2010
MARCH

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Monetary Policy Report

BANCO CENTRAL DE CHILE

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

Contents*/

*/ The statistical closing date of the *Monetary Policy Report* was 29 March 2010.

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, with 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 by which monetary policy contributes to the population's welfare. Low, stable inflation promotes economic activity performance and growth while preventing the erosion of personal income. Moreover, focusing monetary policy on achieving the inflation target helps to moderate fluctuations in national employment and output.

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

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

This *Report* was approved at the Board's session on 1 April 2010 for presentation to the Senate Finance Committee on 6 April 2010.

The Board

Summary

The macroeconomic scenario facing the Chilean economy has suffered major changes since December's *Monetary Policy Report*. The earthquake and tsunami of 27 February had both instant and medium-term implications on growth and inflation. In turn, the first annual closing of National Accounts for 2009 and data for the period preceding the catastrophe showed domestic output and demand growing faster than previously projected. The preliminary assessment of these phenomena configures a macroeconomic scenario of narrowing output gaps and faster convergence of inflation to the target, all in a more uncertain setting than before.

The data accumulated since the statistical closing of December's *Report* suggested that the foreseen recovery of domestic output and demand was not only materializing but was doing so at a faster pace. GDP dropped 1.5% in 2009, less than the fall of 1.9% that had been forecast in December. In the second half of the year, the economy grew at an annualized rate of around 6%, resulting in a smaller output gap than had been estimated in December. Available information before the earthquake and tsunami indicated that the stronger domestic output and demand would continue.

Meanwhile, the relevant international scenario turned more benign and domestic financial conditions began normalizing gradually, with loans increasing from month to month, lower interest rates, and lending conditions that, at the fourth quarter of 2009, proved more expansionary than in the previous quarter. Annual CPI inflation returned to positive territory sooner than had been forecast in December. Core measures, particularly the CPIX1, continued to post smaller month-on-month variations. By the end of February, the exchange rate, with important swings, was higher than those posted in the December *Report*. The labor market also showed a recovery, with increased employment and a different breakdown by type of occupation. Cost pressures, beyond the methodological change in wage measuring, showed no material change in trends.

Merely the combination of the above elements shaped a medium-term scenario where inflationary pressures and inflation would be higher than foreseen in December (box: Changes in the macroeconomic scenario between December and February).

Facing this context, the earthquake and tsunami hit. Its effects on the macroeconomic scenario are important for the assessment of the conduct of monetary policy. To begin with, it caused a loss in the capital stock that damaged the country's productive capacity and thus affects the evaluation of output gaps, inflationary pressures and the monetary policy reaction. It is also having an impact on output, demand, and inflation in the very short term, mostly associated with the disruption of retail and manufacturing activity. Finally, there will be an additional effect coming from the public and private reconstruction efforts. The impact of these on growth and inflation will depend on, among other factors, their size, timing, type of financing, composition and focus of the funds involved.

As for the magnitude of the loss in productive capital stock, the Board assumes, as a working assumption for the baseline scenario in this *Report*, that the disaster destroyed 3% of the net productive capital stock of the economy. This estimate is based on the survey of damages published by the government and the historic relationship between gross and net value of capital stock (box V.1: Effects of the earthquake and tsunami on the capital stock). The Board estimates that said loss of capital stock implies that during this year the level of trend output will be between 1.0% and 1.5% lower than was considered before the catastrophe.

Regarding the short-term effects of the earthquake and tsunami, their magnitude depends on, among many factors, the share in national GDP of the hardest hit regions, the sectoral composition of production by region, and the duration of downtime at production processes. In 2008, Regions VI, VII and VIII produced nearly 16% of national GDP, mostly concentrated in the manufacturing industry. As for the labor market, the three regions concentrate one fifth of the country's jobs. The Board uses as a working assumption for the baseline scenario of this *Report*, that the disaster had a negative effect of about 3 percentage points on first-quarter GDP growth. In the second quarter, assuming a gradual normalization of productive processes, the effect is lowered to around 2 percentage points. These assumptions are based on a scenario where the reduction in output concentrates in Regions VI, VII and VIII, and it primarily affects the manufacturing industry. It is important to consider that the difficulties caused by the catastrophe in spending decisions may hold down demand, and it is likely that some short-term effects will be seen on consumption and inventories. With respect to inflation, problems in production or distribution will probably drive the price level up immediately, an effect that should be for the most part temporary.

Usual economic statistics for March could give a better approximation of the immediate effects of the earthquake and tsunami. Overall, the complexity of an accurate reading of the data must be considered, partly due to difficulties and delays in collecting the information that feeds official statistics. Actually, the task of gathering information about February—in March—already proved problematic.

International baseline scenario assumptions

	2008	2009 (e)	2010 (f)	2011 (f)
	(annual change, percent)			
Terms of trade	-16.1	4.1	12.5	-5.6
Trading partners' GDP (*)	3.0	-0.8	4.0	3.8
World GDP at PPP (*)	3.0	-0.6	4.3	4.4
World GDP at market exchange rate (*)	1.9	-1.7	3.5	3.5
External prices (in US$)	12.2	-6.1	3.7	3.0
			(levels)	
LME copper price (US¢/lb)	316	234	310	290
WTI oil price (US$/barrel)	100	62	82	85
Parity price of gasoline (US$/m^3) (*)	739	471	635	649
US$ libor (nominal, 90 days)	2.9	0.7	0.4	2.0

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

Source: Central Bank of Chile.

In the medium term, the dynamics of demand, economic activity and output gaps will relate not only to usual concerns about the world economy, but also to the size, composition, timing, form of financing and focus of the reconstruction efforts. As a working assumption, the Board assumes that the added investment resulting from the catastrophe will be the equivalent to nearly one percentage point of GDP in 2010. This effect concentrates in the second half of this year and will increase towards 2011. This considers both new investment and reallocated resources from other projects. The materialization of said investments will be favored by its high marginal productivity and because part of the net capital stock losses was insured. In the case of the public sector, according to announcements from the Executive, the baseline scenario considers that the structural deficit of 2009 amounted to 1.2% of GDP and that the structural balance will be attained towards the end of the present Administration. Budgetary reallocations this year will amount to about US$700 million, while the rebuilding of the destroyed public infrastructure will be spread out over four years. As a working assumption, the Board estimates that the burden of financing the public and private reconstruction works will be distributed among its various sources in a balanced way.

Economic growth and current account

	2007	2008	2009	2010 (f)
			(annual change, percent)	
GDP	4.6	3.7	-1.5	4.25 - 5.25
National income	7.4	4.1	-1.2	7.8
Domestic demand	7.6	7.6	-5.9	12.4
Domestic demand				
(w/o change in inventories)	8.0	7.5	-2.8	7.8
Gross fixed capital formation	11.2	18.6	-15.3	14.8
Total consumption	7.0	4.0	1.8	5.7
Goods and services exports	7.6	3.1	-5.6	3.6
Goods and services imports	14.5	12.2	-14.3	22.1
Current account (% of GDP)	4.5	-1.5	2.6	-1.1
			(US$ million)	
Current account	7,458	-2,513	4,217	-2,100
Trade balance	23,941	8,848	13,982	13,100
Exports	67,972	66,464	53,735	64,700
Imports	-44,031	-57,617	-39,754	-51,600
Services	-987	-871	-1,074	-600
Rent	-18,625	-13,423	-10,306	-17,400
Current transfers	3,129	2,934	1,616	2,800

(f) Forecast.

Source: Central Bank of Chile.

Thus, considering all the conjunctural information before the disaster and its after-effects in the short and medium term, the Board estimates that during this year GDP will grow between 4.25% and 5.25%. This range is somewhat lower than was forecast in December. The downward revision of the growth scenario for this year is based on the fact that the immediate economic effects of the earthquake and tsunami will exceed the increases generated by the reconstruction efforts. In fact, it is assumed that, had this shock not occurred, the pace of growth that output and demand were showing, favored by the benign international scenario, would have called for an upward revision of one percentage point in the growth range forecast for this year.

Inflation

(annual change, percent)

	2008	2009	2010 (f)	2011 (f)	2012 (f)
Average CPI inflation	8.7	1.6	2.4	3.0	
December CPI inflation	7.1	-1.4	3.7	2.9	
CPI inflation in around 2 years (*)					3.0
Average CPIX inflation	8.4	2.8	1.2	3.0	
December CPIX inflation	8.6	-1.8	3.0	3.2	
CPIX inflation in around 2 years (*)					3.2
Average CPIX1 inflation	7.8	2.8	0.8	2.9	
December CPIX1 inflation	7.7	-1.1	2.5	3.1	
CPIX1 inflation in around 2 years (*)					3.1

(f) Forecast.
(*) Inflation forecast to the first quarter of 2012.

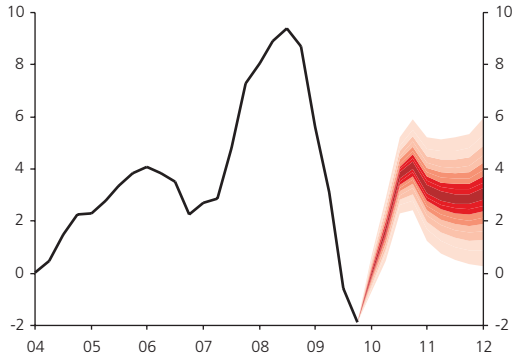
Source: Central Bank of Chile.

In the baseline scenario of this *Report*, the sum of the effects of the catastrophe, the changes in conjunctural data and other specific elements shapes a scenario where inflation will converge to 3% sooner than was forecast in December. The change in the medium-term inflation scenario is determined by the effects of the earthquake and tsunami on productive capacity and by the persistence and magnitude of a potential contraction of private consumption. In the baseline scenario, annual CPI variation will be more than 3% in the second half of this year, standing around 4% for some months. It will later fluctuate around 3% throughout 2011 until the end of the relevant projection horizon, this time the first quarter of 2012. Annual CPIX1 will show a more gradual convergence to 3%.

This scenario also rests on other working assumptions. First, that in the long term the real exchange rate (RER) will be similar to its present level. This, assuming that, with the nominal exchange rate and parities prevailing at the statistical closing of this *Report*, the RER is now consistent with its long-term fundamentals. Another working assumption is that inflationary pressures

CPI inflation forecast (*)

(annual change, percent)

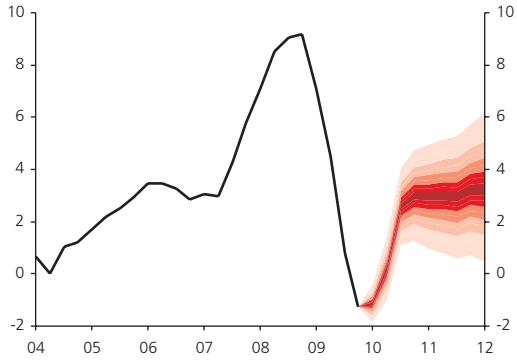


(*) The figure shows the confidence interval of the baseline projection over the respective horizon (colored area). Confidence intervals of 10%, 30%, 50%, 70%, and 90% around the baseline scenario are included. These intervals summarize the risks on inflation as assessed by the Board. These projections incorporate the assumption that monetary policy will continue to be very stimulative in the next quarters. Towards the end of the projection horizon, the monetary policy interest rate will converge to a level similar to the one indicated by March's Economic Expectations Survey. However, its pace of normalization will be somewhat faster than considered in that survey.

Source: Central Bank of Chile.

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. These projections incorporate the assumption that monetary policy will continue to be very stimulative in the next quarters. Towards the end of the projection horizon, the monetary policy interest rate will converge to a level similar to the one indicated by March's Economic Expectations Survey. However, its pace of normalization will be somewhat faster than considered in that survey.

Source: Central Bank of Chile.

coming from the labor market will generally not experience any significant changes with respect to its current indicators. Finally, the external scenario will continue to add momentum to the economy, and imported inflationary pressures will remain contained.

The above projections include the assumption that monetary policy will continue to be very stimulative in the next quarters. Towards the end of the projection horizon, the monetary policy interest rate will converge to a level similar to the one indicated by March's Economic Expectations Survey. However, its pace of normalization will be somewhat faster than considered in that survey.

As usual, the scenario outlined here is subject to various risks. Compared with December forecasts, the recovery process and development prospects for the Chilean economy have not been hindered by the earthquake and tsunami; however, in the short run, the risk scenarios are dominated by the catastrophe. Particularly relevant is the medium-term effect of the aggregate demand impulse originating in the reconstruction works that will be carried out. The magnitude, composition, speed, form of financing and focus of these reconstruction expenditures can have substantial effects on the baseline scenario, in terms of output, inflation and financial markets' performance. There are also risks associated to the time that it will take productive activities to reestablish normality and agents to materialize their expenditures. This has a direct incidence on the assessment of the immediate effects of the catastrophe on the first and second quarters. In any case, this risk is partly mitigated when considering that before the earthquake and tsunami domestic output and demand were already showing a higher velocity than had been projected.

In other areas, the external scenario shows a better outlook, although some risks persist. The fiscal situation of developed economies—especially in some European countries—is cause for concern because of its effects on perceived risks and on the financial system, and its possible implications on the path of recovery of global growth. There is also the risk associated to the administration of monetary stimulus packages, either if they are withdrawn sooner than necessary—considering that some countries' financial systems are still weak—or later than advisable. As usual, the persistence of global imbalances entails risks because of both strong capital inflows to emerging economies and significant changes in the evolution of currency parities.

The realization of some of these risk scenarios will have direct consequences on the country's growth and inflation rates forecast by the Board. Considering the elements described, the Board believes that the balance of risks for inflation and growth is unbiased. However on this occasion, the earthquake and tsunami place unusual uncertainty, particularly regarding figures for economic activity in March and April. Thus, the Board considers that the balance of risks to growth is biased downwards in the very short term.

The Board reiterates that it will continue to use its policies with flexibility in order for projected inflation to stand at 3% over the policy horizon.

Box: Changes in the macroeconomic scenario between December and February

The changes in the macroeconomic scenario since December's *Monetary Policy Report* are tainted by the earthquake and tsunami of 27 February and its consequences for output and inflation. For the purposes of assessing the future conduct of monetary policy, it is useful to have at hand a counterfactual macroeconomic scenario, one that isolates the effects of the catastrophe.

In December's *Report*, the Board projected that GDP would drop 1.9% in 2009. It also stated that in 2010 it would grow between 4.5% and 5.5%. About CPI inflation, which had been negative over the better part of the second half of 2009, the Board forecast that it would return to positive territory during the first half of 2010. This scenario assumed that the recovery of output and demand that had begun in mid-2009 would continue along the same path this year. However, the current output gaps would not close fully in the relevant projection scenario. Additionally, the Board reiterated that it would hold the monetary policy interest rate (MPR) at its minimum level until at least the second quarter of this year.

Incoming information since the statistical closing of December's *Report* indicates, generally, that the recovery trend of domestic output and demand not only materialized but it did so at a faster than expected pace. According to the first annual closing of the National Accounts published on 18 March, GDP of 2009 had a milder fall than had been forecast: 1.5% annually (table 1). In the fourth quarter it actually increased by 2.1% annually. These figures revealed a faster recovery of sectors more closely linked with domestic demand, particularly manufacturing and retail. Domestic demand dropped 5.9% in the year, which compares favorably with the 7.4% fall projected in December. Data for the last quarter of 2009 stood out because of the performance of consumption and investment in machinery & equipments. Meanwhile, inventories for the year as a whole posted a smaller depletion than had been estimated. With this, combined with revised figures from earlier periods, the second half of 2009 closed with an annualized growth rate of around 6%, resulting in output gaps around one percentage point less than previously estimate (figure 1). This latter element by itself induces an upward revision of domestic inflationary pressures, and the convergence of inflation to the target to be faster than was foreseen in December.

Table 1

GDP and demand components

(annual change, percent)

	2007		2008		2009	
	Report Dec. 09	NAcc. (*) Mar.10	*Report* Dec. 09	NAcc. (*) Mar.10	*Report* Dec. 09	NAcc. (*) Mar.10
GDP	4.7	4.6	3.2	3.7	-1.9	-1.5
Domestic demand	7.8	7.6	7.4	7.6	-7.4	-5.9
Domestic demand (w/o change in inventories)	8.2	8.0	7.9	7.5	-3.3	-2.8
Gross fixed capital formation	12.0	11.2	19.5	18.6	-16.1	-15.3
Total consumption	7.1	7.0	4.2	4.0	1.5	1.8
Goods and services exports	7.6	7.6	3.1	3.1	-4.1	-5.6
Goods and services imports	14.9	14.5	12.9	12.2	-15.7	-14.3

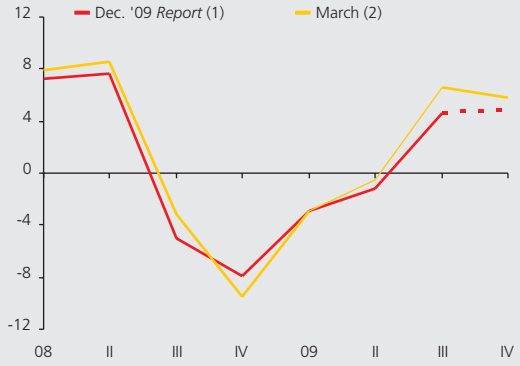
(*) NAcc.: National Accounts.

Source: Central Bank of Chile.

Figure 1

Gross domestic product

(annualized quarterly change, percent)



(1) Fourth quarter 2009 shows forecast included in the baseline scenario.
(2) National Accounts published on 18 March 2010.

Source: Central Bank of Chile.

Data from before the earthquake and tsunami suggested that the strengthened output and demand were being prolonged. Sales indicators were on an upward trend, which combined with optimistic expectations from firms and consumers. The labor market was also showing a recovery with increased employment and a different breakdown by type of occupation. All these elements together, which to a large extent were the result of the strong impulse provided by monetary policy, consolidated a trend for output and inflation above the estimates from end-of 2009. Actually, the results from the Economic Expectations Survey adjusted GDP growth for 2010 from the December 2009 of 4.5%, to 4.9% in February 2010.

Such faster output expansion and narrowing output gaps undoubtedly favored inflationary prospects. In the immediate term, inflation had also posted an increase that exceeded December forecasts, returning to positive y-o-y figures sooner than expected. Part of this difference originated in the methodological change applied to the CPI, which entailed shifting from surveying only the Santiago Metropolitan Region to a nationwide survey. Core inflation measures, particularly the CPIX1, continued to post low month-to-month changes.

On the other hand, the international scenario, as is detailed in the baseline scenario analysis in this *Report*, has tended to improve, providing an external impulse that exceeds December's projections.

A counterfactual projections exercise that considers only developments up to 26 February yields as a result a scenario where output growth would have been faster than foreseen in December, as would have been the pace of inflation returning to the target. It can be estimated that the range for output growth this year would have been revised upward by roughly one percentage point. The output gaps, aside from the fact that they were already below earlier expectations, would have closed more rapidly, with the resulting effects on inflation.

In the medium term, the sum of all the above elements would depict a scenario where inflation would accelerate to 3% or more over the course of this year, and would probably approach the 3% target coming from above in a two-year horizon.

The monetary policy response to this hypothetical scenario is unambiguous. The pace of monetary policy normalization would have been faster than foreseen in December's *Report*. It is likely that the convergence of inflation to the target would have been consistent with a higher MPR starting by mid-year and throughout the projection horizon.

Monetary policy decisions in the last three months

Background: December 2009 *Monetary Policy Report*

In December, the global and local recovery continued as projected in the September *Monetary Policy Report*, in tandem with a resumed confidence of households and firms and with highly expansionary fiscal and monetary conditions. In Chile, output had been increasing since the third quarter, the deterioration of the labor market had ceased, and financial conditions had become slightly less restrictive. Inflation continued to be negative, even somewhat lower than previous forecasts. In the face of persistent output gaps and low inflationary pressures, the Board reiterated that it would keep the monetary policy rate (MPR) at its minimum level at least until the second quarter of 2010. It further estimated that the rate of normalization would be comparable to that captured in the December Economic Expectations Survey (EES) and more gradual than the path implied by financial asset prices in the two weeks prior to the statistical closing date of that *Report*.

The baseline scenario projected that the economy would grow between 4.5 and 5.5% in 2010, after contracting in 2009, while the consumer price index (CPI) would close 2009 with an annual variation of -1.4%. The CPI was expected to become positive over the course of the first half of 2010 and to gradually converge to 3.0% within the monetary policy horizon. Total inflation was projected to increase faster than core inflation, based on forecasts for a progressive, but partial, closing of the output gap within the projection horizon and higher commodity prices.

Meetings between December and February

In December, the macroeconomic outlook was similar to the forecast in the September *Report*. The implied MPR path continued to point to increases starting in mid-2010, comparable to the December EES. The data confirmed that the activity recovery velocity was similar to the forecast, and the recovery would grow stronger as agents fully regained their confidence. Inflation of November was lower than expected, confirming that it would remain below zero for some months, but the medium-term outlook continued to reflect a gradual increase. In the external arena, a path to recovery was visible, but with considerable risks. The general perception was that the external financial system was fragile and that there were ongoing risks and threats related to unresolved structural problems. The recent reduction in the public debt rating of some countries provided evidence that many economies had a vulnerable fiscal position and that the costs of fiscal expansion in economies that had started out in a fragile position were not small. The peso appreciated substantially in a context of a weak dollar and a search for returns by investors, although ultimately the movement was not strongly different from trends for comparable currencies. Domestically, the MPR expectations curve had eased off in the last month, but it showed a degree of steepening beyond the short term. Analysts had incorporated the signals sent by the Bank and assumed that, on average, the MPR adjustment would begin in the second quarter of 2010. Inflationary pressures continued to be moderate in the medium term, partly as a result of undynamic credit and output as well as the drop in the exchange rate. At that time, there was no evidence of changes in either the output trend or risk preferences that might trigger adjustments in consumption, investment, or portfolio decisions and thereby justify changing the course of monetary policy. This explained the need to hold the MPR at its current level and to proceed with the preestablished calendar for eliminating the short-term liquidity facility (*Facilidad de Liquidez a Plazo* or FLAP). Monetary policy had decisively supported the recovery, and it should continue playing this role. The main risk was an early unwinding of the monetary stimulus, before the recovery was sufficiently established. In this context, the Board decided to hold the MPR at 0.5% in annual terms.

In January, output was somewhat more dynamic, but the trend was fundamentally led by the natural resource sectors. The growth of demand was also up, although the magnitude of the rise did not suggest a more expansive scenario than forecast. With regard to the output gap, there was no evidence that they were closing at a different pace than projected. The core inflation trend had been unexpectedly low. This may have been tied to a larger-than-expected effect from the currency appreciation, but the available evidence was inconclusive. Nevertheless, inflation expectations were very much in line with the Bank's projections, confirming that the market and analysts did not foresee a persistent drop in prices. The trend of market interest rates—which in December had implied an MPR path that was steeper than the assumptions in the *Monetary Policy Report*—had been adjusted downward significantly. In general, the trend for the credit aggregates, lending rates, and the preliminary results from the Bank Lending Survey all indicated that financial conditions continued to become gradually less restrictive. Consequently, the most plausible

option was to keep the MPR at its minimum level of 0.50% at least until the second quarter of this year. While domestically the observed inflationary pressures were somewhat lower than estimated in the *Report* and the growth estimates for 2009 and early 2010 were somewhat higher, both movements were within the normal ranges of variation. The November monthly economic activity index (*Índice Mensual de Actividad Económica,* or Imacec) had instilled the market with a degree of optimism, leading private analysts to adjust their projections for 2010 slightly upward. Nevertheless, this did not completely clear up doubts about the strength of the recovery over the course of this year. In December, core inflation was lower than forecast, perhaps as a result of the appreciation of the peso. The lower inflationary pressures were now being compounded by a degree of persistence in the exchange rate appreciation. This evolution was not exceptional, but rather was explained by the weakness of the dollar, and it was seen in a large number of emerging economies and in the majority of the commodity exporters. The medium-term outlook for inflation continued to point to a gradual convergence to the target, driven mainly by the recovery of economic activity. While the baseline scenario of the December *Report* continued to be the most probable, the risks for inflation appeared to have shifted from equilibrium to a downward bias. The external data were positive and even though they showed the recovery of output and demand, there were still concerns about the speed of the recovery in the medium term, in particular considering the challenges of withdrawing the support and stimulus policies. The main economies had avoided a deep recession based on an unprecedented combination of expansive policies, which were sustainable in the short run but not over a longer horizon. Consequently, as time passed, the period for withdrawing the expansive policies grew short, even though these economies and their financial systems could not yet hold up on their own based on market fundamentals. There was a lot of uncertainty about the direction of capital flows, since many countries had a current account surplus, and the consequent evolution of exchange rates. Given this scenario, the Board decided to hold the MPR at 0.5% in annual terms.

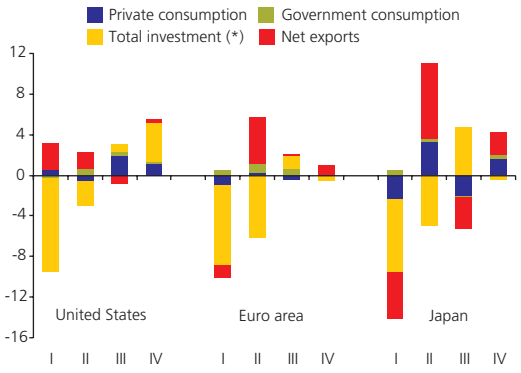
In February, the short-term growth outlook exceeded the projections in the December *Report*, but the difference was mainly explained by a dynamic fourth quarter of 2009, which was tied to non-natural-resource sectors. Domestic demand also grew more strongly in all its components. The CPI forecasts had been adjusted upward, but this reflected the impact of one-time phenomena. The activity and inflation news supported a significant reduction in the risks considered in past meetings, in terms of inflationary pressures being undesirably low for a long period. At the same time, there was not enough evidence to substantiate a scenario that would require withdrawing the monetary stimulus earlier than planned, especially in the presence of increased global volatility. The most plausible option, therefore, was to keep the MPR at its minimum level of 0.50% at least until the second quarter of this year. January inflation was higher than expected, essentially as a result of some specific conditions and changes in the calculation methodology. Core inflation measures still pointed to very contained inflationary pressures. Output data for December confirmed that the economy was in a clear recovery phase, and the inventory cycle showed signs of beginning to contribute to the growth of demand. Externally, foreign markets saw an increase in volatility stemming from problems in some European economies. While the outlook for world growth had not changed, the events of the last month highlighted the continuing fragility of the world economy and the arduous road ahead before the crisis could definitively be resolved. Direct contagion from these problems to the Chilean economy was very limited, but their repercussions in the global economy could yet be sizeable. The peso-dollar parity had increased substantially in the past few weeks. The main factor behind that trend, beyond the global appreciation of the dollar, was the behavior of the Pension Fund Administrators (AFPs) with regard to their currency hedging. Consequently, the impact should tend to disappear with time, and there was room to accommodate the depreciation without great risks in terms of the inflation situation. There was also a notable change in financial conditions, with somewhat more dynamic credit. Interest rates had risen significantly in practically all segments, which could be an indication of a recovery in the demand for credit, especially among higher-risk clients. Thus, there were no elements leading to a change in the projected MPR path. Additional considerations were that the market was still forecasting that the MPR would be maintained for some months and that fiscal policy would be less expansive this year. Short-term inflation expectations had been adjusted slightly upward, and medium-term expectations clearly pointed to convergence with the target, driven mainly by the recovery of output and domestic demand. In this context, the Board decided to keep the MPR at 0.5% in annual terms.

I. International scenario

Figure I.1

Contribution to 2009 GDP growth

(annualized quarterly change, percent)



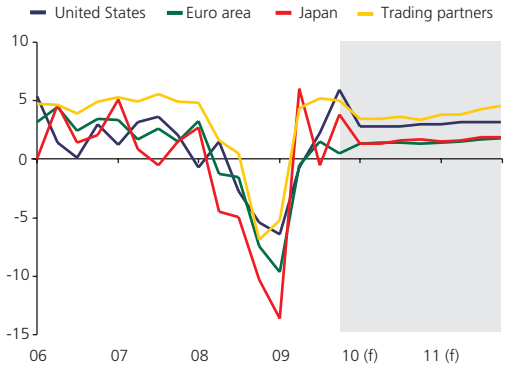
(*) Includes changes in inventories.

Sources: Bureau of Economic Analysis, Cabinet Office, and Eurostat.

Figure I.2

World growth

(annualized quarterly change, percent)



(f) Forecast.

Sources: Central Bank of Chile, based on statistical institutes in each country, Consensus Forecasts and International Monetary Fund.

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.

World growth

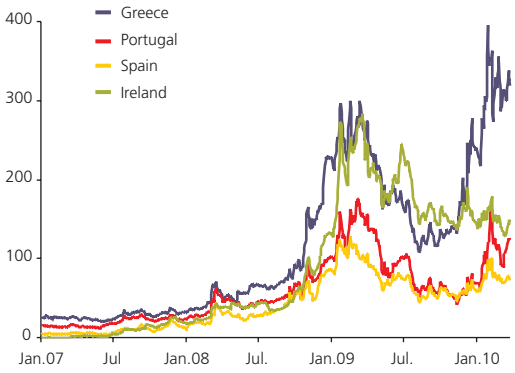
So far this year, the assessment of relevant international scenario for the Chilean economy has become more favorable than in December. Output has continued to recover at the global level, consolidating the growth outlook of Chile's trading partners. Growth forecasts for 2010 and 2011 have been revised upward, and commodity prices are rising again. The perception of risk has continued to subside in the financial markets, although there were some episodes of significant stress over the course of January and February.

World growth statistics for the fourth quarter of 2009 were generally better than projected. The rate of increase in output was fastest in emerging Asia and the United States. In particular, China continued its strong expansion, bringing other Asian economies along with it. Consequently, both the external sector and manufacturing production showed more evident signs of recovery than in other regions. This dynamism was transferred to labor markets, where unemployment rates have begun to fall. In the United States, fourth quarter GDP was better than expected, mainly due to a lower drawdown of inventories and higher investment (figure I.1). Nevertheless, personal consumption was adjusted downward in this economy in 2009. Job destruction continues, albeit at a decreasing rate, and the real estate market is still weak, although there are some signs of recovery. This all puts a note of caution on the dynamism of consumption, given that the fiscal programs that drove it last year are coming to an end. In Europe, the different countries show important differences in their rate of recovery. Germany and some Scandinavian economies maintain an optimistic outlook for more dynamic output, but in other cases the fiscal situation is the main concern. For example, a slower growth rate is predicted in Greece, Ireland, Italy, Portugal, and Spain. The public debt of some of these countries exceeds 100% of GDP, while the estimated fiscal deficit for 2010 reaches into the double digits. Finally, in Latin America, the Brazilian economy has had a particularly favorable evolution.

Figure I.3

Risk premiums (*)

(basis points)



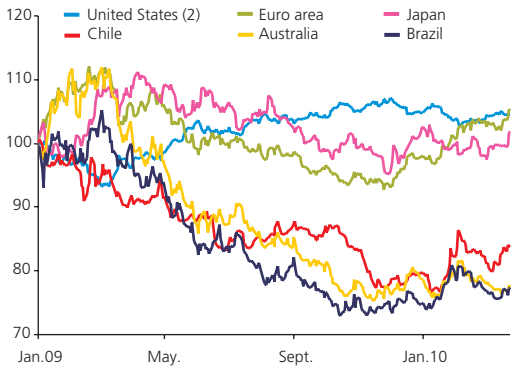
(*) Difference of yields on ten-year government bonds from each country and ten-year German government bonds.

Source: Bloomberg.

Figure I.4

Currency parities (1)

(index 01.Jan.09=100, local currency to the U.S. dollar)



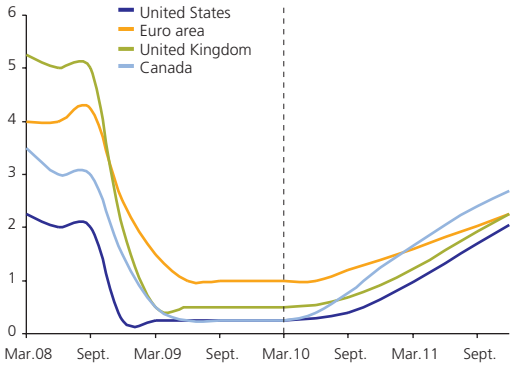
(1) Parity with the U.S. dollar. An increase indicates a depreciation of the local currency.
(2) Considers the U.S. dollar against a basket of the currencies of the main U.S. trading partners. An increase indicates a depreciation of the U.S. dollar.

Source: Bloomberg.

Figure I.5

MPR and forward curves (*)

(percent)



(*) The dotted line separates effective MPR data from the forward curve.

Source: Bloomberg.

As in the last two *Reports*, the generality of the growth forecasts for the 2010–2011 period have been adjusted upward, although the magnitude of the adjustment is marginally lower (table I.1). In the case of the developed economies, the quarterly growth profiles are similar to those of the last *Report* (figure I.2). Annual growth rates vary widely among economies, with the highest in emerging Asia. Nevertheless, the projected average for the two-year period 2010–2011 is more or less in line with growth in 2000–2007 for most regions. Only the United States will grow over the average, while the euro area will grow quite slower.

Table I.1

World growth (*)

(annual change, percent)

	Ave. 90-99	Ave. 00-07	2008	2009 (e)	2010 (f)	2011 (f)
World at PPP	2.9	4.2	3.0	-0.6	4.3	4.4
World at market exchange rate	2.4	3.2	1.9	-1.7	3.5	3.5
United States	3.2	2.6	0.4	-2.4	3.1	3.0
Euro area	2.2	2.1	0.6	-4.1	1.1	1.5
Japan	1.5	1.7	-1.2	-5.2	1.9	1.6
China	10.0	10.1	9.6	8.7	9.9	9.1
Rest of Asia	5.5	5.0	2.9	0.0	5.1	4.8
Latin America	2.7	3.6	4.2	-2.5	4.1	3.7
Commodity exports	2.7	3.1	1.1	-1.2	3.0	3.3
Trading partners	3.1	3.6	3.0	-0.8	4.0	3.8

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

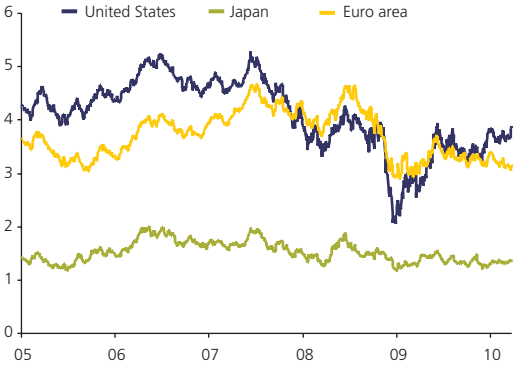
Sources: Central Bank of Chile, based on a sample of investment banks, Consensus Forecasts, and International Monetary Fund.

Financial markets

Compared with December, the perception of risk has subsided in the international financial markets. This has been reflected in a fairly widespread increase in the stock market indices, which, in any case, are still well below the peaks before the crisis. In the past few months, the main source of stress in these markets has been the concern for the fiscal situation of the European economies. As a result, the sovereign debt spreads in these countries rose significantly in February. Subsequently they fluctuated considerably in the face of uncertainty surrounding the source of resources needed to finance the deficits. This is especially visible in the case of the large Greek deficit, despite the commitment of a substantial adjustment. The euro area authorities and the International Monetary Fund (IMF) recently agreed on a financial support mechanism for this country, should it become necessary, which helped ease the tension in the financial markets (figure I.3). In this context, and contrary to projections in the last *Report*, investors again began to use the dollar as a value shelter, causing an appreciation against the currency basket of the country's main trading partners that peaked at 3% between December and February (figure I.4). The counterpart of this trend was seen, in particular, in the euro, which depreciated nearly 6% against the dollar in the same period.

Figure I.6

Long-term interest rates in developed economies (*)
(percent)

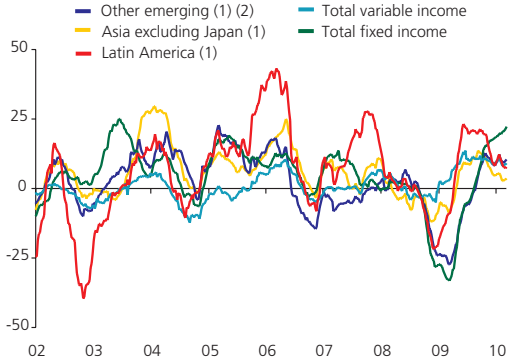


(*) Interest rates on ten-year government bonds.

Source: Bloomberg.

Figure I.7

Net flows of investment funds to emerging economies
(US$ billions, in moving six-month windows, weekly data)

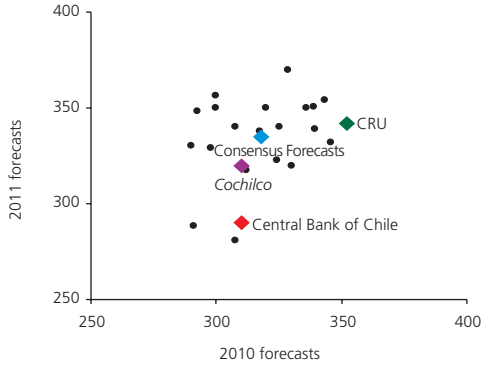


(1) Variable-income flows.
(2) The Middle East, emerging Europe, and Africa.

Source: Emerging Portfolio Fund Research.

Figure I.8

Copper price forecasts (*)
(US¢/lb, annual average)



(*) London Metal Exchange price.

Sources: Central Bank of Chile, *Cochilco* (Chilean Copper Commission), Consensus Forecasts, and Commodity Research Unit, CRU.

Central banks around the world have continued to gradually withdraw their unconventional monetary policy measures. However, the monetary authorities maintain the emphasis on a gradual process of rate normalization, in a context of contained core inflation measures. This has contributed to delayed market expectations for future monetary policy rate increases (figure I.5). The process of raising the reference rate is already underway in Australia, Israel, and, more recently, in Malaysia and India. Norway has also initiated the process of normalizing its policy interest rate, but its latest *Monetary Policy Report* announced that while the gradual increases will continue, they will be implemented later than projected in its previous *Report*.

In this context, long-term interest rates have been relatively stable in the developed economies since the start of the year. The exception is the United States, which has recorded an upward trend consistent with its higher output figures (figure I.6).

However, credit conditions are still tight in the developed economies, especially in the United States and the United Kingdom. For emerging economies, financial conditions continue to improve, with lower financing costs for the corporate sector and governments. Compared with December, accumulated portfolio investment flows to emerging economies continue to record net capital inflows, particularly into Latin America. With regard to the type of instrument, fixed-income assets saw higher inflows than variable-income assets (figure I.7). This has been in line with a favorable scenario for emerging bond issues, taking advantage of low interest rates and calmer markets.

Commodity prices

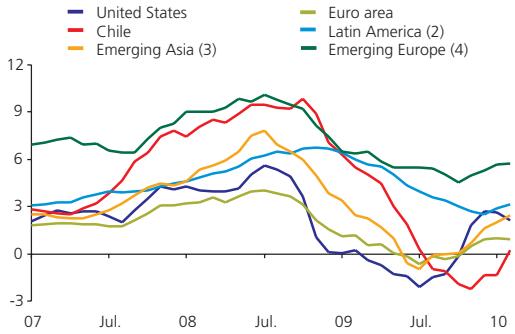
International commodity prices have increased since December, especially metals and products tied to the energy sector. These hikes occurred in a context of an upward adjustment of the global demand for commodities and some geopolitical conflicts that represent risks for fuel production, in particular.

Copper rose 7% since the statistical closing date of the last *Report*, averaging US$3.40 a pound in the last two weeks. This occurred within a scenario of dollar appreciation, which was offset by expectations of a contraction in excess supply in 2010, relative to estimates of the past few months, and a more vigorous recovery of demand in 2011. This is consistent with the better growth outlook for the main consumers of this metal. These assumptions underpin an upward adjustment in the price forecast to US$3.10 a pound in 2010 and US$2.90 a pound in 2011 (figure I.8). The estimate for the long-term price remains at US$2.00 a pound. The higher copper price has affected copper derivatives, causing the price of molybdenum to rise nearly 60% since December.

Figure I.9

CPI inflation (1)

(annual change, percent)



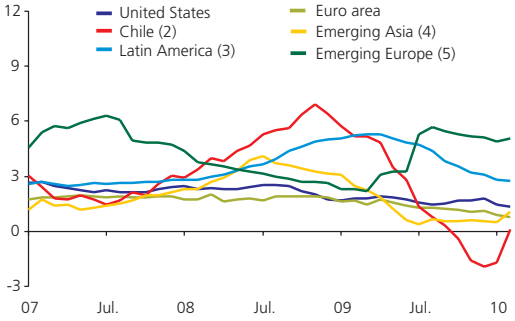
(1) Geometric average of CPI inflation in the countries of each region.
(2) Includes Brazil, Colombia, Mexico, and Peru.
(3) Includes China, Indonesia, Malaysia, South Korea, Singapore, Taiwan, and Thailand .
(4) Includes Czech Republic, Hungary, Russia and Turkey.

Source: Bloomberg.

Figure I.10

Core CPI inflation (1)

(annual change, percent)



(1) Geometric average of core CPI inflation in the countries of each region.
(2) CPI excluding foods and energy.
(3) Includes Mexico and Peru.
(4) Includes South Korea, Taiwan and Thailand .
(5) Only includes Hungary.

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

Table I.2

World inflation

(average annual change in local currency, percent)

	Ave. 90-99	Ave. 00-08	2009	2010 (f)	2011 (f)
United States	3.0	2.9	-0.3	2.2	2.0
Euro area	2.3	2.3	0.3	1.1	1.4
Japan	1.2	-0.1	-1.3	-1.1	-0.4
China	7.8	2.2	-0.7	2.9	3.3
Australia	2.5	3.3	1.8	2.5	2.7
New Zealand	2.1	2.7	2.1	2.0	2.6
Argentina	253.7	8.9	6.2	9.7	10.1
Brazil	854.8	7.1	4.9	4.8	4.7
Mexico	20.4	5.2	5.3	5.2	3.9
IPE (*)	1.8	5.4	-6.1	3.7	3.0
IPL (*)	27,2	5,6	-1,5	3,0	3,6

(*) See glossary for definition.
(f) Forecast.

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

The forecast for the WTI oil price was also adjusted upward, to US$82 a barrel in 2010 and US$85 a barrel in 2011, based on the forward curve for futures contracts in the ten business days prior to the statistical closing date of this *Report*. This is in line with a spot price of over US$80 a barrel, which represents a 12% increase since the close of the December *Report*. This recovery is based on an upward adjustment of expectations for world fuel demand and geopolitical problems in some oil-producing countries.

The prices of fishmeal and wood pulp also recorded hikes of around 10% relative to December. In contrast, prices for agricultural products fell 10%, on aggregate, in the same period.

World inflation

CPI inflation shows a generalized recovery relative to December, partly in response to the higher fuel prices (figure I.9). In line with these higher spot rates, the inflation outlook for this year is higher in all regions, with Asia and emerging Europe leading the increases. Core inflation presents a downward trend in both the United States and the euro area, and market expectations suggest that the trend will continue. In contrast, core inflation appears to have bottomed out in some emerging economies, and it is even starting to increase in a number of these countries (figure I.10).

The baseline scenario considers that external inflation relevant to Chile (measured through the external price index, EPI) will reverse the drop of 2009 and be positive in the two-year period 2010–2011. The expected EPI for this year is lower than forecast in the December *Report*, mainly as a result of the forecast for lower depreciation of the dollar. An upward adjustment is expected for 2011, however, as higher local inflation will offset the exchange rate effects (table I.2).

Risk scenarios

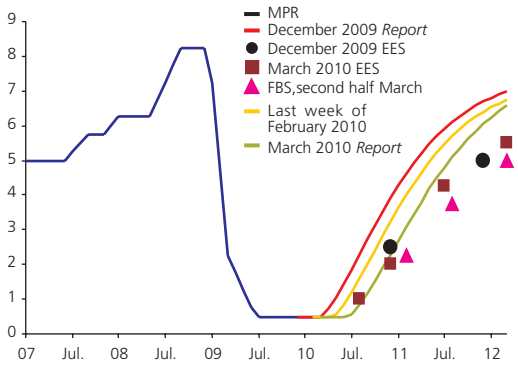
Although the global economic scenario has improved, there are still some risks in the medium term. Concerns remain about the sustainability of growth in the developed economies, as it needs to be accompanied by robust and sustained domestic demand. In some countries, especially a number of European economies, the fiscal situation makes them vulnerable to a slower recovery process, and it could have an impact on their risk perception and their financial systems. The debate continues over the appropriate process for withdrawing the monetary stimulus measures, with concerns about the timing being too early or too late. Finally, as usual, global imbalances continue to represent a risk for international capital flows and currency movements.

II. Financial markets

Figure II.1

MPR and forward curve

(percent)



Source: Central Bank of Chile.

Figure II.2

Expected MPR in December 2010 and two years out, in the EES

(percent)

Source: Central Bank of Chile.

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

Monetary policy

The macroeconomic scenario facing the Chilean economy has suffered major changes since December's *Monetary Policy Report*. The preliminary assessment of the effects of the earthquake and tsunami, as well as evidence prior to this phenomenon, indicate a macroeconomic scenario in which the output gap is narrower and inflation will converge to the target faster than forecast. As a working assumption, the baseline scenario considers that monetary policy will continue to be very stimulative in the next quarters. Toward the end of the projection horizon, the MPR will converge to a level similar to the one indicated by March's Economic Expectations Survey (EES). However, its pace of normalization will be somewhat faster than considered in that survey.

Until the last week of February, expectations for the MPR deduced from financial asset prices projected that the pace of the upward cycle, in the short term, would be similar to the assumptions considered in the January and February monetary policy meetings. This pace was also comparable to projections in the December 2009 EES. That was, the MPR would begin to rise in the second quarter of 2010 and would reach levels around 2.5% in December of the same year (figure II.1).

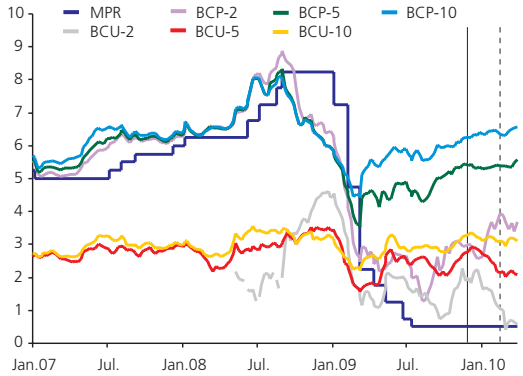
After the earthquake and tsunami, expectations for the MPR's level and rate of increase fell in several surveys, especially in the short term, but rose toward the end of the projection horizon. Thus, these estimates push back the start of the upward cycle to the third quarter of this year and place the MPR in December 2010 between 25 and 50 basis points lower than the December 2009 surveys. The March EES indicated that the MPR would be 2.0% at the end of 2010 (versus 2.5% in December) (figure II.2). The Financial Brokers' Survey (FBS) from 24 March 2010 found that the MPR is expected to be 2.25% in February 2011 (versus 2.50% twelve months out in the FBS for the second half of December). Expectations deduced from the financial asset price forward curve in the ten days prior to the close of this *Report* put the MPR at 2.30% in December 2010 (versus 3.25% in the week before the catastrophe).

Changes in the interest rates on Central Bank instruments have been mixed since the last *Report* (figure II.3). Specifically, indexed rates fell, while rates on nominal instruments increased, with the sharpest movements in the short-term segments. Toward the end of February, this divergence between UF and pesos rates could have stemmed from a combination

Figure II.3

MPR and interest rates on Central Bank of Chile instruments (*)

(weekly averages, percent)



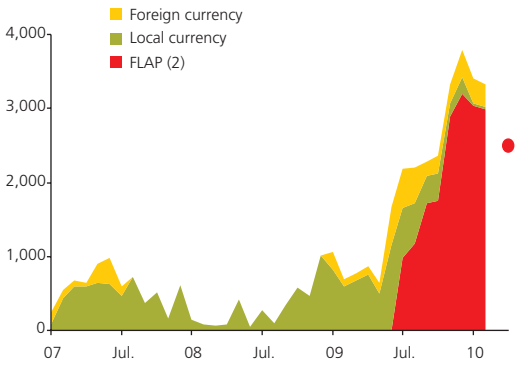
(*) Solid vertical line indicates the statistical closing date of the December 2009 *Monetary Policy Report*. Dotted vertical line indicates the first week after the earthquake and tsunami.

Source: Central Bank of Chile.

Figure II.4

Liquid assets of the Central Bank of Chile balance sheet with bank counterparties (1)

(Ch$ billion)



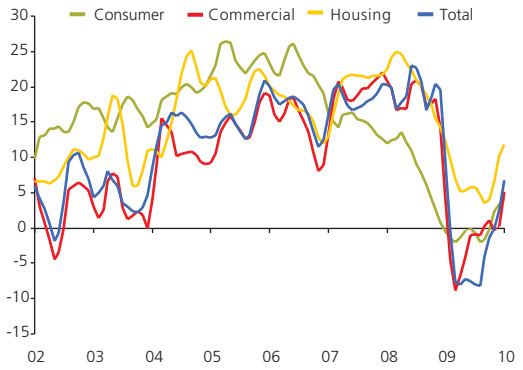
(1) Total assets excluding international reserves, subordinate debt, and other assets.
(2) Point indicates the amount on 29 March 2010.

Source: Central Bank of Chile.

Figure II.5

Personal and business loans

(annualized change in the moving quarter, seasonally adjusted series, percent)



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

of several elements. Lower private bond issues denominated in UF and higher inflation expectations appear to have more than offset government issues, which reached US$1.5 billion in the first quarter. All interest rates dropped immediately after the earthquake and tsunami, but they recovered in the following weeks. Longer-term interest rates have been affected by market estimates of the sources the government will use to finance the post-catastrophe reconstruction efforts and how this will affect Treasury debt issues.

As indicated in November 2009, the Bank has gradually withdrawn the complementary liquidity measures. The accumulated balance in the short-term liquidity facility (*Facilidad de Liquidez a Plazo*, or FLAP) began to decrease in January. After the Board announced its closure schedule in November, use of the facility peaked in December with an accumulated amount of almost $3.2 trillion. Thereafter, the amount coming due exceeded rollovers. At the close of this *Report*, the total accumulated amount was around $2.5 trillion. Liquidity needs have been met through the use of other facilities, such as repos and the standing liquidity facility (figure II.4).

Financial conditions

According to the Bank Lending Survey for the fourth quarter of 2009, the majority of financial institutions surveyed signaled that loan approval standards were less restrictive than in the previous quarter. At the same time, there was a perception that demand was strengthening. The greater flexibility was reflected in an increase in loan amounts and a lengthening of terms, according to the surveyed institutions. The increased demand for credit from firms stems from an increase in investment in fixed assets and a greater need for working capital. In the case of individuals, it reflects a better employment situation and/or income conditions.

The available data for the year thus far, which are mostly from before the earthquake and tsunami, indicated that financial conditions facing households and firms, have continued to normalize. The total stock of loans grew month-on-month starting in December, for the first time since January 2009. This trend was primarily driven by the commercial loan component (figure II.5).

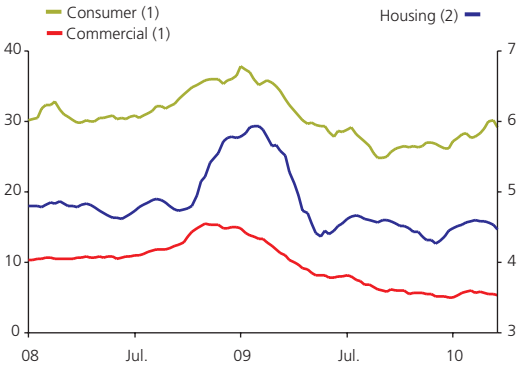
The interest rates charged by banks were relatively stable in the first quarter, with the exception of increases in some consumer loan segments. In the weeks following the close of the December *Report*, seasonally adjusted interest rates continued to fall, reaching lows comparable to 2004 rates in the last week of December. From there, they began to increase gradually. After the earthquake, the rates on commercial loans and housing mortgages fell again, while consumer loan rates continued to increase at some maturities (table II.1 and figure II.6).

The effects of the earthquake and tsunami on financial conditions are not clear. For now, the available data indicate that the banking industry granted loan payment relief benefits in March, reduced the fixed costs on credit cards, and applied a zero payment on credit cards, at least for March. Rates on housing loans have also dropped, partly as a result of the presumably lower demand for this type of operation. The duration and reach of these benefits

Figure II.6

Lending rates

(average of four moving weeks, percent)



(1) Weighted average rate on all operations in pesos for this type of loan.
(2) Operations in UF at over three years.

Source: Central Bank of Chile.

Table II.1

Interest rate movements since year-end 2008 (1)

	Average Oct.–Dec. 2008 (a)	Dec. 2009 (b)	Before earthquake and tsunami (c) (2)	After earthquake and tsunami (d) (2)	Difference (c)- (a) (basis points)	Difference (c) - (b) (basis points)	Difference (d) - (c) (basis points)
MPR	8.25	0.50	0.50	0.50	-775	0	0
Deposit rates							
30-89 days	8.4	0.7	0.6	0.6	-788	-16	6
90–365 days	9.2	1.4	1.6	1.3	-762	14	-26
Lending rates							
Consumer (3)	36.2	26.6	28.9	29.2	-729	238	23
Consumer 181–365 days	40.4	34.0	35.9	35.5	-449	188	-42
Consumer over 3 years	35.9	25.1	27.2	27.3	-871	207	6
Commercial (3)	15.1	4.7	5.6	5.3	-943	89	-30
Commercial 30–89 days	16.7	3.5	3.9	3.9	-1.274	48	-7
Commercial 181–365 days	14.5	7.1	9.4	8.4	-512	226	-98
Housing	5.6	4.5	4.6	4.5	-102	4	-11

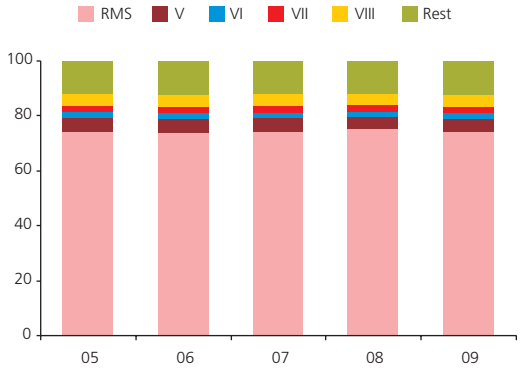
(1) Interest rates in pesos, except for housing loans, which are inflation indexed (UF).
(2) Moving average of the last four weeks. The period after the earthquake and tsunami runs through the third week of March 2010.
(3) Weighted averages.

Source: Central Bank of Chile.

Figure II.7

Regional share in total loans

(percent)

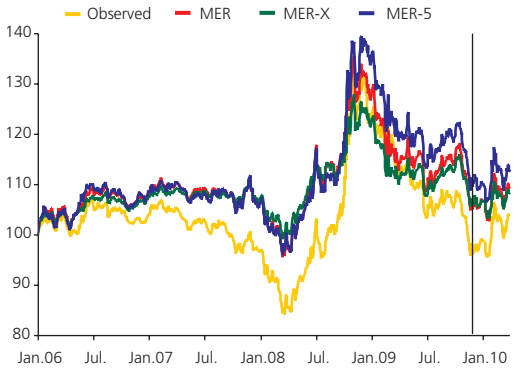


Source: Superintendence of Banks and Financial Institutions (SBIF).

Figure II.8

Nominal exchange rate (*)

(index 02.Jan.2006=100)



(*) Vertical line indicates the statistical closing date of the December 2009 *Monetary Policy Report.*

Source: Central Bank of Chile.

are uncertain. With regard to the approval of new loans, especially in the most affected areas, banks may undertake a more thorough assessment of the value of clients' assets and constitute greater loan loss provisions. Moreover, the loss of wealth resulting from the catastrophe could lead people to make important changes in their spending and debt decisions. To contextualize these effects, note that financial system loans in the Sixth, Seventh, and Eighth regions represented almost 9% of the total for the country in 2009. In the same period, Santiago Metropolitan Region and the Fifth Region accounted for 74% and 5%, respectively (figure II.7).

In the week following the earthquake, the local stock market fell 3.0% in pesos and 1.5% in dollars, but the drop was fully recovered by the close of this *Report*. All told, the IPSA rose 11% relative to the close of the December *Report*, or 3.8% measured in dollars. In the same period, the Latin American stock exchanges fell 1.6%, while the world stock exchanges increased 3.1%, in dollars, on aggregate.

In the first two months of the year, M1 continued to follow the growth trend that characterized it in 2009, consistent with the monetary stimulus. Its annual growth rate in February was almost 34%, although the velocity of increase continued to slow. The broader aggregates grew somewhat more than in December: M2 and M3 increased 1.8% and 4.0% in annual terms, respectively, in February.

Exchange rate

The peso has fluctuated considerably and is currently 5.9% above the level in the December *Report* (based on the average of the ten business days prior to the close of the respective *Reports*). The nominal exchange rate fluctuated substantially in this period, partly due to global phenomena and partly to local factors (figure II.8).

After the close of the December *Report*, the peso continued to appreciate in the first half of January, reaching $490 to the dollar. This was the continuation of a process that started in early October and was largely due to a global

Figure II.9

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

(*) Includes data for February 2010.

Source: Central Bank of Chile.

Table II.2

Observed, multilateral, and real exchange rates (1)
(Observed: pesos to the U.S. dollar, monthly average; MER and MER-X: 02.Jan.1998=100; RER: 1986=100)

	Observed	MER	MER-X	RER
Jan.09	623.01	120.86	115.36	103.02
Feb.09	606.00	115.28	109.49	98.36
Mar.09	592.93	112.16	106.38	94.70
Apr.09	583.18	112.21	106.89	95.83
May 09	565.72	111.25	106.55	95.30
Jun.09	553.08	110.01	105.68	95.11
Jul.09	540.42	107.74	103.55	93.76
Aug.09	546.88	110.22	106.23	96.78
Sept.09	549.07	111.45	107.61	96.33
Oct.09	545.83	112.26	108.74	97.30
Nov.09	507.78	104.73	101.52	91.73
Dec.09	501.45	102.97	99.71	90.78
Jan.10	500.66	101.34	97.92	88.97
Feb.10	532.56	106.20	102.23	93.12
Mar.10 (2)	522.58	104.64	100.15	

(1) See glossary for definition.
(2) Average as of 29 March.

Source: Central Bank of Chile.

depreciation of the U.S. currency. In late January and early February, the peso depreciated sharply, peaking at $550 to the dollar (on 5 February). This was partly the result of factors common to all economies. In particular, uncertainty about the resolution of fiscal deficits in certain European economies caused considerable tension in the financial markets and triggered a flight to quality. Local factors also played a role, including changes in the hedging decisions of the Pension Fund Administrators (AFPs).

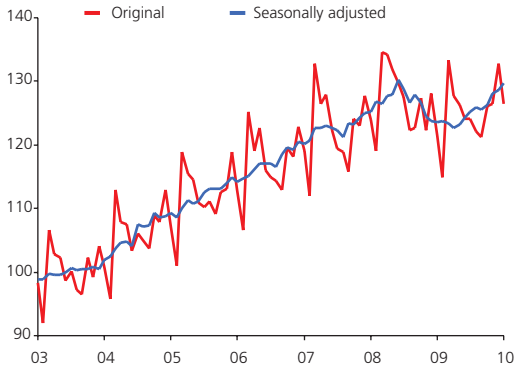
The relatively low uncertainty in the international financial markets largely explained the appreciation trend seen in the second half of February. In the local market, the AFPs had reduced their foreign currency hedging position. After the earthquake and tsunami, the peso experienced new fluctuations in the face of private expectations on how the reconstruction will be financed, the flow of insurance payments, the effect of the catastrophe on the current account, and the recovery of the value of the dollar at the international level.

The importance of certain idiosyncratic factors is seen in the fact that multilateral indicators such as the MER and the MER-5 recorded smaller fluctuations than the peso-dollar exchange rate: 2.6 and 1.9%, respectively. Considering the level of the nominal exchange rate and currency parities in the ten days prior to the close of this *Report*, the real exchange rate (RER) is around 92 (using 1986=100). This is 1.2% higher than at the close of the December *Report* (table II.2 and figure II.9). A methodological assumption is that in the long term, the RER will be similar to the levels observed in the two weeks prior to the close of this *Report*.

III. Demand and Output

Figure III.1

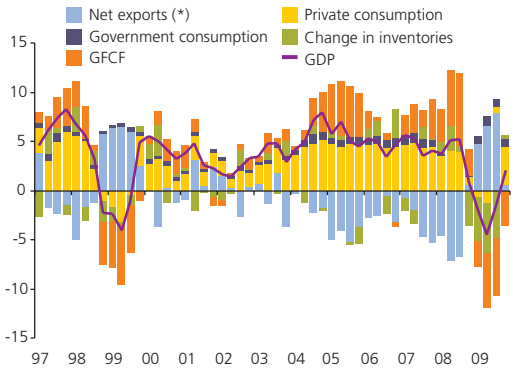
Monthly indicator of economic activity (Imacec)
(index 2003=100)



Source: Central Bank of Chile.

Figure III.2

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



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

Source: Central Bank of Chile.

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

Aggregate demand

The earthquake and tsunami have important macroeconomic consequences. The immediate disruptive effects of the catastrophe can be expected to translate into lower output levels and higher inflation in the very short term. Its size depends, among other factors, on the share in national GDP of the most affected regions, the sectoral composition of production by region, and the downtime of productive processes. In the medium term, the macroeconomic scenario will be determined by the evolution of productive capacity and the magnitude, composition, time period, sources of financing, and focus of the reconstruction efforts. The timing and speed with which they are implemented will be important factors in determining the form the reconstruction takes. Moreover, the destroyed capital will probably be replaced with a more efficient one, which will raise productivity. The process of rebuilding lost wealth will probably also have effects on consumption.

The baseline scenario in this *Report* projects that the Chilean economy will grow between 4.25 and 5.25% in 2010. This range is somewhat lower than the forecast in December. The downward revision of the growth scenario for this year is based on the assumption that the immediate effects of the catastrophe on output will dominate the increase from the reconstruction efforts.

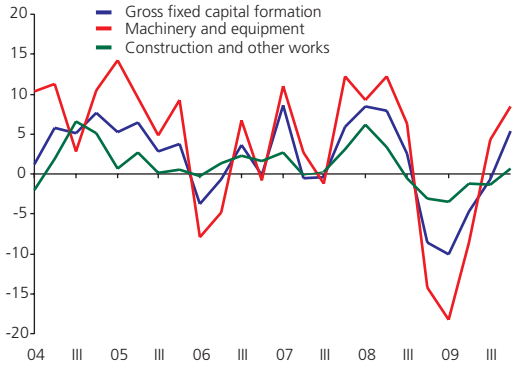
The assessment of the changes in the macroeconomic scenario takes several factors into account. Data for the period before the earthquake and tsunami show that output and demand grew at a faster rate than projected in the December *Report*. GDP contracted 1.5% in 2009. In the fourth quarter of that year, however, it grew 2.1% in annual terms, with a 5.9% expansion rate following on a 6.6% rate in the third quarter. Moreover, the Imacec was higher than expected in January (4.2% annually and 1.0% in seasonally adjusted terms) (figure III.1). Thus, both the close of 2009 and more recent data indicate that the output gap was closing faster than projected in December.

[1]/ In accordance with the policy on the regular disclosure of the Quarterly National Accounts, year-end GDP for 2009 and revised 2007 and 2008 data were published on 18 March.

Figure III.3

Gross fixed capital formation (GFCF) (*)

(quarterly change, percent)



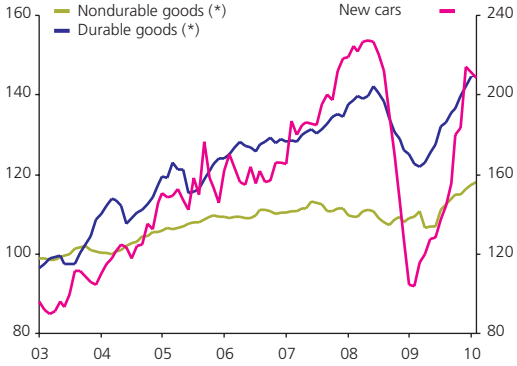
(*) Seasonally adjusted series.

Source: Central Bank of Chile.

Figure III.4

Retail sales and new car sales

(indices 2003=100, seasonally adjusted series)

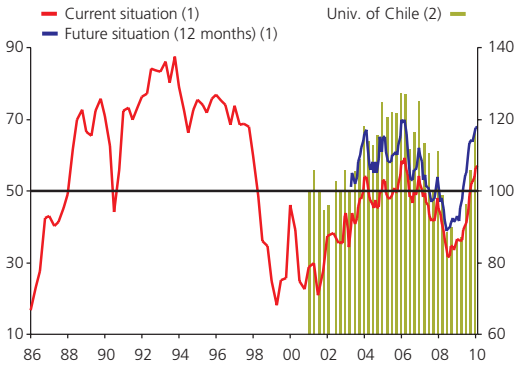


(*) Sold in the moving quarter.

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

Figure III.5

Consumer perception indices



(1) IPEC: a value over (under) 50 points indicates optimism (pessimism). Before January 2003, the index was quarterly; after that date, it is published monthly.
(2) Index March 2001 = 100.

Sources: Adimark and University of Chile.

In the fourth quarter of 2009, domestic demand grew 1.4% in annual terms. When inventory changes are removed, annual growth was 1%, with an expansion velocity near to 14% (figure III.2). Key factors in this trend include the increase in private consumption and the recovery of gross fixed capital formation. Consumption expanded at a velocity close to 10% in the third and fourth quarters of 2009. Gross fixed capital formation contracted significantly during the crisis. However, in the fourth quarter of 2009, it already grew relative to the previous quarter, after contracting for four consecutive quarters. Machinery and equipment—the most strongly affected component during the crisis—grew over 8% in the last quarter of 2009, relative to the previous quarter (figure III.3). Until the last *Report*, it was difficult to explain the difference in the magnitude of the inventory drawdown process in Chile relative to other economies with similar characteristics. The closing of the National Accounts indicates that the fall in inventories was equivalent to 2.4 points of GDP in 2009, which is well below the 4.3 points of GDP estimated in December. This reduces the anomaly to a large extent.

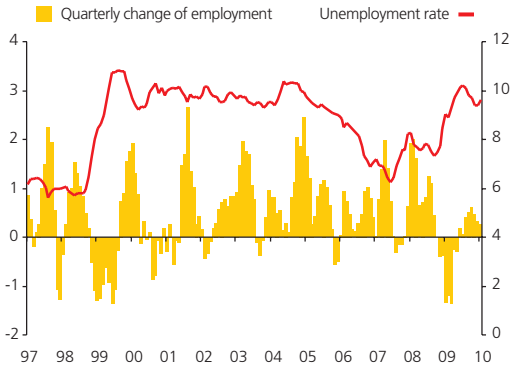
The current account of the balance of payments recorded a bigger surplus than projected in December, reaching US$4.217 billion, which is equivalent to 2.6% of 2009 GDP. This is a reflection of the higher exports and lower rents abroad than estimated at that time, which were partially offset by lower transfers.

Several indicators for 2010 point to a consolidation of the consumption trend in the period before the earthquake. This component of demand continued to show signs of a more dynamic performance than projected in the December *Report*. Retail sales of both durable and nondurable goods far exceeded the levels recorded before the crisis, while new car sales approached the levels of the first half of 2008 (figure III.4). Other indicators suggest that this consumption trend will continue. Consumer perspectives, measured through the Economic Perception Index (*Índice de Percepción de la Economía*, or IPEC), are substantially above the neutral level and close to the peak of the decade, recorded in 2006. In particular, consumers expressed a positive outlook for the country twelve months out and a perception that this is a good time to buy household items. The University of Chile's survey captured similar improvements (figure III.5). A second indication was the shift in the labor market. Although the seasonally adjusted unemployment rate was 9.6% in the quarter ending in January, the labor market has posted increases in employment for eight consecutive months (figure III.6). There was also a recomposition by job category: wage labor increased in seasonally adjusted terms, while self-employment slowly fell. In February, the employment outlook captured in the Monthly Business Confidence Index (*Indicador Mensual de Confianza Empresarial*, or IMCE) was also well above the neutral level in the aggregate. Another important factor was the growth of real household income. Finally, financial conditions are in the process of normalizing, which was reflected in an increase in consumer and business loans. This is also captured in the Bank Lending Survey for the fourth quarter of 2009, in which the majority of institutions surveyed reported a loosening of lending conditions and a strengthening of the demand for credit.

Figure III.6

Labor market indicators (*)

(percent)



(*) Seasonally adjusted series.

Sources: Central Bank of Chile and National Statistics Bureau.

Figure III.7

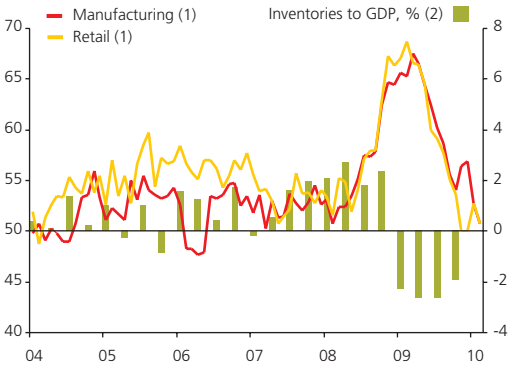
Capital goods imports

(US$ million accrued per quarter, seasonally adjusted series)

Source: Central Bank of Chile.

Figure III.8

Current situation of inventories



(1) A value over (under) 50 points indicates that the inventory level is too high (low).
(2) Seasonally adjusted quarterly series.

Sources: Central Bank of Chile and Icare/ Adolfo Ibáñez University.

The favorable outlook for investment continued to solidify, according to the available data in early 2010. Capital goods imports continued to recover in levels (figure III.7). Although the survey carried out by the Capital Goods and Technological Development Corporation (*Corporación de Desarrollo Tecnológico y de Bienes de Capital*, CBC) contained a downward adjustment to investment in 2009–2010 (primarily due to the rescheduling of projects in the energy sector), it revealed an increase in projects for the next two-year period. Housing construction did not show a clear trend of increased activity before the earthquake and tsunami, although sales were somewhat more dynamic. Recent indicators such as sales of cement and construction materials and the Monthly Construction Activity Index (*Índice Mensual de la Actividad de la Construcción*, or Imacon) were relatively flat in seasonally adjusted terms. The construction component of the IMCE, although rising, continued to be below the neutral level. With regard to inventories, the most recent evidence, such as the inventory indicator in the IMCE and the gap between manufacturing production and sales, revealed that the drawdown process has ended (figure III.8).

In terms of the value of exports, the seasonally adjusted data for February were at levels similar to mid-2008. This mainly reflected the performance of mining exports, which continued to benefit from the high copper price and the recovery of copper production. Manufacturing exports were also more dynamic, which is consistent with the recovery of output in the sector, particularly in segments tied to investment.

Thus, until late February the local context shows a scenario with a lower output gap and more dynamic demand and output than projected in the December *Report* (box: Changes in the macroeconomic scenario between December and February). In this context, the catasphofe struck at end of February, whose effects on the macroeconomic scenario are relevant for the conduct of monetary policy.

In the short term, the baseline scenario of this *Report* considers a disruption in production in the most affected regions: the Sixth, Seventh, and Eighth. The greatest impact occurs in March and then gradually dilutes. For June normalization is supposed. The most affected productive area is manufacturing, given its relative importance in these regions. Overall, the effect of the earthquake and tsunami on annual GDP growth is estimated to be a contraction of about 3 and 2 percentage points of less growth in the first and second quarters of this year, respectively.

The usual economic statistics for March may provide a better approximation of the shorter-term effects of the earthquake and tsunami. However, a precise statistical reading of these data is complex, in part because of the difficulties and delays in collecting the data on which the official statistics are based. Problems have already been encountered in gathering information for February, which took place in March.

With regard to the short-term impact on exports, the Eighth Region accounted for just over 9% of shipments during 2009. The majority of these are manufacturing exports, in particular products such as pulp, wood and its derivatives, and fishmeal. The evolution of factors such as the destruction of installed capacity and of export distribution channels will determine the immediate effect on the volume of exports. The prices

of some of these products are high, and some companies have reported that their insurance will pay compensation for lost profits, which will attenuate the economic costs of the work stoppage. Another consideration is that the reconstruction could trigger an increase in domestic demand for wood and steel products. The fishing industry—in particular segments related to fishmeal production—could also see losses in output as a result of difficulties in resuming the extraction and processing of ocean resources. Seasonally adjusted weekly export data show that manufacturing shipments fell significantly in the first days of March, but they recovered considerably in the second week.

Consumption will probably be negatively affected by the restoration of wealth that will have to take place. In addition, consumption could be restructured in favor of the durable component, which will also depend on access to the financial markets. Changes in consumer expectations will shed some light on the size of this phenomenon. With regard to the labor market, evidence from past episodes suggests that in the most immediate term, employment could fall in response to the initial drop in GDP. Several indicators point to a loss of jobs in firms that have had to suspend their operations due to the destruction of their facilities. However, the reconstruction can be expected to drive employment, especially in construction.

The effect of the earthquake and tsunami on financial conditions, another determinant of consumption, is not clear. The available data indicate that banks initially granted a number of benefits to debtors, at least for March. The duration and reach of these benefits are uncertain.

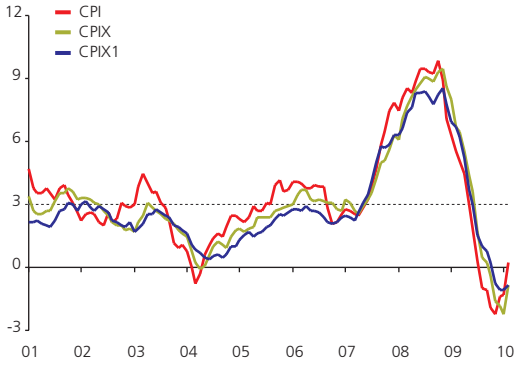
The replacement of the destroyed capital stock will be facilitated by the fact that the marginal productivity of new capital is higher. Moreover, a share of the capital stock losses is covered by insurance. In the case of the public sector, based on announcements by the Administration, the baseline scenario considers that the structural deficit in 2009 was 1.2% of GDP and that the structural balance will reach through the end of the current administration. Budgetary reallocations will come to US$700 million this year, while the process of rebuilding the destroyed public infrastructure will be divided over four years. As a working assumption, the Board considers that the financing of the public and private reconstruction efforts will be balanced among the different sources.

IV. Prices and costs

Figure IV.1

CPI, CPIX, and CPIX1 inflation (*)

(annual change, percent)



(*) See glossary for definition.

Source: National Statistics Bureau.

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 first two months of 2010, annual CPI inflation exceeded the forecast in the December *Monetary Policy Report* , which projected that inflation would become positive over the course of the first half. That happened sooner than expected: in February 2010, annual CPI inflation was 0.3% (table IV.1 and figure IV.1).

Table IV.1

Inflation indicators (*)

(annual change, percent)

		CPI	CPIX	CPIX1	CPIX1 excluding foods	CPI excluding foods and energy	CPIT	CPINT	CPIG	CPIS
2009	Jan.	6.3	8.0	6.9	4.4	5.8	1.7	11.0	4.2	9.6
	Feb.	5.5	6.7	6.7	4.7	5.2	2.4	8.6	4.6	7.4
	Mar.	5.0	6.5	6.2	4.7	5.2	2.1	8.0	3.8	7.3
	Apr.	4.5	5.5	5.3	4.4	4.8	1.6	8.6	2.8	7.2
	May	3.0	4.4	3.7	3.0	3.5	-0.8	8.0	0.5	6.7
	Jun.	1.9	3.6	3.0	2.4	2.8	-2.4	7.6	-1.2	6.1
	Jul.	0.3	1.7	1.5	0.9	1.4	-4.0	7.0	-2.8	4.6
	Aug.	-1.0	0.4	1.0	0.5	0.8	-5.1	6.4	-3.7	2.7
	Sept.	-1.1	0.2	0.8	0.3	0.3	-5.3	4.9	-3.9	2.8
	Oct.	-1.9	-0.4	0.2	-0.4	-0.4	-5.9	3.1	-5.0	2.2
	Nov.	-2.3	-1.6	-0.7	-1.2	-1.6	-4.7	0.3	-4.4	0.8
	Dec.	-1.4	-1.8	-1.1	-1.5	-1.9	-3.4	0.5	-2.7	0.2
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

(*) See glossary for definition.

Sources: Central Bank of Chile e National Statistics Bureau.

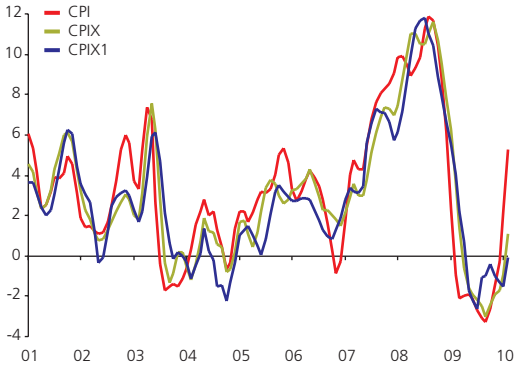
In January of this year, the INE modified the CPI measure. This methodological change had mainly effects in two areas. First, the base year was changed from December 2008=100 to the average of 2009=100. Second, the geographical coverage was expanded from Santiago, Puente Alto, and San Bernardo to the national level. The new CPI also incorporates several marginal changes in the products that make up the basket and their weights, and it redesigns the price collection procedure[1]/.

[1]/ For more detail, see National Statistics Bureau (2010a).

Figure IV.2

Expansion velocity of monthly inflation (*)

(percent)



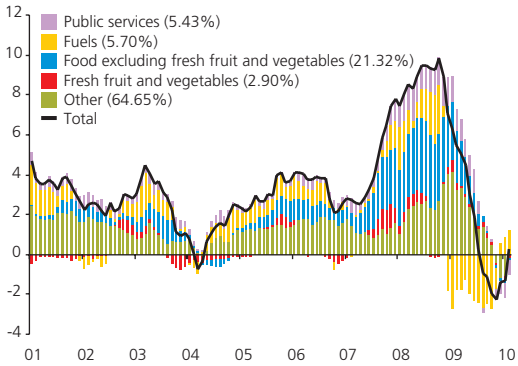
(*) See glossary for definition.

Sources: Central Bank of Chile e National Statistics Bureau.

Figure IV.3

Contribution to annual CPI inflation (*)

(percentage points)



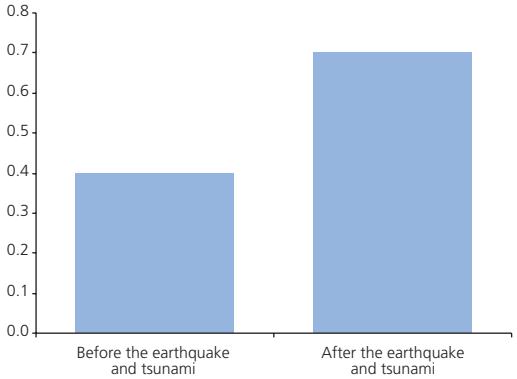
(*) Shares in the 2009 CPI basket (annual base index) are in parentheses. The 2001–2008 period uses the weights in the December 1998 basket. For 2009, the December 2008 basket is used.

Sources: Central Bank of Chile and National Statistics Bureau.

Figure IV.4

Inflation expectations for March 2010

(monthly change, percent)



Source: Market analyst reports.

So far this year, inflation data have been released for January and February. In the first month of the year, CPI inflation showed the largest difference with the earlier forecast. In January, the monthly CPI inflation changed 0.5%, whereas market estimates on average pointed to a change of –0.1%. The unexpected increase in the CPI is largely explained by the increase in financing costs (+0.8 percentage point in the January CPI), including the increase in the stamp tax. Although this latter increase was known in advance, methodological factors associated with the change in the basket amplified the contribution of this component to the CPI[2]/. The monthly and annual increase in the CPIX were also affected by the change in the tax, among other elements, reaching –0.8% in February (versus –1.6% in November).

Thus far, the remaining CPI components have not shown relevant changes in their levels or trends that can be attributed to the new measurement. In fact, a first assessment of the impact of the methodological change on the CPI does not show a change in the inflation trend. The annual change in the CPIX1—which excludes financial costs—continues to be negative: –0.9% in February. Nevertheless, the change in the CPI measure could still have significant new effects on inflation. However, it is impossible to predict their sign and magnitude.

In terms of the expansion velocity, the CPI and CPIX both registered a relevant increase at the start of the year, with the former posting figures on the order of 5% annually. The CPIX1 continues to expand at a negative rate (figure IV.2). With regard to the annual CPI change, fuel prices once again made a positive contribution, largely due to the low basis for comparison in the same period of 2009 (figure IV.3).

At the statistical closing date of this *Report*, inflation data were not available for March. This will provide a first approximation of the shorter-term effects of the catastrophe. In principal, problems can be expected in terms of the availability of some goods due to disruptions in production processes or distribution, triggering price increases that should largely be transitory. The ultimate size of the effect is highly uncertain. The problems caused by the natural disaster make it difficult to obtain information. INE announced that from March until the situation returns to normal, it will not collect price data in the Maule and Biobío regions, but rather will consider the price changes collected in the central macro-area. Inflation expectations for March captured in market opinions in the days following the catastrophe assume that prices will increase (figure IV.4).

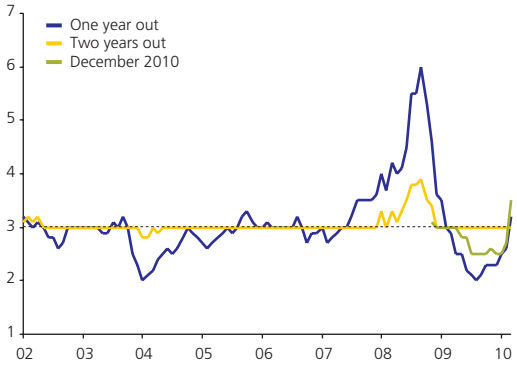
The baseline scenario of this considers that the immediate effects of the catastrophe will be concentrated in an increase in food prices. This effect will be seen in both perishables and nonperishables, and it will affect all the CPI indicators, although the impact on the CPIX and CPIX1 will certainly be smaller. In addition, the working assumption used in this *Report* is that the impact of rising price levels will largely be concentrated in March and, to a much lesser degree, in April. The effect will be reversed, at least in part, in May and June. Thus, the immediate effect of the earthquake and tsunami on

[2]/ On one hand, the weight of this product in the basket increased from 1.6% to 1.9%, and on the other hand the change in the base year from monthly to annual meant that the incidence of the increase was greater.

Figure IV.5

EES: inflation expectations

(percent)



Source: Central Bank of Chile.

Figure IV.6

Average forward inflation compensation based on swap rates

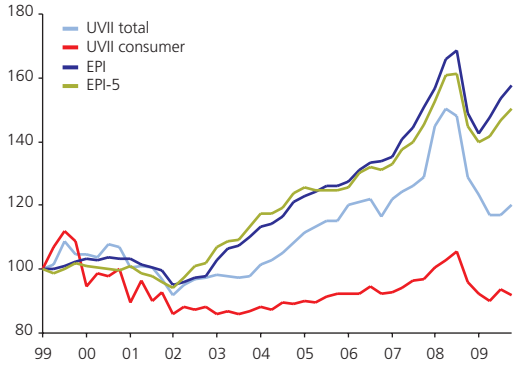
(weekly moving average, percent)

Source: Central Bank of Chile.

Figure IV.7

External inflation (*)

(index 1999:I=100)



(*) See glossary for definition.

Source: Central Bank of Chile.

inflation might not be felt beyond the end of the second quarter of this year. However, this scenario is subject to an extended degree of uncertainty.

The baseline scenario thus projects that annual CPI inflation will return to levels around 3% by mid-year. In addition to the effects of the events in late February and the usual inflation dynamics, there will be upward effects from the reestablishment of the fuel tax in late March and a new increase in the stamp tax around mid-year. The decreed increase in Transantiago tariffs will have marginal effects on the CPI, because it will be offset by decreases in tariffs in other regional capitals. Nevertheless, given the timing of the changes, inflation will fluctuate in March, April, and May.

Inflation expectations

Medium-term inflation expectations remain in line with the 3% inflation target. The results from the Economic Expectations Survey (EES) continue to indicate that inflation will be 3% two years ahead (figure IV.5). For shorter horizons, inflation expectations have increased, especially after the catastrophe. The inflation forecast for December of this year rose from a range of 2.5 to 2.7% between July 2009 and February 2010 to an estimate of 3.5% in March. The change in private expectations is similar one year ahead. Break even inflation at different maturities, as deduced from financial asset prices, continued to be highly volatile in the first two months of the year. However, they also increased for the short term in March. In the medium term they recorded much smaller changes (figure IV.6).

Cost pressures

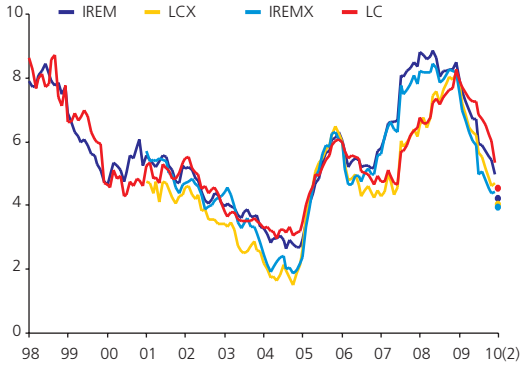
With regard to imported cost pressures, commodity prices have continued to rise in world markets. In the ten business days prior to the statistical closing date of this *Report*, the WTI oil price was over US$80 a barrel. This value is 12% higher compared to the same period considered in the December *Report*. In the baseline scenario, petroleum prices will average US$82 in 2010 and US$85 in 2011, both of which are somewhat higher than foreseen in December *Report*. On the contrary, food prices fell in the period, especially in the case of rice. Total import prices rose in the last quarter of 2009, mainly because of the price of oil imports. Consumer import prices reversed some of the increase recorded in the third quarter. Also, the external inflation relevant for the Chilean economy continued to increase in annual terms, becoming positive again in the last quarter of 2009 (figure IV.7).

The peso fluctuated substantially, ending the period at a 5.9% higher level than in the December *Report* (based on the ten business days prior to the close of each *Report*). The nominal exchange rate has fluctuated considerably in this period, partly as a result of a global phenomenon, but an important part has been in response to local factors. The importance of certain idiosyncratic factors is seen in the fact that multilateral indicators such as the MER and the MER-5 recorded smaller fluctuations than the peso-dollar exchange rate: 2.6 and 1.9%, respectively. However, considering the level of the nominal exchange rate and currency parities prevailing at the statistical closing of this *Report*, the RER is at levels consistent with its long-term fundamentals. The baseline scenario assumes that in the long run, the RER will not differ largely from the levels observed in the two weeks prior to the statistical closing of this *Report*.

Figure IV.8

Nominal wages (1)

(annual change, percent)



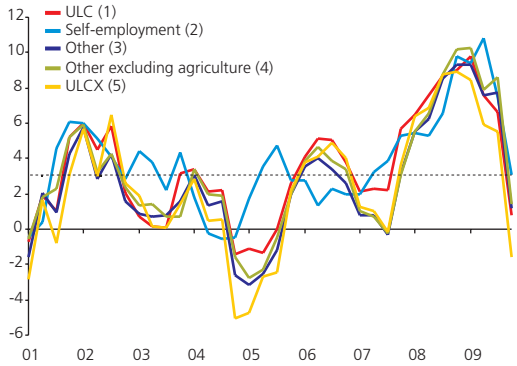
(1) See glossary for definition.
(2) Starting in January, the new indices use an annual base index (2009=100).

Sources: Central Bank of Chile e National Statistics Bureau.

Figure IV.9

Unit labor costs

(annual change, percent)



(1) Includes total nominal labor costs, real waged hours worked, wage employment, and total GDP.
(2) Same as Total, but replaces wage employment with national employment.
(3) Includes other labor costs, other wage employment, other GDP (excluding EGW, mining, and fishing), and real waged hours worked.
(4) Same as Other, but excluding the agricultural sector from other wage employment and from other GDP.
(5) See glossary for definition.

Sources: Central Bank of Chile e National Statistics Bureau.

The producer price index (PPI), which only considers domestic goods and services prices, continued to increase in annual terms, becoming positive again at the start of the year. In February, its annual increase was 10.4% (versus –7.4% en November). The performance of the annual PPI change is largely explained by intermediate goods, where the annual increase in fuel prices plays an important role. The wholesale price index (WPI), which includes imported and domestic goods prices, shifted from a contraction of 15.7% to a drop of 8.1% between November and February. The three-month outlook for costs, as captured in the IMCE business survey, increased in February to 68 points, after holding steady at 62 points since last November. A similar trend is seen in the twelve-month inflation outlook, which rose from 2.5 to 2.8% in the same period.

Wages

Cost pressures from the labor market have not changed much in the past few months. Notably, however, is the change that the INE made in its methodology for measuring wages in January 2010. It considers changes in the structure of weights in the index, the calculation model and the base year from a one of monthly to an annual. In addition, the sample size was also increased for each activity to improve the representativeness of the country's productive structure[3]/. Based on the new available data, the annual growth rate of nominal wages was around 0.8 percentage point lower than previously calculated (figure IV.8). The baseline scenario assumes that labor costs will not contribute additional inflationary pressures to the economy and that the annual growth rate of nominal wages will continue to fall, in line with the recent and expected inflation trend and with the cyclical conditions in the labor market.

Unit labor costs (ULC) recorded annual growth rates of between –1.3 and 3.0% in December 2009. In the last quarter of the year, the ULC continued to reduce its growth rate relative to the preceding quarters, and even decreased in the case of the ULCX (figure IV.9).

[3]/ For more detail, see National Statistics Bureau (INE) (2010b).

Box IV.1: Evolution of inflation in Chile in the 2007–2009 period

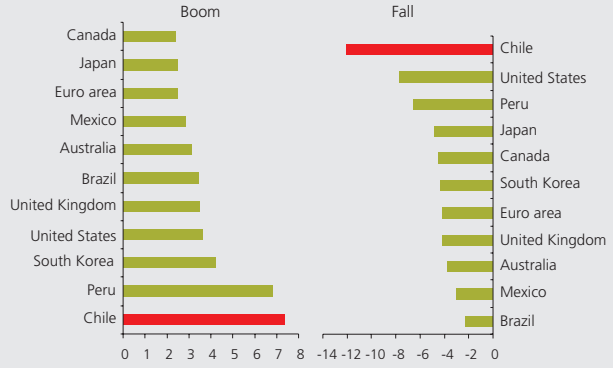
Inflation underwent sharp changes worldwide in the three-year period from 2007 to 2009. The strong increase in commodity prices, especially foods and oil, triggered a marked acceleration of inflation in a large group of economies and caused a rising concern for the inflation problem over the course of 2008. Thereafter, the detonation of the financial crisis in the developed markets and the subsequent crisis of confidence generated a significant drop in commodity prices and an expansion of output gaps that led to an unusually fast drop in world inflation.

In Chile, these phenomena were especially intense. Both the rise and fall of total inflation in Chile were among the sharpest in a large sample of economies (figure IV.10). This box sheds some light on the factors that explain the difference in the behavior of inflation in Chile and the rest of the world.

Figure IV.10

International comparison of total inflation in the boom and bust periods (*)

(percentage points)



(*) The increase is the difference between the minimum annual inflation in 2007 and the peak in 2008. The decrease is the difference between the peak in 2008 and inflation in December 2009.

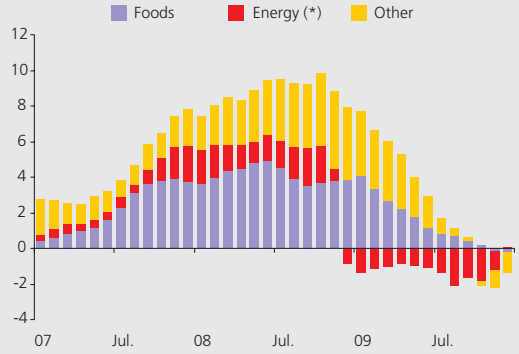
Source: Central Bank of Chile.

The increase in inflation in Chile in 2007 and 2008 had an important global component.[1]/ The contribution of food and fuel prices to inflation grew substantially in those years, with an average contribution of 4 percentage points (figure IV.11). The role of these prices in inflation grew in a number of economies. However, Chile also experienced a strong idiosyncratic shock. The drought and the problems with the supply of Argentine natural gas forced the utilization of less efficient and more expensive alternative energy sources, at a time when the price of oil and its derivatives was rising sharply. This caused a significant hike in energy costs. To illustrate, representative electricity rates—which are considered in the CPI—rose more than 50% between January 2007 and December 2008. The effects of the higher energy costs not only had an immediate impact on the CPI, but also affected the productive capacity of the economy and medium-term inflation dynamics[2]/.

Figure IV.11

Decomposition of total inflation in Chile

(contribution to total inflation, percent)



(*) Includes fuels and electricity.

Source: Central Bank of Chile.

Given these domestic and external factors, one thing that differentiates the behavior of inflation dynamics in Chile vis-à-vis the rest of the world is that the sharp rise and fall in total inflation was replicated in core inflation, which was quite unique to Chile (figure IV.12).

The question that naturally arises, then, is what factors can explain why both total and core inflation increased and fell so sharply in Chile. Factors such as the size of the shock, its degree of pass-through to the local economy (in the case of external shocks) or its persistence could have affected the other prices in the economy. Especially, if the price formation process of the economic agents begin to consider that due to these shocks there are permanent changes in the price level.

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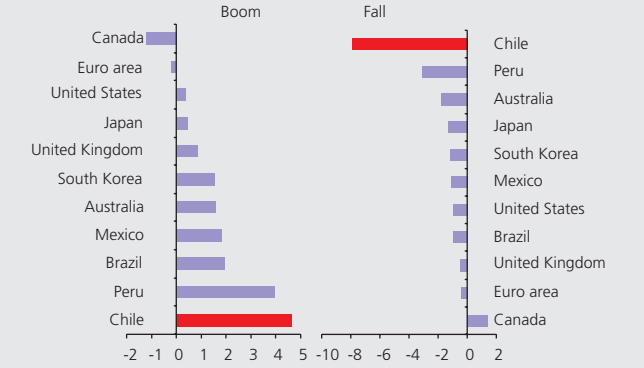
[1]/ For details, see box I.2: "The response of inflation in the current cycle," *Monetary Policy Report*, May 2009, page 22.

[2]/ For details on the impact of energy costs on real and trend GDP, see box V.1: "Energy costs and productivity," *Monetary Policy Report*, December 2009, page 34; box VI.1: "Trend GDP and energy cost increase," *Monetary Policy Report*, May 2008, page 50; box V.2: "Energy costs," *Monetary Policy Report*, September 2008, pages 39 and 40 and box IV.1: "Quantification of the higher cost of energy and its impact on activity," *Monetary Policy Report*, January 2007, pages 40 and 41.

Figure IV.12

International comparison of core inflation in the boom and bust periods (*)

(percentage points)



(*)The increase is the difference between the minimum annual inflation in 2007 and the peak in 2008. The decrease is the difference between the peak in 2008 and inflation in December 2009.

Source: Central Bank of Chile.

As mentioned, a common factor in the rising inflation worldwide was the increase in food and fuel prices. A first task is to determine the degree of pass-through from these shocks to domestic prices. Factors such as the weight of the affected goods in the consumption basket, any associated price controls, or exchange rate dynamics could determine the impact on local inflation. Pistelli and Riquelme (2010), based on an analysis of core, food, and energy inflation of a sample of countries, find that structural factors such as differences in price levels and local price regulation are significant for explaining the divergence between Chile and the rest of the world in the behavior of food and fuel inflation. According to the authors, between 2007 and 2008, approximately half of the difference in the increase in food inflation in Chile versus the chosen sample of countries is explained by these factors. Rigobon (2009) reviews the effect on domestic inflation of permanent shocks in commodity prices in external markets, measured in local currency. Including Chile, the results indicate that for the case of oil and fuels, the pass-through is lower in developed countries than in developing economies. Also, he further concludes that the pass-through of this shock to electricity and food prices is fairly heterogeneous. The pass-through of food prices—characterized by a permanent shock to the wheat price—is somewhat greater in developing economies. For Chile, he finds that the pass-through is fast and significant, but not very persistent over time.[3]/ The degree of pass-through for the Chilean economy increases when particular products are considered apart from total inflation, such as bread, cereals, and flour prices.

A second factor that might explain the local inflation dynamics is the degree of propagation of inflationary shocks. For the third quarter of 2008, the Board considered that increased inflation, which had been especially sharp over the course of that year, had triggered changes in the propagation of shocks to other prices. Factors such as stronger domestic and external cost pressures, an economy that at the time was operating with little excess capacity and a strongly growing domestic demand could be determining that result.[4]/ This assessment is supported by Pincheira (2009) with regard to persistence. He finds that the average duration of an inflationary shock has increased in the last few years. Thus, while the half-life of these shocks was 50 months in 2006 and 2007, it practically doubled in 2008 and then fell to around 70 months in 2009.

Céspedes et al. (2009) analyze the relevance of food and energy shocks for inflation. The authors estimate that in the period of rising inflation, the increase in core inflation mainly stemmed from the food and energy component. According to the authors, however, in the period of falling inflation, the output gap and the real exchange rate played an important role in the core inflation dynamics. This latter finding is not entirely unexpected, given the changes in the macroeconomic scenario following the detonation of the financial crisis in the developed economies. In a complementary study, Pedersen (2010) shows that in Chile, the duration and pass-through of a shock to food and energy prices to other prices is greater than in other economies.

In sum, the evidence indicates that during the period in which total and core inflation were rising sharply in Chile, inflation propagation and persistence increased substantially. It is possible that structural differences in the local goods markets explain a significant part of the pass-through of the food and fuel price shock in external markets to the local market. The results also indicate that during the period of declining inflation in 2009, the drop in energy prices initially dominated, followed increasingly by the evolution of fundamentals such as the size of the gaps and the real exchange rate. It can not be ruled out that the sharp increase and subsequent drop in expected inflation may also have contributed to these inflation fluctuations.

[3]/ For more detail, see box I.3: "Food prices and their impact on inflation: an international comparison," *Monetary Policy Report*, January 2008, pages 27 and 28.

[4]/ Box V.3: "Inflation propagation," *Monetary Policy Report*, September 2008, page 41 and 42.

V. Inflation scenarios

Table V.1

World growth (*)

(annual change, percent)

	Ave. 90-99	Ave. 00-07	2008	2009 (e)	2010 (f)	2011 (f)
World at PPP	2.9	4.2	3.0	-0.6	4.3	4.4
World at market exchange rate	2.4	3.2	1.9	-1.7	3.5	3.5
United States	3.2	2.6	0.4	-2.4	3.1	3.0
Euro area	2.2	2.1	0.6	-4.1	1.1	1.5
Japan	1.5	1.7	-1.2	-5.2	1.9	1.6
China	10.0	10.1	9.6	8.7	9.9	9.1
Rest of Asia	5.5	5.0	2.9	0.0	5.1	4.8
Latin America	2.7	3.6	4.2	-2.5	4.1	3.7
Commodities exports	2.7	3.1	1.1	-1.2	3.0	3.3
Trading partners	3.1	3.6	3.0	-0.8	4.0	3.8

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

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

Table V.2

World inflation

(average annual change in local currency, percent)

	Ave. 90-99	Ave. 00-08	2009	2010 (f)	2011 (f)
United States	3.0	2.9	-0.3	2.2	2.0
Euro area	2.3	2.3	0.3	1.1	1.4
Japan	1.2	-0.1	-1.3	-1.1	-0.4
China	7.8	2.2	-0.7	2.9	3.3
Australia	2.5	3.3	1.8	2.5	2.7
New Zealand	2.1	2.7	2.1	2.0	2.6
Argentina	253.7	8.9	6.2	9.7	10.1
Brazil	854.8	7.1	4.9	4.8	4.7
Mexico	20.4	5.2	5.3	5.2	3.9
EPI (*)	1.8	5.4	-6.1	3.7	3.0
LPI (*)	27.2	5.6	-1.5	3.0	3.6

(*) See glossary for definition.
(f) Forecast.

Source: Central Bank of Chile based on Consensus Forecasts and the International Monetary Fund.

This chapter presents the Board's assessment on the Chilean economic outlook over the next two years, including the analysis and decision of the Monetary Policy Meeting held on 18 March 2010. Projections are presented of the most likely inflation and growth trajectories, conditional to 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 past few months were marked by the improved world economy, the stronger dynamism of output and demand, and the effects of the earthquake and tsunami at the end of February. Given the magnitude of these developments, this *Report* features a box containing a forecasting exercise that includes international occurrences and the economic scenario evaluation up to 27 February.

External scenario

The external scenario continued to improve in recent months. The last quarter of 2009 posted higher growth than projected in most economies, and projections for 2010 and 2011 have been revised up again. The world economy is forecast to grow 4.3% this year and marginally more in 2011. Chile's trading partners will post somewhat smaller y-o-y growth rates. China will continue with y-o-y increases of 9%-10% and U.S. GDP will expectedly grow by around 3% annually. The euro area, although showing great dispersion across its members, will grow by an average 1.3% in 2010 and 2011 (table V.1).

The improved outlook for the world economy has explained an important part of the price hike of many commodities. At the statistical closing of this *Report*, copper was near US$3.5 per pound LME, which compares favorably with its December forecast. WTI oil is somewhat above US$80 per barrel, also outperforming its price in the previous *Report*. In the baseline scenario, assuming a normalization towards long-term prices, copper will average US$3.10 per pound this year and US$2.90 next year. The oil price, based on futures contracts over the ten days prior to the statistical closing, is assumed to average US$82 and US$85, respectively, in 2010 and 2011. Thus, the terms of trade will rise by 12.5% this year and drop by 5.6% next year; excluding the copper price, the figures change to an average decline of 1.3% in 2010 and 2011.

Tabla V.3

Economic growth and current account

	2007	2008	2009	2010 (f)
			(annual change, percent)	
GDP	4.6	3.7	-1.5	4.25 - 5.25
National income	7.4	4.1	-1.2	7.8
Domestic demand	7.6	7.6	-5.9	12.4
Domestic demand				
(w/o change in inventories)	8.0	7.5	-2.8	7.8
Gross fixed capital formation	11.2	18.6	-15.3	14.8
Total consumption	7.0	4.0	1.8	5.7
Goods and services exports	7.6	3.1	-5.6	3.6
Goods and services imports	14.5	12.2	-14.3	22.1
Current account (% of GDP)	4.5	-1.5	2.6	-1.1
			(US$ million)	
Current account	7,458	-2,513	4,217	-2,100
Trade balance	23,941	8,848	13,982	13,100
Exports	67,972	66,464	53,735	64,700
Imports	-44,031	-57,617	-39,754	-51,600
Services	-987	-871	-1,074	-600
Rent	-18,625	-13,423	-10,306	-17,400
Current transfers	3,129	2,934	1,616	2,800

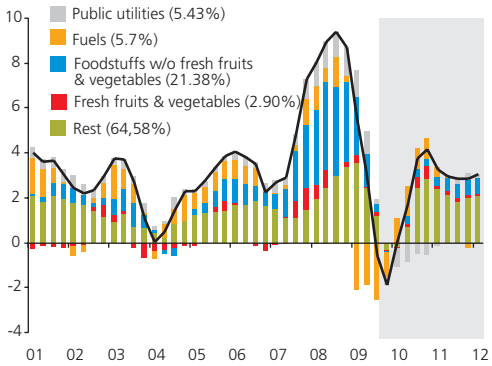
(f) Forecast.

Source: Central Bank of Chile.

Figure V.1

Incidences in annual CPI inflation (1) (2)

(percentage points)



(1) The gray area, as from the first quarter of 2010, depicts the breakdown of forecast inflation in the baseline scenario.
(2) In parentheses, shares in the CPI basket with annual base 2009. For the period 2001-2008, weights in the basket of December 1998. For 2009, weights in the basket of December 2008.

Sources: Central Bank of Chile and National Statistics Bureau.

In the main industrialized countries, headline inflation is still low, but picking up, and core measures are contained. This, with uncertainties associated with financial market performance and with growth, has led markets to expect a slower withdrawal of the monetary stimulus. In several emerging economies, prospects of increased inflation have settled down, while measures to normalize monetary policies have been applied. The dollar, contrary to the trend it was showing up to December and what was then forecast, has strengthened. This has resulted in projected inflation relevant to Chile—as measured by the EPI—being lowered for this and next year with respect to December's *Report* (table V.2).

Aggregate demand, output and external accounts

Barring the earthquake and tsunami, the projected growth rate for this year would have been revised up by around one percentage point (box: Changes in the macroeconomic scenario between December and February). This, due to the improved tone of the external scenario and the faster pace of output and demand. The effects of the catastrophe shape a new projection for this year's growth between 4.25% and 5.25%. This range runs somewhat below the one foreseen in December. The downward revision of the growth scenario for this year is based on the fact that the immediate economic effects of the earthquake and tsunami will exceed the increases generated by the reconstruction works (table V.3).

Growth forecasts are based on working assumptions about the effects of the earthquake and tsunami on economic activity, in three dimensions. First, using the survey of damages delivered by the government on 23 March (which considers the replacement cost of capital goods), and the historic relationship between depreciation and replacement costs, an estimated 3% reduction in the net capital stock results (box V.1: Effects of the earthquake and tsunami on the capital stock). The Board estimates that said loss in capital stock implies that during this year trend GDP will be 1.0% to 1.5% less than considered prior to the catastrophe.

Second, first-quarter GDP growth is projected to be around 3 percentage points less due to the catastrophe. In the second quarter, the effect will decline to close to 2 percentage points, assuming a gradual normalization of productive activities. This considers that the biggest impact concentrates in regions VI, VII, and VIII, and in the manufacturing industry.

Finally, it is assumed that the higher investment associated with the catastrophe will be the equivalent of about one percentage point of 2010's GDP. This effect will concentrate in the second half and will increase towards 2011. This considers both new investment and reallocated resources from other projects. The realization of the above is favored by the high profitability of reconstruction projects. According to announcements made by the Executive, the baseline scenario considers that in 2009 the structural deficit amounted to 1.2% of GDP, and that the structural balance will be attained towards the end of the current Administration. Budgetary reallocations this year will amount to about US$700 million, while the rebuilding of the destroyed public infrastructure will be spread out over four years. As a working assumption, the Board estimates that the burden of financing the public and private reconstruction works will be distributed among its various sources in a balanced way.

Tabla V.4

Inflation

(annual change, percent)

	2008	2009	2010 (f)	2011 (f)	2012 (f)
Average CPI inflation	8.7	1.6	2.4	3.0	
December CPI inflation	7.1	-1.4	3.7	2.9	
CPI inflation in around 2 years (*)					3.0
Average CPIX inflation	8.4	2.8	1.2	3.0	
December CPIX inflation	8.6	-1.8	3.0	3.2	
CPIX inflation in around 2 years (*)					3.2
Average CPIX1 inflation	7.8	2.8	0.8	2.9	
December CPIX1 inflation	7.7	-1.1	2.5	3.1	
CPIX1 inflation in around 2 years (*)					3.1

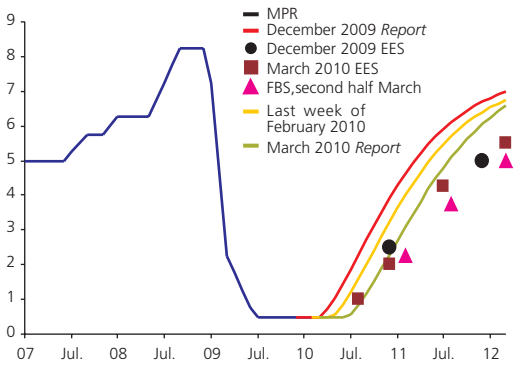
(f) Forecast.
(*) Inflation forecast to the first quarter of 2012.

Source: Central Bank of Chile.

Figure V.2

MPR and forward curve

(percent)



Source: Central Bank of Chile.

As for domestic demand, the baseline scenario projects it to grow 12.4% y-o-y in 2010, that is, 3.5 percentage points more than projected in December. The closing of 2009 and data from before the catastrophe explain a large part of the revision, particularly with respect to consumption and investment. In the baseline scenario, consumption will grow 5.7% annually this year (3.5% in December). This change assumes that the recomposition of the wealth that was lost to the earthquake and tsunami and the difficulties in materializing spending decisions will have mostly short-term effects. Gross fixed capital formation will increase 14.8% y-o-y, with machinery and equipments growing more than construction and other works. The impulse of reconstruction efforts will affect mostly this latter item. In 2003 prices, the investment over GDP ratio will rise to nearly 27.5% this year (around 25% in 2009). At current prices it will stay in the 21.5%-22% of GDP range. Inventory replacement will continue, after falling sharply in 2009.

Although the external scenario looks better than it did in December and the world economy will add momentum to this year's growth, the effects of the earthquake and tsunami on the country's productive capacity will cause a negative impact on exports. Such an impact will be strongest in the first half of the year, and will be impossible to fully offset it over the second half. Thus, an increase of 4.5% in total volume exports is foreseen for this year (5.1% in December).

The favorable external scenario and higher prices for commodities including copper, wood pulp and fishmeal offset in valued terms the smaller increase in exports. From December to March, projected total valued exports for 2010 shifted from somewhat below US$61 billion to almost US$65 billion. Imports will also increase more, because of increased investment in machinery and equipments, the higher price of oil and the need to temporarily substitute imported goods for domestically produced ones, particularly in some manufacturing lines.

The current account will post a deficit of 1.1% of GDP in 2010. The higher copper price will result in increased transfers abroad. This is compounded with an increase in imports, owing to the fact that domestic goods unavailable in the short term will have to be replaced by imported goods, and lost capital will have to be substituted for in the medium term[1]/. The private saving rate will continue to be high.

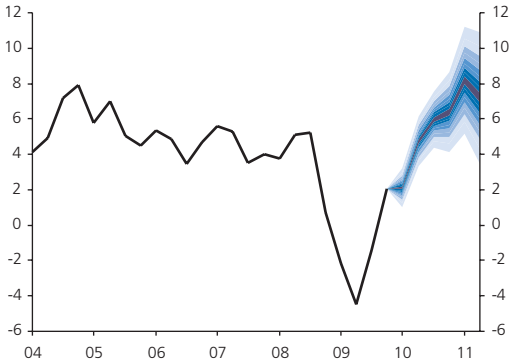
Measured at trend prices—which consider only corrections in prices and not in volumes—the current account balance for 2010 would stand between -6.0% and -5.5% of GDP. This bigger negative balance is the result of volume imports and exports in 2010 being particularly affected by the earthquake and tsunami. On one hand, there is faster growth in investment, given the reconstruction efforts. On the other hand, there is greater consumption both

[1]/ A significant part of the reconstruction efforts will be financed via reinsurances abroad. The usual treatment of the Balance of Payments (BP) indicates that said flows must be booked in the Current Account's transfers entry. However, the IMF's Sixth BP manual establishes that whenever these flows correspond to indemnities originating in catastrophes (e.g., an earthquake) they be booked as capital transfers, in order to make them consistent with National Accounts estimates. These extraordinary flows will be recorded in the capital account and not in the current account.

Figure V.3

Quarterly GDP growh scenarios (*)

(annual change, percent)



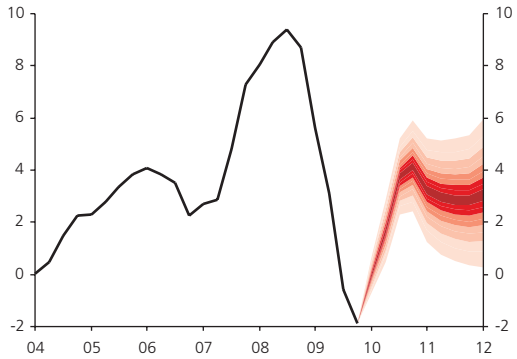
(*) The figure shows the confidence interval of the baseline projection over the respective horizon (colored area). Confidence intervals of 10%, 30%, 50%, 70%, and 90% around the baseline scenario are included. These intervals summarize the risks on inflation as assessed by the Board. These projections incorporate the assumption that monetary policy will continue to be very stimulative in the next quarters. Towards the end of the projection horizon, the monetary policy interest rate will converge to a level similar to the one indicated by March's Economic Expectations Survey. However, its pace of normalization will be somewhat faster than considered in that survey.

Source: Central Bank of Chile.

Figure V.4

CPI inflation forecast (*)

(annual change, percent)



(*) The figure shows the confidence interval of the baseline projection over the respective horizon (colored area). Confidence intervals of 10%, 30%, 50%, 70%, and 90% around the baseline scenario are included. These intervals summarize the risks on inflation as assessed by the Board. These projections incorporate the assumption that monetary policy will continue to be very stimulative in the next quarters. Towards the end of the projection horizon, the monetary policy interest rate will converge to a level similar to the one indicated by March's Economic Expectations Survey. However, its pace of normalization will be somewhat faster than considered in that survey.

Source: Central Bank of Chile.

of imported goods, because of replaced production lines damaged by the catastrophe, and of normally exported goods that will be redirected to the reconstruction. Finally, productive disruptions will also decrease exports. Long-term prices for copper and oil are US$2 per pound and US$75 per barrel, respectively, the same as in December.

Inflation

The Board foresees that inflation will converge to 3% faster than thought in December. Beyond short-term swings due to the effects of the catastrophe on retail and manufacturing production and distribution, the local macroeconomic scenario displays reduced output gaps. Towards the second half of the year, y-o-y CPI inflation will exceed 3%, and will stand around 4% for some months[2]/. Later on, it will fluctuate again around 3% throughout 2011 until the end of the relevant projection horizon, this time the first quarter of 2012. Y-o-y CPIX1 inflation will approach 3% more gradually, largely because the short-term effects of the earthquake and tsunami on inflation will concentrate on the prices of perishable goods (figure V.1 and table V.4).

Various assumptions are behind this scenario. The real exchange rate (RER) is forecast to maintain its current level over the long term, considering that at the statistical closing of this *Report*, the RER is consistent with its long-term fundamentals. Another assumption is that labor market inflationary pressures will post no material changes. The external scenario is expected to continue adding momentum to the economy and imported inflationary pressures are believed to be contained. Finally, these projections incorporate the assumption that monetary policy will continue to be very stimulative in the next quarters. Towards the end of the projection horizon, the monetary policy interest rate will converge to a level similar to the one indicated by March´s Economic Expectations Survey. However, its pace of normalization will be somewhat faster than considered in that survey (figure V.2).

Risk scenarios

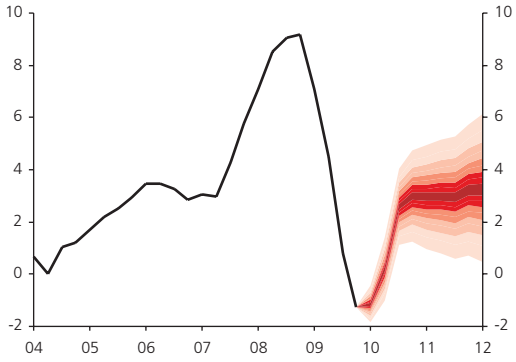
The baseline scenario reflects the events believed to be the most likely with the information at hand when the projections are made. Different developments will shape a different macroeconomic scenario—and an also different monetary policy trajectory. With these evaluations, the Board believes that the balance of risks for growth and inflation is unbiased (figures V.3, V.4 and V.5). However on this occasion, the earthquake and tsunami place unusual uncertainty, particularly regarding figures for economic activity in March and April. Thus, the Board considers that the balance of risks to growth is biased downwards in the very short term.

[2]/ The baseline scenario assumes that changes in public transport fares within the Santiago Metropolitan Region, Iquique, Greater Valparaíso, Rancagua and Greater Concepción will have a marginal impact on the CPI. This, because the CPI effect of the decreed increase in Transantiago fares will be offset by decreases in the fares at the aforementioned areas. Overall, the temporary nature of the changes will result in fluctuations in the monthly inflation of March, April, and May.

Figure V.5

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. These projections incorporate the assumption that monetary policy will continue to be very stimulative in the next quarters. Towards the end of the projection horizon, the monetary policy interest rate will converge to a level similar to the one indicated by March's Economic Expectations Survey. However, its pace of normalization will be somewhat faster than considered in that survey.

Source: Central Bank of Chile.

Short-term risk scenarios are dominated by the catastrophe. The impact on the medium-term scenario of the aggregate demand impulse coming from reconstruction efforts is one of the major risks. The magnitude, breakdown, speed, form of financing and focus of such reconstruction expenditures can have significant effects on the baseline scenario in terms of output, inflation and financial markets' behavior. How long it will take for productive activities and agents' spending to regain normality is also a risk. This has direct implications on the assessment of the immediate effects of the earthquake and tsunami. Overall, these are partly mitigated when considering that before the catastrophe domestic output and demand were already showing a faster than expected velocity.

Internationally, risks—although smaller—are still present. The fiscal situation of developed economies—especially in Europe—is cause for concern because of its potential effects on perceived risks and on the financial system, plus its possible implications on the path of recovery of global growth. Risks remain relating with monetary stimulus packages, both if they are withdrawn sooner than necessary or later than advisable. Persistent global imbalances are still a source of risk, originating in potentially strong capital inflows to emerging economies or in substantial changes in the trends of currency parities.

The Board will continue to evaluate the probabilities of these risks and their consequences on domestic inflationary prospects. The Board also reiterates that it will continue to use its policy instruments with flexibility in order for projected inflation to stand at 3% over the policy horizon.

Box V.1: **Effects of the earthquake and tsunami on the capital stock**

The effects of a natural disaster like the one the country suffered last February are relevant in the assessment of monetary policy conduct. In essence, because of the loss of productive capital stock, which lowers trend GDP and affects the size of output gaps, and also because of the macroeconomic impact of the subsequent reconstruction efforts. These factors influence the magnitude of inflationary pressures facing the economy and, therefore, are determinant in the evaluation of the monetary policy path consistent with attaining the inflation target in the projection horizon.

One key aspect of the baseline projection scenario presented in this *Report* is determining which working assumption the Board will use to measure the loss in capital stock caused by the earthquake and tsunami. This box explains how such assumption is determined.

It is important to begin by providing some definitions of how the capital stock is measured. First, gross capital stock stands for the value of assets used in the productive process, valued "as if they were new". In other words, the nominal gross value of the capital stock can be approximated to the replacement cost. Second, the net capital stock equals the gross capital stock minus asset depreciation. The latter is the reduction in value of fixed assets used in production, because of physical deterioration, normal obsolescence or damage from accidents. If assets are not fully renewed as time passes, the gap between gross and net capital stock value widens.

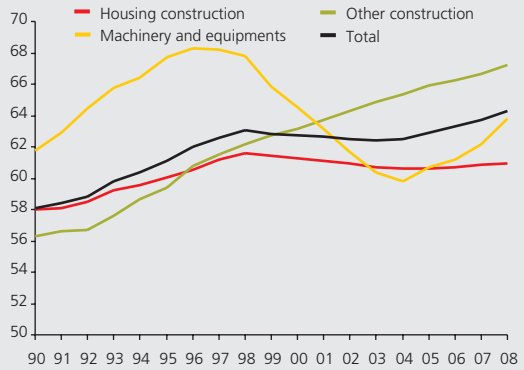
The distinction between gross and net capital value is a relevant one, because net capital stock is what counts when measuring an economy's productive capacity and, therefore, trend output, the output gap and inflationary pressures.

According to estimates from the National Accounts Department, in 2009 the Chilean economy's gross capital stock amounted to US$675 billion. The net value of the same capital stock was US$435 billion[1]/. The breakdown, in both gross and net terms, shows that nearly 35% was accounted for by housing construction, 17% by machinery and equipments, and 48% by other types of construction. The historical relation between gross and net capital value indicates that, between 2000 and 2008, the net value of capital was the equivalent to a fraction of 62 to 64% of the gross value. By type of good, said relation fluctuated within similar ranges (figure V.6).

Figure V.6

Ratio between gross and net capital stock

(percent)



Source: Updated figures from Henríquez (2008).

According to the Government's evaluation of the damages caused by the earthquake and tsunami delivered on 23 March, the replacement cost of the capital cost destroyed by the catastrophe of 27 February amounts to US$20.94 billion. Following the reasoning described above, this figure is equivalent to the gross value of the destroyed capital stock. As aforesaid, in the last decade the net capital stock was—on average—the equivalent of 63% of the gross stock, so it can be assumed that the net value of the capital stock destroyed amounts roughly to US$13.20 billion. This figure is equivalent to around 3% of the net capital stock of 2009.

Thus, based on said Government's report, and considering the ratio between gross and net capital stock in the last decade, the Board assumes for the baseline scenario of this *Report* that the earthquake and tsunami caused a loss in net capital stock of 3%. The Board estimates that, during this year, this loss in capital stock will result in the level of trend GDP being 1.0 to 1.5% less than was forecast before the catastrophe. This drop in net capital stock and its incidence on output gaps is one of the elements that determine that inflation will converge to the target sooner than forecast in December.

[1]/ This figure is based on the preliminary updating of figures included in Henríquez (2008), available at http://www.bcentral.cl/estudios/estudios-economicos-estadisticos/ xls/CuadrosStock1985-2008.xls.

Index of tables and figures

Tables

Figures

Glossary

Commodities exporters: Australia, Canada, and New Zealand.

CPIGX: Goods price index, which excludes fuels, and fresh fruit and vegetables, leaving 48.6% of the total CPI basket (45.6% in the December 2008 basket).

CPISX: Services price index, which excludes basic services and public transportation fares, leaving 34.4% of the total CPI basket (36.8% in the December 2008 basket).

CPIX: Core consumer price index. CPI excluding fuels, and fresh fruit and vegetables, leaving 91% of the total CPI basket (91% in the December 2008 basket).

CPIX1: CPIX excluding fresh meat and fish, regulated tariffs, indexed prices, and financial services, leaving 73% of the total CPI basket (73% in the December 2008 basket).

EPI: External price index, calculated using the wholesale price index (WPI)—or the CPI if the WPI is not available—expressed in U.S. dollars, of the countries relevant to Chile (that is, the countries used for the calculation of the multilateral exchange rate, MER), weighted according to their share of Chilean trade, excluding oil and copper.

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

Expansion velocity: For monthly data, the annualized change in the moving quarter in a seasonally adjusted series. For quarterly data, the annualized quarterly change in a seasonally adjusted series.

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

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

Growth of trading partners: The growth of Chile's main trading partners, weighted by their share in total exports over two moving years. The countries included are the destination for 94% 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.

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

LPI: Local currency price index of economies relevant to Chile, implied in the EPI. Calculated based on the WPI (or CPI, according to availability) expressed in the local currency of the countries considered in the calculation of the EPI and their share in Chile's trade, excluding oil and copper.

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 2010, the following countries are included: Argentina, Belgium, Brazil, Canada, China, Colombia, Ecuador, France, Germany, The Netherlands, Italy, Japan, Mexico, Peru, South Korea, Spain, Sweden, Switzerland, The United Kingdom, The United States, and Venezuela.

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

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

Parity price of gasoline: Reference cost of gasoline imports, calculated on the basis of quotes for similar conditions to Chile, in relevant markets (America, Europe, and Asia). Includes shipping, insurance, duties, and other costs.

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

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

ULCX: Unit labor costs (ULC) including only wage labor and excluding wages and output from natural resource sectors.

World growth at market exchange rate: Each country is weighted according to its GDP in U.S. dollars, published in the IMF's *World Economic Outlook*.

World growth: Regional growth weighted by its share in world GDP at PPP, published in the IMF's *World Economic Outlook* (WEO, October 2009, and the January 2010 update). World growth projections for 2009–2011 are calculated from a sample of countries that represent about 85% of world GDP. The growth of the remaining 15% is estimated at around 3.4% in the three-year period 2009–2011.

Abbreviations

BCP: Central Bank bonds in pesos

EES: Economic Expectations Survey

FBS: Financial Brokers' Survey

CPIG: Consumer goods price index

CPINT: Nontradables consumer price index

CPIS: Consumer services price index

CPIT: Tradables consumer price index

FLAP: Short-term liquidity facility (*Facilidad de liquidez a plazo*)

MPR: Monetary policy rate

LME: London Metal Exchange

WTI: West Texas Intermediate

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