MONETARY POLICY REPORT

MAY 2001

CENTRAL BANK OF CHILE

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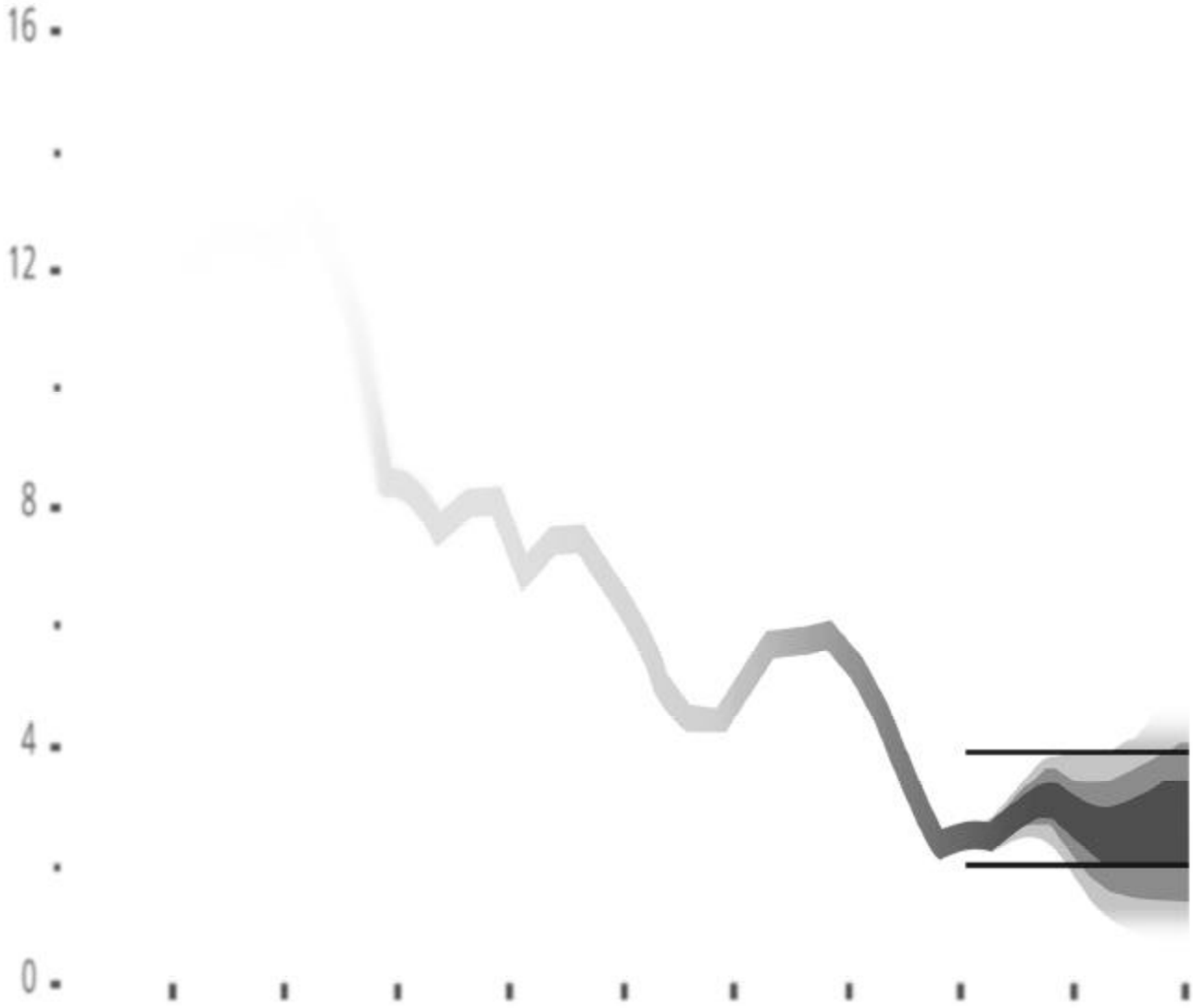

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PREFACE

The main purpose of the Central Bank of Chile's monetary policy is to keep inflation low and stable, defined as a range of 2% to 4% per annum, centered on 3%. Controlling inflation is the means by which monetary policy contributes to the population's welfare. Low, stable inflation improves economic performance and growth, while preventing the erosion of personal income. Furthermore, monetary policy's focus on inflation targeting helps to moderate fluctuations in employment and domestic output.

The main objectives of this Report on Monetary Policy are: (i) to inform and explain to the general public the Board's view of recent and expected inflation trends and their consequences for the conduction of monetary policy; (ii) to publicly explain the medium-term framework used by the Board of Governors of the Central Bank to formulate monetary policy; and (iii) to provide information that is useful in the formulation of economic agents' expectations regarding future inflation and output trends.

The report is published three times a year, in January, May and September. The first section of this report concentrates on recent developments in inflation in Chile, imported prices, and specific price trends that temporarily affect the pace of inflation. The report then examines the main factors that will influence inflation's future behavior, including the international environment, financial conditions, prospects for aggregate demand, the current account and the labor market. Finally, the last section summarizes the consequences of this analysis both in terms of prospects and risks affecting inflation and economic growth over the next eight quarters. The report also provides several boxes that offer more detailed information on issues relevant to evaluating inflation and monetary policy.

This Report was approved at the 11 May 2001 meeting of the Board of the Central Bank of Chile.

The Board

The Board of the Central Bank reduced the policy interest rate on several occasions between January and April of this year, for a total of 125 basis points, thus reaching UF + 3.75%. This more expansive monetary policy stance was a response to the rapid fall in annual inflation, which reached the target range ahead of schedule, combined with clear signs of decelerating domestic demand throughout the first quarter. These developments also indicated a significant decline in medium-term inflationary pressures despite significant peso depreciation during the same period. Meanwhile, the prospects for world economic growth steadily worsened, while the region's countries suffered greater financial turbulence.

The worsening of the international scenario is directly linked to the United States, where economic growth has slowed more sharply than originally forecast. Moreover, domestic demand in Japan continues to stagnate, while the external sector remains sluggish. This has brought with it a drop in the prices of Chile's main exports, as well as an initial decline in commodity export volumes during the first quarter.

Monetary policy in the main economies has reacted to this harder than expected landing. The US Federal Reserve has reduced its reference rate by 200 basis points since January, while the Bank of Japan has started to apply more expansive, monetary aggregate based policies. As expected for some time, the European Central Bank also recently reduced its policy rate, by 25 basis points. Nonetheless, this has not calmed volatile international financial markets, because uncertainty about the future performance of the world economy persists, especially regarding how quickly the US will recover and resume closer to potential growth rates.

Instability has been particularly pronounced in Argentina, due to a high fiscal deficit and changes in its economic authorities. This uncertainty has also partially affected Brazil, where the Central Bank has applied more restrictive monetary policies. To date, eased monetary conditions at the global level have not translated into a better growth scenario for most emerging economies.

In any case, the Chilean economy has outperformed the rest of the region. Not only has it retained its investment grade rating but also its sovereign spread has remained stable and shown a slight tendency to fall. Undoubtedly the current set of macroeconomic policies has contributed to this result, particularly the floating exchange rate, low and stable inflation within an inflation targeting framework, a solid financial system, and fiscal policy within clearly defined rules. Moreover, the Chilean economy's external accounts show a small current account deficit and very controlled needs for short-term financing. It is therefore evident that the country's current macroeconomic environment differs substantially from conditions in 1998, when it was suffering the effects of the Asian and other international crises.

The above, however, has not changed the fact that net capital flows into the country have been scarce during the first quarter, reflecting the perception that residents of emerging countries are no longer as appealing prospects for loans as they were three or four years ago. In Chile's case, another significant variable explaining low growth in net external debt in recent quarters is the sluggish performance of domestic demand and, most recently, local investors' preference for local financing sources.

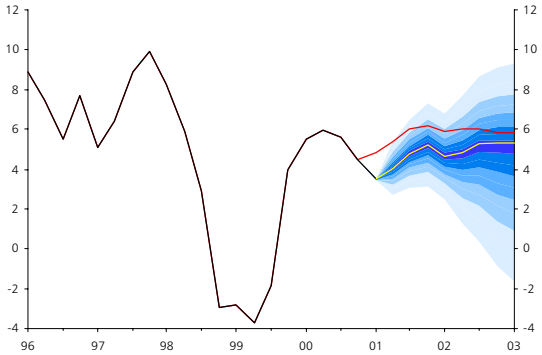
Initially, the slowdown in economic activity toward the end of last year was considered temporary. Information for the early months of this year, however, suggests that GDP will be less than 3.5% for the first quarter, more than one point below expectations implicit in the January Report. Retail sales, employment and consumer imports reveal that household spending has not grown compared to the second half of last year. Moreover, after growing significantly last year, gross capital formation slowed during the first quarter, as did machinery and equipment and the rest of the construction sector.

Persistent, high unemployment continues to inspire prudent behavior among both debtors and banks involved in the consumer credit market, while idle capacity in the housing market has discouraged new projects in this sector. These conditions suggest that growth in domestic expenditure will result in a small current account deficit, despite the fall in the terms of trade forecast for this year. This situation will also affect the economy in other ways, including the persistence of peso depreciation, moderate growth in real salaries, and lower than usual retail margins.

In this climate the Board of the Central Bank has successively reduced interest rates, in order to avoid a more serious deterioration in domestic spending and activity, which could in time push inflation below the target range. The low current account deficit has to date limited the impact of monetary policy decisions on the exchange rate. Because of persistent idle capacity, depreciation has not significantly affected inflation, a situation that is also reflected in the fact that inflation expectations remain in line with the target.

The interest rate reductions mentioned above, combined with those applied during the third quarter of 2000, are having a favorable effect on some components of private expenditure, particularly the housing market. Similarly, the cost to companies of domestic financing in UFs has fallen, resulting in more bond issues on the domestic market. The dynamic performance of exports other than Chile's main products reveals that real exchange rate depreciation has positively influenced activity in those sectors oriented to markets abroad. Growth in consumption, in contrast, has fallen due to greater prudence resulting from high unemployment and personal debt levels accumulated during most of the 1990s. At present, monetary policy's eventual impact on household consumption decisions depends on the degree to which reductions in the rate are transferred to the cost of consumer debt and on how strongly investment ends up affecting employment.

Quarterly GDP growth scenario (1)
(percentage change over the same quarter of the previous year)



(1) The figure shows the baseline projection (yellow line) and the confidence interval for the respective time interval (colored zone).
Confidence intervals of 10%, 30%, 50%, 70% and 90% are used. These confidence intervals summarize the Central Bank's risk assessment for future economic growth, on the assumption that the monetary policy rate will remain at UF + 3.75% for the next two years.
The red line indicates the projection in January 2001.

Source: Central Bank of Chile.

The main scenario of this Report states that starting in the second quarter economic activity will gradually pick up, reaching average growth of 5% over the next eight quarters (through to the third quarter of 2003). For this year and next, growth will reach 4.3% and 5.0% respectively, and continue to rise through the end of the projection horizon. At the same time, domestic expenditure will grow slightly more than GDP, reaching 4.8% this year and 5.4% next. In 2001, the decline forecast for the terms of trade will affect external accounts, with the current account deficit reaching 2.2% of GDP. In 2002, this will turn around, and the current account deficit will fall to 1% of GDP. These projections are based on the methodological assumption that the monetary policy rate (*tasa de política monetaria, TPM*) will remain constant at its current level.

Economic growth and current account 1997-2002
(annual change, percent)

Specification	1997	1998	1999	2000	2001(f)	2002(f)
Domestic demand	9.1	3.9	-10.0	6.6	4.8	5.4
Exports of goods and services	9.4	5.9	6.9	7.5	4.6	4.8
Imports of goods and services	12.9	5.4	-14.3	10.1	5.6	5.6
Current account deficit	-5.0	-5.7	-0.1	-1.4	-2.2	-1.0
GDP	7.4	3.9	-1.1	5.4	4.3	5.0

(f) Projection.

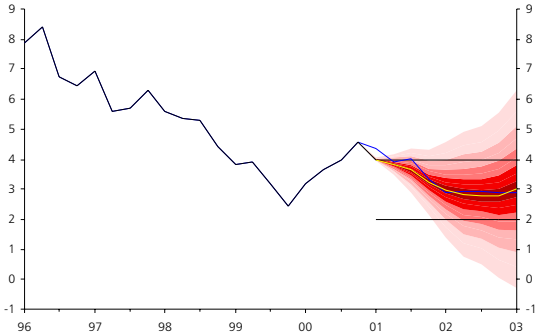
Source: Central Bank of Chile.

This baseline scenario for economic growth depends on several main assumptions. The first is that activity in the United States will stop decelerating between the second and third quarter of this year, resuming a near potential growth rate (3.5%) in 2002. This allows us to project a rapid recovery in the world economy, which would also revert the negative price trend for our main exports, observed since the end of last year. Moreover, this rapid recovery scenario would bring with it a reduced risk of crises in emerging economies. Domestically, a gradual decline in unemployment and resumed growth of consumption are expected. There are some signs that this is already happening, among them the recent strength of consumer imports and employment in construction. In any case, whether or not these figures indicate a real change in consumer confidence trends will become apparent as the second and third quarters progress.

The rapid fall in annual inflation during the first quarter of this year confirms that the oil price increase in 2000 did not unleash medium-term inflation expectations. Similarly, although the recently announced increase in fuel prices will affect inflation somewhat during the second quarter, its impact is expected to fade as the northern hemisphere's summer advances and supply conditions in the US gasoline market normalize. The price of crude oil should fall below current levels, reaching an average of US$25 per barrel this year, US$23 next.

The exchange rate has fluctuated more in recent weeks and tended to depreciate. This has not only affected spot exchange rates but also pushed future prices upward. Undoubtedly, Argentina's recent problems have played a role in the performance of the exchange market, as well as

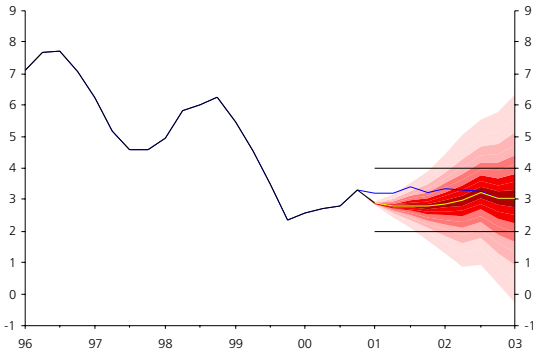
Inflation (CPI) projection (1)
(percentage change over the same quarter of the previous year)



(1) The figure shows the baseline projection (yellow line) and the confidence interval for the respective time interval (colored zone). Confidence intervals of 10%, 30%, 50%, 70% and 90% are used. These confidence intervals summarize the Central Bank's risk assessment for future inflation, on the assumption that the monetary policy rate will remain at UF + 3.75% for the next two years.
The blue line indicates the projection in January 2001.

Source: Central Bank of Chile.

Underlying (CPIX) inflation projection (1)
(percentage change over the same quarter of the previous year)



(1) The figure shows the baseline projection (yellow line) and the confidence interval for the respective time interval (colored zone).
Confidence intervals of 10%, 30%, 50%, 70% and 90% are used. These confidence intervals summarize the Central Bank's risk assessment for future inflation, on the assumption that the monetary policy rate will remain at UF + 3.75% for the next two years.
The blue line indicates the projection in January 2001.

Source: Central Bank of Chile.

increasing long-term interest rates slightly. In any case, the main scenario of this Report assumes domestic activity will pick up and turbulence on international financial markets will settle down, conditions that are hardly consistent with further depreciation of the real exchange rate. Thus, the working assumption used to develop projections is that the real exchange rate will hold steady at its current level over the next eight quarters. Retail margins will gradually tend to return to normal, recovering part of the contraction of recent months. This trend is already apparent in indirect measurements of margins, such as the dollar price of durable goods or the ratio between retail and wholesale durable prices.

Altogether, this information suggests that total inflation as measured by the CPI will remain within the target range for the next eight quarters. In the coming months, it is assumed that inflation will fluctuate between 3.5% and 4.0% with some pronounced peaks and troughs, reaching 3.2% toward the end of 2001, 2.8% toward the end of 2002, and 3.0% during the first quarter of 2003. CPIX inflation should remain closer to 3% over the next 24 months.

Several factors will influence inflation's performance. In the first place, during the fourth quarter of this year, annual inflation should fall due to the high basis for comparison over the same period in 2000, associated with fuel price increases during that period, a condition that should not recur this year. This will be offset by the transfer of recent depreciation to inflation and decompression of retail margins.

Of course, the significant degree of uncertainty about the speed and magnitude of these events remains, but this primarily affects projections over the short term. Further in the future, inflation's convergence into the target range has strengthened the private sector's medium-term expectations for inflation. Since November, financial asset prices and results of the monthly survey of expectations show a tendency to converge on expected inflation of about 3% per annum for every timeframe.

These growth and inflation projections are consistent with the events that the Board believes to be most likely during the coming eight quarters. It is possible, however, that the economy will follow a different path from that forecast within this baseline scenario over the next two years. Altogether, these alternative events represent the balance of risks, and as usual are associated with the international climate and the performance of Chile's own economy.

Among these alternative scenarios, a more prolonged slowdown in world economic growth would be particularly significant, as it would keep prices for Chile's main exports down, and could also affect export volumes. In terms of the exchange rate, events affecting the expected growth rate of the world economy, and therefore the timing and magnitude of future monetary policy actions in the US or the Euro zone could cause the exchange rate to appreciate. Similarly, although international markets differentiate between the Chilean economy and other emerging countries, undoubtedly Chile is not completely immune to major financial problems in Argentina or Brazil. In this scenario,

external financing would become scarcer and, as a result, the exchange rate could temporarily depreciate even further.

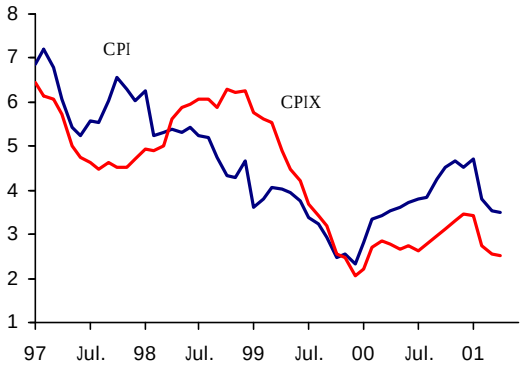
On the domestic front, it is important to note that at any given time multiple sources of uncertainty exist that could have a decisive influence on the confidence necessary for companies to develop new investment projects and for households to increase consumption. This uncertainty is greater today due to both the complex external scenario, which is in a state of flux, and a certain degree of pessimism and discouragement at the local level.

These considerations are particularly relevant now, because the macroeconomic climate affecting the Chilean economy in recent years needs to reassign resources – both capital and labor – from non-tradable to tradable economic sectors. These sector adjustments are costly, and the ease or difficulty with which they take place depends heavily on market flexibility and the economy's ability to respond to technological developments and changes abroad. The main scenario of this Report assumes these difficulties will not worsen in the near future, thus permitting an improvement in employment beyond the construction sector. Alternative developments, be they regulatory or technological, especially in the labor market, could make employment's recovery much more timid in coming quarters, a condition that aggregate demand policies would have a hard time offsetting. In this sense, the government's recent announcements that it will introduce a series of modifications to facilitate the role of financial markets in allocating resources are particularly significant. It would be very beneficial for this same, more flexible spirit to predominate in the debate of the labor reform project and the application of regulations in different markets.

Should these alternative scenarios occur at either the external or the domestic level, they would certainly modify inflation and growth projections. The Board believes that in light of the information available to date, the balance of risks affecting economic activity shows a slight downward bias. How quickly the US economy will grow remains uncertain, as does the speed of recovery in consumption and employment over the coming months. In any case, today this uncertainty is somewhat less than it was a few months ago. The risks associated with the exchange rate's performance in some alternative scenarios could also place more pressure on inflation. With all these factors in mind, the Board believes that the risk of inflation is balanced.

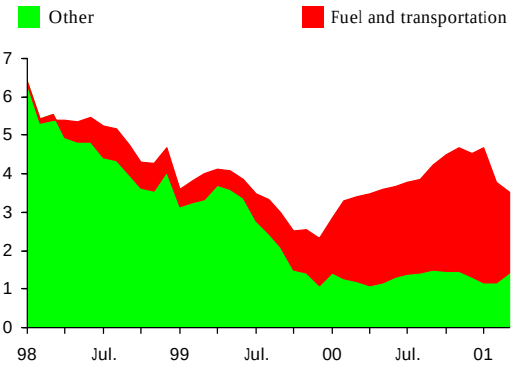
Nonetheless, the Central Bank remains alert to any sign that one of these alternative scenarios is actually taking place, in order to apply monetary policy with all the flexibility necessary to avoid compromising its inflation target. The Board will pay special attention in the coming months to how quickly consumption and employment grow, along with developments in the world economy, particularly growth in the United States and financial conditions affecting other emerging economies.

Figure I.1
CPI and CPIX inflation
(percentage change over the same period of the previous year)



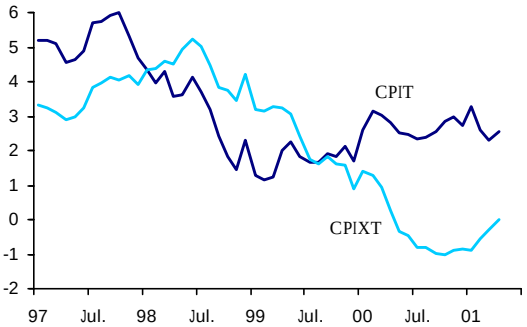
Source: National Statistics Bureau.

Figure I.2
Fuel and transportation, and other inflation
(total contribution to inflation; %)



Source: Central Bank of Chile.

Figure I.3
CPIT and CPIXT inflation
(percentage change over the same period of the previous year)



Source: National Statistics Bureau, Central Bank of Chile.

This section reviews recent price trends, examining and interpreting the behavior of different inflation indicators, their trends and main components.

Recent trends in inflation

At the end of April, Consumer Price Index (CPI) inflation had reached 3.5%, somewhat lower than expected in the previous report. This was influenced by the noticeable decline in perishable prices early in the year and the fall, during the first quarter, of fuel prices. Even discounting these factors, conditions confirm that the increase in annual inflation through January of this year was a temporary phenomenon that did not affect price trends (Figure I.1 and Table I.1).

Table I.1
CPI and CPIX
(annual rate of change)

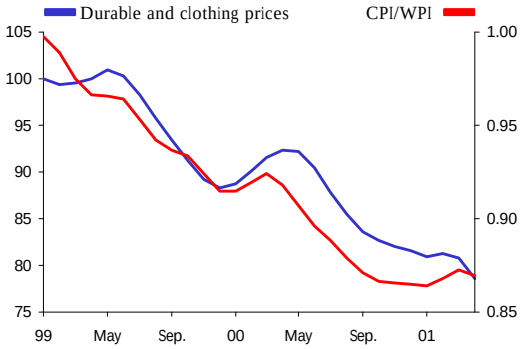
		CPI	CPIX
2000	jan.	2.8	2.2
	feb.	3.3	2.7
	mar.	3.4	2.8
	apr.	3.5	2.8
	may	3.6	2.7
	jun.	3.7	2.7
	jul.	3.8	2.6
	aug.	3.9	2.8
	sep.	4.2	3.0
	oct.	4.5	3.1
	nov.	4.7	3.3
	dec.	4.5	3.4
2001	jan.	4.7	3.4
	feb.	3.8	2.7
	mar.	3.5	2.5
	apr.	3.5	2.5

Source National Statistics Bureau.

Lower fuel prices from January to March and a higher basis for comparison of public transportation fares contributed almost one percentage point to reducing annual CPI and underlying CPI (CPIX) inflation. More recently, in April and May, the fuel price and public transportation fares rose by one percentage point, together contributing from 0.6 to 0.7 percentage points. This should not have any long-term effect on inflation (Figure I.2).

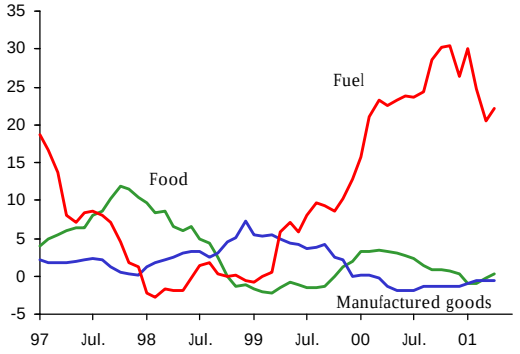
The decline in annual CPI inflation during the first four months was due to seasonal factors, as well as lower fuel and perishable prices from January to March.

Figure I.4
Price of durable goods and clothing in dollars and durable price ratio CPI/WPI
(durables and clothing prices in December 98 index = 100, CPI/WPI in %, moving quarterly series average)



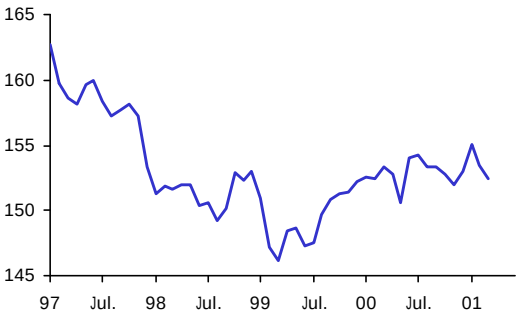
Source: Central Bank of Chile.

Figure I.5
Breakdown of tradable inflation
(percentage change over the same period of the previous year)



Source: Central Bank of Chile.

Figure I.6
Index of external prices relevant to Chile
(1986 index = 100)



Source: Central Bank of Chile.

Tradable goods inflation

Tradable goods inflation fell at the beginning of the year, and then picked up slightly in recent months. Increases in fuel prices during April-May were behind the recent increase in inflation for this group, which could reach over 3% per annum by the end of May (Figure I.3 and Table I.2).

Table I.2
CPIT, CPIXT, CPIN, CPIXN
(annual rate of change)

		CPIT	CPIXT	CPIN	CPIXN
2000	jan.	2.6	1.4	3.0	2.9
	feb.	3.1	1.3	3.5	3.9
	mar.	3.0	0.9	3.8	4.4
	apr.	2.8	0.3	4.2	4.9
	may	2.5	-0.4	4.6	5.2
	jun.	2.4	-0.5	4.9	5.4
	jul.	2.3	-0.8	5.2	5.6
	aug.	2.4	-0.8	5.2	5.7
	sep.	2.6	-1.0	5.8	6.3
	oct.	2.9	-1.0	6.0	6.6
	nov.	3.0	-0.9	6.3	6.9
	dec.	2.7	-0.9	6.2	7.1
2001	jan.	3.3	-0.9	6.0	7.0
	feb.	2.6	-0.5	4.9	5.4
	mar.	2.3	-0.3	4.7	4.8
	apr.	2.6	0.0	4.4	4.6

Sources: National Statistics Bureau, Central Bank of Chile.

The remaining prices for tradable goods, mainly durables, no longer show negative rates of annual change. Items such as clothing, which are affected by seasonal sales, have fallen less than in previous years. This indicates that pressure on retail margins has lessened, a situation also apparent in the stable performance of dollar prices for durable goods and clothing and the relationship between retail and wholesale durable goods prices (Figure I.4). Overall, by the end of April prices for the previous 12 months included in the underlying inflation rate for tradable goods (CPIXT) remained unchanged at 0.0% compared to –0.9% last December (Figure I.5).

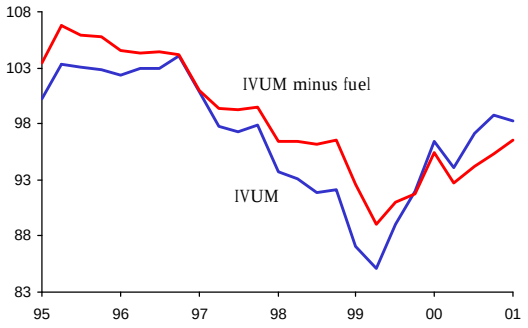
The accumulated evidence for durable prices indicates that retail margins for these goods are no longer shrinking.

Importable manufactured goods inflation

The baseline projection scenario takes into account the impact of the dollar's recent performance on world inflation in dollars and import prices for Chile this year and next. The external price index, measured in dollars (IPEX), fell 0.6% in March 2001 over March 2000. For the rest of 2001, the depreciation expected for the dollar should determine external inflation's performance (Figure I.6).

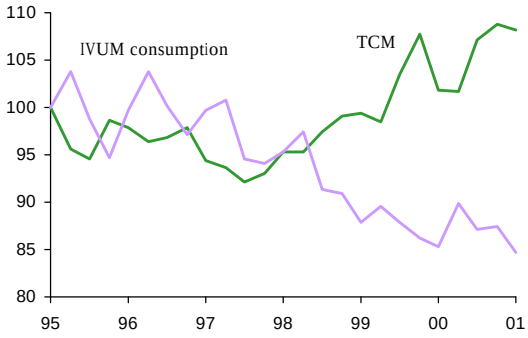
The baseline scenario assumes a rise over the next two years in external inflation, of manufactured goods measured in dollars.

Figure I.7
Total IVUM and IVUM minus fuel
(1990 index = 100)



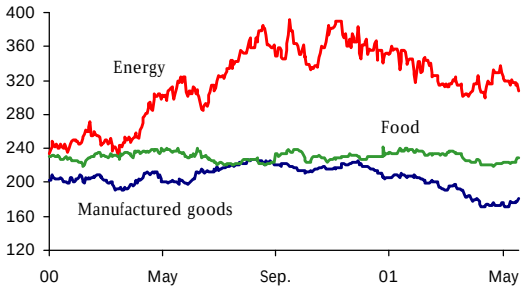
Source: Central Bank of Chile.

Figure I.8
IVUM consumption and multilateral exchange rate (TCM)
(1995.I index = 100)



Source: Central Bank of Chile.

Figure I.9
Breakdown of CRB index



Source: Bloomberg.

Until or through the first quarter of this year, dollar prices for imports (as measured by the import values unit index, IVUM) have increased which is expected to continue over the coming quarters, a trend affected by higher fuel prices (Figure I.7). Prices of consumer goods purchased abroad fell by 0.5% in 2000 and 0.9% during the first quarter of this year, a factor that continues to hold down domestic inflation for durable goods (Figure I.8).

Commodity and wholesale prices in Chile

During the first four months of 2001 commodity prices fell in most categories. The Commodity Price Index prepared by the *Commodities Research Bureau* (CRB) fell by around 6% between December 2000 and April 2001. This is mainly due to energy prices and industrial goods, although, in the case of the former, recent oil and gasoline price increases have turned this around (Figure I.9).

Commodity prices fell during the first four months of the year, led by energy and industrial goods.

The Wholesale Price Index (WPI) ended April with a 10.7% annual rise, up from 7.9% in December. The increase in the nominal exchange rate during March and April appeared in full in the WPI for imported goods. Higher average oil and fuel prices also affected the WPI for both domestic goods and imports. Nonetheless, readers should remember that the link between the WPI and the CPI is weak, aside from common factors affecting both indices[1] (Figure I.10 and Table I.3).

Peso depreciation and recent fuel price increases have affected the WPI of both domestic and imported products.

Fuel prices

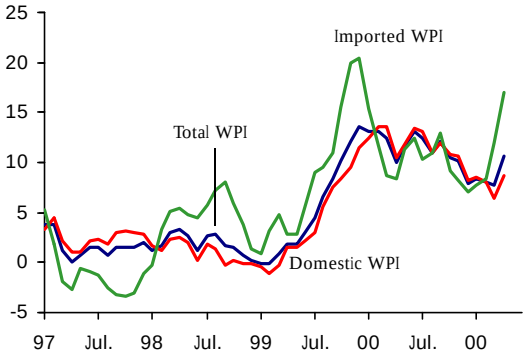
The end of the Northern Hemisphere's winter reduced world demand for heating fuels. This affected domestic liquefied gas prices, pushing them down by almost four-tenths of a percentage point. More recently, trouble at some refineries along with the arrival of the northern summer has caused gasoline prices to rise significantly on international markets. These price increases should turn around during the third quarter, once supply conditions normalize and the Northern Hemisphere's summer ends.

In the medium term, domestic fuel prices are expected to remain stable.

The latest available figures continue to suggest that the Brent oil price will hold steady at an average US$25 this year, US$23 next (Figure I.11).

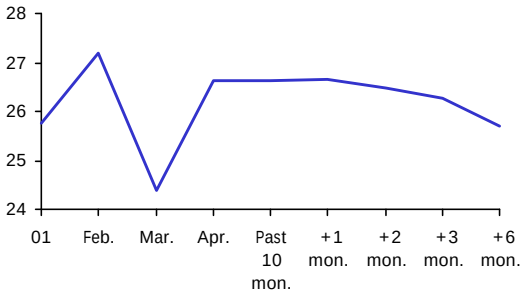
[1] The degree of correspondence between the CPI and the WPI is estimated at no more than 50% and in general is composed of items with rather stable prices. For more details, see the Monetary Policy Report, January 2001.

Figure I.10
Total, domestic and imported wholesale price index (WPI)
(percentage change over the same period of the previous year)



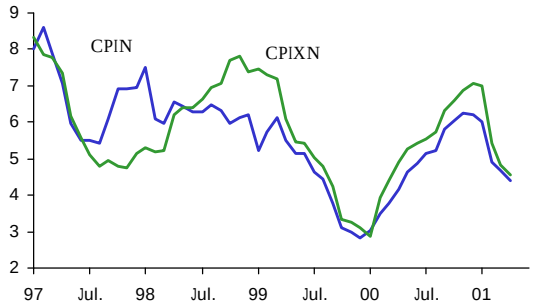
Source: National Statistics Bureau.

Figure I.11
Average future oil price over the past thirty days
(dollars per barrel)



Source: Bloomberg.

Figure I.12
CPIN and CPIXN
(percentage change over the same period of the previous year)



Source: National Statistics Bureau, Central Bank of Chile.

Non-tradable goods and services inflation

Annual inflation affecting non-tradable goods has fallen significantly since the beginning of the year, reaching 4.4% annual growth by the end of April. Underlying inflation for this sector (CPIXN) performed similarly, thereby closing gap with the CPIN (Figure I.12 and Table I.2) as well.

The main factor behind this decline was the fact that regulated service charges, such as public transportation,[2] telephone service and drinking water, rose less than last year.

Lower non-tradable inflation is associated with the fact that public transportation fares and some regulated utility charges rose less than last year.

Services with regulated fees

Public transportation fares have remained constant since the end of last year. February's decline was offset by a similar rise during May. This latest fare increase was due to a higher price for diesel oil and peso depreciation and is expected to contribute some 0.15 percentage points, evenly distributed, to inflation in May and June.

Other charges showed no significant changes during this period, although the exchange rate during March and April could have a one-time effect on service charges such as those for telephones. An analysis of electric power generation charges, reviewed every year in May and November, found that in May 2001 residential service charges in Santiago rose 6.1%. This correction is expected to contribute 0.1 percentage points to May's inflation (Figure I.13).

Unlike last year, no significant increases in regulated tariffs are expected for the first half of the year.

Personal services

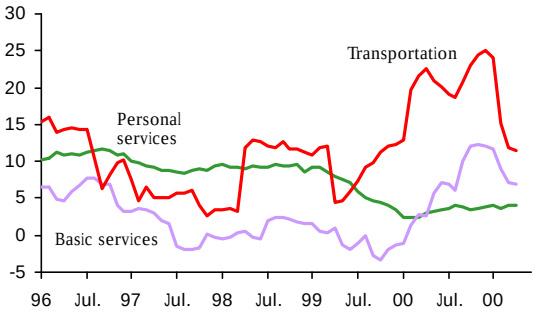
Through April, personal services showed an annual rise of 4.0%, slightly more than in December, and in line with nominal wage trends.

Perishable goods

Perishable goods prices continue to show a larger than usual seasonal decline for this time of year. However, the working assumption for projections for coming months is that perishables will resume their usual seasonable behavior (Figure I.14).

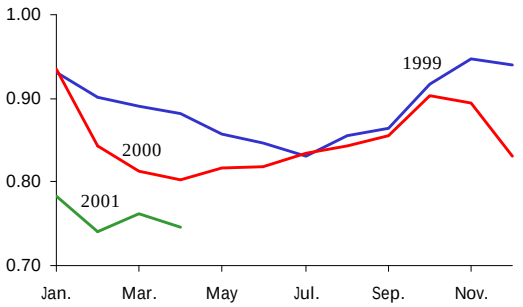
[2] In effect, in February 2000 public transport fares rose by 30 pesos, contributing 1.05 percentage points to the CPIN and somewhat more to the CPINX.

Figure I.13
Breakdown of non-tradable CPI
(percentage change over the same period of the previous year)



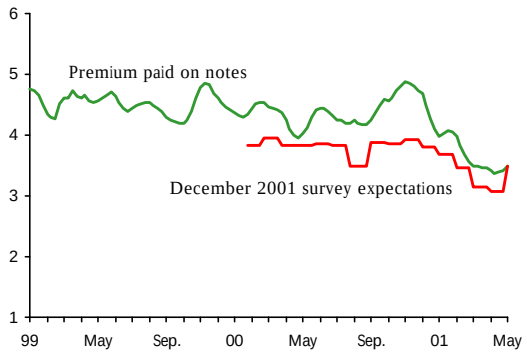
Source: Central Bank of Chile.

Figure I.14
Perishable goods price versus CPI



Source: National Statistics Bureau.

Figure I.15
Premium paid on 1-year nominal versus indexed notes and expectations survey December 2001 (1) y (2)
(percent; average moving fortnight)



(1) Since August 2000, this represents the difference between the short rate on PDBC-360 auctions and the one-year zero coupon indexed bond. Previously, because zero coupon bonds did not exist, the 360-day active banking rate (*tasa activa bancaria*, TAB) published by the banking association was used.
(2) Includes risk premium.

Sources: Central Bank of Chile, Association of Banks.

Prospects for the second and third quarters of 2001

From May to September, CPI-measured inflation will range from 3.5% to 4%, with pronounced peaks and troughs. While inflation is expected to rise by the end of the second quarter due to fuel price increases, by the end of the third quarter it should drop again, in line with lower fuel prices and the stability of other prices. This also assumes that perishables will follow their usual weather and seasonal patterns during the winter (June to August). In the short term, durable prices will probably hold steady, because margins will stop shrinking. Overall, no significant inflationary pressures are expected to affect prices in coming months.

Table I.3
Total WPI, WPI domestic and imported products
(annual change)

		WPI	WPI domestic	WPI imported
2000	jan.	13.1	12.4	15.4
	feb.	13.1	13.7	11.6
	mar.	12.4	13.6	8.7
	apr.	9.9	10.5	8.3
	may	11.7	11.8	11.3
	jun.	13.1	13.3	12.5
	jul.	12.5	13.2	10.4
	aug.	11.0	11.0	11.0
	sep.	12.1	11.9	13.0
	oct.	10.5	10.9	9.2
	nov.	10.1	10.7	8.3
	dec.	7.9	8.2	7.0
2001	jan.	8.3	8.5	7.7
	feb.	8.1	8.0	8.3
	mar.	7.7	6.4	11.9
	apr.	10.7	8.7	17.0

Sources: National Statistics Bureau.

In the longer term, the differential between the one-year Central Bank 90-day discountable promissory notes (PDBC- 360) and a zero coupon indexed bond, also maturing in one year, suggests inflation expectations slightly above the center of the target range. The May expectations survey was similar, indicating inflation should reach 3.5% in December of this year and 3.2% in December 2001 (Table I.4, Figure I.15).

Table I.4
Interest rates on nominal Central Bank instruments and inflation premium
(monthly average; percent)

	2000				2001				
	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May
90 day PDBC	10.3	11.5	10.9	9.3	8.3	8.1	6.1	8.6	8.9
360 day PDBC	10.3	10.7	10.6	10.0	9.0	8.4	7.5	7.9	8.0
Spread between PDBC 360 and 1-year zero coupon	4.5	4.8	4.8	4.2	4.1	3.8	3.5	3.4	3.6
Survey of inflation expectations									
December '01	3.8	3.8	3.9	3.8	3.7	3.5	3.2	3.1	3.5
December '02	3.5	3.5	3.5	3.4	3.5	3.3	3.0	3.0	3.2

Source: Central Bank of Chile.

By the end of the first four months of 2001, inflation as measured by the CPI was lower than forecast in January. During the second quarter, inflation is expected to rise temporarily, mainly due to an increase in fuel prices and some regulated service charges. By the end of the third quarter, inflation should fall back to current levels, ending the year at around the center of the target range.

This section examines recent trends and prospects for the world economy over the next two years, outlining the external scenario that the Chilean economy is most likely to face. World economic activity, international inflation, terms of trade and international financial conditions that will affect Chile are analyzed in this context.

Trends in world activity and prospects for this year have certainly evolved less favorably than forecast some months ago. Stagnation in Japan has combined with the deceleration in the United States, indirectly affecting the rest of the world and Chile's terms of trade. In the financial sector, the outlook for capital flows into Latin America and Chile has worsened. This shows that, to date, the negative impact of more volatile international financial markets and political uncertainty within the region has prevailed over the positive dynamic that US monetary policy was supposed to favor. Markets differentiate, however, to a significant degree between Chile and the rest of the region, as is apparent in the performance of its sovereign bond premium.

World growth

The projection of world growth for 2001, measured at Purchasing Power Parity (PPP), is 3.3%. Although this is less than the 3.8% forecast in the past report, it remains similar to average world growth throughout the nineties.

Less favorable growth prospects for this year are mainly due to the harder landing in the US, which, according to consensus estimates from April, will grow by just 1.7% this year. This assumes that US economic growth will recover during the second half of the year. More recent projections converge on a rate of about 1.5% for the year in the US, while the world's economy is projected to grow by around 4% in 2002.

Despite a marginal downward correction to growth projections for Europe, this is the most dynamic economy in the developed world this year. Despite a more adverse international outlook, future prospects for this region remain relatively stable, with growth projected at 2.5% in 2001 and 2.8% in 2002.

In Japan, however, prospects are rather more discouraging, due to the negative impact on its external sector of the deceleration in the United States, combined with the slow recovery of domestic demand. A rise in unemployment has made consumption's recovery even more difficult, while companies still seem to have room for additional restructuring.

This year, slowdowns in the US and Japan will affect the performance of Asia's emerging economies, but growth projections continue to converge towards 7% for 2002, with China driving regional growth. These countries currently enjoy a much more solid external position than in 1997, thanks to currency depreciation, the flexibility of current exchange rates in most of them, and a somewhat more consolidated banking system.

In Latin America, this year's growth will be affected by a more sluggish world economy and market turbulence. Mexico's economy will probably grow at less than half the rate it did in 2000. Argentina's difficulties

will have a real and financial impact on other economies within the region. Brazil is the most affected and pressure on its currency has led to tighter monetary policy. *Consensus Forecast* projections suggest growth in Latin America will reach 3.1% this year, 0.6% less than forecast in the previous report. In 2002, regional growth should again reach 4%, as measured by PPP (Table II.1).

Table II.1
World growth
(percent)

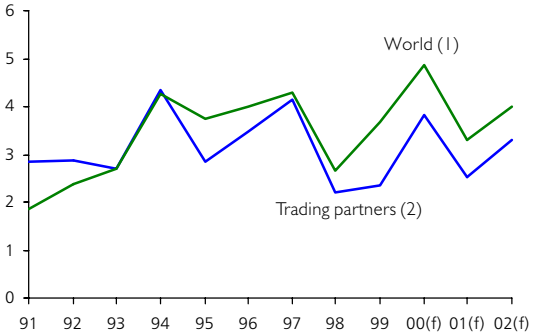
	Average 1990-1998	1999 (e)	2000 (e)	2001 (f)	2002 (f)
World (1)	3.2	3.7	4.9	3.3	4.0
United States	2.9	4.2	5.0	1.7	3.1
Europe	2.0	2.5	3.2	2.5	2.8
Japan	1.8	0.8	1.7	0.9	1.6
Rest of Asia (2)	8.1	6.4	7.4	6.2	6.8
Latin America (3)	3.1	-0.1	4.0	3.1	3.9
Trading Partners (4)	3.1	2.4	3.8	2.5	3.3

(1) Weighted regional growth by share of world GDP at PPP. Countries included represent 85% of world GDP (1999).
(2) China, Indonesia, Malaysia, Thailand, Singapore, Korea, Philippines, Taiwan and Hong Kong.
(3) Brazil, Argentina, Mexico, Colombia, Uruguay, Venezuela, Ecuador, Paraguay, Bolivia and Peru.
(4) Growth of Chile's main trading partners weighted by share of total exports (1998). Countries included account for 94% of total exports.
(e) Estimates.
(f) Projections.

Sources:
Consensus Forecasts (March and April 2001).
International Monetary Fund, World Economic Outlook (May 2001).
Central Bank of Chile.

Projections for world growth at constant PPP have fallen to 3.3% for 2001, reaching 4% in 2002.

Figure II.1
World growth
(percent)



(1) Weighted growth by share of world GDP.
(2) Weighted growth by share of Chile's total exports (1998).
(f) Projections.

Sources:
Consensus Forecasts (March and April 2001).
International Monetary Fund, World Economic Outlook (May 2001).
Central Bank of Chile.

In this scenario, demand prospects for Chilean exports have also worsened. This is already apparent in commodity shipments to Asia and in the price of Chile's main exports. Current estimates for the average growth of Chile's main trading partners this year are now half a percentage point less than forecast some months ago, reaching 2.5% in 2001, then recovering to reach 3.3%[1] in 2002 (Figure II.1).

Commodity prices and terms of trade

Figure II.2
Commodity price index (1)
(1967=100)

(1) Daily index of futures prices prepared by the Commodity Research Bureau.

Source: Bloomberg.

The CRB[2] Commodity Price Index today is at about 6% less than in December (Figure II.2). Chilean export prices have not been exempt from this situation.

The copper price has been falling since September of last year, reaching less than 80 cents per pound today. Rising inventories in recent months is due to the return of stocks that were in producers' hands, because expectations of higher demand declined in the short term. To the degree that the outlook for world growth stabilizes and given the situation affecting world supply, inventories should once again begin to fall. In

[1] World growth weighted by purchasing power parity prices (PPP) exceeds the weighted figure for Chile's main trading partners, because of the difference in Asia's share. This is because China, with high growth rates, accounts for a much larger share of world GDP at PPP than it does within Chile's exports. Meanwhile, Japan's share of Chilean exports is almost double its share of world GDP at PPP, and its economy is growing substantially less.

[2] *Commodity Research Bureau*.

Figure II.3
Copper price (1)
(cents per pound)

(1) Daily prices London Metal Exchange.
Source: Bloomberg.

line with this forecast, copper is expected to average 80 cents per pound this year, and 90 cents per pound next year (Figure II.3 and Table II.2).

Table II.2
Copper price projections
(cents per pound, London Metal Exchange, average)

	2000	2001	2002
Central Bank	82.3	80.0	90.0
World Bank	82.3	87.3	90.7
Cochilco	82.3	83-88	-
Goldman Sachs	82.3	76.5	-
Futures (1)	82.3	78.6	79.4

(1) Average over the 30 days prior to 7 May 2001.

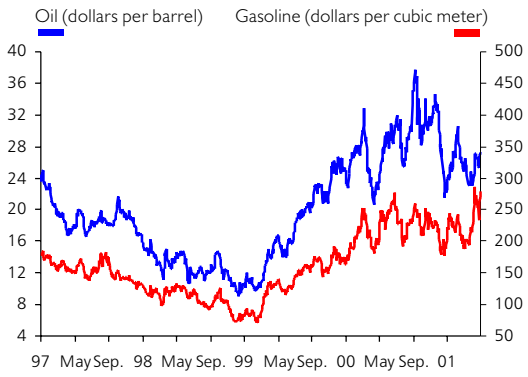
Sources:
Bloomberg.
World Bank, Development Economics, Development Prospects Group (30 January 2001).
Chilean Copper Corporation.
Goldman Sachs. The International Economics Analyst (March/April 2001).
Central Bank of Chile.

Price trends affecting other export commodities have also been negative. Since mid-2000, wood pulp prices have fallen steadily, mainly due to inventory accumulation by the main US, Canadian and Scandinavian producers. Futures levels suggest this will continue until prices reach US$520 per metric ton. The price of fishmeal is also likely to continue to fall, given that the Japanese economy, the main destination for this product, will grow less than last year. Suspension of consumption in the European Union, in an attempt to stop the spread of mad cow disease, will worsen this effect.

The price of copper is projected to average 80 cents per pound in 2001, 90 cents per pound in 2002.

The price of crude oil remains volatile, while gasoline has grown significantly more expensive in recent weeks. There is considerable consensus that these are temporary conditions that will not change expected trends in fuel prices this year and next. This has occurred firstly because the beginning of the northern summer coincided with lower gasoline inventories as a result of problems at some refinery plants. Secondly, futures prices for oil and gasoline tend to decline toward year's end, based on the ongoing rise in oil inventories confirmed in recent weeks. This leads to maintaining the projection for the Brent oil price of US$ 25 per barrel this year and US$ 23 in 2002 (Figure II.4 and Table II.3).

Figure II.4
Oil and gasoline prices (1)



(1) Daily Brent oil prices and 87 octane gasoline.
Source: Bloomberg.

Table II.3
Brent oil price projections
(dollars per barrel, average)

	2000	2001	2002
Central Bank	28.4	25.0	23.0
World Bank	28.4	25.0	21.0
JP Morgan	28.4	26.2	20.7
Goldman Sachs	28.4	22.3	-
Economic Intelligence Unit	28.4	23.9	23.0
Futures (1)	28.4	26.0	23.8

(1) Average over the 30 days prior to 7 May 2001.

Sources:
Bloomberg.
World Bank. Development Economics, Development Prospects Group (30 January 2001).
JP Morgan. Energy Research (March 2001).
Goldman Sachs. The International Economics Analyst (March/April 2001).
Economist Intelligence Unit. Global Outlook (April 2001).
Central Bank of Chile.

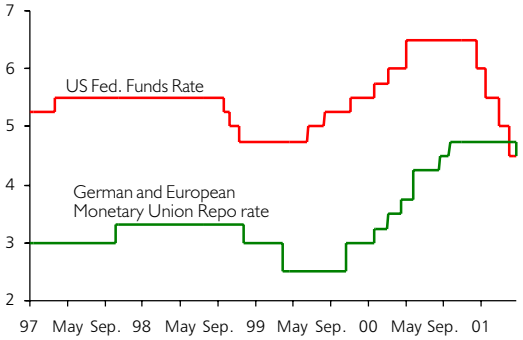
Figure II.5
Yen/US$ exchange rate

Source: Bloomberg.

Figure II.6
US$/Euro exchange rate (1)

(1) US$/ecu through 31 December 1998
Source: Bloomberg.

Figure II.7
Policy interest rates
(percent)



Source: Bloomberg.

The amounts assumed by the baseline scenario in January should hold, with oil averaging $25 per barrel in 2001, before converging to an average US$23 per barrel in 2002.

Overall, the terms of trade should fall by 1.7% this year, then rise by 5.3% in 2002.

International inflation

Expectations for world inflation show no significant change over the scenario forecast in the previous report. On the one hand, inflation projections for the US remain at 2.5% for 2001-2002. In Europe, inflation is expected to end up at slightly under 2.0% toward the end of next year. Japan will continue to experience deflation during this period.

World inflation, measured in dollars, will rise this year, due to the prospect of euro appreciation being somewhat offset by yen depreciation. For 2002, dollar inflation should rise more noticeably, due to dollar depreciation against both currencies (Figures II.5 and II.6 and Table II.4).

Table II.4
World inflation
(percent)

	Average 1990-1998	1999 (e)	2000 (f)	2001 (f)	2002 (f)
	(Average monthly change in local currency)				
United States	3.1	2.2	3.4	2.9	2.3
Europe	3.5	1.4	2.3	2.2	1.9
Japan	1.4	-0.3	-0.7	-0.3	0.0
Rest of Asia (1)	8.3	1.2	1.0	2.4	3.0
Latin America (2)	421.9	9.8	9.0	7.2	6.0

(1) China, Indonesia, Malaysia, Thailand, Singapore, Korea, Philippines, Taiwan and Hong Kong.
(2) Brazil, Argentina, Mexico, Colombia, Uruguay, Venezuela, Ecuador, Paraguay, Bolivia and Peru.
(e) Estimates.
(f) Projections.

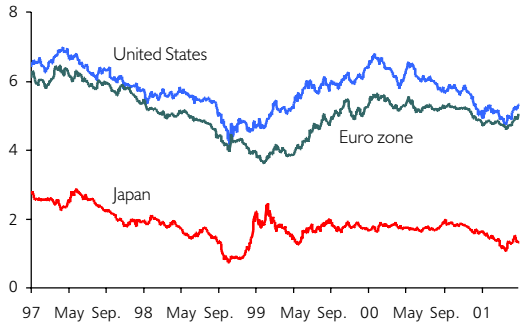
Sources:
Consensus Forecasts (March and April 2001).
International Monetary Fund, World Economic Outlook (May 2001).
Central Bank of Chile.

International interest rates

The trend toward a more relaxed monetary stance continues in the world's main economies. Since early January, the Federal Reserve has cut the federal fund rate by 200 basis points, after starting at a rather high level. Japan's monetary authorities have now reoriented their policy, aiming to achieve a zero or slightly positive inflation rate. As expected for some time, the European Central Bank recently reduced its policy rate by 25 basis points.

Currently, financial markets expect an additional cut to US federal fund rates of about 50 basis points during the upcoming Federal Open Market Committee meetings. This, along with the decision to implement the latest cut ahead of schedule, suggests that the Fed seeks to ensure rapid economic recovery during the second half of the year. Despite recent reluctance, additional cuts to Euro zone rates are also expected (Figure II.7).

Figure II.8
10-year government bond yields
(percent)



Source: Bloomberg.

The market expects increasingly relaxed monetary policies from both the Fed and the ECB.

In line with expectations that the US economy will slow down, longer-term government bond yields tended to fall toward the end of March, with the ten-year US bond even falling below 5%. After rates were cut in March, however, the bond yield recovered to about 5.2% and has continued to rise. Ten-year bonds in yens have performed similarly, as have instruments in the Euro zone, although the yield curve has been almost flat. In general, the rising tendency apparent in recent days for the longest-term yield curve suggests less uncertainty about world economic growth (Figure II.8).

Emerging financial markets

So far this year, emerging economies have suffered from significant volatility, due to the exchange rate crisis in Turkey in mid-February and Argentina's political and economic troubles. In any case, there has been some differentiation regarding the risks affecting each economy, as evidenced by sovereign spreads and capital flows since the beginning of the year.

In fact, the EMBI index for Latin America rose from 725 basis points in January to 858 basis points in May. Argentina's spread averaged 794 basis points in January, rising to 1231 basis points recently. Chile's sovereign spread, meanwhile, has fallen from 208 basis points in January to 170 basis points as this report went to press in May (Figure II.9 and Box II.1).

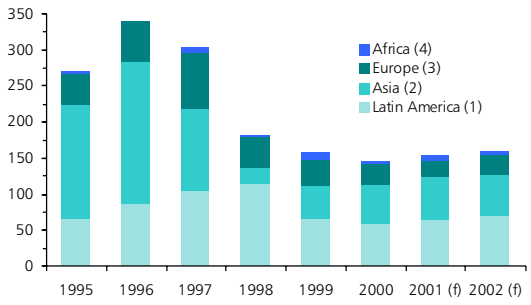
Figure II.9
Sovereign spreads
(basis points)

Source: JP Morgan, Merrill Lynch.

Emerging economies' sovereign spreads rose during the first quarter. Chile's, however, declined, revealing differentiation.

Another sign that investors are differentiating is that, although so far this year there have been net outflows of capital from emerging economies in the form of stocks and bonds, this has not been the case in Chile. Similarly, despite projections of reduced capital flows into the region after the turbulence in Argentina, projections for Chile have been corrected upward.

Figure II.10
Net capital flows to emerging economies
(US$ billion)



(1) Argentina, Brazil, Mexico, Colombia, Ecuador, Peru, Venezuela and Chile.
(2) China, India, Indonesia, South Korea, Malaysia, Philippines, Taiwan and Thailand.
(3) Russia, Poland, Hungary, Czech Republic, Slovak Republic, Bulgaria and Turkey.
(4) Morocco, Nigeria and South Africa.
(f) Projections.

Source: JP Morgan, Global Economic Forecast (30 April 2001).

The outlook for external financing this year and next is expected to become somewhat more expansive than in 2000. Net capital inflows into emerging economies as a group are expected to rise 5% on average, 16% for Latin America, assuming no further turbulence in financial markets (Figure II.10).

Sources of risk

Since the international outlook has worsened since the beginning of the year, the possibility of further downward corrections to growth projections remains. In fact, the slowdown in the United States could intensify, for example if the Fed's cuts to interest rates take longer to boost activity,

or if the few positive signs recently detected do not represent a change in tendency. Similarly, slow recovery of domestic demand in Japan, combined with a weaker external sector, could result in an even less positive outlook for demand for our main exports. Finally, although there is some evidence that Chile differentiates itself from other emerging economies, our economy is not immune to a sizable crisis in the region.

The outlook for the international environment has become less dynamic, due to the slowdown in growth in both the United States and Japan. Political and economic uncertainty in emerging economies and international financial markets persist. Although Chile's economy is differentiated from the rest of the region, it is not completely immune to contagion from troubled neighboring economies.

BOX II.1: CHILE'S ECONOMIC SOUNDNESS FACED WITH CRISES IN EMERGING ECONOMIES

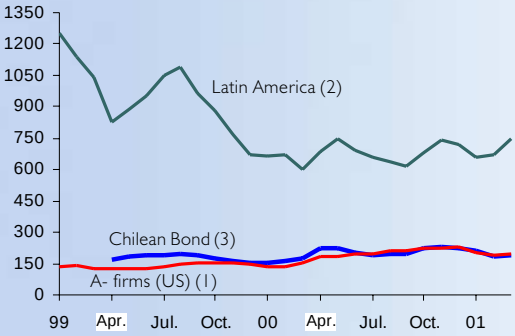
Table II.5
Emerging countries' sovereign debt rating (1)

	MOODY'S	S&P	FITCH
Argentina	B2	B	B+
Brazil	B1	BB-	BB-
Chile	Baa1	A-	A-
Mexico	Baa3	BB+	BB+
Indonesia	B3	B-	B-
Malaysia	Baa2	BBB	BBB
Philippines	Ba1	BB+	BB+
Thailand	Baa3	BBB-	BBB-
Korea	Baa2	BBB	BBB+

(1) Risk rating for long-term sovereign debt issued in dollars. Information through April 2001.

Source: Bloomberg.

Figure II.11
Sovereign spread
(basis points)



(1) Spread compared to US A- rated firms.
(2) Average spreads published in the EMBI index for Argentina, Brazil and Mexico.
(3) Spread for Chile's sovereign bond, issued in April 1999.

Sources: JP Morgan, Merrill Lynch, Chase Manhattan Bank.

During the past decade, a series of crises affected emerging economies, that had different levels of contagion effects in the rest of the world, including Chile. Recent turbulence in Turkey and Argentina reveals that risks subsist. This Box seeks to evaluate the strengths of the Chilean economy faced with this potential contagion.

In the first place, we examine information from different international rating bodies, which indicates that Chile is better positioned than the rest of the world's emerging economies to face the kind of crises mentioned. The economy is investment grade, demonstrating the low risk of not meeting its debt obligations, and therefore making it eligible for institutional investors (Table II.5).

A series of economic and financial indicators back up this positive perception of the Chilean economy. The main vulnerability indicators considered by agents abroad deal with the country's exposure to external liabilities, measured as stocks and flows, economic performance, access to capital markets, and political risk, among others. Chile enjoys a solid rating in all these areas. The country has advanced toward a floating exchange rate, along with an inflation targeting system. The exchange risk hedging market has developed significantly and regulations governing banking system risk have been improved. Additionally, the Central Bank holds a healthy amount of international reserves. Finally, both the financial sector and public finances are solvent.

Foreign agents' perception of risk levels associated with our economy can be deduced from the sovereign debt spread, which is calculated based on the additional yield that the market demands of government bonds issued in April 1999.

The following Figure shows how this indicator has behaved, compared to a Lat3 index, which includes the spreads for Argentine, Brazilian and Mexican debt, based on information from JP Morgan's EMBI index. Finally the A- variable (US) is provided, which corresponds to the spread for US firms with an A- rating and similar maturities (Figure II.11).

Often, Chile's spread is compared to the indicator for Latin America. If we look at the figure, however, the reason for this basis of comparison is less clear. Not only is the spread for Chile's sovereign bonds lower than the indicator for Latin America, but also it performs very similarly to the spread for A- rated firms in the US. Similarly, the Figure does not show a clear correlation with the Lat3 indicator, while it does seem to indicate movement in line with the A- (US) index.

Therefore, to formalize this observation about risk premiums, an econometric analysis follows, which compares the performance of the spread affecting Chile's debt with movements in these other two variables. For this regression, the first difference for variables was used, given that for the period under consideration the variables present a unit root, and because we are seeking to disaggregate fluctuations in sovereign spreads.

The estimated equation with results for each parameter follows. The t-test, for statistical significance, appears in parenthesis.

$$\Delta Spread(cl)_t = \underset{(-0.6)}{-0.49} + \underset{(2.5)}{0.44} * \Delta A^{-}(eeuu)_t + \underset{(2.6)}{0.48} * \Delta A^{-}(eeuu)_{t-1} + \underset{(4.4)}{0.08} * \Delta La$$

R^2 Corrected = 0.27

This equation suggests that fluctuations in Chile's sovereign spread show a significant correlation with changing spreads of A- firms in the US and the regional sovereign spread. For fluctuations of similar magnitude, the most

important coefficient is A- (US), which reaches 0.92. The coefficient of the Lat3 indicator, which represents regional conditions, is lower, at 0.08. To evaluate these results readers should keep in mind that although parameter magnitudes indicate that the first variable weighs more heavily, the A- spread shows less historic variability than the Lat3 (5 versus 44 basis points). Thus, the impact of average fluctuations in both variables on Chile's spread has been of similar magnitude.

A good illustration of these results is the performance of Chile's sovereign spread so far this year. Despite being temporarily affected by turbulence introduced first by Turkey and later by Argentina, it has clearly declined, as has the spread of A- firms in the US.

The inclusion of other variables, such as Nasdaq volatility (the US technology stock exchange), and the spread between the interest on 10-year government bonds and LIBOR on 3-month dollar bonds do not alter the conclusions provided by this model.

Another point deals with the existence of relevant variables that could not be included, particularly those related to macroeconomic fundamentals. It is clear that indicators associated with economic performance, external debt and capital flows from abroad, among others, are variables that influence a country's risk rating. Given the frequency of data used, however, these elements cannot be included in the model, but it is assumed that the A- variable includes to some degree the effects of changing market conditions on some economic fundamentals. The fact that Chile has enjoyed an A- rating from Standard & Poor's since 1995 makes it possible to argue that the market has internalized the economic fundamentals of Chile's economy and that these have not changed drastically in recent years. Similarly, for this period, solvency indicators for the Chilean economy have remained solid and relatively stable.

It is a fact that the spread affecting Chile's debts has too short a history to be able to capture the main crises affecting emerging economies in the 1990s. In terms of recent turbulence (Brazil in 1999, Turkey in 2001, Argentina in November and last March), however, investors clearly differentiate between different markets and economies. Nonetheless, Chile is not completely immune to major crises in emerging economies.

This section reviews recent trends in financial markets, particularly monetary policy, interest rates and the exchange rate, monetary and credit aggregates, and external financing of the Chilean economy.

Interest rates, monetary aggregates and credit

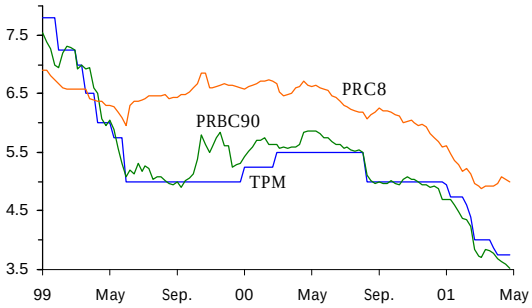
Monetary policy and interest rate structure

Since the beginning of the year, the Board has steadily reduced the monetary policy interest rate (*tasa de interés de política monetaria, TPM*), which today stands at UF + 3.75%, its lowest point since the end of the 1980s. These policy decisions are the result of consolidation of a scenario involving less inflationary pressure in the medium term.

The TPM has been reduced by 125 basis points since the beginning of the year, to reach UF + 3.75% currently.

Rates for Central Bank promissory notes have shown a clear tendency to fall since mid-March, in anticipation of changes to the monetary policy rate (TPM). Most recently, interest on short-term instruments (PRBC90) has fallen below the TPM, while interest on longer-term instruments (PRC8) has reached about 5.0%, having risen almost 20 basis points in recent weeks, mainly due to instability in Argentina (Table III.1, Figure III.1).

Figure III.1
Monetary policy rate (TPM) and interest rates on Central Bank of Chile notes
(weekly average, percent)



Source: Central Bank of Chile.

Table III.1
Interest rates
(monthly average; percent)

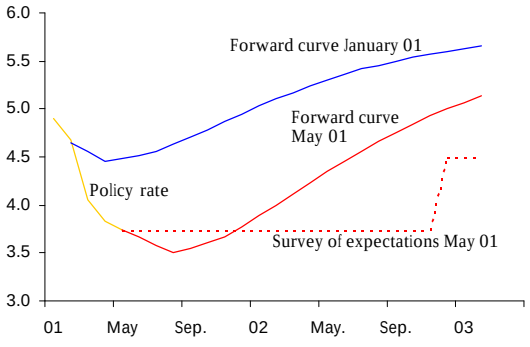
	2000				2001				
	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May
TPM	5.00	5.00	5.00	5.00	4.90	4.68	4.05	3.84	3.75
PRBC 90 *	5.00	4.99	5.04	4.94	4.71	4.42	3.84	3.72	3.57
PRC *									
8 years	6.20	6.13	6.01	5.89	5.60	5.21	4.93	5.00	5.05
20 years	6.20	6.13	6.06	5.99	5.78	5.48	5.26	5.37	5.46
Deposit (90 days to 1 year)	4.88	4.89	4.82	4.81	4.50	4.24	3.97	3.77	3.62
Lending (90 days to 1 year)	7.63	7.36	7.20	6.97	6.85	6.77	6.18	5.94	6.02

* Based on auctions.

Source: Central Bank of Chile.

The structure of real interest rates and market expectations are consistent with the monetary policy rate remaining at its current level.

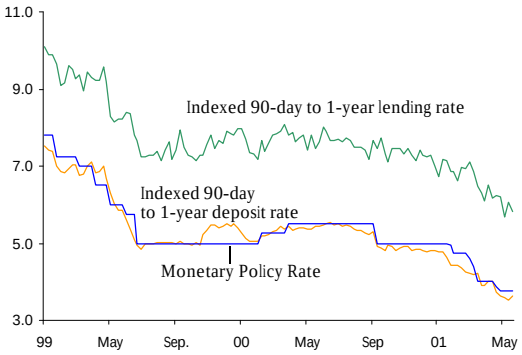
Figure III.2
Policy rate, expected TPM and forward curve
(percent)



Source: Central Bank of Chile.

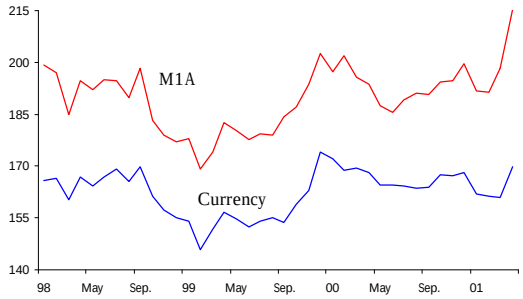
This interest rate structure suggests that the market expects the TPM to fall by 25 basis points early in the second half of the year, before returning to its current value in late 2001. This contrasts with results from the May survey of expectations, which predicted a constant 3.75% level for the TPM through to the end of the year (Figure III.2).

Figure III.3
Policy, 90-day to 1-year deposit and lending rates
(weekly average; percent)



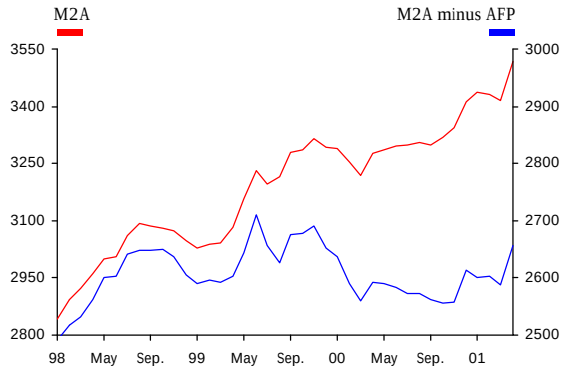
Source: Central Bank of Chile.

Figure III.4
Seasonally adjusted transaction demand for currency and money
(January 1990=100)



Source: Central Bank of Chile.

Figure III.5
Real seasonally adjusted M2A and M2A minus AFPs
(millions of 1986 pesos)



Source: Central Bank of Chile.

Short-term interest in the financial system and more liquid monetary aggregates

The performance of real rates on Central Bank instruments influences other market interest rates. 90-day to one-year deposit rates are somewhat lower than the TPM, at a level consistent with the cost of the monetary reserve (Figure III.3), while lending rates for the same period have fallen more slowly, to reach levels not seen since 1986 and 1987. The spread between lending and deposit rates is higher than last year's average, so there is room for lending rates to move closer to deposit rates.

The performance of short-term rates within the financial system affects the demand for more liquid monetary aggregates. This also contributes relevant information for evaluating the economy's behavior and the impact of monetary policy, although the Central Bank has no explicit or implicit objectives regarding money's behavior.

In March and April, the more liquid monetary aggregates demonstrated stronger growth.

Currency and private money (M1A), once adjusted for seasonal and interest rate effects, are linked to consumers' and companies' transaction needs. In March and April both variables showed a tendency to expand, which suggests that expenditure could pick up in the coming months (Figure III.4 and Table III.2).

Table III.2
Seasonally adjusted real monetary aggregates
(monthly change)

	2000				2001			
	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.
Currency (1)	0.1	2.3	-0.3	0.7	-3.7	-0.5	-0.2	5.5
M1A (1)	-0.2	2.0	0.1	2.6	-3.9	-0.2	3.5	8.5
M2A								
with AFP	-0.2	0.7	0.7	2.0	0.7	-0.2	-0.4	3.0
without AFP	-0.4	-0.2	0.0	2.2	-0.5	0.1	-0.6	2.7
M7A								
with AFP	-0.1	0.0	0.4	1.9	0.3	0.1	0.1	1.4
without AFP	-0.3	-0.3	0.8	2.1	-0.3	-0.2	0.0	2.5
M7B	0.5	0.3	0.3	1.9	0.1	0.1	0.3	1.7

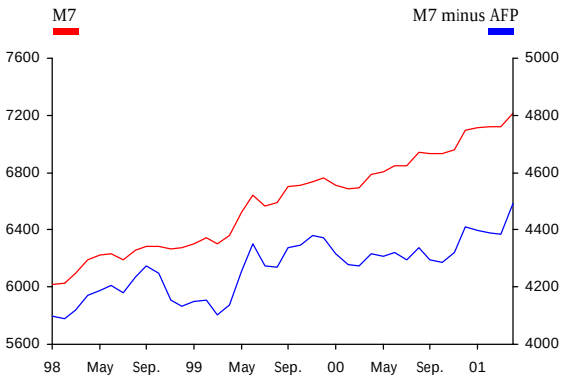
(1) Monthly change seasonally and interest rate adjusted.
Source: Central Bank of Chile.

Other monetary aggregates, credit and long-term financial system interest rates

The behavior of the broader aggregates, M2 and M7, excluding the AFPs' share, has followed money's performance. Aggregates held by AFPs have performed somewhat less strongly in the recent past, which can be explained by the shifting of their portfolios into other financial instruments (Figure III.5 and III.6).[1]

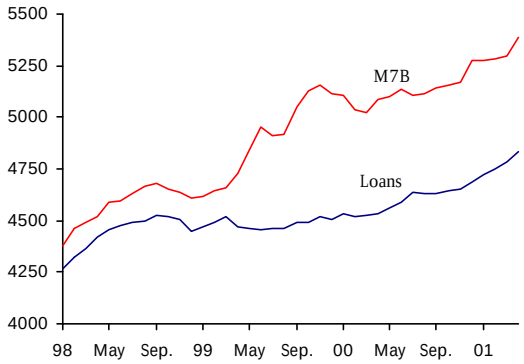
[1] Pension fund managers (*Administradoras de Fondos de Pensiones*) account for about 24% of M2A and 38% of M7.

Figure III.6
Real seasonally adjusted M7 and M7 minus AFP
(millions of 1986 pesos)



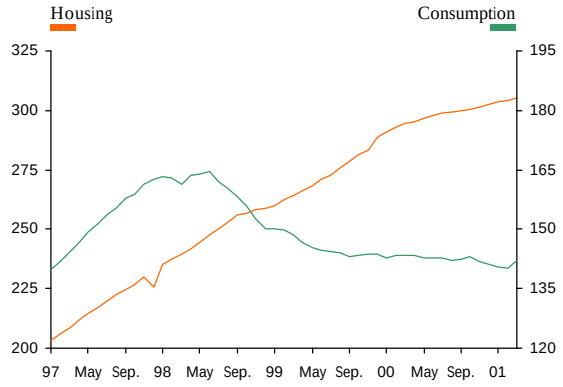
Source: Central Bank of Chile.

Figure III.7
Real seasonally adjusted M7B and total loans
(billions of 1986 pesos)



Source: Central Bank of Chile.

Figure III.8
Real seasonally adjusted credit to individuals
(UF thousands; monthly balance)



Source: Superintendent of Banks and Financial Institutions.

Using M7, an indicator for the supply of domestic financing within the banking system can be obtained. To do so, one must subtract currency and Central Bank notes, and add public sector time and demand deposits. This indicator is known as M7B (banking M7). The ratio between total loans and M7B has traditionally been close to one. For 1999-2001, however, it reached 0.9, indicating increased bank liquidity. Although there is room for expanding domestic credit (Figure III.7), this is unlikely to happen until the uncertainty and risks associated with unemployment decline.

Mortgages and bills of credit are performing more positively, thanks to the significant decline in rates (starting at 5.9%, depending on maturity and the amount involved) (Table III.3). Credits for housing have grown steadily during the first quarter (Figure III.8). Loans to companies have picked up to levels similar to those at the end of last year, after declining slightly in January (Table III.4 and Figure III.9).

Table III.3
Loans to public and private sectors
(monthly changes over real seasonally adjusted series)

	2000				2001			
	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.
Loans in domestic currency								
Cash	0.2	0.5	0.2	1.2	0.7	0.6	-0.1	-0.2
Mortgages	-0.1	0.1	0.2	0.3	0.2	0.6	0.5	0.2
Loans in foreign currency (1)	-2.0	1.0	-1.5	-0.9	0.5	-0.4	6.1	14.1
Total	-0.1	0.4	0.1	0.8	0.7	0.6	0.7	0.9

(1) Loans in foreign currency have been converted to local currency using the observed exchange rate.
Source: Superintendent of Banks and Financial Institutions and Central Bank of Chile.

Table III.4
Loans to the private sector
(monthly change over real seasonally adjusted series)

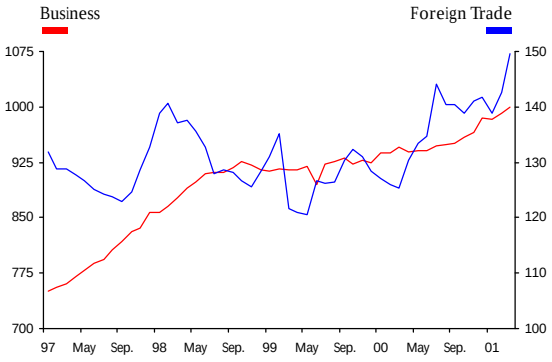
	2000					2001		
	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.
Loans to individual								
Consumption	-0.3	0.2	0.5	-0.9	-0.4	-0.5	-0.4	1.5
Housing	0.1	0.2	0.2	0.3	0.4	0.3	0.2	0.3
Loans to companies								
Retail	-2.6	0.0	-1.1	1.7	0.4	-2.0	2.5	4.9
Foreig trade	0.2	0.2	0.8	0.8	2.0	-0.2	0.8	0.8
Total	0.0	0.1	0.5	0.5	1.1	0.1	0.5	1.3

Source: Superintendent of Banks and Financial Institutions and Central Bank of Chile.

Consumer credits, in contrast, remain flat. This is because individuals are more cautious when it comes to going into debt, and banks are more cautious about lending due to a perception of greater risk, due to persistent, high unemployment. This is further influenced, although to a lesser degree, by regulatory changes over the past three years (Box IV.1). Overall, the performance of credit to the private sector has reflected developments in the real sector, where consumption has stagnated, although investment is growing.

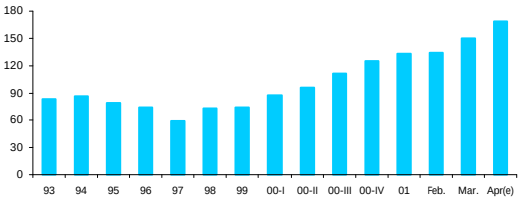
The way that companies finance themselves has also responded to today's interest rates on long-term Central Bank instruments. This, combined with the reduced availability of financing from abroad, has

Figure III.9
Seasonally adjusted real credit to companies
(UF thousands; monthly balance)



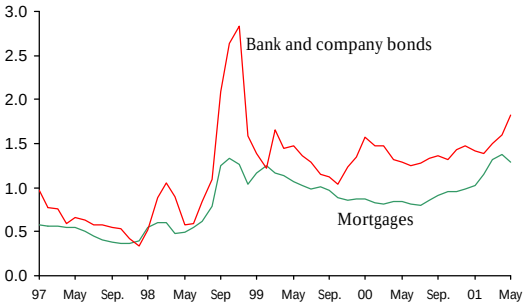
Source: Superintendent of Banks and Financial Institutions.

Figure III.10
Private, non-financial sector bonds outstanding
(UF millions)



(e) Estimate.
Source: Superintendent of Securities and Insurance.

Figure III.11
Interest differential between fixed income instruments and Central Bank papers
MDRR* secondary markets (moving quarterly average; percent)



* Monthly domestic rate of return.
Source: Santiago Stock Exchange.

encouraged the issuing of corporate bonds in *unidades de fomento* (UFs, an indexed accounting unit) on the domestic market. Since early 2000, the number of private bond issues on the local finance market has grown steadily, rising particularly strongly in recent months. Today, the total has reached some 170 million UF, about 28% of total UF instruments issued by the Central Bank, compared to 17% in 1999. During the same period, foreign private debt has risen by about US$3.3 billion, while bonds have risen US$2.2 billion (Figure III.10).

The spread on documents in UF issued by private bodies over those issued by the Central Bank has tended to increase due to their rising supply.

Consistent with this increase in the supply of financial instrument in UF documents issued by private bodies, their spreads over Central Bank notes have also risen. Since last September, the gap between interest on mortgages and long-term Central Bank papers has risen by about 40 basis points, as has the premium on the average internal rate of return on company and bank bonds over Central Bank papers (Table III.5 and Figure III.11). In recent months this increase has been particularly intense in the case of bonds, coinciding with significant issues by several conglomerates.

Table III.5
Internal yield (TIR) on Central Bank notes, mortgages and private bonds
(monthly average; percent)

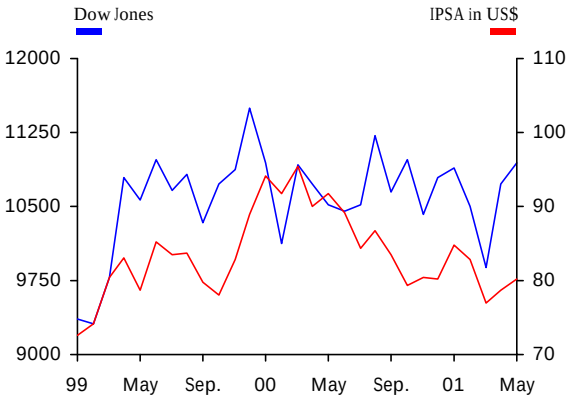
	2000				2001				
	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May
Mortgages	7.11	7.09	6.98	6.90	6.71	6.52	6.46	6.64	6.61
Premium*	0.92	1.05	0.92	0.73	0.97	1.16	1.21	1.37	1.29
Company bonds	7.51	7.47	7.65	7.34	6.76	6.77	6.72	6.87	7.15
Premium*	1.32	1.43	1.59	1.17	1.02	1.41	1.47	1.60	1.83
Central Bank	6.19	6.04	6.06	6.17	5.74	5.36	5.25	5.27	5.32

* Difference between the TIR and the average price for Central Bank notes on the Stock Exchange.
Source: Santiago Stock Exchange.

Other financial asset prices

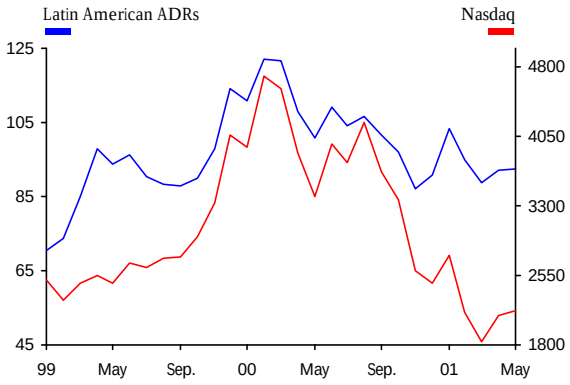
This year, the IGPA (the general share price index for the Santiago exchange) has risen 5.3%, while the IPSA (selected share prices on the Santiago exchange) has risen by 4.5%. Measured in dollars, the IGPA has risen 0.7%, while the IPSA has fallen 0.1%. The dollars of both is less than that of external indices such as the Dow Jones and Latin American ADRs, and contrasts with the significant fall in the Nasdaq (Table III.6). The price-earnings ratio has risen from an average of 17 in 2000 to around 19 in April 2001, similar to that of 1999 (Figures III.12 and Figure III.13). So far this year, stock exchange transactions have involved small amounts, on average considerably less than the same period of last year.

Figure III.12
IPSA and Dow Jones stock indices



Sources: Bloomberg, Santiago Stock Exchange.

Figure III.13
Latin American ADRs and Nasdaq stock indices



Source: Bloomberg.

Table III.7
Stock indices by sector

	Yearly change*	Monthly change*
IPSA	4.5	2.5
IGPA	5.3	1.1
Sectors		
Banking and finance	14.0	0.0
Agriculture, hunting and forestry	2.9	-2.3
Mining	12.0	2.6
Manufacturing	3.6	0.4
Food and drink	14.3	1.1
Construction	4.4	0.7
Other products	-6.9	-1.8
Metal mechanical	-1.8	1.4
Fishing	-0.6	0.0
Chemical products	28.0	5.6
Textiles and clothing	-21.9	0.0
Services various	4.9	1.6

* Calculated using information through 7 May.

Source: Stock Exchange, Electronic Stock Exchange of Chile.

Table III.6
Monthly change in stock indices

	IPSA *	IGPA *	Dow Jones	ADR LAT.	NASDAQ
Apr. '00	-5.5	-4.3	-1.7	-11.4	-15.6
May	1.9	-1.9	-2.0	-6.5	-11.9
Jun.	-2.9	-2.9	-0.7	8.2	16.6
Jul.	-5.4	-4.2	0.7	-4.6	-5.0
Aug.	2.9	1.1	6.6	2.6	11.7
Sep.	-3.8	-4.7	-5.0	-4.9	-12.7
Oct.	-4.8	-2.3	3.0	-4.3	-8.3
Nov.	1.3	0.7	-5.1	-10.4	-22.9
Dec.	-0.2	0.6	3.6	4.4	-4.9
Jan. '01	5.6	5.5	0.9	13.7	12.2
Feb.	-2.3	-2.4	-3.6	-8.0	-22.4
Mar.	-7.2	-3.6	-5.9	-6.7	-14.5
Apr.	2.2	0.7	8.7	4.0	15.0
May **	2.1	0.7	1.9	0.1	2.7

* Expressed in US dollars.
** Calculated using information through 7 May.

Sources: Bloomberg, Santiago Stock Exchange.

During 2001, trends in share prices by sector reveal that the most dynamic have been the banking, financial and mining sectors, while share prices for the varied services, manufacturing, agricultural-fishery and forestry sectors grew moderately. In manufacturing, the positive performance of food and drinks and chemical products contrasts with negative results for textile, clothing and other goods (Table III.7).

The exchange rate

So far this year, the nominal exchange rate has depreciated by almost 4.8%.[2] The dollar rose from 571 Chilean pesos in January to over 600 pesos in recent weeks. This depreciation is mainly due to economic instability in the region, although weak domestic demand also played a role during the first quarter.

In multilateral terms, the peso has depreciated less (Table III.8), because of weakness against the dollar of currencies such as the euro, the yen and the real. The real exchange rate index (*índice de tipo de cambio real, TCR*) rose 1.8% between December and April, presently reaching levels similar to the average for 1994 (Figure III.14 and III.15).

Table III.8
Multilateral exchange rate index (TCM) (1) and observed exchange rate (TCO)

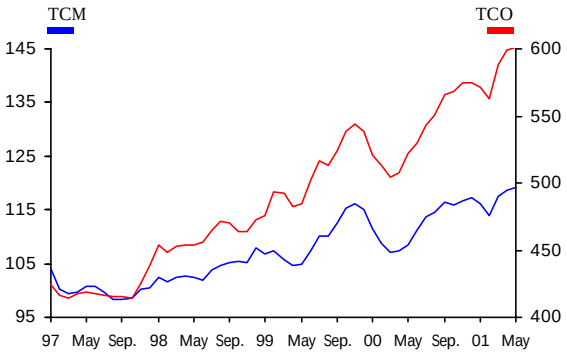
	Average *	Dec. '00	Monthly change	Yearly change
TCO	601.7	574.6	0.5	4.7
TCM**	119.3	117.2	0.6	1.8
TCM 5***	129.2	125.4	0.8	3.0

* Average of the last ten working days, 23 April to 7 May.
** The multilateral exchange rate index (Tipo de Cambio multilateral, TCM), *represents a nominal peso value for a broad basket of foreign currencies.*
*** The TCM5 brings together currencies from the US, Japan, the United Kingdom, Canada and the Euro zone.

Source: Central Bank of Chile.

[2] This is the average devaluation of the Chilean peso against the US dollar registered from December 2000 to the last ten working days before the statistical closing date of this report.

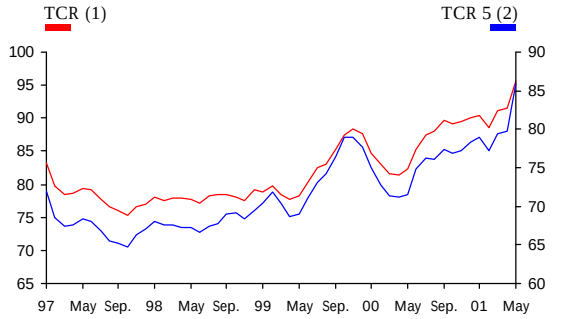
Figure III.14
Multilateral exchange rate index (TCM) (1)
and observed exchange rate (TCO)



(1) Calculation based on parities of Chile's main trading partners. These are (ordered by weight): United States, Japan, Argentina, Brazil, Mexico, Germany, Spain, Italy, France, United Kingdom, Korea, Canada, Peru, Holland, Belgium, Colombia, Taiwan, Venezuela, Ecuador, Sweden and China. More information in the Informe Económico y Financiero, 30 March 2001.

Source: Central Bank of Chile.

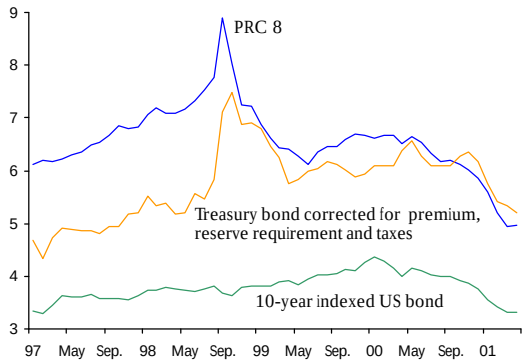
Figure III.15
Real exchange rate (TCR) index



(1) Based on parities of Chile's main trading partners (ordered by weight): United States, Japan, Argentina, Brazil, Mexico, Germany, Spain, Italy, France, United Kingdom, Korea, Canada, Peru, Holland, Belgium, Colombia, Taiwan, Venezuela, Ecuador, Sweden and China.
(2) Includes USA, Japan, Canada, United Kingdom, Euro. More information in the Informe Económico y Financiero, 30 March 2001.

Source: Central Bank of Chile.

Figure III.16
Real domestic and external interest rates
(percent)



Sources: Bloomberg, Central Bank of Chile.

In May, the Central Bank's monthly survey indicated that the market expected the nominal exchange rate to reach around 610 pesos per dollar by the end of 2001 and 625 pesos per dollar by the end of 2002. These figures indicate implicit expected depreciation of about 1.2% from May to December 2001 and 2.4% in 2002. A depreciation of around 3.5% over a two-year horizon is suggested by currency futures prices,[3] although these amounts are more influenced by the current Argentine situation (Table III.9).

Table III.9
Exchange rate futures

	May futures	May survey	Futures from previous IPoM
Current*	602.0	601.7	573.2
3 months	608.0	601.0	576.5
6 months	612.5	606.0	581.5
Dec. '01	614.1	610.0	592.9
Dec. '02 **	631.8	625.0	612.8

* In the case of futures, we used the average of the previous 10 working days, that is 23 April to 7 May. In the case of the survey, we used the average for 3 to 9 May, which was when the survey was conducted. For the previous IPoM, we used the statistical closing date, 19 January 2001.
** We carried out a linear extrapolation based on futures values to 24 months.

Source: Bloomberg.

The (TCM) multilateral exchange rate is expected to depreciate less than the dollar, because the market anticipates an increased depreciation on the currencies of the region, offsetting the expected appreciation of the euro and yen.

As with futures, the spread between real interest rates indicates expectations about the real exchange rate. In recent months, the difference between the PRC-8 and the indexed 10-year US bond has been slightly negative, since local rates fell more than those abroad. This spread is compatible with a stable real exchange rate or a slight appreciation, if the exchange rate risk premium is taken into account (Figures III.16).

The central scenario assumes the real exchange rate will remain stable.

Given that the inflation differential between Chile and its main trading partners is about 1%, the average nominal depreciation suggested by both the expectations survey and futures is compatible with real depreciation. Nonetheless, information provided by real interest rate differentials is consistent with a real appreciation. Moreover, the baseline scenario for activity is that growth in expenditure and output will speed up in the coming quarters, and combined with less turbulence on international financial markets. Therefore, the working assumption for the real exchange rate is that it will remain stable. The consequences of this central scenario on growth and inflation and the balance of risks are discussed in Chapter VI.

[3] Futures prices against currencies reflect nominal interest rate differentials between countries and are therefore another point of reference for expectations of nominal depreciation. Nonetheless, one should keep in mind that futures prices also include a liquidity premium.

External financing of the chilean economy

The Chilean economy's international solvency and liquidity indicators reveal a solid position, especially when compared to emerging economies as a whole. This is reflected in the low risk premium assigned to the Chilean economy.

Capital account

During the first quarter of 2001 there were significant inflows of direct investment from abroad. In effect, net foreign direct investment rose significantly, to reach 78% of the total registered in 2000. This was mainly due to changes in ownership of telecommunications and electric sector companies.

The counterpart to sales of shares in the companies mentioned above has been direct investment by Chilean residents abroad, which reached a figure similar to that of the last quarter of 2000. Moreover, portfolio investment abroad remained strong, because of significant investment by pension funds. The final result was a positive capital account balance for the period (Table III.10).

Table III.10
Capital account
(US$ million)

	1999 (e)	2000 (e)	2001 (e)
CAPITAL MINUS RESERVES	-763.5	1,198.6	153.6
Foreign investment	4,496.1	-1,364.1	-98.0
Direct investment	4,365.8	-1,103.3	858.9
Portfolio investment	130.3	-260.8	-956.9
Other capital	-5,259.6	2,562.7	251.6
Medium- and long-term capital	65.0	240.6	428.5
Short-term capital	-5,324.6	2,322.1	-176.9
ERRORS AND OMISSIONS	158.3	-12.2	-321.8
SURPLUS (DEFICIT) BALANCE OF PAYMENTS	-683.3	197.9	-56.7

(e) Estimates.
Source: Central Bank of Chile.

Another aspect that must be mentioned is that the structure of financing has changed. In fact, inflows of medium-term, non-investment capital, mainly credits from abroad, were positive in the first quarter of the year. In contrast, short-term capital fell, due to outflows associated with foreign trade, the result of a seasonal increase in pending export returns.

Projections for 2001 indicate the capital account balance will remain positive, due to net income from medium- and short-term credits, particularly those associated with foreign trade, along with positive direct investment inflows. By the end of 2001, the capital account balance is expected to be about 42% higher than last year, due to the recovery in foreign investment, which is projected to rise by about 55% over 2000. Direct investment abroad by Chileans should rise by about 12%. Although for the rest of the year net portfolio investment flows are expected to be positive, estimates for the year indicate a net outflow due to the significant outflow already observed. This will occur despite new bonds likely to be issued abroad.

The projection for net credit indicates a positive balance, despite more bond issues in UFs, signaling a shift by some firms away from external financing in favor of domestic sources and significant amortizations that will occur during the year. This is due to the fact that similar credits will cover commitments to a significant degree.

Finally, the measures taken by the Board to suppress exchange restrictions affecting a series of financial operations should also influence the future behavior of the capital account, because these measures seek to make access to international capital markets more fluid.

External vulnerability indicators

In Chile, the indicator of foreign debt over GDP has been rising, as has foreign debt over exports, the result of reduced growth prospects and a weaker export sector. These indicators, however, remain favorable compared to those of other emerging economies. In Latin America's case, Chile continues to perform better than Brazil and Mexico. This contrasts with the instability affecting the Argentina economy, which led Standard & Poor's to reduce the risk classification of its foreign debt. External vulnerability indicators for emerging Asian economies generally show improvements over the previous report (Table III.11).

Table III.11
External vulnerability indicators for emerging markets

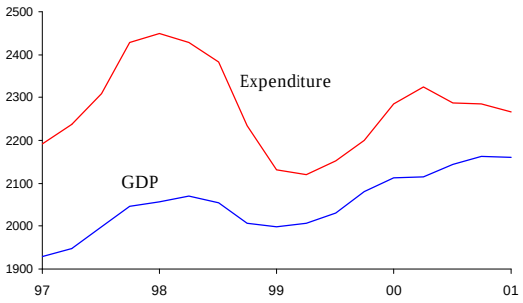
	S&P debt rating	Total foreign debt (% GDP) (1)	Foreign debt (% exports) (1)	Short-term foreign debt + amortizations (% NIR*) (2)	Current account deficit (% GDP)	M2 (% NIR) (3)
Chile	A-	59	165	48**	-2.2**	201
Argentina	B	54	383	109	-2.9	157
Brazil	BB-	43	320	207	-4.6	630
Mexico	BB+	28	81	145	-3.3	627
China	BBB	14	49	23	0.5	976
Korea	BBB	31	58	79	2.1	347
Philippines	BB+	81	121	126	11.4	323
Indonesia	B-	95	181	96	5.0	271
Malaysia	BBB	43	35	48	5.4	328
Thailand	BBB-	64	85	61	5.1	363
Taiwan	AA+	16	27	29	3.4	548

(1) Projections for 2001.
(2) Short-term foreign debt and reserves at the end of 2000. Estimated amortizations for 2001.
(3) Latest information available.
* NIR: Net international (foreign currency) reserves.
** Source: Central Bank of Chile.

Source: JP Morgan. World Financial Markets (30 April 2001).

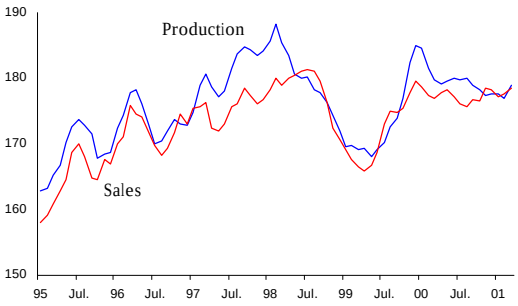
The decline in medium-term inflationary pressures has led to successive reductions in the monetary policy rate, which currently stands at UF + 3.75%. In line with these events, nominal and real rates for all maturities have also fallen, although longer-term rates rose in recent weeks, mainly due to instability in the region. The market expects the monetary policy rate to remain the same during the first half of the year. The baseline scenario assumes the real exchange rate will remain stable. In synthesis, current monetary conditions favor an expansion in economic activity, which is partly reflected in recent trends affecting monetary aggregates, credit to companies, and bond issues on the domestic market.

Figure IV.1
Seasonally adjusted GDP and expenditure (1)
(billions of 1986 pesos)



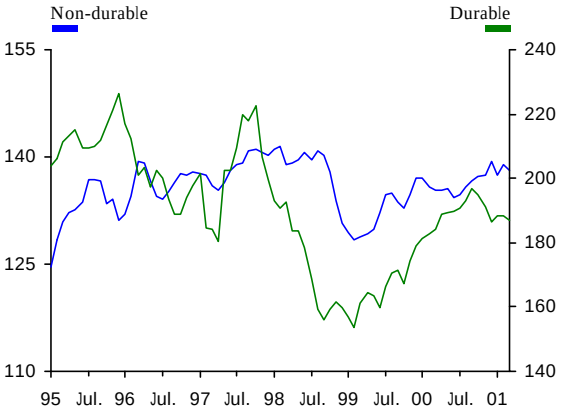
(1) Estimate for 2000.IV.
Source: Central Bank of Chile.

Figure IV.2
Production and industrial sales of consumer goods
(average 1989=100)



(1) Moving quarterly average.
Source: National Statistics Bureau.

Figure IV.3
Seasonally adjusted sales of non-durable and durable consumer goods (1)
(average 1989=100)



(1) Moving quarterly average.
Source: National Statistics Bureau.

This section analyzes recent and foreseeable trends in the real sector of the economy, including prospects for expenditure and the current account, in order to examine their incidence on the future behavior of inflation. To do so, it reviews in detail factors influencing both domestic and external demand.

Economic activity during the first quarter

Economic activity rose by less than during the first quarter, below that expected in the previous report (Figure IV.1). Contributing factors included still weak domestic consumption and a slower pace of growth of gross capital formation, for the machinery and the construction components.

By sector, aggregate activity's slower growth was associated with the poor performance of manufacturing, whose production index fell on average 1.5% during the quarter, compared to the same period of the previous year. Mining's rather flat performance and still low retail sector growth add to this result.

Domestic demand

Consumption and inventory changes

Private consumption averaged 4.1% during 2000, slowing significantly throughout the second semester. This weakness carried over into the first quarter of 2001, revealing less promising conditions than forecast in the previous report. This was apparent in the performance of several partial indicators, such as manufacturing production and sales, associated with domestic consumption, which held steady or fell in recent months (Figure IV.2).

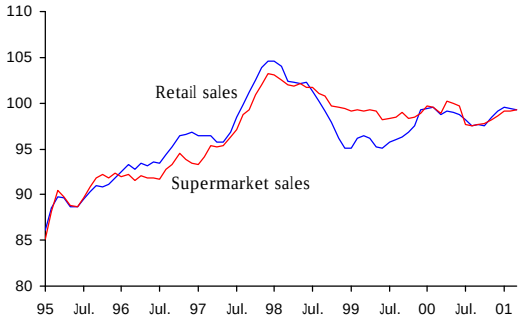
In line with the above, sales of durable and undurable consumer goods as well as the retail sector remain flat (Figure IV.3 and IV.4).

At the root of weak consumption lies families' more prudent behavior, probably due to uncertainty regarding their future job situation or high unemployment, along with a precarious financial situation affecting individuals. Although consumer credit rose in March over the previous month, it remained low compared to previous years (Figure IV.5).

Other partial indicators, however, reveal that consumption could recover somewhat in the second quarter. Imports of consumer goods and new automobile sales have performed better in recent months. Similarly, the most recent economic perception index by ADIMARK (IPEC) revealed a positive shift in economic agents' expectations, after several quarters of pessimism. (Figure IV.6 and IV.7).

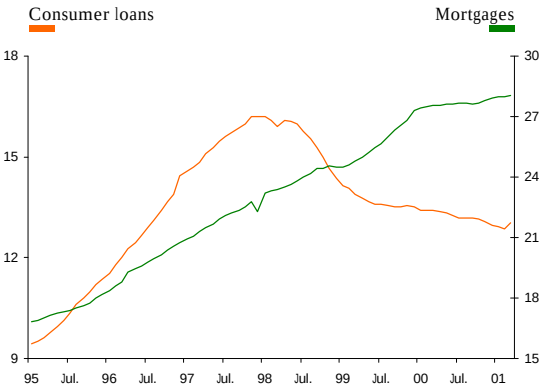
In the coming months, household consumer expenditure is expected to rise.

Figure IV.4
Seasonally adjusted retail and supermarket sales (1)
(average 2000=100)



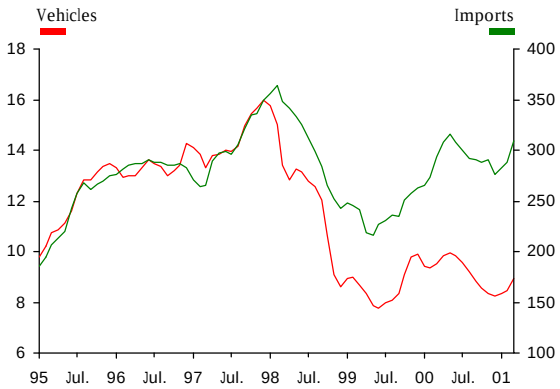
(1) Moving quarterly average.
Source: National Chamber of Commerce.

Figure IV.5
Household debt indicators
(average loans as percentage of income from work (1))



(1) Income from work represents the seasonally adjusted total wage bill.
Source: Central Bank of Chile.

Figure IV.6
Seasonally adjusted new vehicle sales and imports of consumer goods (1)
(thousands of units and millions of dollars)



(1) Moving quarterly average.
Sources: Central Bank of Chile, Asociación Nacional Automotriz de Chile *(Chile's national association of car dealerships).*

The prospects for growth in consumer spending in coming months are more favorable than they have been to date, although only the passing of time will reveal if there is a real change in trend. In this sense, trends in unemployment and indicators for the financing of private consumption will be particularly important.

Fixed investment: construction and machinery and equipment

The gross formation of fixed capital (GFFC) was the most dynamic component within aggregate demand in late 2000. In effect, during the fourth quarter of 2000 it rose by 12.0% over the same quarter of the previous year, accelerating its increase with respect to the first half of the year.

If we look at individual components, investment in machinery and equipment has shown the strongest and most stable growth within GFFC. The construction component has been more moderate, reaching 6.3% during the last quarter of 2000, compared to the last quarter of 1999.

During the first quarter of 2001, GFFC slowed down compared to trends observed during previous quarters. Nonetheless, more recent indicators show that, at the margin, the scenario is more positive. Thus, imports of capital goods picked up somewhat in March, favored by an increase in shipments such as data processing units and transport vehicles (Figure IV.8).

In the construction sector, investment in residential properties has been the strongest, despite a decline in building permits in recent months (Figure IV.9). This subsector is expected to drive recovery during the year, given the advantageous conditions prevalent in the mortgage market. This should likewise translate into rising employment in this sector, as has been observed since the middle of last year.

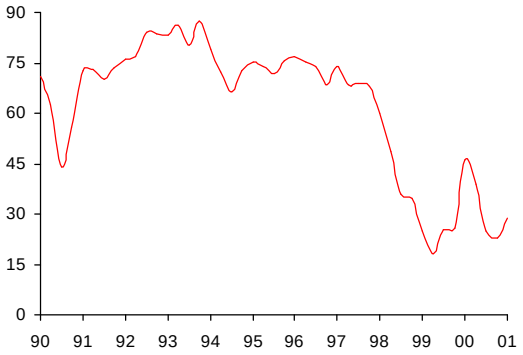
The turnaround in residential construction was favored by the positive performance of new housing sales during the first months of the year. In effect, in February 2001, sales rose by an annual 26.6%, thus closing the negative cycle prevalent throughout 2000.

The increase in sales of new housing, however, has not yet considerably reduced the average number of months necessary to liquidate existing stock, because the supply of new housing has continued to grow during the same period (Figure IV.10).

Information from the last survey of projects by the Capital Goods Corporation (*Corporación de Bienes de Capital*) allows analysts to monitor the main engineering works, an important component of gross formation of fixed capital.

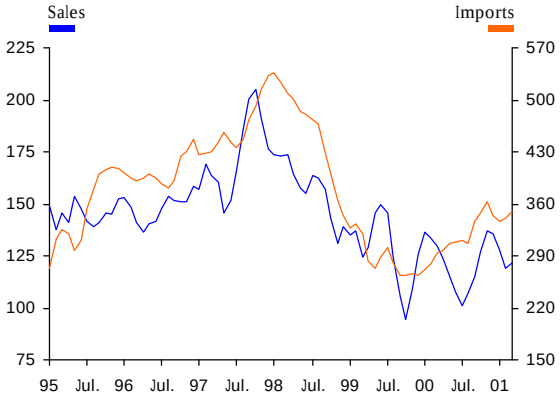
The latest survey available through March of this year found that projects have developed in line with expected growth in investment for 2001. However, the survey also forecasts lower investment than originally projected in the January 2001 report, which should be partly offset by an increase in 2002 and thereafter. This lower investment for 2001 was mainly due to the postponement of mining projects in response to lower metal prices. In any case, the rate of investment should remain at 27% to 28% of GDP during 2001 and 2002.

Figure IV.7
Economic perception index (IPEC)
(percentage of people expecting the economy to improve in future)



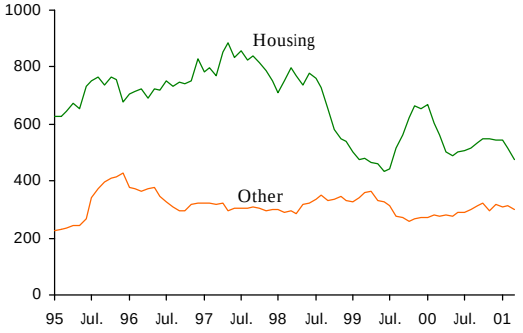
Source: ADIMARK.

Figure IV.8
Seasonally adjusted imports and sales of capital goods (1)
(US$ millions and average monthly index 1990=100)



(1) Moving quarterly average.
Sources: Central Bank of Chile, National Statistics Bureau.

Figure IV.9
Building permits, new works (1)
(thousands of square meters)



(1) Moving quarterly average.
Source: National Statistics Bureau.

The rate of investment is expected to reach between 27% and 28% of GDP this year and next.

The past survey continued to highlight public works projects, especially those associated with bidding processes and investment in sanitation works. At the same time, expected investment in energy, manufacturing, forestry and ports rise noticeably for 2001 and 2002. Meanwhile, the outlook for real estate investment for this year has improved, while projected investment in telecommunications has fallen compared to the high levels of previous periods (Table IV.1).

Table IV.1
Investment survey
(US$ millions)

Sector	1998	1999	2000(e)	2001(f)	2002(f)
Mining	2,129	770	568	908	2,484
Forestry	166	60	150	166	441
Manufacturing	562	324	99	196	411
Energy	1,827	1,160	278	408	920
Ports	110	79	56	83	135
Real estate	1,780	1,339	1,415	1,744	1,771
Public works	687	796	1,199	991	1,378
Telecommunications	845	729	631	157	38
Other	115	20	15	8	2
Total	8,221	5,275	4,411	4,662	7,579

(f) Projected.
(e) Estimate.
Source: Corporation for Technological Development of Capital Goods (*Corporación de Desarrollo Tecnológico de Bienes de Capital*).

Fiscal policy

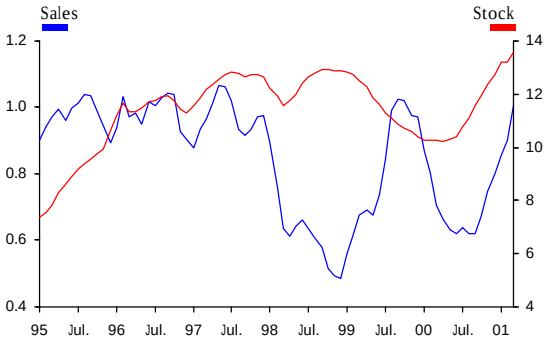
Based on the implementation of the national budget during the fourth quarter of last year, it is clear that public spending with macroeconomic impact rose by 2.1% over the same period of the previous year, totaling 3.1% for 2000. Tax revenues rose by 9.7% during 2000 (Table IV.2). Altogether, this brought the general fiscal surplus for 2000 to 0.1% of GDP, clearly a much more favorable result than the 1.5% overall deficit posted at the end of 1999 (Figure IV.11 and IV.12).

Table IV.2
Fiscal indicators

	1998	1999	2000	2001(p)
	(annual change, percent)			
Public absorption	6.2	5.7	3.1	5.0
Current revenue	0.0	-2.9	11.5	6.2
Tax revenue	-0.2	-5.6	9.7	11.8
	(percentage of GDP)			
General surplus (1) (2)	0.4	-1.5	0.1	-0.5
FCC	-0.4	-0.7	-0.7	-0.7
Fiscal impulse (2)	0.9	1.3	-1.4	-0.3

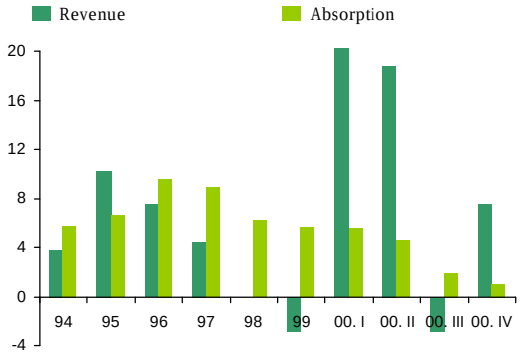
(p) Budget 2001. 2001 projection consistent with a structural surplus of 1% of GDP.
(1) With no adjustment for FCC.
(2) Estimate for 2001.
Source: Budget Division.

Figure IV.10
Seasonally adjusted sales and stock of new housing (1)
(thousands of units)



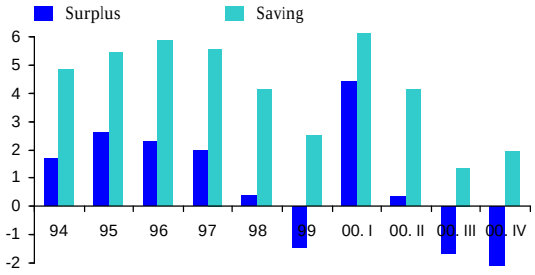
(1) Moving quarterly average.
Source: Cámara Chilena de la Construcción *(Chilean builders' organization)*.

Figure IV.11
Current revenue (1) and public absorption
(change over previous year, percent)



(1) Includes income from privatizations in 2000.
Source: Budget Division.

Figure IV.12
Central government's current saving and general surplus (1)
(percentage of GDP)



(1) No adjustment for FCC and including income from privatizations in 2000.
Source: Budget Division.

The national budget proposal for 2001 was developed assuming potential GDP would rise by 5.7%, inflation by 3.0%, and an average copper price of 88 cents per pound. To guarantee a structural fiscal surplus of 1% of GDP based on these assumptions, real public absorption (public expenditure with macroeconomic impact) was expected to increase by 5.0%.

In practice, tax revenues will be less than assumed in the 2001 budget due to the downward correction of the GDP growth projection, which for this report has reached 4.3% instead of the 6.2% assumed by the national budget. This would set the stage for a fiscal deficit of about 0.5% of GDP, up from the –0.1% projection included in the 2001 budget.

The lower tax revenue scenario will translate into a greater fiscal impulse to the economy. In any case, employment programs, subsidies to hiring labor, and moving public investment programs up to the first half of 2001 do not represent spending and, according to Finance Ministry authorities, will be financed through reallocations beyond what was committed within the budget.

The other factor that will weaken the fiscal position is the lower than expected price of copper. The projection for 2001 in this report suggests the price will average just 80 cents per pound, which will lead to larger withdrawals from the Copper Stabilization Fund to compensate the difference.

This year, the fiscal deficit will be higher than expected due to revenues being lower than assumed in the 2001 budget.

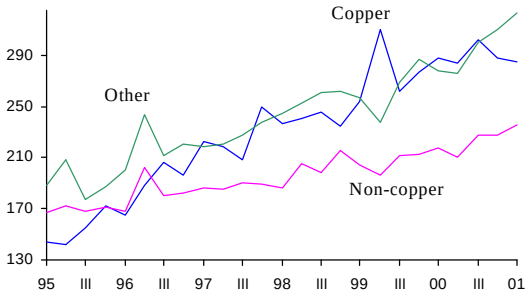
External sector and the current account

Results for the first quarter of 2001 show less growth in both exports and imports compared to the last quarters of 2000 as well as projections in January's report. External demand has shown signs of weakening due to deceleration of the world economy, particularly in important trading partners, such as Japan and the United States. During this period, the main impact has been in export prices, which fell 5.2% over the same period of the previous year. Export volumes, on the other hand, rose by 4.6%, less than rates posted in previous quarters (Figure IV.13 and Table IV.3).

During the first quarter, the value of copper exports fell by 0.7%, while non-copper exports fell by 0.9%. In the case of the former, a 0.9% drop in volumes influenced this result, but was partially offset by a 0.2% increase in prices. In the case of non-copper exports, the positive performance of non-traditional export volumes stand out rising by about 16% (Figure IV.14).

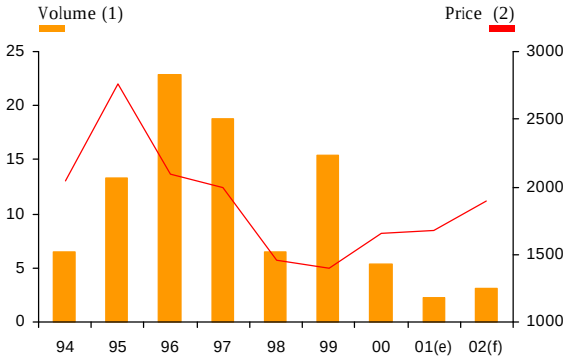
The decline (US$108 million) in non-copper exports by value was mainly due to trends affecting several major products, particularly fresh fruit (mainly because prices and volumes of grapes were down), and, to a lesser degree, other goods such as gold and wood pulp (Figure IV.15). In contrast, exports of products such as methanol and fishmeal contributed to attenuating these declines, whether through price increases (in methanol's case) or higher volumes (fishmeal). The chemical sector stood out in the significant increase in non-traditional exports.

Figure IV.13
Seasonally adjusted exports by category (1)
(base 1990 Ist quarter = 100)



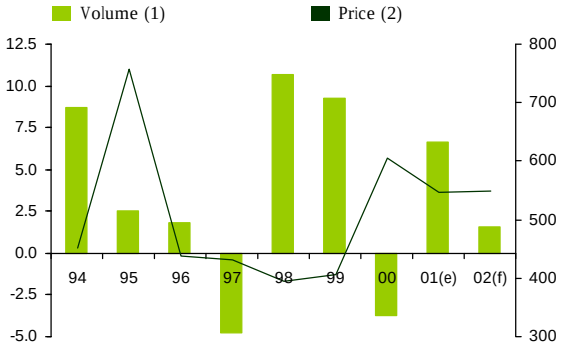
(1) Provisional figures for 2001.
Source: Central Bank of Chile.

Figure IV.14
Copper exports by volume and price



(1) Annual change, percent, in export volume.
(2) US dollars per ton.
(f) Projected.
(e) Estimate.
Source: Central Bank of Chile.

Figure IV.15
Pulp exports by volume and price
(percentage change over previous year)



(1) Annual change, percentage of export volume.
(2) US dollars per ton.
(f) Projected.
(e) Estimate.
Source: Central Bank of Chile.

Table IV.3
Exports
Percentage change in quantity, price and value by geographical destination
(2001:I / 2000:I)

Specificacion	Asia	(Japan)	Rest of World	(USA)	(Argentina)	Total
% change in quantity						
Copper	-15.4	-14.5	12.1	31.4	28.5	-1.1
Non copper	20.5	14.2	16.3	1.6	-2.0	8.2
Main	-4.1	-23.4	-0.1	-7.6	-34.9	-0.9
Other	37.8	26.0	31.4	17.4	1.7	16.1
Total	0.8	1.8	15.0	5.2	0.9	4.6
% change in prices						
Copper	-3.2	-4.7	2.5	0.7	0.1	0.7
Non copper	-26.1	-26.3	-12.0	-8.6	3.1	-8.3
Main	-8.3	0.5	-6.5	-11.9	23.3	-6.9
Other	-34.9	-31.3	-15.8	-4.1	1.7	-9.4
Total	-15.6	-18.5	-7.7	-7.2	2.8	-5.1
% change by value						
Copper	-18.2	-18.5	14.9	32.4	28.5	-0.5
Non copper	-11.0	-15.8	2.4	-7.1	1.1	-0.8
Main	-12.1	-23.0	-6.6	-18.6	-19.7	-7.7
Other	-10.0	-13.4	10.6	12.6	3.4	5.2
Total	-14.9	-17.0	6.2	-2.4	3.6	-0.7

Source: Central Bank of Chile.

The deteriorating international environment becomes apparent if we examine exports' performance by geographical destination. Exports to Asia, mainly Japan, a major copper buyer, fell by 15.9%. Exports to the United States fell by 2.4%, as a result of falling grape and wood shipments, partially offset by increased copper and methanol exports.

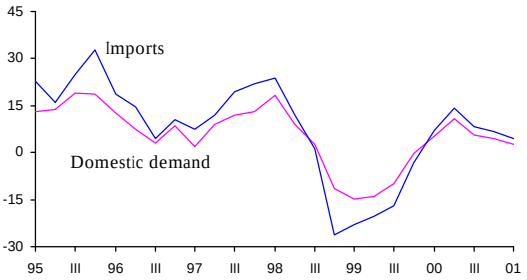
Imports during the first quarter rose by 8.1%, CIF, in line with the performance of domestic demand (Figure IV.16). This behavior, however, were not even for all categories of goods. Thus, capital goods imports rose most, by value, compared to fuels, non-fuel intermediate goods, and consumer goods. Similarly, prices rose 1.5% on average, with modest increases in fuel and other intermediate goods prices, and a slight drop in consumer goods prices. In terms of volumes, capital goods rose the most (18.3%), followed by fuels and consumer goods (Figure IV.17).

Current account projections for 2001 and 2002

The outlook for both export and import growth this year is less favorable than in 2000 and than in the previous report. This is because conditions affecting the main economies are less auspicious, which translates into a slight decline in average export prices (Figure IV.18 and Table IV.4).

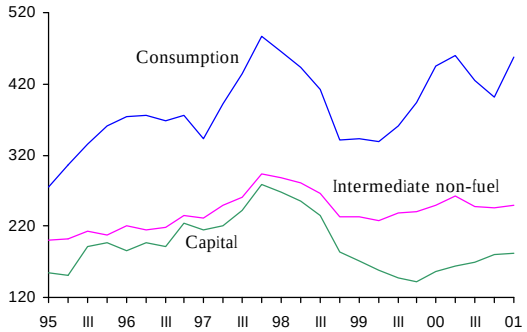
The world scenario has an effect on total growth of export volumes of goods, which are projected to reach 4.4% this year and 4.8% in 2002. Moderate growth of copper export volumes, which will rise from 2.6% this year to 3% next year, is the main factor influencing this projection.

Figure IV.16
Import growth by volume and domestic demand (1)
(percentage change over the same quarter of the previous year)



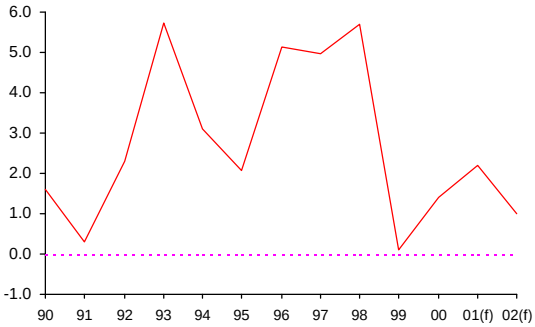
(1) Domestic demand for 2001.I estimated.
Source: Central Bank of Chile.

Figure IV.17
Seasonally adjusted imports by volume and category (1)
(base 1990 Ist quarter = 100)



(1) Provisional figures for 2001.
Source: Central Bank of Chile.

Figure IV.18
Current account deficit
(percentage of GDP)



(f) Projections.
Source: Central Bank of Chile.

Table IV.4
Current account
(US$ million)

	1999	2000 I	2000 II	2000 Total	2001 (e)	2002 (f)
CURRENT ACCOUNT	-80	-150	-840	-990	-1,500	-770
Balance of trade	1,660	950	490	1,440	840	1,630
Exports	15,620	9,180	8,980	18,160	18,690	20,910
Imports	13,950	8,230	8,490	16,720	17,850	19,280
Non-financial services	-310	-210	-350	-560	-490	-390
Financial services	-1,880	-1,120	-1,280	-2,400	-2,330	-2,590
Unilateral transfers	450	230	300	530	480	580

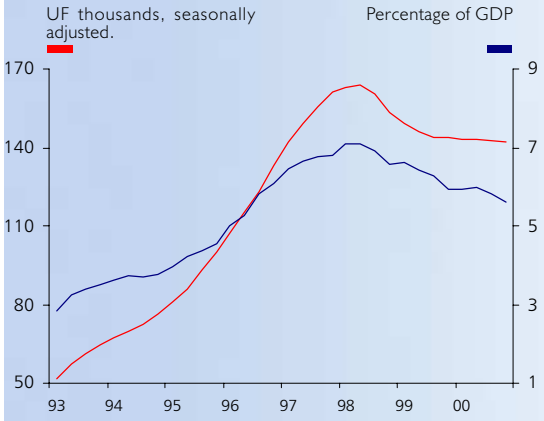
(e) Estimates.
(f) Projections.
Source: Central Bank of Chile.

Current account projections for 2001 suggest a US$1.5 billion deficit, that is, 2.2% of GDP. This higher than previously expected deficit will mainly be the result of eroding terms of trade, particularly the lower price of copper for this year compared to 90 cents per pound last year, which adds up to about US$900 million, or over one percentage point of GDP. This situation is projected to turn around in 2002, when the current account deficit should fall to US$770 million, 1% of GDP.

During the first quarter of the year, consumption remained flat. In any case, there are some indications that household expenditure will pick up during the rest of the year. Gross capital formation is expected to continue to perform more strongly than other components of expenditure. Domestic demand's performance will lead to a modest current account deficit, despite the decline in Chile's terms of trade forecast for 2001.

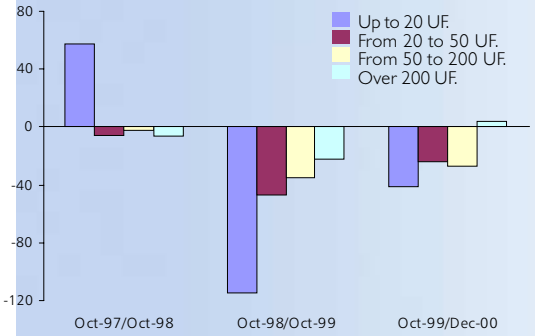
BOX IV.I: TRENDS IN CONSUMER LOANS

Figure IV.19
Consumer loans



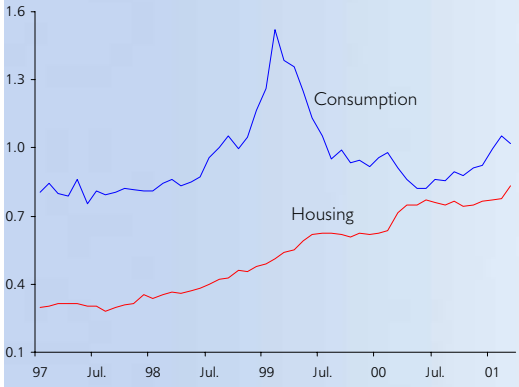
Source: Superintendent of Banks and Financial Institutions.

Figure IV.20
Change in the number of debtors
Consumer portfolio (in 1000s)



Source: Superintendent of Banks and Financial Institutions.

Figure IV.21
Non-performing debt
(percent by type of credit)



Source: Superintendent of Banks and Financial Institutions.

Starting in 1992, consumer credit in the finance system began to grow faster than other loans, peaking during the first quarter of 1998 (Figure IV.19). In early 1997, however, growth of this variable began to slow, and since 1998 it has contracted. In effect, from the second quarter of 1998 to the first quarter of 2001, the outstanding balance of consumer credit fell by 14%. As a percentage of GDP, consumer credit fell from 7.0% to 5.5% in the same period.[1]

It is interesting to examine the relationship between consumer credit, consumption itself, and other macroeconomic variables. Moreover, it is important to find out if other factors, such as regulations, have also affected the behavior of this kind of credit.

In this sense, it is important to keep in mind that the recent performance of consumer credit is consistent with the current macroeconomic environment affecting the Chilean economy. Lower private debt is consistent with weaker consumption, aggregate economic activity, lower capital inflows, a decline in the terms of trade, exchange rate depreciation (relative price correction) and a lower current account deficit (Gourinchas, Landerretche, Valdés 2001). All these factors have influenced conditions in Chile in recent years.

The empirical evidence shows that, as with other loans, consumer credit performs in a pro-cyclical fashion in Chile. Moreover, fluctuations in this kind of credit are more extreme that those of other loans within the financial system. This pro-cyclical behavior of consumer loans is not peculiar to the Chilean economy, given that it occurs in many countries (Butelmann and Landerretche 1998).

A decline in consumer credit to individuals could also be due to some of the regulatory changes introduced between mid-1997 and early 1998. During this period, consumer credits involving small amounts fell drastically, both in terms of amounts and the number of debtors (Figure IV.20). Other regulatory changes, including those covering debt collection in 1999 by type of debtor and some associated with the maximum interest rate (*tasa máxima convencional*), now completed, may also have affected levels of consumer lending.

In the current situation, however, the impact of these changes should be less than that of the economic cycle. Thus, in a macroeconomic context such as the current one, with more uncertainty about labor conditions and fewer prospects for growth in wages, individuals are expected to show more caution when it comes to assuming debts, as do banks when granting credit.

More rigor on the part of financial institutions when granting credits is reflected in non-performing consumer debt, which peaked in early 1999, then fell to slightly higher levels than those prior to 1998 (Figure IV.21), suggesting that higher risk debtors have left the system.

There is also some evidence that households have tended to use credit less. In this regard, there has been a significant decline in the amount used as compared to approved maximums for credit cards, which went from the previous level of 50% to 40% in the fourth quarter of 1999. That is, the amount of credit actually used on credit cards fell by 25% (Figure IV.22).

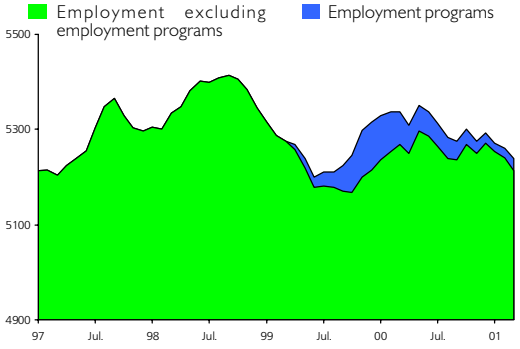
[1] In no case was consumer credit as a percentage of GDP higher than 1997 levels in countries such as Canada, the United States, Belgium, Germany and Great Britain (Butelmann and Landerretche op. cit.).

Figure IV.22
Credit cards: percentage used over total amount approved
Change in amount (percent)

Source: Superintendent of Banks and Financial Institutions.

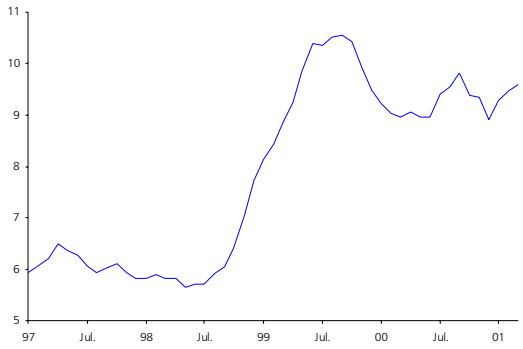
Finally, it can be concluded that consumer-lending trends are consistent with the macroeconomic climate prevailing in Chile. To the degree that unemployment tends to fall, consumption will rise, assisted in part by the reduced risk associated with the labor market.

Figure V.1
Seasonally adjusted national employment
(thousands of people)



Source: National Statistics Bureau, Ministry of Labor and Social Security.

Figure V.2
Seasonally adjusted national unemployment
(percentage of the workforce)



Source: National Statistics Bureau.

Figure V.3
Seasonally adjusted national participation rate
(percentage of the population 15 years and over)

Source: National Statistics Bureau.

This section analyzes recent trends affecting employment, wages and productivity, in order to identify potential future inflationary pressures derived from factor markets.

Employment and unemployment

During the first quarter of 2001, labor market conditions worsened. Compared to the fourth quarter of 2000, employment fell by about 100,000 posts last March (Figure V.1). Seasonally adjusted this drop amounts to a 1% reduction in employment. Lower job creation led the national unemployment rate to rise during the first quarter to 8.8% (Figure V.2). The main cause of lower job creation was the destruction of private sector employment, since municipal programs rose slightly during this period.

Lower employment's impact on unemployment was again attenuated this quarter by a reduction in the work force, which shrank by 1.4% according to the National Statistics Bureau (*Instituto Nacional de Estadística*, INE) over the last quarter of 2000 (Figure V.3). This decline was mainly due to falling participation among both men and women in the 15-34 age group (Box V.1). One reason for this behavior is that persistent unemployment discourages an active job search.

During the first quarter of 2001, overall job creation within the economy continued to fall, keeping the unemployment rate high.

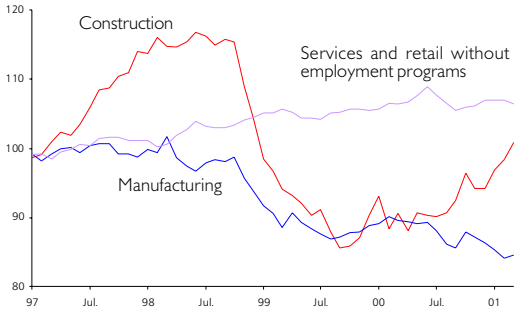
Lower job creation during the first quarter of 2001 is associated with important sectors of the economy. In agriculture, for example, employment (seasonally adjusted) stagnated, while the retail sector performed less strongly and manufacturing employment fell (Figure V.4).

Employment by groups of economic activity also fell significantly. Seasonally adjusted figures reveal that employment of skilled labor (professionals, sales people, clerks and managers) fell during the quarter ending in March. Similarly, employment of unskilled labor also fell by 2.3% over the same quarter of the previous year. This last trend contrasts strongly with increases of up to 27% posted in previous quarters.

Construction was the one exception in this rather somber panorama, growing 11% over last year, with dynamic hiring patterns holding steady since mid-2000. This was thanks to the positive behavior of investment and the housing market during the same period, although the fact that public works projects were also moved up cannot be ignored. This, combined with lower employment of unskilled labor, has revealed that the loss of jobs affecting this work group is mainly associated with manufacturing (Figure V.5).

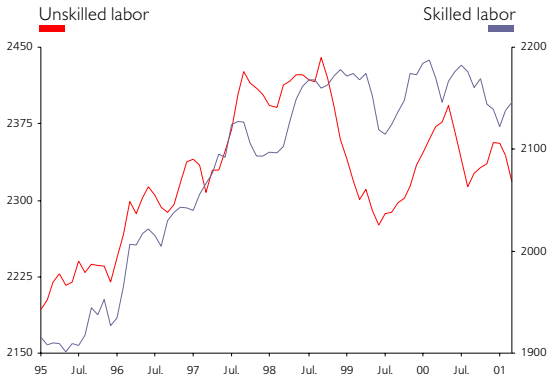
As the January 2001 issue of the Monetary Policy Report explained in detail, a series of hypotheses, which are not necessarily mutually exclusive, could explain these persistent high levels of unemployment at both the aggregate and specific sector levels. In the first place, private nominal wages have continued to rise in line with inflation, despite high unemployment. Similarly, the strong real increase in the minimum wage in recent years has affected the hiring of younger workers:

Figure V.4
Seasonally adjusted employment by sector
(January 1997 = 100)



Source: National Statistics Bureau.

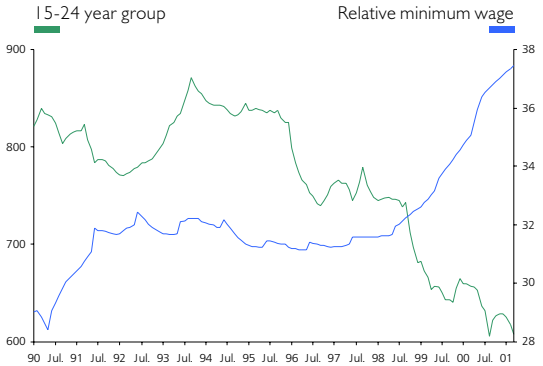
Figure V.5
Seasonally adjusted employment by occupation (1)
(thousands of persons)



(1) Occupations considered skilled include: professionals, technicians, managers, administrators, directors, office employees and sales staff.
Unskilled occupations (excluding farmers, ranchers and fishing people) include: drivers, crafts people, operators, workers, day laborers and personal service employees.

Source: National Statistics Bureau.

Figure V.6
Seasonally adjusted employment for the 15-24 age group and relative minimum wage (1)
(thousands of people and percent)



(1) Represents the moving average of the minimum wage compared to total wages.

Source: National Statistics Bureau.

employment among workers 15-24 years of age fell by 5% during the first quarter over the same quarter of the previous year (Figure V.6), more than the decline affecting other age groups. Moreover, imperfections in different markets could make the efficient reallocation of labor difficult, which also contributes to persistent unemployment. In any event, public sector wage increases have been moderate, which will help job creation (Figure V.7).

Along with problems specific to the labor market, prospects for the recovery of employment in coming months will also depend on the performance of relevant sectors, such as manufacturing and commerce. One element that could strengthen the future performance of some of these sectors is the possibility of renegotiating debts that the government is encouraging in favor of labor intensive firms, particularly small- and medium-sized operations (known as PYMEs). Nonetheless, there is still uncertainty about these companies' capacity for recovery and response in terms of their demand for labor should the financial environment improve. Finally, for employment to recover during the present year, domestic demand growth must consolidate and unexpected events must not occur, in particular, any decline in the external scenario affecting Chile's economy.

Productive resources use

Recent technological changes indicate that in the past few years companies have been improving their efficiency, which was postponed during the expansion of the nineties. Thus, some significant increases in the output to employment ratio have been achieved, particularly in specific sectors such as manufacturing and retail (Figures V.8 and V.9). This is the other side of the coin characterized by persistent, high unemployment.

This upward trend in productivity can in part be associated with an increase in the hours worked, which, although they have recovered since the sharp fall in early 1998 have still not returned to the levels of the mid-nineties (Figure V.10).

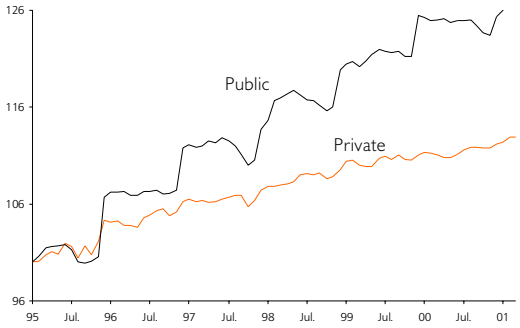
Aside from productivity trends, output and employment gaps reveal that productive resources within the economy are significantly underused, especially in the labor market. In effect, unemployment among men aged 35-54, one of the indicators least affected by fluctuations in the workforce, remain clearly above their normal level (Figure V.11).

Idle capacity within the labor market is somewhat greater than it appears, because municipal employment programs generated a total of 25,000 jobs during the first quarter of 2001, about 0.4% of the workforce. This figure will probably grow in coming months, due to the implementation of new employment programs during the winter.

Significant idle capacity persists within the labor market.

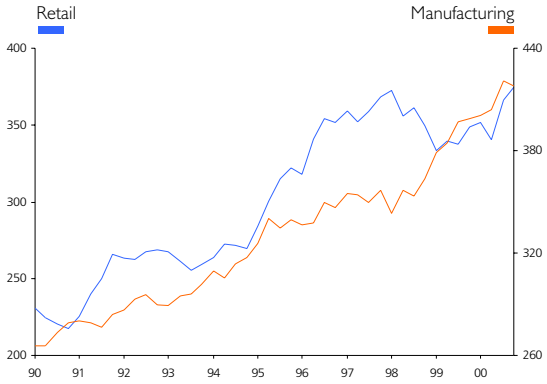
All the above information indicates that the potential for inflationary pressure derived from the labor market remains very much under control. Thus, inflationary acceleration as measured by the CPIX has closely followed the negative performance of the output gap (Figure V.12). Finally, given the current unemployment rate and expected growth in

Figure V.7
Real public and private wages
(January 1995 = 100)



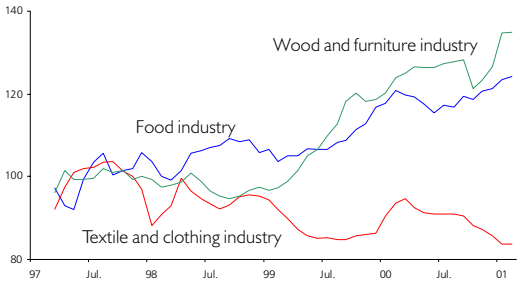
Source: National Statistics Bureau.

Figure V.8
Average productivity of work by sector
(thousands of 1986 pesos, per person)



Source: National Statistics Bureau.

Figure V.9
Average labor productivity in manufacturing
(1997 = 100)



Source: SOFOFA.

investment spending, the economy's productive capacity is expected to rise by about 5% this year and next. This does not represent, however, a limit on actual economic growth, given that the current output level is below its potential.

Wages and unit labor costs

During the first quarter of 2001, nominal wages performed unevenly in terms of annual growth rates. The Nominal Wage Index developed by INE for the private sector posted average annual growth of 5.3%, somewhat less than the previous period (5.7%). The Nominal Labor Cost Index showed the greatest downward corrections in 2000, a trend that turned around in the first months of 2001, with annual change reaching 4.8%. The public sector's nominal annual wage index rose by an annual 5.3% in March. In general, nominal wages performed similarly to inflation and institutional readjustments in 2000. As a result, the acceleration in private wages is expected to weaken in coming months, due to lower inflation posted during the first months of 2001 (Figure V.13).

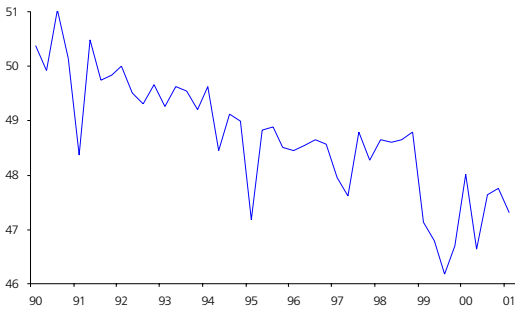
With regard to real wages, during March the labor cost index posted an annual increase of 1.3%, a significant expansion over previous months, which is strongly influenced by the drop in February's CPI (Figure V.14). Labor costs, when deflated using CPIX, shows annual growth of 2.7%. This suggests that real wages have not, generally speaking, contributed to employment's recovery (Figure V.15). Despite the persistence of unemployment, real wages continue to grow at relatively high rates. Even so, real wages have produced no inflationary pressures to date, because higher productivity has had a moderating effect on unit labor costs (Figure V.16), which posted an annual decline of 1.1% in March.

Wage's inflationary effects have been slight, because of the increase in average labor productivity and lower wage increases in the public sector.

Recently, the government raised the minimum wage by 5.5%, considerably less than in previous years (when it rose by almost 10%).

So far this year, employment figures reveal a worsening of conditions in the labor market, which has also pushed participation rates down. Inflationary pressures arising from the labor market are under control, however, because an increase in average labor productivity has weakened the effect of wage increases. In the coming quarters, job creation in the construction sector should remain strong, while employment in manufacturing should stop falling.

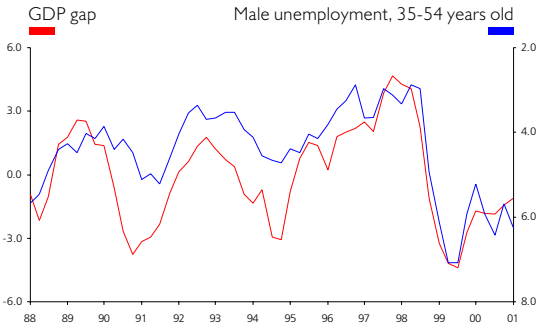
Figure V.10
Average hours worked in Greater Santiago (1) (seasonally adjusted hours)



(1) Includes unemployed with occasional work; temporarily inactive and unemployed people who worked a few hours during the reference week.

Source: University of Chile.

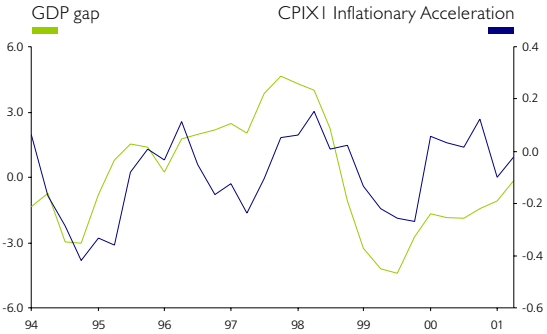
Figure V.11
Capacity gap (1) and seasonally adjusted employment (percent)



(1) Trend GDP calculated using the Hodrick-Prescott filer. Estimate for 2001.I.

Sources: Central Bank of Chile, National Statistics Bureau.

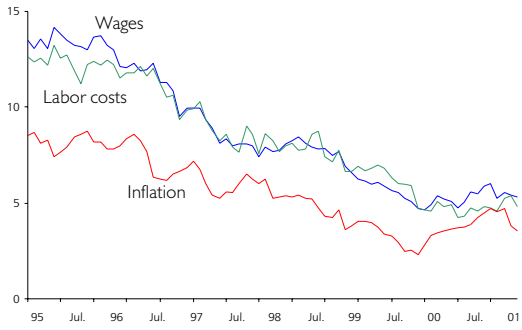
Figure V.12
Capacity gap (1) and inflationary acceleration (2) (percent)



(1) Trend GDP calculated using Hodrick-Prescott filter. GDP estimated for 2000.I and 2001.II.
(2) Estimate 2000.I.

Sources: Central Bank of Chile, National Statistics Bureau.

Figure V.13
Wage indices, labor costs and inflation (percentage change over 12 months)

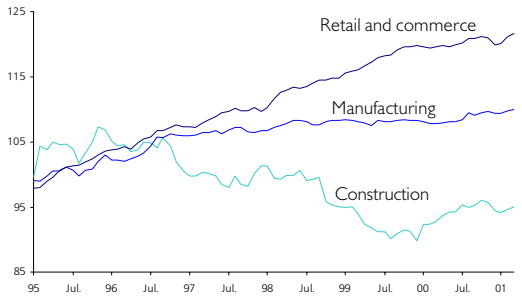


Source: National Statistics Bureau.

Figure V.14
Wages and labor costs (real index, January 1997=100)

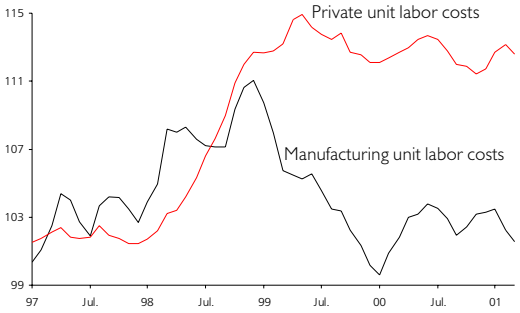
Source: National Statistics Bureau.

Figure V.15
Real wages by sector (January 1995 = 100)



Source: National Statistics Bureau, Central Bank of Chile.

Figure V.16
Unit labor costs (1)
(moving quarterly average, January 1997=100)



(1) Ratio between the nominal cost of labor for the private sector and seasonally adjusted average labor productivity (IMACEC/Employment).

Sources: National Statistics Bureau, Central Bank of Chile.

BOX V.1: FACTORS DETERMINING WORKFORCE PARTICIPATION

Persistent unemployment has begun to depress participation in the workforce. After rising continuously during the late eighties, since the mid-nineties participation held steady at 54% (Figure V.2). Starting in the second quarter of 1999, however, it began to shrink, falling to 53% during the first quarter of 2001. Falling participation rates in recent quarters have affected both men and women, and particularly young people (Tables V.1 and V.2).

Table V.1
Growth in national participation rates by age group
(annual change, percent)

		Age group						Total
		15-24	25-34	35-44	45-54	55-64	+ 65	
		Men						
00	I	-1.8	-0.7	-0.7	0.0	-0.7	-3.8	-1.1
	II	-6.0	-0.9	-0.1	-0.7	1.7	9.0	-0.9
	III	-6.1	-0.3	-0.5	-0.7	-1.7	-2.2	-1.3
	IV	-7.4	-1.0	-0.8	-0.3	-0.9	-11.3	-2.0
01	I	-6.4	-1.3	-0.3	-0.4	-1.3	-5.3	-1.9
		Women						
00	I	2.1	3.2	-1.0	3.3	-0.1	16.4	1.2
	II	-2.8	2.0	2.3	2.8	4.2	-5.1	0.4
	III	-1.6	-1.2	-0.9	1.4	0.9	2.9	-1.5
	IV	-5.5	-1.6	-4.1	1.1	-5.5	-7.9	-4.1
01	I	-12.0	-3.3	-4.0	1.5	-1.0	-8.5	-4.5

Source: National Statistics Bureau.

Table V.2
Participation rates in Greater Santiago, by age group
(annual change, percent)

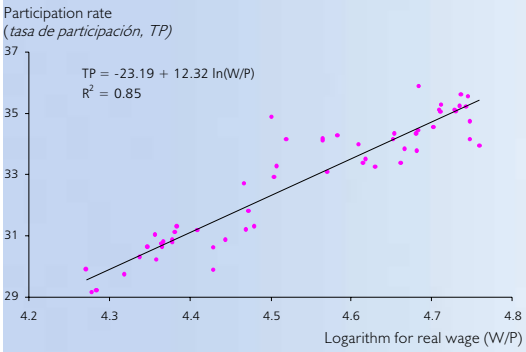
		Age group									Total
		14-19	20-24	25-29	30-34	35-39	40-44	45-49	50-54	55-60	+60	
00	I	0.5	1.2	-5.4	5.0	-0.8	0.9	-2.1	3.8	-3.5	-2.5	0.5
	II	-14.4	-2.5	-6.1	-1.1	-0.8	-3.8	-3.5	1.4	0.3	-3.6	-2.9
	III	7.8	-1.6	-3.2	2.7	0.3	-1.6	0.9	-3.3	5.5	-6.8	-1.0
	IV	-16.5	-3.0	-3.2	3.2	-3.4	2.0	-5.1	-0.8	-2.4	-13.5	-2.6
01	I	-12.8	-3.3	3.5	-1.6	0.0	1.8	-2.0	0.1	8.0	-0.4	0.3

Source: University of Chile.

Economic theory establishes three main mechanisms that explain changing participation rates. In the first place, two effects relating participation rates and unemployment counterbalance each other: the added worker and the discouraged worker.[1] In the first case, declining family income during periods of high employment encourages other members of the family to enter the workforce. In the second case, the probability of not finding a job paying more

[1] See Hamermesh (1993), Goodman (1994), Goodman, et. al. (1993), Kaufman and Hotchkiss (1999).

Figure V.17
Women's participate rate and real wages
(percent, 87:I - 01:I)



Source: National Statistics Bureau.

than the reservation wage discourages the worker and reduces participation in the labor market. Finally, the effect of increases in real wages[2] is also relevant, as it can raise the probability of participation in the workforce when the market wage is higher than the reservation wage. The relationship between the real wage and the participation rate is particularly noticeable when it comes to women (Figure V.17).

Empirical evidence indicates that, if we control for real wages, the discouraged worker effect prevails in the long term,[3] while in the short term, when unemployment rises, men and women enter the workforce. From these results, we can conclude that the drop in the labor participation rate is probably the result of persistently high unemployment rates, which is particularly discouraging to the youngest group of workers.

Results from econometric calculations follow (t-tests are in parenthesis) for men and women. Ordinary Least Squares were used in estimations for 1987-2001, correcting for standard error using the Newey-West method. In these calculations the workforce (L_t) depends on the unemployment rate (U_t), real wages (W_t) and the population (N_t). The sign of the coefficient that accompanies the variable Ut measures the relative importance of the discouraged worker and the added worker. The specification used permits the capture of the short-term relationship, measured by lags in the first differences (denoted by Δ), and the long-term relationship corresponding to the variables in levels . Finally, several dummy variables were included to control for seasonal factors (*D*).

Equation for men

$$\Delta L_t = \underset{(4.0)}{0.4} + \underset{(4.0)}{0.4} * \Delta L_{t-4} - \underset{(-2.4)}{0.6} * \Delta N_t - \underset{(-3.0)}{0.4} * \Delta N_{t-3} + \underset{(2.8)}{0.2} * \Delta U_{t-1} + \underset{(2.5)}{0.2} \Delta U_{t-3} - \underset{(-5.5)}{0.22} * L_{t-1} + \underset{(4.8)}{0.17} * N_{t-1}$$

$$- \underset{(4.0)}{0.2} * U_{t-1} - \underset{(-2.7)}{0.006} D(2)$$

Corrected $R^2 = 0.58$
Durbin Watson = 1.94

The long-term elasticity of the workforce and unemployment was calculated as:

-(-0.20/-0.22)=-0.9

Equation for women

$$\Delta L_t = \underset{(4.9)}{1.7} - \underset{(-6.0)}{15} * \Delta N_{t-3} + \underset{(1.6)}{0.4} * \Delta U_{t-2} - \underset{(-3.8)}{0.35} * L_{t-1} + \underset{(2.8)}{0.22} * W_{t-1} - \underset{(-1.9)}{0.36} U_{t-1} + \underset{(2.6)}{0.02} * D(3) + \underset{(7.5)}{0.05} * D(4)$$

Corrected $R^2 = 0.63$
Durbin Watson = 2.1

Long-term elasticities between the workforce, unemployment and real wages were calculated as:

Unemployment =-(-0.36/-0.35)=-1.02
Real wage =-(0.22/-0.35)=0.62

[2] See Kaufman and Hotchkiss (1999), Killingsworth (1983).
[3] For more details, see Contreras and García (2001), Henry and Snower (1996). García (1995) found a similar effect.

As can be seen, controlling for trends in real wages, the short-term effect of the unemployment rate on participation is positive, indicating the relevance of the added worker effect. In the long term, the coefficient is negative, revealing the importance of the discouraged worker effect. These results indicate that under current conditions, idle capacity in the labor market is greater than that derived solely from the unemployment rate. In effect, if employment shows a sustained recovery over time, not only will unemployment fall, but also participation rates will rise.

This section presents the Board's evaluation of the prospects for the Chilean economy over the next two years, analyzed during the Monetary Policy meeting on 10 May 2001. Projections are provided for inflation and economic growth and the most significant risks are examined. These projections assume that the monetary policy rate will remain at the rate set by the meeting, 3.75% (UF +), for this evaluation period. Moreover, projections depend on the series of events that together make up the baseline or most probable scenario. New information will modify that scenario and associated projections. Forecasts are presented in the form of confidence intervals in order to reflect the sources of risk to future monetary policy.

Baseline scenario: main assumptions

International outlook

The international outlook continued to deteriorate during the early months of the year, but growth projections have tended to converge, with growth of world output for this year estimated at 3.3%, and 4% per annum for 2002. These figures are lower than previous projections, as are those for the weighted growth of Chilean export markets, which is projected to fall half a percentage point this year. The prospects for the terms of trade in 2001 and 2002 are also somewhat lower than forecast in the last Report. In particular, the copper price is projected at 80 cents per pound this year and 90 cents per pound next year, leading to a projection of a 1.7% fall in the terms of trade this year, recovering to 5.3% in 2002.

Evidently, it is hard to forecast the behavior of the oil price, given the enormous volatility, which is generally observed in fuel markets. However, recent increases have a temporary component and futures prices allow forecasts similar to those values projected in the previous report. The price of crude oil on international markets should remain at around US$25 in 2001, then average US$23 throughout 2002.

World growth over the next eight quarters is expected to average somewhat more than 3.5% per annum.

The prospects for capital flows into Chile remain limited, according to estimates by some investment banks. International financial markets, however, have tended to differentiate between Chile and other emerging economies. The sovereign spread is expected to hold steady at current levels of around 175 basis points over coming quarters, falling slightly in 2002. Futures markets reveal expectations that the Fed will reduce its reference rate by an additional 25-50 basis points, to then increase the rate in line with the recovery of the US economy.

Projections for international inflation stand at 1% for this year and 2.8% for next year, and have not changed significantly since the last report. This is because lower oil prices and a gradual depreciation of the dollar were already included in estimates for 2001.

The oil price is expected to average US$25 per barrel in 2001 and US$23 in 2002.

Interest rates and the exchange rate

The baseline scenario assumes that the monetary policy rate will hold steady over the next 24 months at 3.75% (UF +). This is not a projection, but rather a methodological assumption that permits an evaluation of the coherence of current monetary policy with the medium-term inflation target that guides it.

In general, the market has anticipated reductions in the monetary policy rate since January, as is apparent in the sustained reduction of both nominal and real interest rates for every maturity since March. Rates have tended to stabilize recently, indicating expectations that the policy rate will remain at current levels in coming months. This reflects the incorporation of inflation expectations within the target range for 2001 and 2002, as well as domestic demand and GDP growth similar to the projections included in this report.

The baseline scenario assumes that the monetary policy rate will hold steady at 3.75% (UF +) over the next 24 months.

The nominal exchange rate and international inflation influence import prices and Chile's competitive position abroad. For the ten days prior to the 10 May monetary policy meeting, the average price for the observed dollar reached 602 pesos per US$, while the multilateral exchange rate (*tipo de cambio multilateral, TCM*) stood at 119 (2 January 1998=100), almost 2.7% higher than last January in the case of the TCM and 1.8% higher in the case of the real exchange rate.

To evaluate the future behavior of the exchange rate, market expectations and nominal and real interest rate differentials are useful, and can be complemented by an analysis of the fundamentals behind this relative price. This is particularly important under current conditions, given that turbulence in Argentine has above all affected the exchange rate. As a working hypothesis it is assumed that, in real terms, the exchange rate will remain stable at its current level over the next eight quarters. Although futures prices reveal depreciation is expected over this same horizon, this is not consistent with expectations of 5% average growth in activity and expenditure for the rest of this year and next, as inferred from market projections and those of this Report. Also, the baseline scenario assumes that volatility in international financial markets will tend to decline. Significant degrees of uncertainty about the future behavior of this variable remain, however, and are reflected in volatile exchange rates within floating regimes. This uncertainty has been incorporated into the balance of risks included in the corresponding subsection of this chapter.

Fiscal policy

Projections are based on information contained in the national budget approved for this year. Due to slower growth in activity and a lower-than-expected copper price, fiscal accounts will post a larger deficit

than originally forecast for 2001, near 0.5% of GDP. As a result of lower tax revenues, fiscal impulse will be greater than previously forecast. According to Finance Ministry authorities, employment programs, subsidies to the hiring of labor and the fact that public investment programs were moved up to the first half of 2001 will not increase expenditure above what was originally committed, but rather will be financed through the reallocation of items within the budget.

The baseline scenario incorporates the impact of the new macroeconomic scenario on fiscal accounts.

Potential output

The behavior of the gap between demand and potential output plays an important role in judging future inflationary pressures. The evaluation of productivity and potential output is based on historical trends, corrected for elements that could generate some changes, such as shifts in the investment rate.

Current levels of fixed investment, along with its expected behavior over the next two years, suggest that the stock of capital in the economy will expand moderately. Total factor productivity, which fell throughout 1998 and 1999, is expected to consolidate the positive growth apparent in recent quarters.

This suggests that the economy's productive capacity will grow at almost 5% over the next two years. This growth in supply does not constitute an immediate restriction on demand growth and inflation control, because some productive resources are idle, above all in the labor market. In this sense, it is important that this and other markets become increasingly flexible, in order to efficiently reallocate resources in response to relative price changes. A decline in flexibility could have a negative impact on the investment rate, productivity growth and employment within the Chilean economy, which would reduce its ability to grow in the medium term.

Transitory price factors

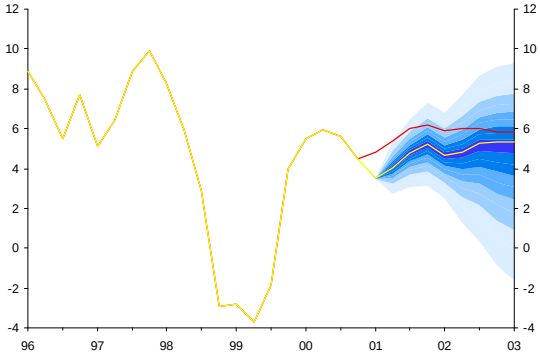
During the second quarter of this year, domestic fuel prices have been higher than initially expected, with the resulting impact on total CPI. This effect is expected to dissipate once the northern hemisphere's summer is over, as suggested by futures prices. Other regulated prices are expected to remain the same, as are prices for perishables.

Inflation and economic growth in the base line scenario

Economic growth

The available evidence shows that economic activity and expenditure slowed in the first quarter of 2001 compared to their growth in 2000, as a result of lower-than-expected investment and, above all, weak private consumption.

Figure VI.1
Quarterly GDP growth scenario (1)
(percentage change over the same quarter of the previous year)



(1) The figure shows the baseline projection (yellow line) and the confidence interval for the respective time interval (colored zone).
Confidence intervals of 10%, 30%, 50%, 70% and 90% are used. These confidence intervals summarize the Central Bank's risk assessment for future economic growth, on the assumption that the monetary policy rate will remain at UF + 3.75% for the next two years.
The red line indicates the projection in January 2001.

Source: Central Bank of Chile.

Under current macroeconomic conditions, economic growth in 2001 and 2002 will be investment-driven until consumption recovers. The decisive factor for consumption will be what happens with employment, which continues to stagnate. There are signs of more dynamism, however, in the construction industry and in some partial consumption indicators.

Investment growth prospects over the next two years reflect the gradual disappearance of excess housing capacity, the result of current conditions in the credit market. Fixed investment outside the housing market, including in machinery and capital equipment, and in engineering works and other buildings, shows some strength, which is expected to persist.

Demand projections are complemented, finally, with assumptions about the future behavior of mining, fishing and power generation. In the short term, these areas show significant fluctuations due to factors unrelated to the economic cycle.

All the above leads to a forecast of 5% growth for the baseline scenario over the next eight quarters, that is, from the second quarter of this year to the first quarter of 2003. In the short term, growth should reach around 4.3% during 2001, rising to 5% in 2002 and continuing to increase throughout the forecast horizon (Figure VI.1). Domestic demand should average somewhat more than 5% annual growth over the same period. The current account deficit is projected to reach 2.2% of GDP during 2001 and 1% of GDP in 2002.

Alternative scenarios for GDP are expressed as a distribution of probabilities regarding future economic growth. Their distribution reflects the confidence intervals that accompany the baseline scenario for growth, taking into account historical shifts in supply and demand conditions, as well as risks specific to current economic conditions (discussed below), and always assuming that the monetary policy rate remains unchanged.

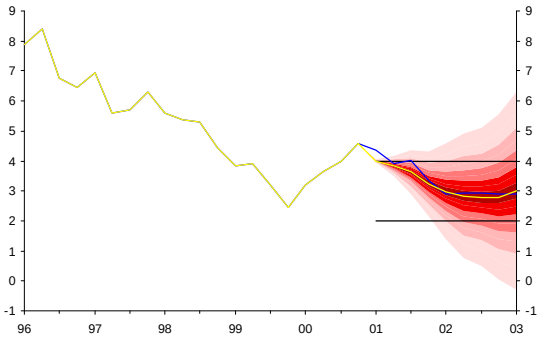
Inflation

The monetary policy stance determines the behavior of inflation in the medium and long term. In the short term, however, the relationship is more uncertain and more variable, revealing the impact of a wide range of factors. These include underlying price trends, the behavior of the exchange rate, labour cost pressures, sales margins, competition conditions in end markets, fares affecting regulated services, and the probable course of output and demand pressures.

After stagnating in early 2001, monetary aggregates performed more strongly during the second quarter, suggesting that private expenditure will start to pick up. So far this year, growth in the broader aggregates and lending have been more stable than money, a tendency that is expected to continue in 2001 and 2002.

Nominal wages, measured by the INE (National Bureau of Statistics), have reflected the impact of automatic indexation clauses based on past inflation, a trend that is particularly noticeable in private sector wages. Continuing high unemployment has only had a marginal effect on containing wage increases, a reflection of the limited downward flexibility typical of wage-setting in the Chilean economy, which also limits the possibility of efficient sectoral adjustments. Higher average labor productivity, however, has limited wages' impact on inflation to date.

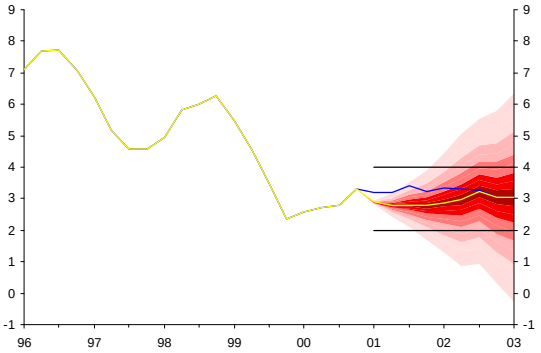
Figure VI.2
Inflation (CPI) projection (1)
(percentage change over the same quarter of the previous year)



(1) The figure shows the baseline projection (yellow line) and the confidence interval for the respective time interval (colored zone). Confidence intervals of 10%, 30%, 50%, 70% and 90% are used. These confidence intervals summarize the Central Bank's risk assessment for future inflation, on the assumption that the monetary policy rate will remain at UF + 3.75% for the next two years.
The blue line indicates the projection in January 2001.

Source: Central Bank of Chile.

Figure VI.3
Underlying (CPIX) inflation projection (1)
(percentage change over the same quarter of the previous year)



(1) The figure shows the baseline projection (yellow line) and the confidence interval for the respective time interval (colored zone).
Confidence intervals of 10%, 30%, 50%, 70% and 90% are used. These confidence intervals summarize the Central Bank's risk assessment for future inflation, on the assumption that the monetary policy rate will remain at UF + 3.75% for the next two years.
The blue line indicates the projection in January 2001.

Source: Central Bank of Chile.

The rapid drop in annual inflation within the target range during the first quarter showed that there were no sustained second-round effects from the rise in fuel prices last year. Likewise, the impact of the recent rise in gasoline prices should not persistently affect price performance. Expectations of inflation are close to the inflation target, according to the survey published monthly by the Central Bank, and the same expectations are implicit in nominal interest rates.

The 12-month projection for both CPI and CPIX inflation is based on the combination of these factors, and assumes that the monetary policy rate will remain constant at UF + 3.75%. The target for price stability is defined in terms of CPI inflation, but the Board also watches the behavior of CPIX inflation to evaluate the impact of demand pressures on prices more precisely. Projections are expressed as a distribution of probabilities for annual inflation over the projection horizon, that is, from the second quarter of 2001 to the first quarter of 2003. They refer to average changes in the price index in each quarter compared to the same period of the previous year (Figures VI.2 and VI.3).

After the rise in overall inflation in 2000 as a result of one-time changes in fuel prices, projections show that total CPI-measured inflation will remain within the target range. Thus, annual inflation rates over the short term are expected to be highly unstable, ranging from 3.5% to 4%, and then falling to 3.2% towards the end of 2001, 2.8% by late 2002, before rising again to 3.0% in the first quarter of 2003 (eight quarters on). In the baseline scenario, CPIX-measured inflation is projected to reach about 3% over the next eight quarters.

Balance of risks

The baseline scenario described above corresponds to the most likely trajectory for inflation and economic growth, conditional to the working assumptions about a constant monetary policy rate and other economic and financial developments already mentioned. As mentioned above, however, risk factors may change this scenario and the behavior of both inflation and economic growth. This subsection examines some of the alternative scenarios that could be relevant for the future course of monetary policy.

The main threat from abroad is the magnitude of the deceleration in the US economy. In fact, there are doubts about how quickly the US economy will once again approach trend growth rates, which provokes persistent financial instability. This more complex international climate could dampen export growth and terms of trade. The oil market also remains unstable, as recent trends indicate. However, evidence gathered in recent quarters suggests that significant oil price shifts, either above or below those expected, are unlikely to have a significant effect on inflation expectations over the medium term.

The baseline scenario assumes that instability in emerging financial markets will gradually subside. This is a significant factor because, while the Chilean economy is on a different footing than the rest of the region, it is not immune to the larger problems of contagion when problems escalate. One sign of this in recent weeks has been the reaction of long-term interest rates and the exchange rate to the ups and downs of the Argentine economy.

On the domestic front, consumption expenditure and employment should pick up in coming quarters, while growth in investment should consolidate above GDP levels of growth. More relaxed monetary conditions in recent months, along with an incipient rise in money supply and some incomplete indicators for consumption, support this forecast. But, unemployment could remain high for the rest of the year and aside from constructions no significant job creation could be observed.

This kind of situation would make it harder to carry out the sectoral adjustments required by macroeconomic conditions prevailing in the Chilean economy over the last couple of years. Whether these corrections can be made easily or with difficulty depends particularly on the flexibility at markets and their ability to respond to changes abroad and in the area of technology. Alternative developments, both regulatory and technological, above all in the labor market, may cause employment to recover much more slowly in coming quarters, to which will be hard to compensate with aggregate demand policies. Recently the government announced changes to facilitate financial markets' role of resource allocation easier to fulfill. It would be most useful if this same spirit of flexibility were to predominate in the discussion of the labor reform project, and the debate and application of regulatory norms in various markets.

The likelihood of these alternative scenarios occurring may indicate biases in both inflation and growth projections. The Board believes that the information available to date suggests that lower growth scenarios are somewhat more probable than are the other alternatives. As a reference point, the 50% confidence interval shows that average growth will range from 3.8% to 4.8% in 2001, and 3.3% to 6.3% in 2002.

Exchange rate projections could vary depending on expected events affecting predicted world growth rates, and the timing and scope of future monetary policy decisions in either the US or the Euro zone. Likewise, although international markets distinguish between Chile and other emerging economies, the country is not entirely immune to serious financial problems affecting Argentina or Brazil. In this kind of scenario, the dearth of financial resources would become acute, and the exchange rate could suffer an additional, temporary depreciation. With all this in mind, the Board believes the risks to inflation are balanced.

Table IV.1 provides the probability distribution of the annual inflation rate for next two years, assuming that the monetary policy rate remains stable. The Table contains the same information as Figures VI.2 and VI.3, and reveals the variability around the inflation forecast due to specific price volatilities, the exchange rate, and uncertainty about economic growth projections. For the 12-month measure of inflation as measured by the CPI, the confidence interval with a 50% probability ranges from 2.3% to 3.6% for the fourth quarter of this year, and there is a 50% probability that it will fall somewhere between 1.5% and 4.5% for the following12 months. For CPIX inflation, the corresponding range is 2.2% to 3.5% in the following 12 months, and 1.6% to 4.4% in the following 12 months. Values outside these ranges are possible, but less likely the further they move in either direction.

The working assumption of a fixed monetary policy rate is fundamental to correctly interpreting the distribution of probabilities and risks for baseline inflation and growth projections. In effect, this distribution reflects the likelihood of changes in inflation forecasts, not inflation itself, since it does not take into account possible monetary policy measures and their impact on inflation. A major revision in these

projections would require corrections to monetary policy in order to stabilize inflation around the medium-term target. Thus, probabilities do not reflect the real behavior of inflation, but rather an evaluation of the risks relevant to future trends in monetary policy.

Growth-related risks are believed to be slightly downward-biased, whereas those relating to inflation are balanced.

TABLE VI.1
Inflation scenarios (1)

		Inflation ranges			
		2% or less	2% a 3%	3% a 4%	4% or more
		(porcent)			
CPI inflacion					
	2002.I	31	20	20	30
	2003.I	40	11	11	38
CPIX inflación					
	2002.I	33	20	19	28
	2003.I	40	11	11	38

(1) Average inflation according to the average annual CPI.
Source: Central Bank of Chile.

Other projections

Projections can also be developed based on methodological suppositions other than that of a constant monetary policy rate at its current level. If the baseline scenario is developed using the forward rates curve, inflation and growth projections for 2002 are slightly lower than those in this Report, because the monetary policy rate is expected to rise after late 2001. Use of the monthly expectations survey for May yields similar results.

Conclusion

In conclusion, the Board considers the current monetary policy stance coherent with maintaining inflation within the target range. In the main scenario, CPI measured inflation is projected at close to 3.2% by the end of this year, and around 2.8% at the end of next year, while economic growth will average 4.3% in 2001 and 5% in 2002

However, it is important to stress the conditional nature of these projections. Currently, there are some risk factors that could change the future path of inflation, but it is hard to weigh their influence using available information. This means that during upcoming meetings the Board will pay special attention to evaluating three main areas: first, the performance of the Chilean economy, particularly consumption and employment, such as indicators allowing it to assess growth of domestic expenditure and inflationary pressures; second, developments in the world economy and main export prices; third, conditions in international financial markets, particularly for emerging economies. As always, the Board will react flexibly to any event that could threaten meeting its inflation target, which is monetary policy's fundamental contribution to economic and social progress.

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