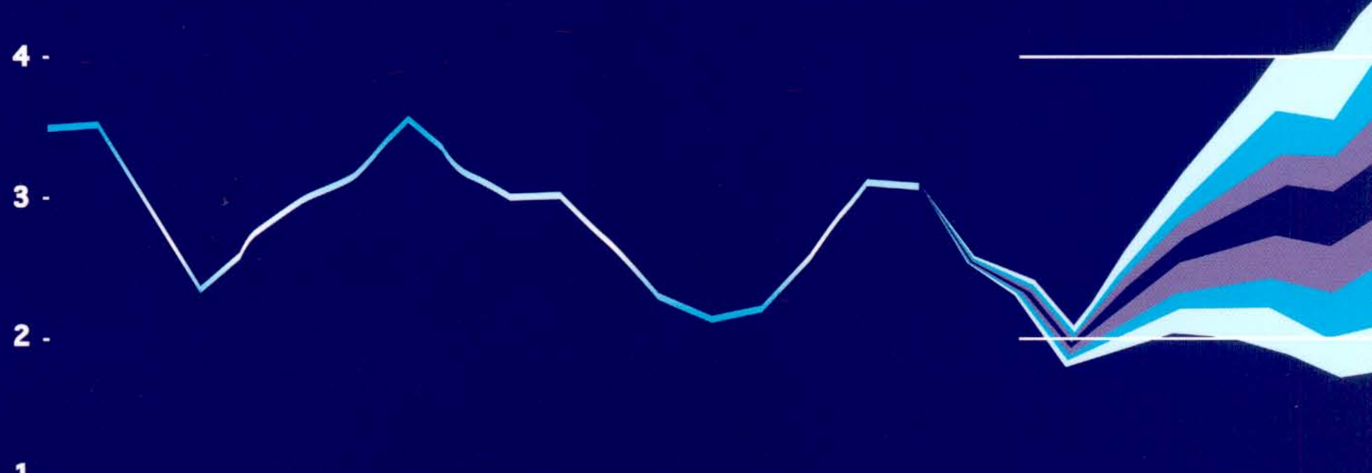
Monetary Policy Report

SEPTEMBER 2004



CENTRAL BANK
OF CHILE

Summary */

The Chilean economy has continued to strengthen, in line with expectations in the last *Monetary Policy Report*, supported by a favorable international economic climate, as well as good financial conditions at home that reflect the sustained impulse of monetary policy. This external scenario and the resulting higher terms of trade, together with a stronger-than-foreseen recovery of investment, offset the reduction in consumption that the increase in oil price could have provoked in the short run. This increase in the price of crude oil, that was considered as a risk in May's *Report*, is affecting Chile particularly in the form of higher inflation, which is now expected to come close to 3% per annum by year's end, although its transmission to other prices will be limited. This picture considers CPI inflation ranging between 3% and 3.5% during part of 2005, to then descend past 3% toward the end of the usual policy horizon of 24 months. This would leave behind the undesirably low inflation episode of the last quarters. Core inflation, that so far has been close to previous projections, will expectedly approach 3% towards the end of the projection horizon, due to the persistent bridging of capacity gaps and consistently with a gradual reduction of the marked monetary impulse. Hence, in its monetary policy meeting of September, the Board considered it appropriate to raise the monetary policy interest rate by 25 basis points, based on the favorable behavior and good perspectives of output and domestic spending.

After growing by an annual average of about 4.5% during 2004, Chile's trading partners are expected to slow down somewhat, to around 3.5% annual next year, still exceeding the average of the past few decades. Vigorous world growth consolidation, turmoil in the Middle East and the incapacity of OPEC and other oil producers to boost production have combined to depict a picture of atypically tight oil supply and demand with risks associated to provision, that reflect in higher oil prices, both effective and expected. Therefore, the baseline scenario considers a price for *Brent* oil near US$37 per barrel this year and US$34 next, to approach US$28 only in the long term, a substantial upward correction of projections from the last *Report*. In spite of it all, Chile's terms of trade remain high, thanks to export prices —especially copper— above the ones forecasted a few months back. Today's projections place the average price of copper at US$1.26 per lb this year and US$1.15 per lb in 2005. Foreign financing conditions for emerging economies continue to be very positive, although sovereign spreads are expected to rise, consistently with the normalization of monetary impulse in the main economies.

*/ This is an unofficial translation of the Central Bank of Chile's four-monthly *Monetary Policy Report*. In case of any discrepancy or difference in interpretation, the Spanish original prevails.

In Chile, the expansionary monetary policy impulse has been transmitted through the various financial channels. Household's loan, consumption and housing have continued to accelerate their growth pace. Bank credits to companies, which until early this year were lagging behind, have begun to pick up, especially medium-sized and large loans, coinciding with the recovery of investment. Other financing options directed at smaller firms, such as leasing and factoring, also show increased dynamism. In the fixed-income market, long-term interest rates have remained stable, even declining somewhat from May to date. Larger companies have continued placing their bonds and commercial papers in the local market, and some have taken advantage of the positive trend of stock prices to make new issuances. Regarding money and other monetary liabilities, the different aggregates show, after many years, simultaneous increases in their growth rates.

Since May and until a while ago, the peso was somewhat more depreciated than was implicit in the previous *Report*'s forecasts. Such depreciation coincided with a similar response of other currencies and asset prices from emerging economies to the possibility of a faster increase in interest rates in the U.S. More recently, these movements reversed as expectations moderated. In any case, our estimates of the real exchange rate consistent with its long-term fundamentals are slightly lower than the current value of the real exchange rate.

The Chilean economy is adjusting well to the implications of the present macroeconomic scenario, including an increase —partly temporary— in the terms of trade. This is apparent in higher growth rates of domestic expenditure, together with a substantial improvement in the external accounts.

Baseline scenario assumptions

	2002	2003	2004(f)	2005(f)	2006(f)
			(annual change, percent)		
Terms of trade	3.3	2.9	17.9	-5.1	-4.2
Traging partners' GDP (1)	2.0	2.8	4.6	3.5	3.5
World GDP	2.7	3.7	5.0	4.1	4.0
External prices (in US$)	-4.6	10.5	6.2	2.5	1.4
			(levels)		
Copper price, LME (US¢ / lb)	70.8	80.6	126	115	102
Brent oil price (US$/barrel)	24.9	28.9	37	34	30
Libor US$ (Nominal, 90 days)	2.0	1.2	1.6	2.8	4.0

(1) Growth of Chile's main trading partners weighted by share of total exports (2003). Countries included account for 88% of total exports.
(2) Regional growth weighted by share of world GDP at PPP. Countries included represent 85% of world GDP (2004).
(f) Projection.

Source: Central Bank of Chile.

In this sense, the dynamics of private disposable income, one of the most relevant variables for consumption behavior, has been affected mainly by the rise in the price of fuels —while the copper price increase has had an incidence mainly on the public sector's income and in payment to foreign-owned factors— which particularly influences households with restricted access to credit markets. Therefore, it can be anticipated that, unless a dramatic fall in oil price occurs, in the second half of this year consumption figures will not continue to show the acceleration observed in the past few quarters, a condition already visible in some measures of durable consumption.

Although unemployment figures from the National Bureau of Statistics (INE) for the first semester showed an increase beyond their normal seasonal highs, for the moment there is no evident inconsistency of the aggregate labor market information with the faster pace of economic growth and the level of labor costs. Higher unemployment and the relatively stagnant total national employment as measured by the INE are associated basically to a reduction in self-employment and lower occupation in agriculture. On the other hand, salaried labor —substantially more sensitive to the business cycle than self employment— is showing annual growth rates unseen for the past several years. This behavior of salaried labor can be observed in other measures, such as the number of affiliates to the Chilean Security Association and the vacancy indicator. The University of Chile's survey, meanwhile, shows a more promising labor market situation.

Hence, irrespective of the effect of fuel prices on private consumption —an effect considered in this *Report*'s forecasts—, household spending is not expected to show additional signs of weakness –that could lead to a larger and more persistent deceleration of domestic output toward 2005 and 2006— attributable to the current behavior of the labor market. This matter, in any case, must be monitored with special caution in the quarters to come.

Public expenditure is in line with the structural surplus rule, while public earnings have increased considerably because of the higher copper price and the economic recovery. Overall, these developments cause an increase in public savings, such that the national saving rate for this year is expected to surpass the rate of previous years by a couple of points. For 2005, projections in this *Report* are based on the assumption that the structural surplus rule is maintained, including the recent revision of parameters for trend growth and the long-term copper price.

In the second quarter of this year, investment returned faster than predicted to a trend consistent with the macroeconomic impulse, characterized by good external conditions and expansionary monetary policy. In particular, imports of capital goods reached their highest levels since 1998, while information from the Capital Goods Corporation reveals improved expectations for the near future, consistently with other measures of expectations and with corporate earnings, particularly in export-oriented enterprises. This, together with investment being on a higher growth trend than in 2003, allows to anticipate that this year, the ratio of investment to GDP (in constant terms) will reach 24%, its highest in the last five years.

Exports and imports have been growing faster than expected in May. The former's expected value for the year is above US$30 billion, with a significant positive trade balance. Thus, the current account surplus for this year is expected to be in the range of 2.5% to 3% of GDP, more than forecasted a few months back. The volume of exports and imports also show strong dynamism, particularly in manufacturing and mining, although their growth rates have been affected temporarily by recent sharp increases in productive capacity and inventory decumulation from mining companies.

In the second quarter of this year, manufacturing activity continued to grow at around 5% per annum. This was explained both by the behavior of consumer oriented producers since the middle of last year, and by the results of natural-resource-related sectors, especially fishery and woodpulp. Mining came short of expectations, but owing to factors believed to be temporary. It should be mentioned that the actual constraint on natural gas supply from Argentina between June and August was almost 70% less than considered in May's *Report*, and lately it has virtually disappeared.

The economy is thus approaching a GDP growth rate between 5% and 5.5% for this year, with domestic expenditure increasing at a similar pace. Toward 2005, a number of factors combine to determine growth. First, the world economy will slow down somewhat, after the strong recovery it showed earlier in the year. Second, the persistently high price of Brent oil —considered in this *Report*'s projections— will also influence aggregate growth, particularly because of its impact on consumption. Third, the expansionary monetary conditions will continue to affect private spending decisions. And finally, the normalization of investment confirms the macroeconomic scenario of sustained growth. Therefore, the Chilean economy can be expected to reach growth rates in the 4.5% to 5.5% range during next year, with domestic expenditure around one point above these numbers. This growth scenario does not differ much from private projections such as the Central Bank of Chile's expectations survey and analyses reported in *Consensus Forecasts*. The current account balance is expected to post a surplus larger than forecasted in May, thanks to national savings recovering more strongly than investment. This yields a current account surplus between 2.5% and 3% of GDP this year, and around 1% in 2005. These projections are consistent with a large trade balance, about US$9 billion this year and in the US$6 to 7 billion next year.

Economic growth and the current account

	2002	2003	2004(f)	2005(f)
	(annual change, percent)			
GDP	2.2	3.3	5.0 - 5.5	4.5 - 5.5
National income	2.5	3.9	7.1	5.3
Domestic demand	2.5	3.5	5.3	6.3
Gross fixed capital formation	1.4	4.8	8.0	7.8
Rest of domestic demand	2.8	3.1	4.5	5.8
Exports of goods and services	1.5	7.8	12.0	4.8
Imports of goods and services	2.4	8.8	13.0	7.5
Current account (% of GDP)	-1.3	-0.8	2.8	1.1
	(US$ million)			
Current account	-885	-594	2,600	1,100
Goods	2,256	3,015	9,100	6,700
Exports	18,177	21,046	30,900	30,700
Imports	-15,921	-18,031	-21,800	-24,000
Services	-657	-767	-1,000	-800
Income	-2,915	-3,280	-6,400	-5,700
Unilateral transfers	430	438	900	900

(f) Projection.

Source: Central Bank of Chile.

These projections are based on an interest rate path associated to a monetary impulse that declines gradually over the next few years, consistent with achieving the defined target range centered in 3%, and that is comparable with the rates that can be derived from the prices of financial assets. On the other hand, the baseline scenario considers a slight appreciation of the exchange rate over the next two years from its levels of the past ten days. These working assumptions are consistent with the present conjuncture and with expected conditions based on information available until the closing of this *Report*, but must not be taken as a commitment from the Central Bank with respect to the future conduct of monetary policy. Other factors, such as the actual evolution of inflation, growth and some key prices, will produce changes in inflation projections in the usual policy horizon and, thereby, on the course of monetary policy.

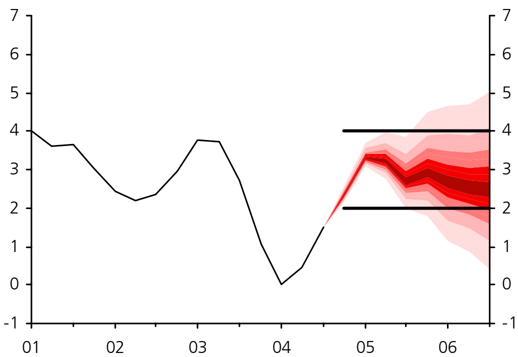
Trend growth prospects for the Chilean economy have remained fairly unchanged. Concerns of early last year, about total factor productivity and labor productivity showing very weak growth rates or even declines, have dissipated. Specifically, the strong increase of self employment observed in 2003, that contaminated productivity measures, was actually a temporary phenomenon. In addition, the recovery of investment and of the cyclical component of total factor productivity should favor an increase in the growth rate of productive capacity in the short term. Thus, for the next two years, trend growth is still expected to go from around 4% to slightly below 5%. No significant short-run effects on productive capacity are expected from higher international fuel prices. Thus, the existing excess capacity should tend to clear progressively.

This bridging of capacity gaps, plus the gradual decline in unemployment rates, are crucial elements underlying this *Report*'s medium-term inflation projections. The evolution of labor cost will also have a decisive effect. Today, core inflation CPIX1 is expected to continue increasing along the same line it has increased this year to date. Actually, since last May, the different indices of inflation and underlying measures reveal that the period of undesirably low inflation is coming to an end and inflation is returning to the target range, averting one of the risks identified at the end of last year. CPIX1 inflation has increased at a somewhat slower pace than anticipated in the last *Report*, but trend indices still show an increase, in both seasonally adjusted and trimmed means measures.

More recent news came mainly from the strong rise in fuel prices, which will result in one point of higher CPI inflation by year's end. Although in principle this is a cost-side shock with only a one-time effect on the price level, given the magnitude and persistence of the oil price increase, by early next year the trajectory of inflation will be above the projections of some months ago.

In the first place, because of wage- and other price-indexation mechanisms, part of the increase in CPI inflation will be gradually transmitted to costs and some specific prices. Although labor productivity continues on the rise, increased pressures are expected for 2005 and 2006 on the side of overall unit labor costs. In the second place, the increase in import costs due to the higher price of fuels and, more generally, to a higher forecast of world inflation, will add to the underlying cost pressures. Finally, retail margins have stopped compressing, and some components that are more closely linked to domestic supply and demand conditions, have even shown a recovery since early in the year, which is expected to continue.

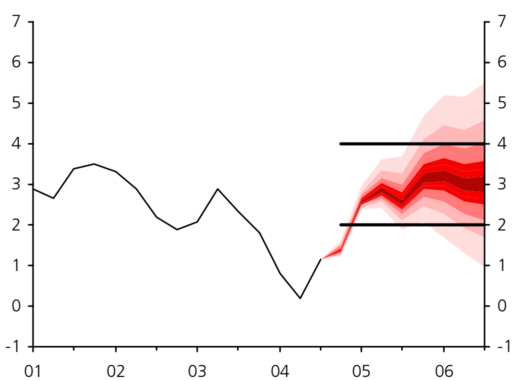
CPI inflation projection (*)
(annual change, percent)



(*) The figure shows the confidence interval for the baseline projection for the respective forecast horizon (colored area). Confidence intervals of 5%, 15%, 25%, 35%, 45%, 55%, 65%, 75%, 85% and 95% are used. These confidence intervals summarize the Central Bank's risk assessment for future inflation, assuming that the impulse of the monetary policy declines gradually with a trend comparable with the rates that can be derived from the prices of financial assets.

Source: Central Bank of Chile.

Core inflation (CPIX) projection (*)
(annual change, percent)



(*) The figure shows the confidence interval for the baseline projection for the respective forecast horizon (colored area). Confidence intervals of 5%, 15%, 25%, 35%, 45%, 55%, 65%, 75%, 85% and 95% are used. These confidence intervals summarize the Central Bank's risk assessment for future inflation, assuming that the impulse of the monetary policy declines gradually with a trend comparable with the rates that can be derived from the prices of financial assets.

Source: Central Bank of Chile.

Not only the persistence of the oil price increase, but also the magnitude of its transmission to core inflation will have to be closely monitored in coming quarters. In effect, this magnitude depends on the degree of actual indexation of nominal wages to past inflation *vis-a-vis* expected inflation, and on the capacity of retail margins to accommodate the increase in fuel prices. The projection scenario in this *Report* considers that the degree of indexation of the Chilean economy today is less than it was in the past, and that margins can temporarily absorb part of the higher import costs.

All considered, annual CPIX1 inflation will average around 3% over the projection horizon, while CPIX and CPI inflation will average slightly less than 3%. This is consistent with CPIX1 inflation converging from its spot rates of 2% to somewhat above 3.5%, and declining gradually to 3% in the course of 2005 and 2006. This estimated behavior of inflation, anchored in 3%, is derived from projections based on the various assumptions of the baseline scenario, particularly those concerning the evolution of the monetary impulse and the limited transmission of the increase in fuel prices to core inflation. In addition, as a working assumption, the announced reduction in the working day has been assumed to have no effect on labor costs, because no information exists that might be indicative of how the production sector has prepared to this measure or how it will react when it is finally put into effect.

The expected inflation rate that can be deduced from the Central Bank's expectations survey and from *Consensus Forecasts*, as well as from inflation compensation implicit in differentials between nominal and indexed interest rates, is at or below 3% per annum at different terms.

Inflation

	2002	2003	2004(f)	2005(f)	2006(f)
Average CPI inflation	2.5	2.8	1.1	3.0	
December CPI inflation	2.8	1.1	2.9	2.8	
12- and 24-month CPI inflation (*)				2.8	2.5
Average CPIX inflation	2.6	2.3	0.9	2.8	
December CPIX inflation	1.9	1.6	1.8	3.2	
12- and 24-month CPIX inflation (*)				2.9	2.9
Average CPIX1 inflation	2.5	2.2	0.9	2.9	
December CPIX1 inflation	2.1	1.8	1.4	3.6	
12- and 24-month CPIX1 inflation (*)				3.3	3.4

(*) Inflation projected for September of each year.
(f) Proyection

Source: Central Bank of Chile.

Although conditions continue to be favorable, the economy is still exposed to risk scenarios that may drive inflation and output growth figures away from projections in this *Report*'s baseline scenario. Internationally, there is uncertainty about the short- and medium-term behavior of the oil price, which depends on very hard to predict developments, such as turmoil in the Middle East and possible increases in oil production capacity. Also, the impact of the evolution assumed for oil price on the pace of global activity and/or inflation in the main economies can be more intense, with implications on monetary policy in the developed world that are not easily foreseen. In addition, fiscal and external imbalances have persisted in the largest economies, and so the possibility still exists of sudden adjustments that may introduce additional volatility in international financial markets. Risks for the baseline scenario might be magnified by an overreaction of economic agents to an unexpectedly steep rate cycle in the US, affecting the more indebted emerging economies with more intensity.

In regards to domestic activity, the most notorious risks are associated to the behavior of consumption and investment in the short run. On the one hand, so far the high oil price has been assumed to have a limited incidence, and the recent evolution of the labor market has been considered to place no additional risks on household expectations. Both elements must be carefully assessed in the quarters to come. On the other hand, the recovery of investment was a surprise, but for the time being it is taken as a sooner than expected normalization, without resulting in the next few years in a substantially higher gross capital formation ratio to GDP than estimated for this year. However, it is possible for this component of expenditure to react more intensely than expected to the current expansionary monetary conditions and to positive macroeconomic scenarios both outside and inside our borders.

Finally, the baseline projection scenario assumes that the transmission of the increase in fuel prices to core inflation will be limited. What will be the final magnitude of this transmission, particularly its effects on wages, inflation expectations and actual inflation, only time will tell. Similarly, only time will reveal the actual effect, if any, of the shortening in the working day on Chile's macroeconomic scene.

The implications of all these risks on the Chilean economy and on monetary policy are not evident, because direct price pressures combine with other developments that influence the behavior of capacity gaps. However, the Board estimates that, overall, the balance of risks associated to the evolution of output is balanced, and that for inflation it is biased upward.