was smaller: 2.0% for the MER-5, 1.4% for the MER and, excluding the U.S. dollar, 1.0% for the MER-X.

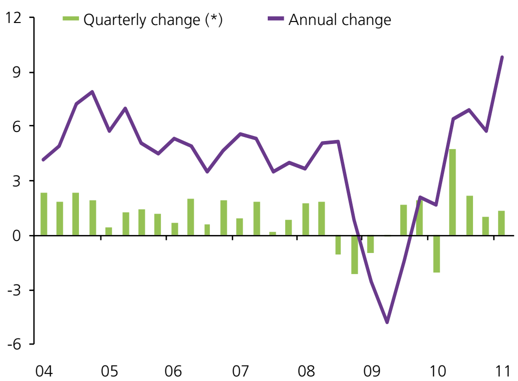
Considering the level of the nominal exchange rate and currency parities prevailing in the ten days prior to the statistical closing of this *Report*, the real exchange rate (RER) stands at 90.4 (using 1986=100), somewhat more depreciated than in March (figure II.8). This figure is within the range of values consistent with its long-term fundamentals. The persistent weakness of the dollar globally has taken the real exchange rates of various economies to or near decade lows (figure II.9). As a working assumption, it is considered that Chile's RER will remain at these values over the coming quarters.

III. Demand and output

Figure III.1

Gross domestic product

(percent)

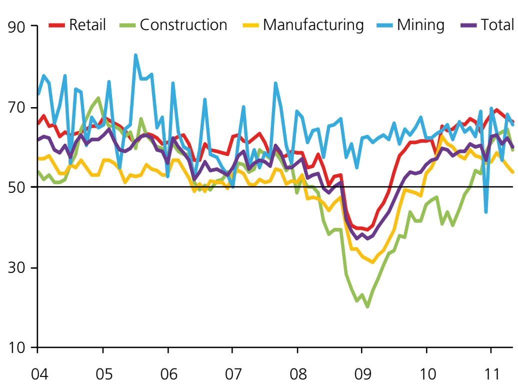


(*) Seasonally-adjusted series.

Source: Central Bank of Chile.

Figure III.2

Firms' expectations: Imce (*)



(*) Value over (under) 50 points indicates optimism (pessimism).

Source: Universidad Adolfo Ibáñez/Icare.

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

Aggregate demand

In the first quarter of 2011, domestic demand and output showed strong dynamism, above March's projections. Partial second-quarter indicators reflect an economy that continues to grow strongly, though with a moderation in its velocity of expansion.

Table III.1

Gross domestic product

(real annual growth, percent)

	Weighted	2009	2010					2011
	2010	Year	I	II	III	IV	Year	I
Agriculture-forestry	3.6	-1.1	0.3	2.5	1.0	-0.4	1.0	15.8
Fishing	0.9	-7.3	-24.8	-9.1	-25.0	9.1	-13.7	36.6
Mining	6.4	-1.3	2.1	1.7	3.0	-1.6	1.2	-1.8
Manufacturing	14.3	-6.4	-6.1	-0.7	1.9	0.9	-1.0	11.1
EGW	2.3	14.5	12.5	22.8	14.6	6.7	13.7	9.2
Construction	6.8	-7.9	-1.9	4.1	5.2	6.8	3.6	10.7
Retail (1)	11.2	-3.1	8.8	16.2	14.5	14.0	13.3	13.0
Transportation	7.4	-2.6	1.5	10.0	12.2	9.9	8.5	14.0
Communications	3.4	11.2	13.8	10.9	10.4	7.2	10.5	9.6
Other services (2)	37.4	1.1	2.9	4.9	4.9	4.6	4.4	6.9
Natural resources (2)	9.6	0.9	-0.4	4.5	3.1	1.2	2.1	5.6
Other (2)	84.1	-1.7	1.7	5.8	6.3	5.7	4.9	10.0
GDP total (3)	**100**	**-1.7**	**1.7**	**6.4**	**6.9**	**5.8**	**5.2**	**9.8**

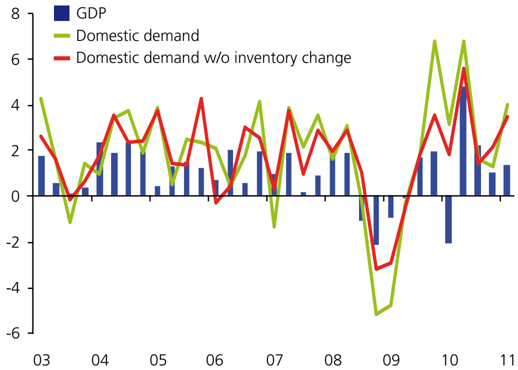
(1) Includes restaurants and hotels.
(2) For definition, see glossary.
(3) Total GDP is defined as the sum of natural resources GDP, other GDP, net VAT collected and import duties, minus banking imputations.

Source: Central Bank of Chile.

According to first-quarter National Accounts, GDP grew 9.8% annually, with an annualized quarter-on-quarter expansion of more than 5% (figure III.1). In annual terms, the great majority of productive sectors posted significant rates of growth, except mining that posted a contraction of nearly 2% (table III.1). These y-o-y expansion figures are affected by last year's low basis of comparison due to the earthquake and tsunami of February 2010. Aside from this, the agricultural-forestry and fishing sectors grew significantly, in line with a substantial increase in their export volumes during the first quarter of the year. The evolution of retail and other services continues to stand out, consistent with a dynamic domestic demand and particularly strong consumption. Construction has recovered further and faces favorable

Figure III.3

GDP and domestic demand (*)
(quarterly change, percent)

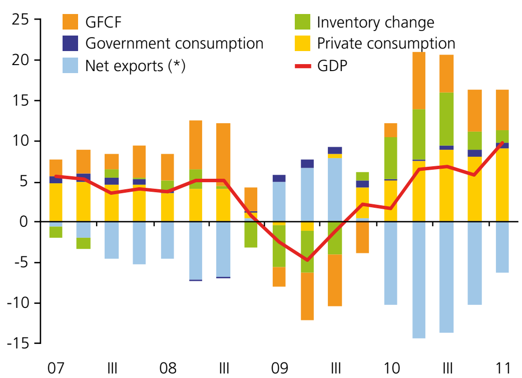


(*) Seasonally-adjusted series.

Source: Central Bank of Chile.

Figure III.4

Contribution to annual GDP growth
(real annual change, percentage points)

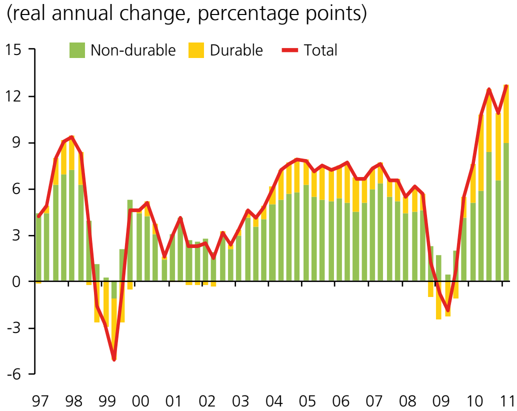


(*) Goods and services exports minus goods and services imports.

Source: Central Bank of Chile.

Figure III.5

Incidence in private consumption annual growth
(real annual change, percentage points)



Source: Central Bank of Chile.

prospects, partly due to the execution of several mining and real-estate projects. The Monthly Index of Business Confidence (Imce) shows a favorable perspective for the different sectors. In aggregate terms, it accumulates 21 consecutive months above the 50-point pivot (figure III.2).

The outlook for the second quarter derived from June's Economic Expectations Survey (EES) point to y-o-y growth of 6.2% for the period. For the full year, the baseline scenario of this *Report* estimates that y-o-y GDP growth will be in the 6.0% to 7.0% range, higher than projected in March. The June EES anticipates closing the year at 6.3%. This projection has been revised upwards since last March.

Domestic demand also grew strongly during the first quarter, close to 15% annually. Excluding inventory change, y-o-y growth approached 13%, with a significant increase in the expansion velocity from the previous quarter (figure III.3). As in earlier quarters, the boost came mainly from the private consumption side, followed by gross fixed capital formation (GFCF) (figure III.4).

On the fiscal front, during the first quarter of 2011, the overall surplus was 1.1% of annual GDP. Total income rose nearly 22% in real annual terms, explained mainly by copper revenues. Expenditure dropped 2.6% in real annual terms, driven by a decline in investment. Meanwhile, the current account of the balance of payments posted a surplus of US$722 million in the first quarter. With this, the balance accumulated in the last moving year amounted to 1.1% of GDP.

Consumption and its fundamentals

Private consumption continues to grow strongly. Its behavior is consistent with increased personal income and the recovery of durable goods inventories (box III.1). Although the latest data show some deceleration, there is the risk of its strong dynamism lasting a long time. In this regard, during the first quarter of 2011 private consumption grew nearly 13% annually at 2003 prices, accumulating four quarters with two-digit expansion (figure III.5). In the first quarter, durable goods consumption increased 37% annually and habitual consumption[1]/ grew close to 10% annually. A significant part of the increase in consumption is related with goods of imported origin. In fact, imports of this category of goods have increased steadily during the past year.

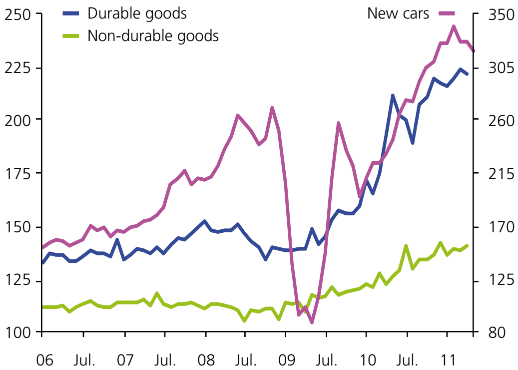
Partial second-quarter information notes that some consumer indicators show a certain moderation in their growth speed. Retail sales have stabilized at high levels, while new car sales has slowed down, posting three consecutive months of declines (figure III.6). Consumer goods imports also posted lower velocities in the past months. Still, all these variables are at or very near historic highs.

[1]/ Habitual consumption corresponds to consumption of non-durable goods and services.

Figure III.6

Retail sales and new car sales (*)

(Index 2003=100, seasonally-adjusted series)



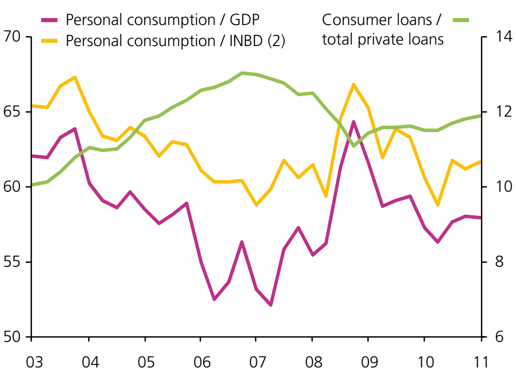
(*) Sold during moving quarter.

Sources: National Association of Car Dealers, Central Bank of Chile, and National Chamber of Commerce.

Figure III.7

Aggregate consumption indicators (1)

(percent)



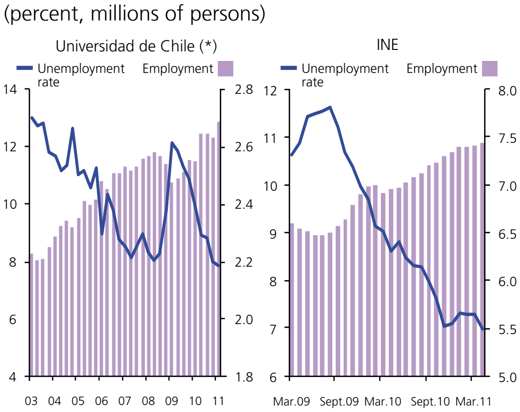
(1) Nominal series.
(2) For definition, see glossary.

Source: Central Bank of Chile.

Figure III.8

Labor market

(percent, millions of persons)



(*) Seasonally-adjusted series.

Sources: Central Bank of Chile, National Statistics Bureau (INE) and Universidad de Chile.

Aside from the increase in income, consumption growth has coincided with favorable financial conditions. According to the Bank Lending Survey of the first quarter of 2011, most banks keep a policy of greater flexibility in credit access conditions, while perceiving an ever-growing demand. Over the past few months, interest rates show no significant change and consumer loans have increased their expansion velocity.

Despite more robust consumer loans in the margin, consumption levels and y-o-y growth rates are smaller than those in previous expansion episodes. The ratio of consumer loans to total private loans has remained in the 10% to 13% range during the period 2003-2011. Even during the first quarter of 2011 it was below the peaks of late 2006 and early 2007. Similarly, the ratio of private consumption to GDP or to the National Gross Disposable Income (NGDI) has hovered around the 2003-2010 average, and during the first quarter of 2011 and the entire year 2010 it was slightly below that average (figure III.7).

The performance of household income has responded largely to labor market strength. Employment is showing high growth rates while unemployment drops rapidly. According to INE data, in the moving quarter February-March-April of 2011 unemployment fell to 7.0% (7.3% in the moving quarter January-February-March of 2011). This is a surprising figure because under the former measurement it was common to see unemployment increase in the winter season. It must be kept in mind that the change in the National Employment Survey means that the rate of growth in employment may be influenced by changes in the seasonal pattern and the larger weight assigned to groups whose working status is more sensitive to the business cycle[2]/. Thus, although comparisons are more difficult after the change in the INE Survey, other indicators show unemployment in its lowest levels of the past decade (box III.2).

For March, after seasonal adjustment, Universidad de Chile's Employment and Unemployment Survey for Greater Santiago shows a reduction in unemployment with respect to last December (figure III.8).

Employment figures of the Chilean Safety Association (AChS) and the number of participants in Pension Fund Administrators (AFPs) also show an increase in employment. Casuistic sources of information confirm the tight labor market and agree that, in certain sectors and regions of the country, hiring labor has become an even more complex task, with its resulting pressures on labor cost.

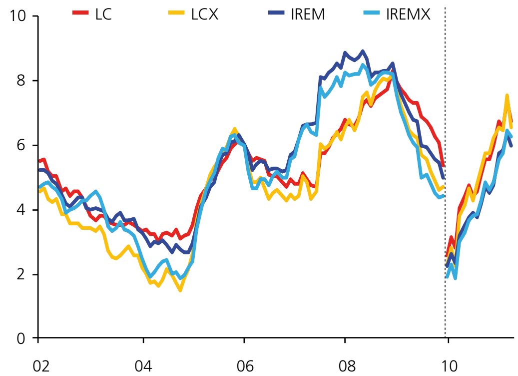
Accordingly, y-o-y growth rate of wages has increased in recent months. In April, all indicators posted increases between 5.9% and 6.7% annually, which compares with numbers between 4.7% and 6.2% last December (figure III.9). In real terms, the variation fluctuates around 3% annually. By productive sectors, mining, retail and construction stand out for showing the greatest increases in wages.

[2]/ For details, see box III.1: New National Employment Survey (NNES), *Monetary Policy Report*, March 2011, page 26.

Figure III.9

Nominal wages (1) (2)

(annual change, percent)



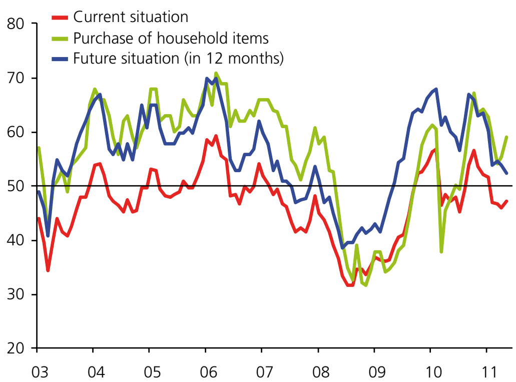
(1) As from January 2010, new indices with annual base 2009=100 are used, so they are not strictly comparable to previous figures.

(2) For definition, see glossary.

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

Figure III.10

Consumer expectations: Ipec (*)



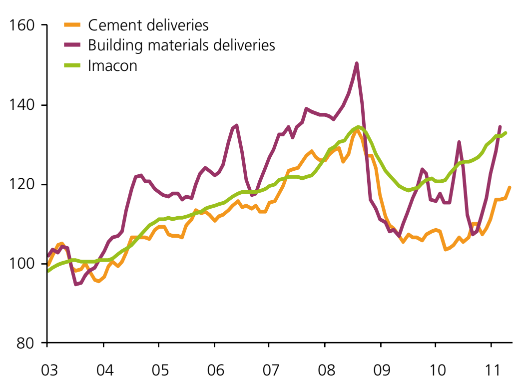
(*) Value over (under) 50 points indicates optimism (pessimism).

Source: Adimark.

Figure III.11

Construction activity indicators (*)

(indices, 2003=100, seasonally-adjusted series)



(*) Moving quarterly average.

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

As per the Economic Perception Index (Ipec), on aggregate, consumer expectations recorded mixed movements during the past several months, although some responses are in the optimistic zone (figure III.10). Expectations about the country's situation twelve months ahead are above the 50-point pivot and so is the purchase of household items, the latter is even picking up at the margin, confirming the strength of the sale of durable goods.

Investment and construction

Gross fixed capital formation continued to grow strongly during the first quarter, at 19.3% annually. The GFCF to GDP ratio increased to 29.5% in 2003 prices, driven by the machinery and equipment component, which rose 28.4% annually. In any case, the quantum of capital goods imports has slowed down somewhat in recent months, although it is still high by historic standards.

Investment in construction and other works grew 10.3% annually in the first quarter, increasing its expansion velocity. The Monthly Index of Construction Activity (Imacon) remains high, as does the delivery of cement and materials (figure III.11). On the new homes side, the months to exhaust the supply continue falling and sales are increasing both in regions and in Santiago. Moreover, several sources of casuistic information point at a stronger real-estate market going forward, considering the shortage of housing in some regions.

According to information in April's Survey of the Capital Goods Corporation, private investment fell 2.6% in 2010 and 2.8% in 2011 compared with the Survey of January 2011. However, for the three-year period 2012-2014 there are positive corrections for investment, of 5.4%, 12.6% and 26.9%, respectively, also compared with the previous survey. To some extent, the reductions of 2010 and 2011 correspond rather to a postponement of projects for 2012-2014.

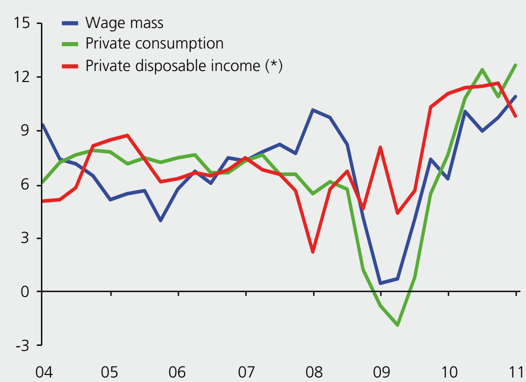
Box III.1: **Recent consumption behavior**

Domestic demand has posted significant growth rates in recent quarters. An important part of this increase has to do with the strong increase in private consumption (figure III.4). This latter variable has averaged 10.8% annual growth between the first quarter of 2010 and the same period of 2011. Such increase is faster than before the crisis and is mostly focused on durable goods (figure III.5). This box examines the recent evolution of consumption and its prospects.

Several factors are behind the behavior of consumption in the current cycle. First, the economic policy response to the crisis of 2008-2009, the high terms of trade and the recovery of the labor market resulted in household income posting a milder drop than in previous episodes of contraction, and is now growing at high annual rates. As opposed to consumption, in this cycle the y-o-y variation rate of private disposable income and the wage bill did not become negative (figure III.12).

Figure III.12

Private income and consumption
(annual change, percent)



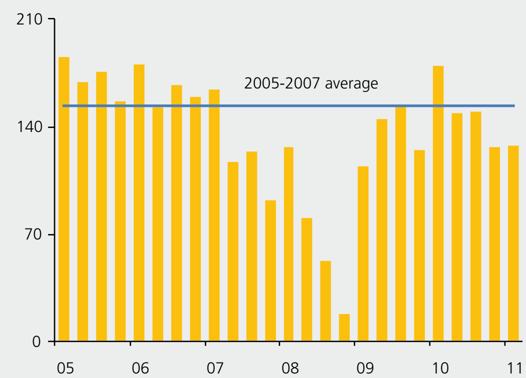
(*) Moving yearly average.

Source: Central Bank of Chile.

As a result of the behavior of income and consumption, private saving increased between early 2009 and early 2010, to stand in the first quarter of 2010 even above the average for the period 2005-2007 (figure III.13). Therefore, it can be argued that the increase in private consumption that has been observed since last year is consistent with the evolution of income and the recovery of savings between 2009 and 2010.

Figure III.13

Private per capita savings
(thousands of 2003 pesos)



Source: Central Bank of Chile.

The long-term association between private consumption and its fundamentals also sheds light on the consistency of its growth. Echavarría et al. (2011) estimate this relationship, finding that, prior to the 2008-2009 crisis, consumption was slightly above its long-term levels. This difference was corrected in 2009. The increase that consumption has been showing since 2010 is due, primarily, to a recovery to levels aligned with its fundamentals, even though today these levels are marginally above them.

Another way to check the consistency of the evolution of consumption is to compare it with a measure of its trend—calculated using a Hodrick-Prescott filter. This exercise, with whatever caveats necessary about the present cyclical circumstances, does not show a misalignment with the trend either.

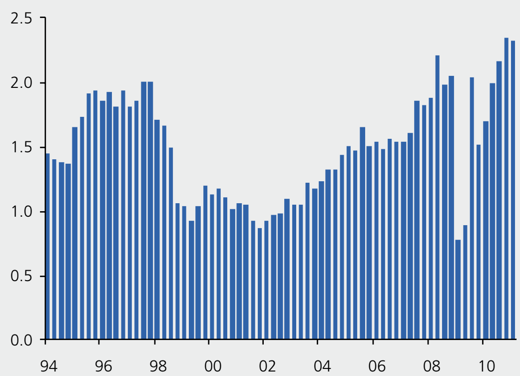
It is also interesting to ask for how long and at what levels can the current growth rates in consumption be sustained. In the case of durable consumption, it is possible that its behavior will respond to a delayed replacement of inventories that were not renewed in 2008-2009 or because of the effects of the earthquake of February 2010. Once the replacement is completed, growth should begin to lessen.

One way to assess the dynamics of durable consumption is to look at the ratio between the sale of new cars and the existing stock of cars[3]/. This measure shows that after a sharp fall in early 2009, today flows have recovered and are growing in line with their medium-term trend (figure III.14). The latest data show some moderation in the growth rate of durable consumption indicators (figure III.6). Hence, one might expect it to slow down its annual growth rate in the coming months. In any case, it must be kept in mind that the rapid technological advances, combined with the price declines of these products, could lead to a more rapid replacement.

Figure III.14

Car sales and car stock

(ratio)



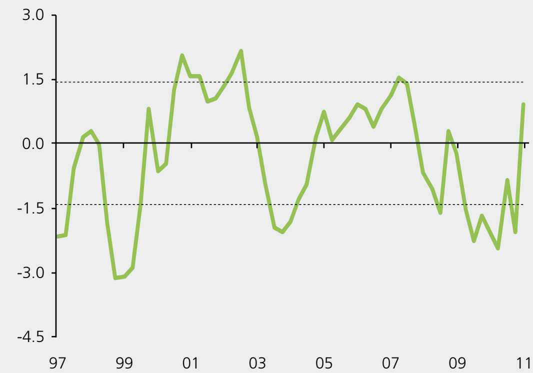
Sources: National Association of Car Dealers, Central Bank of Chile and National Statistics Bureau (INE).

About non-durable consumption, y-o-y expansion rates are today somewhat higher than before the 2008-2009 crisis, substantially because of a recovery of levels in a context of favorable conditions. At the margin, there is no significant misalignment with respect to fundamentals (figure III.15). To the extent that the economy remains in a cyclical position consistent with the trend, this pace of non-durable consumption growth should moderate. However, the strong dynamism exhibited by the labor market and the consequent growth in the wage bill could mean that consumption will remain strong in the coming quarters.

Figure III.15

Non-durable consumption: residue of long-term ratio (*)

(percent)



(*) Dotted lines indicate plus (minus) one standard deviation.

Source: Central Bank of Chile.

Summing up, consumption growth has been consistent with the evolution of its fundamentals, with a special role played by labor income and the normalization of durable goods inventories. The baseline scenario assumes that growth in GDP and domestic demand will turn down in the coming quarters. This, in line with the withdrawal of the monetary stimulus already done and the fact that, due to the normal lags in monetary policy pass-through, it´s effects are not yet fully appreciated in the economy. Still, the persistence of the dynamism of output, or consumption, in excess of trend growth configures a risk scenario that the Board is closely monitoring due to its implications on inflationary pressures and the achievement of the inflation target.

[3]/ New car sales account for nearly 50% of durable goods consumption.

Box III.2: **Labor market indicators**

Over the past few quarters, employment has increased strongly, while the rate of unemployment has fallen rapidly and wages have posted an acceleration, reflecting the fast closing of labor market gaps. Nonetheless, an accurate evaluation of this latter element is hindered by the changes in the measuring methodology adopted by the INE to both the national employment and the wages surveys[4]/. Labor market statistics delivered by other institutions such as Universidad de Chile, the Chilean Safety Association (AChS) and the Superintendence of Pension Funds, confirm a robust net job creation, although their coverage is smaller than the INE's. This box puts in historic perspective the recent behavior of labor market data using indicators built on the basis of related series.

Based on the old National Employment Survey and its historic correlation with other sources of information, indicators are built to measure the evolution of employment and unemployment over a longer period (figure III.16)[5]/. They show unemployment posting a sharp drop in 2010, and in 2011 standing above the minimums prevailing before the 2008-2009 crisis and the Asian crisis. Employment, after a drastic fall in 2009, recovered rapidly in 2010 and from then on has been growing at a pace that may be considered in line with the previous trend.

On the wages side, a splicing is made of monthly variations using the data of the INE's old Remunerations Survey. Real wage information show expansion oscillating within a bounded range in the past several months, and standing now somewhat above the 2001-2011 average (figure III.17).

Figure III.16

Employment and unemployment (*)

(index, centered on mean of period 1990-2011)

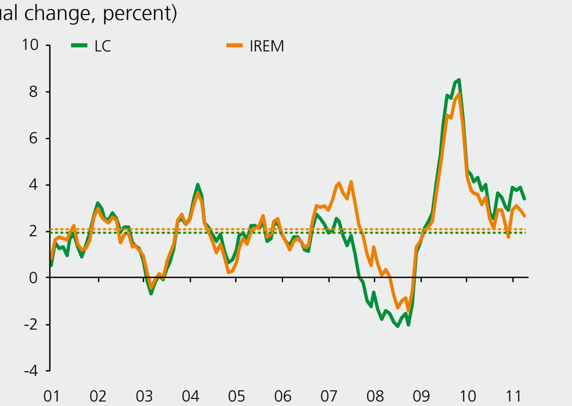
(*) Seasonally-adjusted series. Corresponding to series of "labor market indicator" (IML) which extends the national employment survey (ENE) series according to their relationship with other labor market indicators.

Source: Ricaurte (2011).

Figure III.17

Real wages (*)

(annual change, percent)



(*) Dotted lines show average of the period 2001-2011.

Source: Central Bank of Chile.

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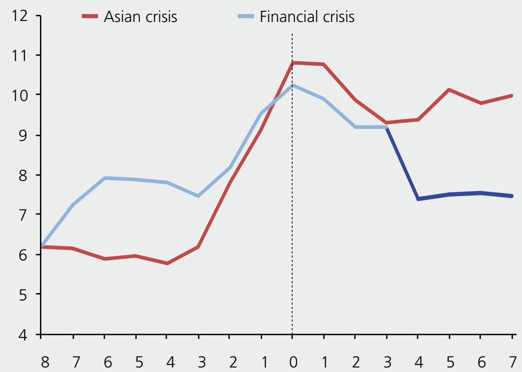
[4]/ For further detail on the differences between the old and the new National Employment Survey, see box III.1: "New National Employment Survey (NNES)", *Monetary Policy Report*, March 2011, page 26.

[5]/ For further detail, see Ricaurte (2011).

Figure III.18

Unemployment rate (*)

(seasonally-adjusted quarterly series, percent)



(*) Series centered on quarter with highest unemployment rate (1999.II and 2009.II, respectively). Data for period 2010.I-2011.I (dark blue line) correspond to the series of the "labor market indicator" (IML) which extends the NES series according to their relationship with other labor market indicators.

Source: Ricaurte (2011).

It is interesting to note the velocity at which labor market indicators have recovered in this cycle. Compared with the post-Asian-crisis cycle, the unemployment rate has taken much less to return to pre-crisis levels, between 4 and 6 quarters. In the late 1990s, the unemployment rate remained high much longer (figure III.18).

There is a variety of reasons that may explain this difference in the recovery of the labor market. This time around, the macroeconomic framework in place allowed implementing important countercyclical responses. Fiscal and monetary policies were clearly expansionary throughout 2009. Monetary policy continued to be stimulative in 2010. Policy responses and the favorable terms of trade permitted GDP to recover more rapidly in this cycle. Furthermore, such recovery has been driven by domestic demand and by the more labor-intensive sectors, such as retail and other services.

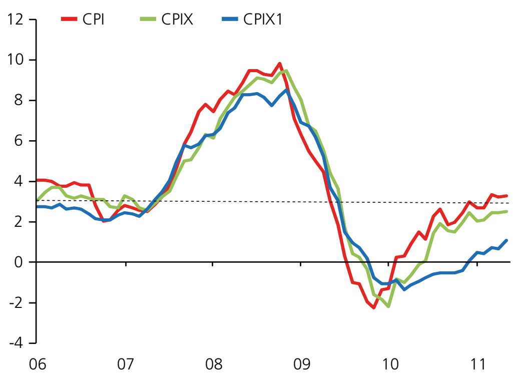
In sum, beyond the already mentioned differences in terms of the cycle and speed of recovery of the labor market, the evolution of unit labor costs —which combine increased employment and higher wages with the increase in economic activity— shows cost pressures growing at rates consistent with the inflation target. However, the possibility of labor market developments configuring a scenario of stronger inflationary pressures than current ones is a latent risk. Therefore, the labor market must be monitored carefully in order to prevent the incubation of inflationary pressures that may affect the normal convergence of inflation to 3%.

IV. Prices and costs

Figure IV.1

CPI, CPIX and CPIX1 inflation (*)

(annual change, percent)



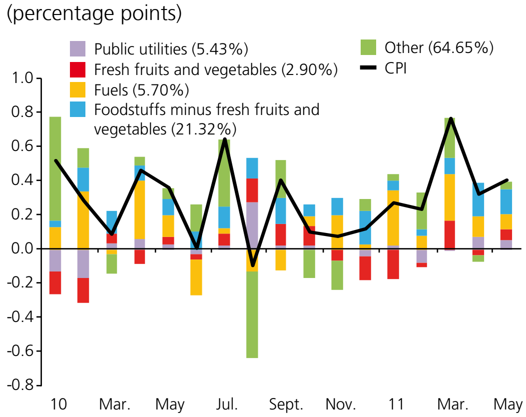
(*) For definition, see glossary.

Source: National Statistics Bureau (INE).

Figure IV.2

Incidences on monthly CPI inflation (*)

(percentage points)



(*) In parentheses, shares in CPI basket.

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

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 trends in inflation

In the last few months, y-o-y inflation has risen somewhat. Headline inflation is slightly above 3%, while core measures are below that number. At May, the CPI accumulated an annual increase of 3.3% (2.7% in February), the CPIX rose to 2.5% (2.1%) and the CPIX1 rose to 1.1% (0.4%) (figure IV.1 and table IV.1). Inflation of recent months has been marked by both increased fuel and foodstuff prices and seasonal patterns. As for the other products in the basket, no price movements are observed that can be linked to an unusual propagation of shocks. Still, the y-o-y increase in the various inflation indicators is smaller than the March estimate, largely because the foreseen rises in specific prices did not occur.

Table IV.1

Inflation indicators (*)

(annual change, percent)

		CPI	CPIX	CPIX1	CPIX1 w/o foodstuffs	CPI w/o foodstuffs and energy	CPIT	CPINT	CGDP	CPIS
2010	Jan.	-1.3	-2.2	-1.1	-1.3	-1.7	-2.5	0.3	-1.8	-0.8
	Feb.	0.3	-0.8	-0.9	-1.2	0.1	-2.5	4.2	-1.5	2.6
	Mar.	0.3	-1.0	-1.3	-1.9	-0.4	-2.2	3.8	-1.3	2.3
	Apr.	0.9	-0.6	-1.1	-1.8	-0.1	-1.2	3.8	-0.2	2.3
	May	1.5	-0.1	-0.9	-1.6	0.4	-0.6	4.4	0.2	3.2
	Jun.	1.2	0.1	-0.7	-1.5	0.6	-1.5	4.9	-0.6	3.5
	Jul.	2.3	1.4	-0.5	-1.4	1.7	-0.9	6.7	-0.3	5.6
	Aug.	2.6	1.9	-0.5	-1.5	1.1	0.4	5.7	-0.3	6.4
	Sept.	1.9	1.6	-0.5	-1.6	1.1	-1.1	6.0	-0.9	5.4
	Oct.	2.0	1.5	-0.5	-1.7	1.1	-0.9	6.0	-0.7	5.5
	Nov.	2.5	2.0	-0.4	-1.7	1.1	-0.2	6.2	-0.4	6.2
	Dec.	3.0	2.5	0.1	-1.3	1.5	0.5	6.4	0.4	6.3
2011	Jan.	2.7	2.0	0.5	-0.8	0.8	1.2	4.8	1.0	4.8
	Feb.	2.7	2.1	0.4	-0.9	0.9	1.2	4.7	0.9	4.8
	Mar.	3.4	2.4	0.7	-0.6	1.4	1.8	5.5	1.6	5.6
	Apr.	3.2	2.4	0.7	-0.7	1.2	1.7	5.2	1.4	5.4
	May	3.3	2.5	1.1	-0.4	1.2	1.8	5.2	1.7	5.1

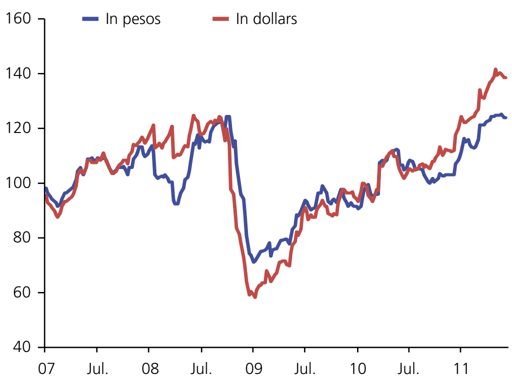
(*) For definition, see glossary.

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

Figure IV.3

Weekly gasoline price

(index, 2007-2010 average =100)

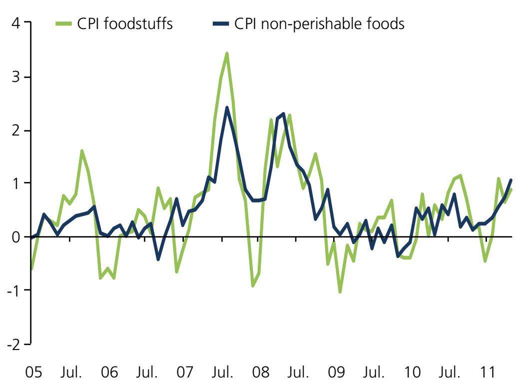


Sources: Central Bank of Chile and National Petroleum Corporation (Enap).

Figure IV.4

CPI of total non-perishable foods

(monthly change, percent)

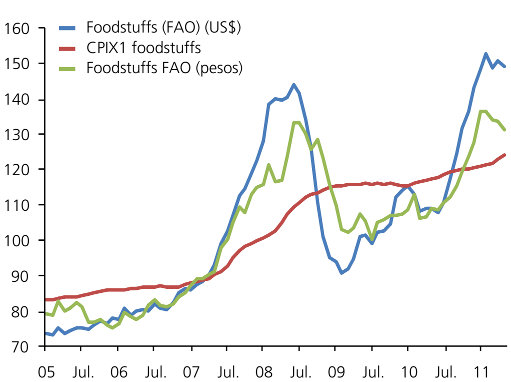


Sources: Central Bank of Chile and National Statistics Bureau (INE).

Figure IV.5

Domestic and external foodstuff prices

(index, January 2004-May 2011 average =100)



Sources: Central Bank of Chile and Bloomberg.

Between March and May, the CPI accumulated an increase of 1.5 percentage points (pp). Almost two thirds of it obeyed to higher fuel and foodstuff prices. Another part was due to the usual seasonal increase in the cost of educational services in March (figure IV.2).

The changes in fuel prices contributed 0.5pp to inflation accumulated between March and May. After the closing of the previous *Report*, the WTI oil price continued to rise, hitting a two-year record-high nominal price in April. In May it dropped and, as of the statistical closing date of this *Report*, it is somewhat below US$100 per barrel. The prices of oil derivatives in external reference markets have shown a similar behavior, although the speed of their declines has been different. Comparing the ten days prior to the statistical closing dates of this and the March *Report*, the price of WTI oil is now 2.4% lower, while the international price of gasoline has returned to March levels. Domestically, the appreciation of the peso and the startup of the Taxpayer Protection System in the face of Changes in Fuel Prices (SIPCO) operations moderated to some extent the price hikes in gasoline, which accumulated close to 1.7% in the same period (figure IV.3).

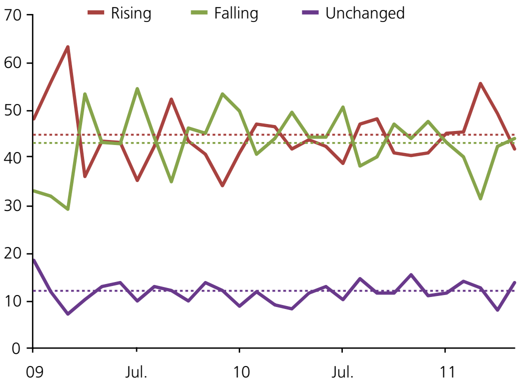
The prices of food items included in the CPI have continued to grow in recent months, with rising monthly increases, even after seasonally adjusting the prices of non-perishables. The increases of the past few months have been larger than the 2005-2006 average and the same months of 2010. In any case, they are quite smaller than they were over the course of 2007 and 2008 (figure IV.4). In the global markets, the prices of some products have fallen most recently, especially sugar. Nevertheless, the price level is still high. The appreciation of the peso has attenuated the increases in international prices (figure IV.5).

Other items that had a significant impact on inflation in recent months were educational service prices, together with public transport fares and electricity charges. Clothing continued to show annual declines in prices. In the remaining prices there were no important movements that might indicate a change in the behavior of inflation. The number of products in the basket that posted a price change has not been materially altered in the past few months (figure IV.6). Excluding food items, the distribution of the monthly change of the prices in the CPIX1 basket shows the median practically unchanged in several months (figure IV.7).

Figure IV.6

CPIX1 items —minus foodstuffs— rising and falling (1) (2)

(percent)



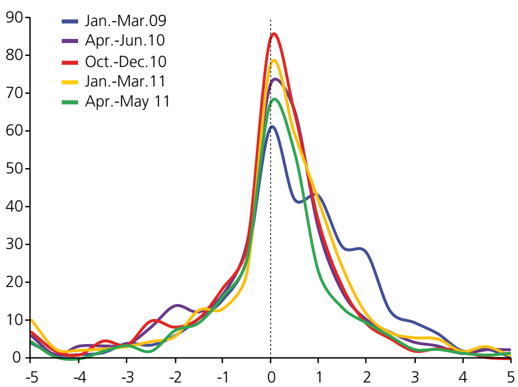
(1) Dotted lines show average between January 2009 and May 2011.
(2) Shows quantity of items whose prices rise and fall in the CPIX1 excluding foodstuffs.

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

Figure IV.7

Distribution of the CPIX1 minus foodstuffs

(frequency of monthly change)

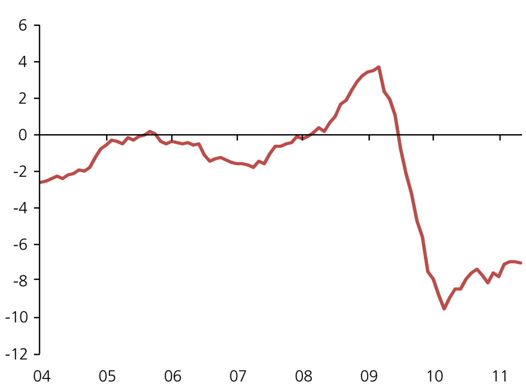


Source: Central Bank of Chile based on data from the National Statistics Bureau (INE).

Figure IV.8

CPI of household items

(annual change, percent)



Source: National Statistics Bureau (INE).

The fact that trend inflation maintains low y-o-y growth rates may respond to a number of factors. Worth singling out is the price drop in several goods whose origin is mainly imported. One example is household items, which weighs around 9% in the CPI and which has posted negative y-o-y variation rates since the mid-2009, and around -7% as of last May (figure IV.8). The behavior of imported consumer goods prices responds both to decreased external prices in dollars and to the appreciation of the peso. On the external prices side, the unit price of imports index (IVUM) of consumer goods, measured in dollars, showed significant declines throughout 2009 and has been growing between 5% and 6% annually since the beginning of 2010. As for the exchange rate, in the past year the peso has appreciated 13%, thus the y-o-y variation of the imported consumer goods prices remains on negative territory since the middle of 2010 (figure IV.9).

The low imported inflation in pesos is also reflected in the evolution of tradable goods inflation (CPIT), with a y-o-y increase of 1.8% in May, after falls of up to 6% during 2009. The non-tradable goods inflation (CPINT), meanwhile, presents a y-o-y variation of 5.2% in May, with a growing positive incidence in the past few months. Wholesale price indices also reflect the incidence of the lower imported inflation. The wholesale price index (WPI), after increasing more than 5% annually between February and April, grew 3.6% annually in May. Regarding structure, the domestic component increased 6% while the imported fraction dropped 1% annually. The latter has remained in negative territory for the larger part of the last year and a half. The producer price index (PPI)—which only considers prices of domestic goods and services—increased 8.5% annually in May, after six months of two-digit increases.

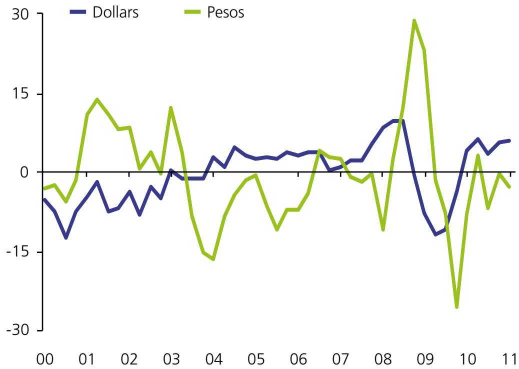
The behavior of the labor market, especially the dynamics of employment and the upward trend of wages, has raised concerns about labor costs. However, the boost in activity that has accompanied these increases has led unit labor costs to continue growing at a pace consistent with the inflation target. In any case, the performance of the labor market and its impact on inflationary pressures is a risk contemplated in the baseline scenario, which must be monitored with special attention.

Some partial indicators show a widening in margins in recent quarters. According to Fecu data, average retail operating margins are at a level similar to or even slightly higher than the previous year and before the margin compression experienced between early 2008 and mid-2009 (figure IV.10). This indicates that, despite increases in some inputs, particularly labor, the lower imported inflation and possible efficiency gains have helped sustain and restore margins.

Figure IV.9

IVUM

(annual change, percent)

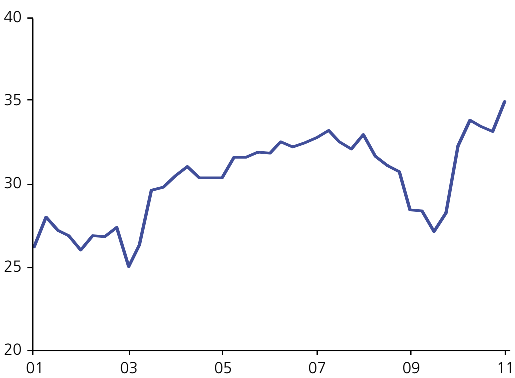


Source: Central Bank of Chile.

Figure IV.10

Retail operating margins (*)

(ratio)

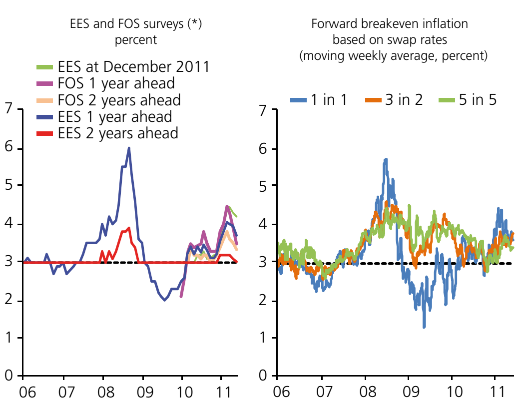


(*) Ratio of gross profits to sales income.

Source: Central Bank of Chile based on data from the Superintendence of Securities and Insurance (SVS).

Figure IV.11

Inflation expectations



(*) The FOS considers the survey of the first half of the month.

Source: Central Bank of Chile.

Short-term inflation outlook

In the short term, y-o-y headline and core inflation variation will increase over current levels. In the case of the CPIX1, its y-o-y rate of increase is forecast to exceed 2% in the fourth quarter of this year. In this component of inflation foodstuff prices will continue to rise at annual rates similar to those of previous months, that is, between 5% and 6%. As in recent months, the propagation of specific shocks to other prices will be similar to its historic average. This behavior of trend inflation will combine with some changes in utility rates, particularly public transport fares and electricity charges, which will take the CPIX close to 3% between the end of the third quarter and into the fourth. Finally, under the assumption that fuel prices will remain relatively stable and fruits and vegetables will show no changes beyond their normal seasonality, it is estimated that the CPI will post a y-o-y variation of about 4% by the end of the third quarter and the beginning of the fourth quarter of the year.

The end of the commodity prices' rising trend in world markets and the monetary policy actions in Chile have brought down inflation expectations in recent weeks. Thus, after increasing in the first quarter of the year, the expectations derived from surveys to financial brokers and analysts have declined. In March, expected inflation one year out from the Financial Brokers Survey (FBS) stood at 4.5%, to later descend to 3.5% in the survey of the first half of June. In the same period, expected inflation for December of this year went from 3.8% to 3.4% in the same survey. Inflation expectations from the Economic Expectations Survey (EES) were also reduced at all terms: One year out, from 4.0% in March to 3.7% in June; two years out, from 3.2% to 3.0% in the same period (figure IV.11).

Inflation expectations derived from breakeven inflation behaved similarly. After increasing further until mid-April they began to drop, more markedly in May and most strongly in the longer-term breakeven inflations. Thus, the one in one forward breakeven inflation derived from average interbank swap rates, rose to 4.1% in April, and is at 3.6% as of June. Expectations three to five years ahead have ranged between 3.5% and 3.8% since the closing of the March *Report*. Expectations six to ten years ahead show a downward trend, going from 3.6% in March to 3.4% in June (figure IV.11).

Consumer surveys also show a decline. In particular, the percentage of people who think that inflation will rise "a lot" in the next twelve months, as measured by the Economic Perception Index (Ipec) fell to 63% in May from 67% in March. Similarly, the cost projections that are obtained from the Monthly Business Confidence Indicator (Imce) also show a decline in the last few months.

V. Inflation scenarios

Table V.1

International baseline scenario assumptions

	2009	2010	2011 (f)	2012 (f)
		(annual change, percent)		
Terms of trade	4.6	23.8	-1.6	-2.1
Trading partners' GDP (*)	-0.3	5.9	4.3	4.7
World GDP at PPP (*)	-0.6	4.9	4.1	4.5
World GDP at market exchange rate (*)	-2.1	3.8	3.2	3.8
External prices (in US$)	-6.2	5.8	9.0	2.8
		(levels)		
LME copper price (US¢/lb)	234	342	415	400
WTI oil price (US$/barrel)	62	79	99	103
Gasoline parity price (US$/m^3) (*)	471	598	825	832
Libor US$ (nominal, 90 days %)	0.7	0.3	0.3	0.9

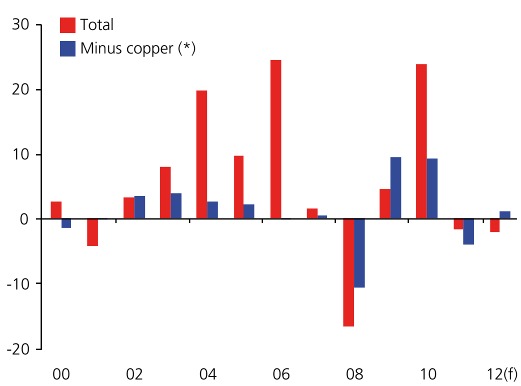
(*) For definition, see glossary.
(f) Forecast.

Source: Central Bank of Chile.

Figure V.1

Terms of trade

(annual change, percent)



(*) Estimated using the average London Metal Exchange price of 2003 as reference. No other potential effects on price and quantity are considered.
(f) Forecast.

Source: Central Bank of Chile.

This chapter presents the Board's assessment on the Chilean economic outlook over the next two years, including the analysis and the decision of the monetary policy meeting of 14 June 2011. Projections are presented of the most likely inflation and growth trajectories, conditional on the assumptions that make up the baseline scenario, so the Board's assessment of the risk balance for output and inflation is also provided

Baseline projection scenario

The external scenario's projections for world growth in the next two years are unchanged from March, although with a substantially different breakdown and negative risks that have intensified. Differences in the dynamism of emerging and developed economies have widened. In the United States, output, employment and expectations indicators have disappointed the market, reducing market growth prospects for 2011. In Japan, the effects of the catastrophe of last March on this year's economic activity are now thought to have been worse than initially estimated. Meanwhile, some emerging economies, especially in Asia, have grown above March's forecasts—even with signs of capacity over-utilization—, which explains the upward revision of growth projections for the year. Thus, in the baseline scenario, the world economy will grow 4.1% in 2011 and 4.5% in 2012, practically the same as forecast in March (table V.1). Accordingly, after several *Reports* where the baseline scenario projections were lower than market consensus, considering the latter's correction downwards now they are aligned again.

In the last few months, commodity prices did not continue their upward trend observed since mid-2010 and posted mild declines. This, considering reduced growth prospects in developed economies and doubts regarding the magnitude of the effects that tightened policies applied in China may have on Chinese demand. In any case, supply-side problems persist for some products, such as climate factors that have damaged the harvests of some foodstuffs. In addition, prices are still high by historical standards and are expected to remain fairly constant over the projection horizon. Baseline scenario estimations place the pound of copper virtually unchanged at US$4.15 and US$4.0 in 2011 and 2012, respectively, while the barrel of WTI oil is modified to an average of US$99 in 2011 (from US$102 in March) and keeps the forecast at US$103 in 2012. Thus, and assuming a widespread increase in the prices of other imports, the terms of trade will drop by somewhat less than 2% annually on average in 2011 and 2012 (figure V.1).

The high prices of fuels and food items have passed through to local inflations around the world, so these have continued to rise. In emerging economies,

Table V.2

Economic growth and current account

	2009	2010	2011 (f)
	(annual change, percent)		
GDP	-1.7	5.2	6.0 - 7.0
National income	-1.9	15.7	6.9
Domestic demand	-5.9	16.4	8.5
Domestic demand (w/o inventory change)	-2.9	11.5	9.2
Gross fixed capital formation	-15.9	18.8	11.9
Total consumption	1.9	9.3	8.3
Goods and services exports	-6.4	1.9	7.1
Goods and services imports	-14.6	29.5	11.0
Current account (percent of GDP)	1.6	1.9	0.0
	(US$ million)		
Current account	2,570	3,802	0
Trade balance	14,117	15,855	15,000
Exports	54,004	71,028	85,300
Imports	-39,888	-55,174	-70,300
Services	-1,444	-1,019	-1,900
Rent	-11,666	-15,424	-15,100
Current transfers	1,563	4,390	2,000

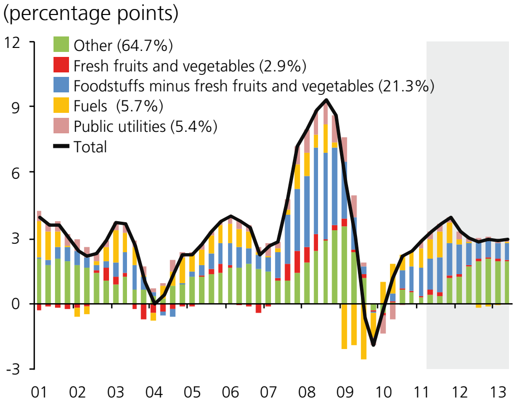
(f) Forecast.

Source: Central Bank of Chile.

Figure V.2

Incidences on annual CPI inflation (1)

(percentage points)



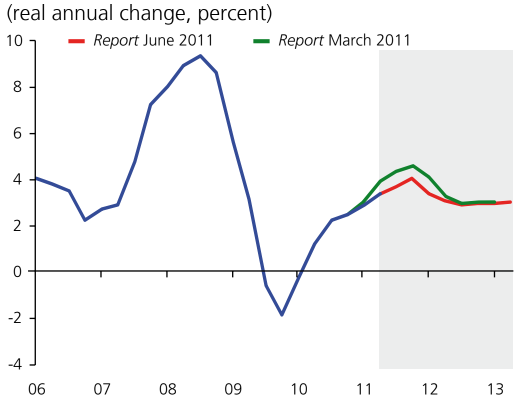
(1) Gray area, as from the second quarter of 2011, depicts the breakdown of forecast inflation in the baseline scenario.
(2) In parentheses, shares in the CPI basket.

Sources: Central Bank of Chile and National Statistics Bureau.

Figure V.3

CPI inflation

(real annual change, percent)



(*) Gray area, as from the second quarter of 2011, shows forecast.

Sources: Central Bank of Chile and National Statistics Bureau.

the pass-through has also been sustained by narrow output gaps and strong domestic demands. This, plus the depreciation of the U.S. dollar in international markets means that in 2011 the external inflation rate relevant to Chile will increase 9% (one percentage point more than foreseen in March).

The external scenario in this Report will add a stronger impulse to the economy than was believed in March, mainly responding to lower external interest rates that will remain low for a longer period. However, such external impulse will gradually fade out on time.

In the baseline scenario, domestic output will increase between 6% and 7% in 2011 (table V.2). This range runs above the March forecast, consistently with the upward bias then identified. This faster growth forecast for 2011 compared to March's responds to actual first-quarter figures that exceeded estimates. For the rest of the year, the pace of expansion of total activity and demand will moderate as forecast in March. In particular, the speed of growth in the GDP of sectors other than natural resources will quickly approach the trend rate, which is still estimated at 5%. This scenario assumes that, on average, output gaps will remain closed throughout the projection horizon.

On the demand side, the stronger growth of the first quarter obeyed primarily to the acceleration of private consumption (especially of non-durables). The baseline scenario assumes that in 2011 private consumption will grow more than forecast in March, although with a bigger role of non-durables over durables. The latter have shown signs of moderating, as can be inferred from the slowdown of car sales, among other factors. Nevertheless, the expected expansion of consumption will have a significant incidence on domestic demand growth, which will increase 8.5% in this year.

In this setting, gross fixed capital formation (GFCF), a component of expenditure that —together with consumption— has driven growth during the past few quarters, will reduce its contribution to GDP growth. However, it will continue to grow at double-digit rates, largely due to the strength of the construction-and-other-works component. Still, it will grow less than was thought of in March, reflecting data in the latest survey of the Capital Goods Corporation that reveals a number of projects being pushed back from this year to the 2012-2014 period. Accordingly, GFCF will be somewhat less than 30% of real GDP in 2011. In the case of the public sector, the baseline scenario assumes that the structural deficit will converge to 1% of GDP towards the end of the present Administration, as has been announced by the respective authority.

In the baseline scenario, projected exports of goods and services are corrected slightly upwards, to a little over 7% in 2011. Contrary to March's estimates, it responds mainly to shipments of goods—manufacturing and agricultural—, which will grow 7.5% annually in real terms. Imports of goods and services will grow 11% in real terms in 2011, somewhat more than forecast a few months ago considering the higher effective figures at hand.

Table V.3

Inflation

	2009	2010	2011 (f)	2012 (f)	2013 (f)
	(annual change, percent)				
Average CPI inflation	1.6	1.4	3.5	3.1	
December CPI inflation	-1.4	3.0	4.0	3.0	
CPI inflation in around 2 years (*)					3.0
Average CPIX inflation	2.8	0.5	2.6	3.2	
December CPIX inflation	-1.8	2.5	3.5	3.1	
CPIX inflation in around 2 years (*)					3.1
Average CPIX1 inflation	2.7	-0.7	1.4	2.9	
December CPIX1 inflation	-1.1	0.1	2.7	3.0	
CPIX1 inflation in around 2 years (*)					3.1

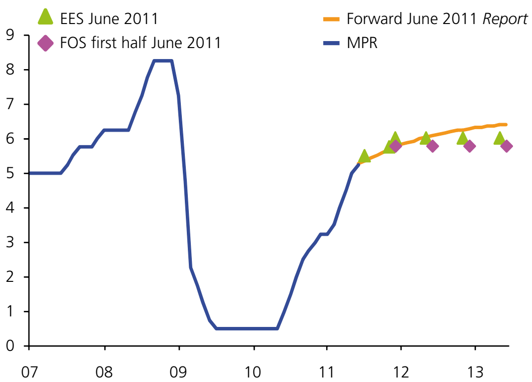
(f) Forecast.
(*) Inflation forecast at the second quarter of 2013.

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 10%, 30%, 50%, 70% and 90% around the baseline scenario are included. These intervals summarize the risks on growth as assessed by the Board. The baseline scenario uses as a working assumption that the MPR will follow a path comparable to the one that can be inferred from the various expectations measures.

Source: Central Bank of Chile.

The baseline scenario estimates a balanced current account in 2011 (revised from a surplus of 1.2% of GDP in March). This responds largely to a downward correction in the projected volume of copper exports, originating in the reduction in mining output facing a lower mineral ore. The fact that revisions to the current account projection stem mainly from corrections to volumes as opposed to prices, results in the current account, measured at trend prices, posting a one-point-larger deficit than assumed in the last *Report*, between 5% and 6% of GDP[1]/.

In the baseline scenario, CPI inflation will come close to the upper bound of the tolerance range for a few months of the second half of 2011, following a path that will run below March's prediction. Thus, at December of this year, headline inflation will be 4%. In 2012, it should converge to 3% and stay around the target until the end of the projection horizon, this time the second quarter of 2013 (figures V.2 and V.3, and table V.3). The projection assumes that, on average, output gaps will be closed throughout the projection horizon, and that the propagation of specific price shocks will continue to match the historic average, as it has in recent months. This projection is based on the assumption that the full transmission of the MPR increase of the past year will become visible in the economy and will contribute to bring inflation to 3% over the policy horizon.

The projections assume that the real exchange rate is at a level consistent with its long-term fundamentals and it will remain at these values over the coming quarters. Imported inflationary pressures will remain well contained. Projections also assume that nominal wages will be corrected according to the economy's cyclical stage and inflation dynamics, and that pricing decisions are based on inflation expectations being aligned with the target. Finally, projections use as a working assumption that the MPR will follow a path comparable to the one that can be inferred from various expectations measures (figure V.4).

Risk scenarios

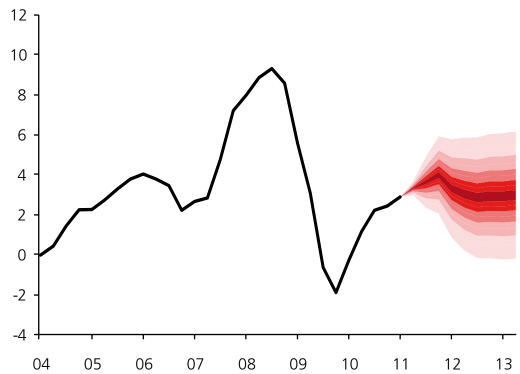
The baseline scenario reflects the events estimated to be the most likely with the information at hand when making these projections. Any divergence will shape a different macroeconomic scenario and an also different monetary policy trajectory. After evaluating them, the Board estimates that risks for inflation and output are balanced (figures V.5, V.6 y V.7).

Although attenuated from March, one important risk is the persistence and propagation of the specific price shocks of the past few quarters. Although relative price stability is assumed for external markets, a scenario of higher prices significantly affecting local inflation because of the present status of output gaps cannot be ruled out. The labor market is showing important strength, with a low unemployment rate and a substantial increase in employment (box III.2). There is also the possibility that output and

[1]/ This calculation considers revisions to prices and not volumes. A copper price of US$2.6 per pound and an oil price of US$75 per barrel are assumed.

Figure V.6

CPI inflation forecast (*)
(annual change, percent)

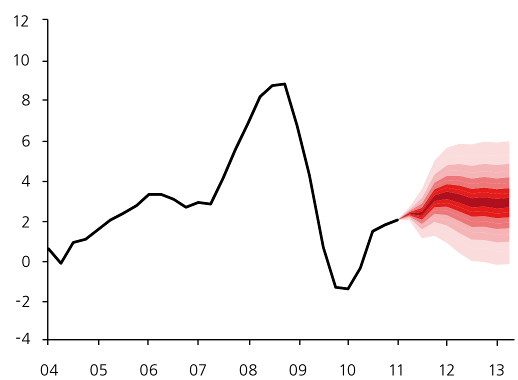


(*) The figure shows the confidence interval of the baseline projection over the respective horizon (colored area). Confidence intervals of 10%, 30%, 50%, 70% and 90% around the baseline scenario are included. These intervals summarize the risks on future inflation as assessed by the Board. The baseline scenario uses as a working assumption that the MPR will follow a path comparable to the one that can be inferred from the various expectations measures.

Source: Central Bank of Chile.

Figure V.7

CPIX inflation forecast (*)
(annual change, percent)



(*) The figure shows the confidence interval of the baseline projection over the respective horizon (colored area). Confidence intervals of 10%, 30%, 50%, 70% and 90% around the baseline scenario are included. These intervals summarize the risks on inflation as assessed by the Board. The baseline scenario uses as a working assumption that the MPR will follow a path comparable to the one that can be inferred from the various expectations measures.

Source: Central Bank of Chile.

demand—especially consumption—may continue to grow as strongly as they did in the first quarter, leading to an over-utilization of installed capacity, causing inflationary pressures. However, it is unlikely that the current velocity can be sustained for a long period (box III.1).

In the external scenario, the recent performance of economic indicators, mainly in developed economies, may be signaling a more protracted weakening of growth. However, this scenario must be evaluated carefully as it may be reflecting temporary factors. The materialization of this risk of additional weakness in developed economies could widen the difference with emerging countries in terms of the growth rate. This would exacerbate the interest rate differentials in the world, boosting capital flows to emerging economies and aggravating exchange rate tensions. Financial tensions in some European economies persist, and balances are still unresolved. How the necessary fiscal consolidation will proceed in Europe and the United States is uncertain, and more so considering the weak private demand and the unsolved banking problems. The way in which monetary policy makers will continue to deal with inflationary pressures is also a latent risk, especially in emerging Asia. Facing the signs of capacity over-utilization in some emerging economies, sharper adjustments to the growth rates of these economies—particularly China—cannot be ruled out, which may affect world GDP and commodity prices.

Accordingly, as it has done in the past, the Board will continue to evaluate the probabilities of these risks and their consequences on local inflationary prospects, and will continue to use its policies with flexibility so that projected inflation stands at 3% over the policy horizon.

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Tables

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Glossary

Commodity exporters: Australia, Canada and New Zealand.

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

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

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

EGW: Electricity, gas and water.

EPI: External price index relevant to Chile. Calculated using the wholesale price index (WPI) (or the CPI, if WPI is not available) expressed in dollars, of the countries used for the calculation of the MER and their share of Chilean trade, excluding oil and copper.

EPI-5: EPI using the price indices of Canada, the Eurozone, Japan, the United Kingdom and the United States.

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

GDP, other: Includes agriculture-forestry, manufacturing, construction, retail, transport and communications, financial and entrepreneurial services, home ownership, personal services and public administration.

GDP other services: Includes financial and entrepreneurial services, home ownership, personal services and public administration.

Growth of trading partners: Growth of Chile's main trading partners weighted by their share in total exports over two moving years. The countries included are the destination of 93% of total exports.

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

IREMX: IREM excluding community, social and personal services, EGW and mining.

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

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

LPI: Local price index of economies relevant to Chile, implicit in the EPI. Calculated using the WPI (or CPI, if WPI is not available) expressed in the local currencies of the countries included in the EPI and their shares in Chilean trade, excluding oil and copper.

M1: A measure of the money supply that includes money in circulation plus checking account deposits net of clearing of the non-financial private sector, plus demand deposits other than checking accounts and demand savings deposits.

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 at savings and loans cooperatives, less the time deposits of the aforementioned mutual funds and savings and loans cooperatives.

M3: M2 plus foreign currency deposits, Central Bank of Chile notes, Treasury bonds, mortgage bills, commercial papers, corporate bonds, other mutual fund shares and pension fund shares in voluntary savings, less mutual fund and other 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, Spain, South Korea, Switzerland, Thailand, the United Kingdom and the United States.

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

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

Parity price of gasoline: Reference cost of gasoline imports, calculated on the basis of quotes for similar conditions to Chile's, in relevant markets (the Americas, Europe and Asia). It also includes maritime shipping, insurance rate, tariffs, and other duties.

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

RER: Real exchange rate. A measure of the real value of the peso against a basket of currencies that matches the basket used to calculate the MER.

World growth: Regional growth weighted by the share in GDP at PPP, published in the IMF's *World Economic Outlook* (WEO, April 2011). World growth projections for 2011-2012 are calculated from a sample of countries that account for 85% of world GDP. For the remaining 15%, average growth is estimated at 4.4% for the period 2011-2012.

World growth at market exchange rate: Growth measured at market exchange rate. Each country is weighted according to its GDP in dollars, as published by the IMF's *World Economic Outlook* (WEO, April 2011). The sample of countries used in the calculation account for 88% of world GDP. For the remaining 12%, average growth is estimated at 2.9% for the period 2011-2012.

Abreviations

BCP: Central Bank bonds in pesos

BCU: Central Bank bonds in UFs

CPIG: Consumer goods price index

CPINT: Non-tradables consumer price index

CPIS: Consumer services price index

CPIT: Tradables consumer price index

EES: Economic Expectations Survey

FOS: Financial operators survey

INBD: National gross disposable income

IVUM: Unit price of imports index

MPR: Monetary policy rate

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