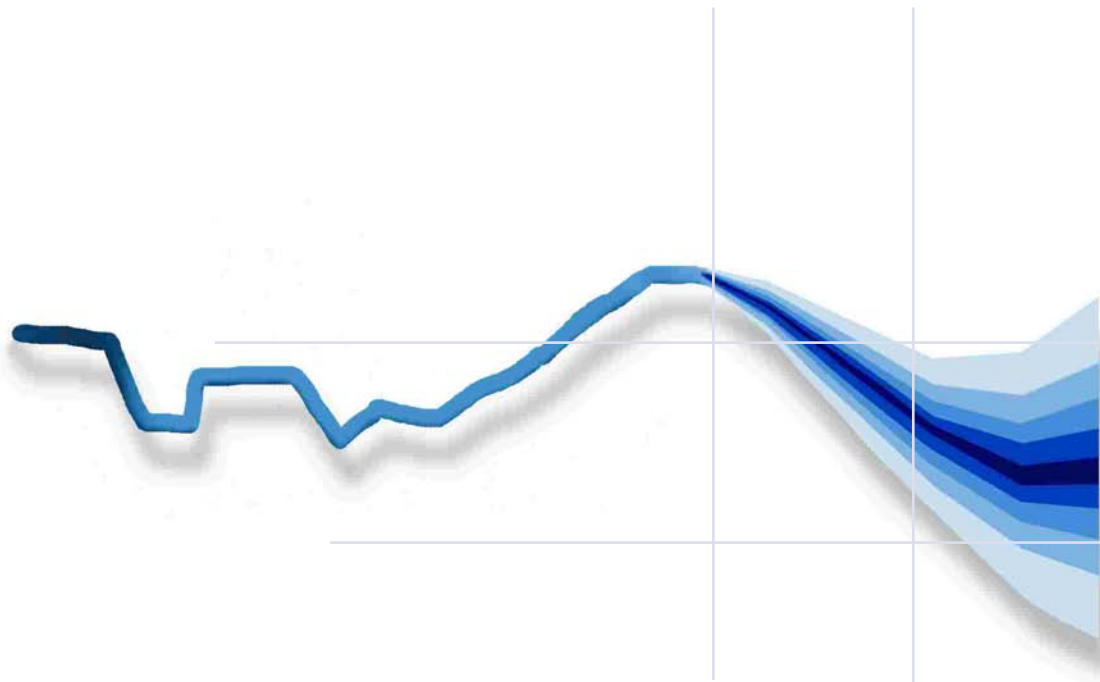


2008
JANUARY

MPR 2008

Monetary Policy Report



BANCO CENTRAL DE CHILE

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

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^{*/} The closing date for statistics in this *Monetary Policy Report* was 8 January 2008.

Preface

The main objective of the Central Bank of Chile's monetary policy is to keep inflation low, stable and sustainable over time. Its explicit commitment is to keep annual CPI inflation around 3% most of the time, with a tolerance range of plus or minus one percentage point. To attain this objective, the Central Bank orients monetary policy toward helping projected inflation to stand at 3% annually over the policy horizon of about two years. Controlling inflation is the means through which monetary policy contributes to the population's welfare. Low, stable inflation favors improved economic performance and growth, while preventing the erosion of personal income. Furthermore, monetary policy's focus on achieving target inflation helps to moderate fluctuations in domestic output and employment.

The main purposes of the *Monetary Policy Report* are the following: (i) to report and explain to the Senate, the Government and the general public the Central Bank of Chile Board's views on recent and expected inflation trends and their implications on monetary policy conduct; (ii) to publicly disclose the medium-term analytical framework used by the Board to formulate monetary policy; and (iii) to provide useful information that can help shape economic agents' expectations regarding future inflation and output trends. This *Report* responds to the obligation set forth in the Bank's Basic Constitutional Act to report to the Senate and the Minister of Finance (Section 80).

The *Monetary Policy Report* is published three times a year, in January, May and September. It focuses on the main factors influencing trend inflation, including the international environment, financial conditions, prospects for aggregate demand, output and employment, and recent price and cost developments. The last chapter summarizes the results of this analysis in terms of both prospects and risks affecting inflation and economic growth over the next eight quarters. The *Report* also includes several boxes that offer more detailed considerations on issues relevant to evaluating inflation and monetary policy.

This *Monetary Policy Report* was approved by the Board at its meeting on 11 January 2008 for presentation before the Senate's finance commission on 16 January 2008.

The Board

Summary

In the final months of 2007, annual CPI inflation continued to exceed expectations, approaching 8% at year's end. In addition to the increases in food prices during the second and third quarters of last year, and that had driven inflation above 5% per annum, there was a new rise in fuel prices and electric rates, and a smaller than expected reversal in the prices of some foods. Output growth lost some dynamism in the second half, while the international scenario turned more uncertain. This, despite still high terms of trade. Thus, a scenario is foreseen where, in the short run, annual inflation continues to grow, but with limited inflationary pressures into the medium term, that combines with an international setting where adverse risks have increased significantly.

As a way of ensuring convergence of annual inflation to 3% in the relevant horizon, monetary policy has adjusted, raising the monetary policy rate (MPR) by 25 basis points in September and December 2007 and January 2008, driving it to 6.25% per annum.

In the past year, a number of shocks have occurred, largely associated with supply factors, whose magnitude and simultaneity took annual inflation to figures substantially above the tolerance range for target inflation. As was stated in September, during most of 2007 there was a sustained increase in world prices of some foods, with high incidence on domestic prices. This combined with the price effects of local frosts on fresh fruit and vegetables. All the above resulted in that, at the close of the third quarter, both headline inflation and underlying measures—CPIX and CPIX1—recorded annual growth rates above 5%. In recent months, the prices of oil and derivatives saw a new unexpected rise, while the effect on electric power costs became apparent due to the change in the electric generation matrix, which shifted to sources more expensive than hydraulic energy. In addition, the prices of some foods, particularly perishables, showed a smaller than projected reversal. Thus, annual CPI inflation ended 2007 close to 8%.

The size of supply shocks can be appreciated by comparing the unusual increase of some prices in 2007 with their average increase over the 2000s so far. Non-perishable food rose by nearly 15% per annum last year, in contrast with an average somewhat lower than 2% in 2000-2006. The prices of fresh fruit and vegetables—even considering high-price years like 2002 and 2005—fell by an average of almost 2% between 2000 and 2006, while in 2007 it showed an increase of more than 30%. Electric power rates, affected by a rise in costs, posted an average increase of 23% during the year—almost twice as much as the rate prevailing in December 2007— compared with a less than 6% average increase between 2000 and 2006. Although somewhat larger than increases seen over the past several

years, the fuel price increase was a surprise, since the majority of market agents' revealed expectations pointed to a slight decline. These developments explain five to six percentage points of inflation accumulated over 2007. At any rate, a significant portion of the other prices showed changes in line with their tendencies of the past few years while others, especially fares of public transportation in Santiago, which fell early in the year, had a negative incidence on 2007's annual inflation.

In the second half of 2007, output grew at a slower pace than in the first and than foreseen in September, largely due to specific shocks. Particularly worth noting was the more abrupt drop in the electric power sector's value added, because of reduced availability of hydrologic resources for power generation, within a context of natural gas scarcity and high prices of oil and derivatives. This picture led to a substantial increase in electric generation costs and the bills of households and firms. While difficult to gauge its impact with accuracy, the higher cost of energy is partly to blame for the slowdown of manufacturing industry. Still, these higher prices of energy, consistent with energy supply conditions, provide incentives for investments forecast for the sector. Thus, 2007's annual GDP growth is estimated at 5.2%. Domestic demand, in turn, continued to grow steadily, led by investment and private consumption.

Economic growth and current account

	2005	2006	2007 (e)	2008 (f)
	(annual change, percent)			
GDP	5.7	4.0	5.2	4.5-5.5
National income	9.2	5.1	3.6	5.1
Domestic demand	11.0	6.0	8.1	6.2
Gross fixed capital formation	21.9	4.0	12.8	8.4
Total consumption	7.5	6.6	7.3	5.6
Exports of goods and services	3.5	4.2	8.1	5.0
Imports of goods and services	17.7	9.4	15.1	8.3
Current account (% of GDP)	1.1	3.6	3.8	-0.5
	(US\$ million)			
Current account	1,315	5,256	6,400	-1,000
Trade balance	10,805	22,213	24,500	16,400
Exports	41,297	58,116	68,300	68,300
Imports	-30,492	-35,903	-43,800	-51,900
Services	-636	-922	-1,500	-2,000
Rent	-10,645	-19,392	-20,100	-18,800
Current transfers	1,791	3,356	3,500	3,400

(e) Estimate.

(f) Projection.

Source: Central Bank of Chile.

For 2008, the projected baseline scenario posts a GDP growth of at 4.5% to 5.5%, with the risk balance biased downward. Domestic demand should grow less than in recent years, although still outpacing output growth. A slowdown in consumption is considered, because of some delay in the effects of increased inflation over real income and a less favorable external scenario. This reduced dynamism of income will occur, also, within a context of deceleration in credit and employment. The normal unfolding of the consumer credit cycle, considering the degree of market penetration it has attained in the population will hardly boost consumption before a weakened income. The increase in fiscal spending, in any case, will tend to mitigate,

at the aggregate level, private income's loss of strength. This projection, however, contains high uncertainty, because consumption may prove more persistent than projected, in line with its behavior of recent years, but it may also fall deeper than considered.

The baseline scenario assumes that during 2008 there will be no significant changes in natural gas shipments from Argentina or in hydrologic conditions with respect to 2007. In this setting, risks are especially important, because of the implications on output and inflation that a scenario of even higher electric rates and/or less power available. A scenario of further increases in these costs would have significant effects on manufacturing activity and on other economic sectors.

International baseline scenario assumptions

	2005	2006	2007 (e)	2008 (f)	2009 (f)
Terms of trade	11.3	22.5	2.9	-11.0	-7.0
Trading partners GDP (*)	3.9	4.5	4.3	3.7	3.8
World GDP at PPP (*)	4.9	5.4	5.3	4.8	5.0
World GDP at market exchange rate (*)	3.3	3.9	3.7	3.1	3.4
External prices (in US\$)	7.5	5.3	7.9	7.1	2.1
LME copper price (US¢/lb)	167	305	323	295	250
WTI oil price (US\$/barrel)	56	66	72	93	88
Gasoline parity price (US\$/m ³) (*)	451	526	597	700	670
Libor US\$ (nominal, 90 days)	3.6	5.2	5.3	4.2	3.9

(*) For definition, see Glossary.

(e) Estimate.

(f) Projection.

Source: Central Bank of Chile.

For 2008, the external stimulus is expected to be smaller than it was in previous years. Growth of trade partners will be somewhat less than 4%; the terms of trade, while remaining high, will begin to normalize; and financial conditions for emerging economies will be less favorable. For the moment, and unlike other occasions, current international financial turbulences have reflected mainly in developed markets, with a moderate increase in emerging economies' sovereign risk. Nevertheless, concerns and uncertainties regarding the extent of the effects of the subprime crisis in the U.S. and around the world have increased substantially.

How this episode will impact emerging economies will depend, in part, on its implications on the real sector. A scenario of limited effects on world output and on commodity prices should not imply significant deterioration of emerging economies. Ultimately, however, it is subject to the specifics of each country. It cannot be ruled out that the most vulnerable ones, say, because of a greater need for external financing, may suffer severe consequences. On the contrary, if the effects on the real sector are significant and end up configuring a scenario of strong deceleration of the world economy and a deep fall of commodity prices, the impact on emerging economies, including Chile, will be larger.

In any case, the effects on domestic inflation of different external scenarios depend both on how the components of external shocks are finally configured and how long transmission will take. It is worth highlighting that Chile's current macroeconomic policy framework allows to cushion

potential effects of an unfavorable external scenario better than it did in the past, particularly because of monetary and foreign exchange policy flexibility and because current account surpluses of the past several years have led to a substantial accumulation of foreign assets. Overall, the reduced range for projected growth this year—compared to September's forecasts—and the risk balance reflect, to an important extent, how such less favorable external scenario may affect Chile's prospects for growth.

Despite this more uncertain external scenario, commodity prices have remained high, keeping inflation as an issue of significant concern around the world. The price of copper has hovered around US\$3/lb and the oil price posted a new increase, fluctuating between US\$90 and US\$100 per barrel. Short- and medium-term forecasts indicate that during 2008-2009 both prices will exceed those projected in September. International food prices, which remain in record highs, have shown mixed behaviors. Dairy products showed a decline toward the end of 2007, while grains rose, especially corn and wheat.

The peso appreciated by around 5% with respect to the closing of the previous Report, that is, comparing the average of the last ten working days previous to the statistical closing of each Report. Said behavior was due, to a large extent, to the dollar depreciating in international markets. Actually, comparing with a wide currency basket—MER—the appreciation of the peso is much smaller: 1.5%. In turn, the real exchange rate dropped by 4% to somewhat above 89, using the 1986=100 base. This figure falls marginally below the range of MERs considered to be consistent with its long-term fundamentals; therefore, the baseline scenario contemplates, as a working assumption, a slight tendency to real depreciation, with a limited effect on projected inflation.

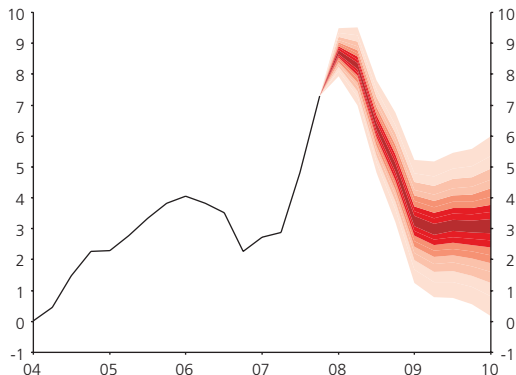
Inflation expectations for the next several quarters have increased, while for the long term they remain well anchored around 3% per annum. Annual growth in nominal salaries has not changed significantly after the mid-2007 increase, and its variation is thought to still be consistent with usual indexation clauses and the evolution of the labor market in the past few years. Thus, unit labor costs are growing at annual rates that are in line with target inflation.

The baseline scenario considers that annual CPI inflation will continue along an upward path over the course of the first quarter of this year, and will remain for all of 2008 above the tolerance range, partly reflecting the recent oil price increase and the lagged correction in electric rates, but also responding to significant increases in indexed prices. Considering that the period from June to December 2007 showed the highest concentration of high monthly CPI changes—accumulating an inflation of 5.8%—, annual CPI inflation can be expected to begin converging to target from mid-2008 onwards, to enter the tolerance range by early 2009, and hovering around 3% until the end of the projection horizon, that is, between the last quarter of next year and the first quarter of 2010. Overall, all possible alternative events considered, the balance of risks for inflation is unbiased.

Annual CPIX1 inflation will remain below headline inflation in the next few months, but its convergence to 3% will be slower than that of CPI. This, because inflationary inertia is greater in prices included in the CPIX1 than in those that are not, such as fresh fruit and vegetables. Thus, annual CPIX1 inflation is forecast to reach 3% only toward the end of the relevant projection horizon.

CPI inflation projection (*)

(annual change, percent)

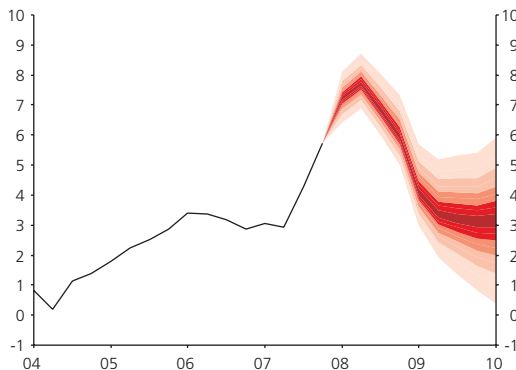


(*) The figure shows confidence intervals for the baseline projection for the respective horizon (colored area). Confidence intervals of 10%, 20%, 50%, 70% and 90% are ranged around the baseline scenario. These intervals summarize the Board's risk assessment for future inflation. The baseline scenario is constructed using the methodological assumption that the MPR will, over coming quarters, follow a path similar to the path that can be inferred from financial asset prices prevailing in the two weeks prior to the closing date for statistics in this *Report*.

Source: Central Bank of Chile.

CPIX inflation projection (*)

(annual change, percent)



(*) The figure shows confidence intervals for the baseline projection for the respective horizon (colored area). Confidence intervals of 10%, 20%, 50%, 70% and 90% are ranged around the baseline scenario. These intervals summarize the Board's risk assessment for future inflation. The baseline scenario is constructed using the methodological assumption that the MPR will, over coming quarters, follow a path similar to the path that can be inferred from financial asset prices prevailing in the two weeks prior to the closing date for statistics in this *Report*.

Source: Central Bank of Chile.

Inflation

	2005	2006	2007	2008 (f)	2009 (f)
CPI inflation, average	3.0	3.4	4.4	7.1	
CPI inflation, December	3.7	2.6	7.8	4.5	
CPI inflation, around 2 years (*)					3.1
CPIX inflation, average	2.3	3.2	4.0	7.0	
CPIX inflation, December	2.9	2.7	6.3	5.4	
CPIX inflation, around 2 years (*)					3.1
CPIX1 inflation, average	1.9	2.5	4.1	6.4	
CPIX1 inflation, December	2.6	2.4	6.3	4.9	
CPIX1 inflation, around 2 years (*)					3.0

(*) Corresponds to the projected average inflation between the fourth quarter of 2009 and the first quarter of 2010.
(f) Projection.

Source: Central Bank of Chile.

The baseline projection also considers that the present level of inflation will not spread into other prices beyond the usual inflationary inertia. It also assumes that, in the next few quarters, nominal salaries will grow at annual rates above current ones and that said rates will decline in the medium term, in line mainly with indexation clauses and normal lags. However, it cannot be ruled out that propagation may not behave as anticipated. For example, a scenario may be configured where high inflation translates into greater than expected growth in salaries, leading to an increase in unit labor costs incompatible with target inflation. It may also happen that propagation ends up being even smaller than historic figures, considering the transitory nature of shocks.

Projections also assume that imported costs will not be a significant source of additional inflationary pressures during the next two years. Uncertainty around this assumption is increased by doubts on the evolution of the external scenario. It cannot be ruled out that, if the deceleration of the world economy exceeds forecasts, international commodity prices, especially for food, copper and oil, may drop substantially and may lead, also, to a reduction in demand for Chilean exports. The counterpart of this scenario is an increase in the exchange rate and a possible negative incidence on economic growth, whose net effect on inflation is difficult to estimate and that will also depend on the true size of existing gaps. Anyway, it can neither be ruled out that the prices of food and especially of oil remain high or even post further increases, as has recently been the rule.

These projections also consider as a methodological assumption that, in the next few quarters, the MPR will move along a similar path to the one that can be inferred from financial asset prices over the last two weeks prior to the closing date for statistics in this *Report*. The Board considers it opportune to point that, while the future trend of the monetary policy interest rate will depend on incoming information and its implications for projected inflation, additional corrections may be necessary to ensure convergence of inflation to the target. Particularly important for this will be the unfolding of the international scenario, the evolution of output gaps and the possible propagation of recent inflationary shocks to other prices.

BOX: Imperfect information and monetary policy conduct

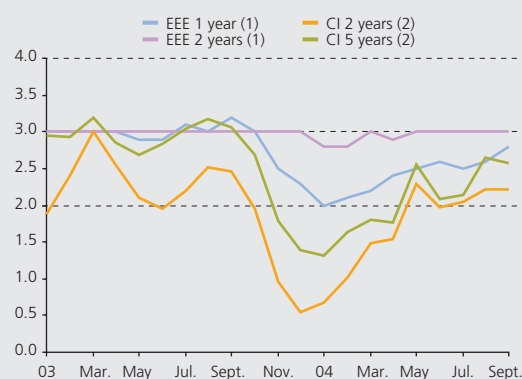
The Board determines the monetary policy rate (MPR) by evaluating every month the impact of new information available on inflation projected two years ahead. This projection is an integral part of the process of developing each *Monetary Policy Report*. Under this rationale, the Board may decide to change the MPR and/or communicate to the public its intention to change its future course for two reasons: first, because incoming information validates the baseline projection scenario and this, in turn, implies adjusting the monetary stimulus so that projected inflation two years ahead remains consistent with the target; second, because the evaluation of new information leads to the conclusion that inflation projections two years ahead are not consistent with target inflation, and changes are needed in the MPR path in order to attain it. The features inherent in the inflationary process make these decisions complex. On one hand, decisions are made with a forward-looking consideration of their effects and with lags that vary in magnitude and timing. On the other, real-time data is practically nonexistent (and those available have very little information content by themselves); they are received with significant delay; and they may be subject to revisions with respect to their initial versions.^{1/}

Therefore, monetary policy conduct must properly weigh the implications of new information both in the baseline scenario and in its related risk. This process becomes more difficult when the Board's assessment differs from market perceptions and/or when new situations arise. This is of paramount importance because, within an inflation targeting scheme, the credibility of the Central Bank's policy actions is a crucial element in achieving the target. Since projected inflation depends on the interest rates expected by market agents, the current MPR is as important for inflation forecasts as its likely future trend. One episode that illustrates a dissonance between the Board and the market occurred in late 2003, when market inflation expectations for the medium and long term differed significantly from target inflation.

Toward the end of 2003, the Board expected low inflation one year ahead.^{2/} While in May and September 2003 it foresaw average inflation of 2.4% in 2004, in January 2004 it reduced the projection to 0.7% (in the end, it was 1.1%). The Board projected that two years ahead, inflation would converge to 3%. The market also anticipated low inflation one year ahead; however, in two and five years it saw inflation substantially below 3%, creating a risk for the credibility of target inflation as the nominal anchor (figure 1). The evaluation of these

changes was made more complex by the big surprises in monthly inflation that coincided with fluctuations in expected inflation in the period. Because of the mechanics of short-term indexed interest rates and shallow longer-term markets, this element affected the inflation compensation indicators, taking out some of their informational content.

Figure 1
Expected inflation 1, 2 and 5 years ahead, 2003-2004
(percent)



(1) Economic Expectations Survey (*Encuesta de Expectativas Económicas*), Central Bank of Chile.
(2) Calculation of the spot inflation compensation on the basis of the monthly average rate of Central Bank's bonds.

Source: Central Bank of Chile.

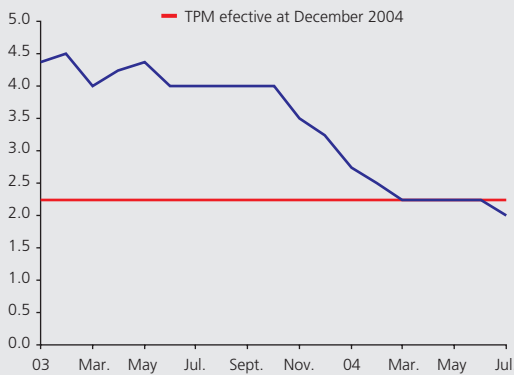
All this occurred while the MPR was kept at 2.75% from early 2003 onward. In August that year, the Board recognized in its communications that short-term inflation was dropping beyond forecasts, while the monetary stimulus though biased, was consistent with inflation converging to 3% over a two-year horizon. Expectations for the MPR inferred from the forward curve were also dropping, flattening the yield curve, with an expected fall in the MPR for December 2004 of about 150 basis points between September and December 2003. The Economic Expectations Survey revealed a similar

^{1/} For a more detailed description of the decisionmaking process, see "Central Bank of Chile: Monetary Policy in an Inflation Targeting Framework," pages 21–24.

^{2/} This forecast was based on a sudden reduction in cost pressures, characterized by a deep fall in the peso/dollar parity—nearly 20% from August 2003 to January 2004—that pushed down annual CPI inflation by close to one percentage point in late 2003. Food prices also dropped significantly, albeit to a lesser degree, as a result of increased market competition.

movement (figure 2). The discrepancy between trend inflation expectations and inflation projected by the Board, combined with the possibility that this would result in a more persistent unanchoring of expectations and that the real implicit monetary stimulus would differ from the stimulus necessary to attain the inflation target, led the Board to cut the MPR by 50 basis points at each of its meetings in December 2003 and January 2004, to 1.75%. After that, medium-term inflation expectations gradually returned to levels consistent with the target.

Figure 2
Expected MPR at December 2004 in Economic Expectations Survey
(percent)



Source: Economic Expectations Survey (*Encuesta de Expectativas Económicas*), Central Bank of Chile.

In sum, monetary policy conduct is a complex process because of the ambiguities that surround it, the forward-looking nature of its goal, imperfect information and uncertainty regarding the transmission of policy actions to output and prices. For this reason, the Board's evaluation of possible courses of action pays special attention to risks surrounding the baseline scenario. This may lead to episodes in which the Board's evaluation differs from the market's; this is a rare situation, but it entails a big policy challenge. The Board has therefore developed a series of tools—including the publication of this *Report*—that foster transparency of decisions and effective communication of the possible course of monetary policy and underlying causes.

At the present time, when inflation has risen to very high levels, the Board considers it crucial to anchor inflation expectations to the target, knowing that market confidence in compliance with the target is a key element in price dynamics. The Board further considers it necessary to reaffirm that, as it has done in the past, it will adopt the necessary decisions to ensure that annual inflation converges to 3% over the policy horizon, as it has done in the past.

Monetary policy decisions in the past four months

Background: *Monetary Policy Report*, September 2007

After May, annual CPI, CPIX and CPIX1 inflation climbed to around 4%, mainly because of unusual increases in the prices of several specific items. These shocks did not necessarily reveal inflationary pressures in connection with the Chilean business cycle. In the first half, GDP growth was strong and above forecasts. Output was believed to be performing in line with trend and was projected to continue to do so in the next few quarters. The external outlook relevant to the Chilean economy showed no drastic changes, although in the few weeks prior to the closing of the *Monetary Policy Report* there were significant corrections in asset prices and high volatility in international financial markets, which deteriorated financial conditions for some emerging economies and might reduce world growth.

The baseline scenario considered that, partly based on recent figures, annual CPI inflation would continue to rise in the next few months, to then descend toward 3% over the course of 2008 and remain relatively constant until the end of the projection horizon. Economic activity would grow 5¾% to 6¼% in 2007, while in 2008 it would stand in the 5.0%-6.0% range. The Board considered that in such a climate, the balance of risks for growth was biased downward, while it was unbiased for inflation. It also estimated that, in the most likely scenario, further increases in the MPR would be necessary in the coming months to keep projected inflation at 3% over the policy horizon. As always, the evolution of the MPR would depend on incoming information and its implications for projected inflation. In particular, the Board would remain attentive to international financial markets and their influence on growth and inflation. The Board also considered that in a context of hard shocks to specific prices and narrow gaps (as was the case at that time), special monitoring of both the possible spreading to other prices and inflation expectations in the medium and long term was required.

Meetings from September to December

At its September meeting, the Board found it difficult to argue in favor of any option other than increasing the MPR by 25 basis points. While the baseline scenario outlined in the latest *Monetary Policy Report* was still valid, some of the risks identified therein had intensified. At the international level, although evaluations of the scope of the subprime crisis and

its potential impact on the real side of the economy were still premature, some claimed that its effects on growth in the U.S. and in the world would not be marginal, leading to a downward revision of growth projections for 2008. Moreover, every indication was that financial markets' volatility would not end any time soon. Domestically, the biggest surprise came from the labor costs side, as some indicators were growing beyond what could be predicted from the usual indexing clauses. The baseline scenario considered a reduction in the monetary stimulus to ensure compliance with the target, preventing the occurrence of second-round effects that would increase inflation more than the relative price adjustments that would be reflected in the CPI figures in the coming months. However, risks had increased and moved in the direction of softening inflationary pressures in the medium term. There were signs pointing to an output deceleration in the next few quarters, including the drop in consumer expectations and partial signs of a weaker construction sector and reduced consumer demand. Meanwhile, it could not be ruled out that the deceleration in consumer loans was due to reduced demand because of less favorable prospects. Moreover, the smaller relative spending in food and energy following the normalization of their prices could cause a build-up of new inflationary pressures. Thus, the Board decided unanimously to raise the MPR 25 basis points to 5.75%, stating that the most prudent course of action was to tie the future path of monetary policy to changes in the international economy and their implications for projected inflation and to explicitly communicate it that way.

At the October meeting, the options examined as most feasible were to maintain the MPR or raise it 25 basis points. The decision was particularly difficult because of developments that, taken separately, could totally justify either choice. The division in each of the expectations indicators that existed at the time of the meeting (different surveys of analysts and money desks, as well as market prices) gave good account of this dilemma. On the external front, the effects of the turbulence were still being felt, although they seemed to have lessened somewhat. However, financial conditions were less favorable than before the crisis. The main development was the significant depreciation of the U.S. dollar with respect to every floating currency, including the Chilean peso. Most notorious were the high commodity prices, probably confirming the strong growth of emerging economies. Domestically, output showed signs of slowing down, which, although mainly explained by the performance of natural resource sectors of the economy, also extended to other sectors, such as manufacturing.

Preliminary estimates suggested that GDP would grow less than forecast in the *Monetary Policy Report*, and gaps would close less than anticipated. On the demand side, it was possible that known energy problems were compounding the negative effect of the erosion of real household income by higher inflation. This introduced a downward bias in the consumption trend. These elements helped reduce inflationary pressures. As for inflation, surprises continued, especially in the prices of perishables. The developments of the previous month thus provided solid grounds for choosing either monetary policy option. It seemed prudent to wait for more information, however, given the uncertainty regarding both the evolution of the external scenario and the way in which the domestic cycle would unfold, together with the 75 basis point increase in the MPR that had already accumulated to then and whose effects were still developing. Therefore, the Board unanimously agreed to maintain the MPR at 5.75%. The biggest risk was of medium-term inflation expectations largely exceeding the target; in that case, severe action would be necessary to reverse them.

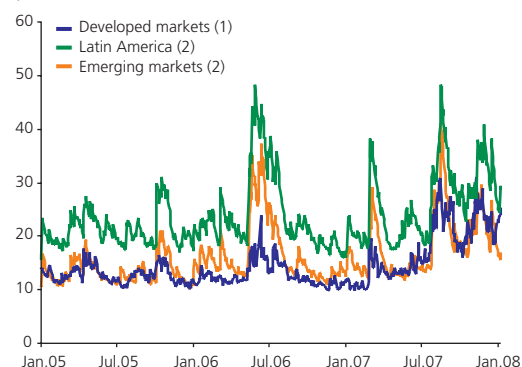
In November, the plausible options were again to maintain the MPR unchanged or raise it 25 basis points. Internationally, information over the developments of the last few weeks suggested a worsened setting, with the expected slowdown materializing, particularly in the U.S. The financial markets, especially credit markets, continued to reflect a significant degree of uncertainty, even intensifying in recent indicators. Moreover, concern for inflation was growing, given the combination of increases in food and fuel prices and the depreciation of the U.S. dollar. Commodity prices, in particular, were high, with oil approaching US\$100 per barrel. Domestically, the most likely outcome was an economic slowdown in the third quarter and more excess capacity than forecast in the September *Monetary Policy Report*. Labor market slack was also growing in the third quarter, although its correlation with employment and wages varied as much across indicators as across sectors. Considering all this, the main source of concern continued to be high inflation, with annual change well above the tolerance range and projections in the September *Report*. The last monthly figure was smaller than forecast, however, suggesting some easing of inflationary pressures. In line with this scenario, the Board again considered it prudent to wait for more information and unanimously decided to keep the MPR unchanged for the second consecutive month, at 5.75%.

In December, the options examined were to either maintain the MPR or raise it 25 basis points. In the external scenario, concern about the extent of the subprime crisis was increasing. The financial implications for the U.S. business cycle, its potential contagion and the policy response were still unknown, but the general perception was that they would be deeper and more protracted than previously estimated. Domestically, the slowdown of consumption was milder than had been foreseen a month before, while investment was still dynamic. The latest figures confirmed a slowdown in output during 2007. The main source of concern continued to be the high level of inflation. Annual CPI variation was well above the tolerance range, and everything suggested that it would stay there for several months. Monetary policy was thought to still be expansionary, because the MPR continued in the lower part of the range defined by various measurements of its neutral level, and borrowing continued to grow strongly. The policy decision was considered especially complex. It was particularly important to examine the risks of a deep worsening of the external scenario or of a more severe slowdown of domestic output that would imply having to reverse the decision to raise the MPR within a few months. These risks seemed limited, however. When facing previous surprises also coming from supply shocks, the Board had taken a cautious stand, focusing its concern on possible second-round effects and implications for medium-term inflation expectations. The evidence so far indicated that lags in inflationary inertia were similar to historic events. The Board stated that it could not allow expectations to drift away from the target, and monetary policy therefore should not rule out some degree of fine-tuning. This included reacting promptly to incoming information and admitting the possibility of changing the direction of policy actions or even reversing previous decisions in less time than usual. The balance of risks led to the conclusion that the risks of acting at that time were smaller than might have been expected. Raising the MPR would help reaffirm the Board's commitment to the inflation target and thus safeguard the Bank's earned credibility, whereas holding it at the current level increased the risk of having to make larger and more costly adjustments to the MPR in the future in the event of a further deterioration in the inflation outlook. Thus, the Board decided unanimously to raise the MPR by 25 basis points, to 6.0%.

I. International outlook

Figure I.1

Volatility in stock exchanges
(percent)

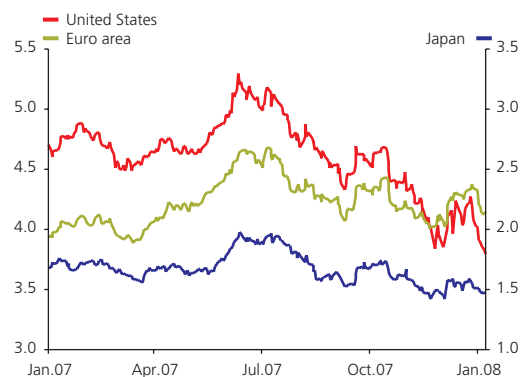


(1) Volatility implicit in options in the S&P 500 index of the U.S. (VIX).
(2) Estimates of past volatilities in respective MSCI indices, denominated in U.S. dollars.

Sources: Bloomberg and Morgan Stanley Capital International.

Figure I.2

Long-term interest rates (*)
(percent)



(*) 10-year government bonds.

Source: Bloomberg.

This chapter examines recent developments and prospects for the world economy over the next two years and describes the relevant external scenario considered most likely for the Chilean economy, along with the main risks.

Developed financial markets

In recent months, developed financial markets have been marked by the potential reach of the mortgage subprime crisis in the U.S. Among other effects, the crisis has caused a global problem of illiquidity and tighter lending standards. It has also shaped a scenario of weaker global economic activity for coming quarters, with a downside risk and a high degree of uncertainty.

This episode of financial turmoil has been characterized by uncertainty regarding the extent to which financial institutions are exposed to subprime-mortgage-backed securities, the impact on other assets and resulting losses. A large fraction of the observed liquidity problems has to do with these factors. The subprime crisis has also proved to be deeper and longer lasting than projected, with no precise assessment of the ultimate extent of its impact and with market players' estimates of associated losses increasing in magnitude and scope in the past few months.^{1/} This has resulted in highly volatile prices of financial assets, changes in risk assessment and the resulting flight to quality (figure I.1).

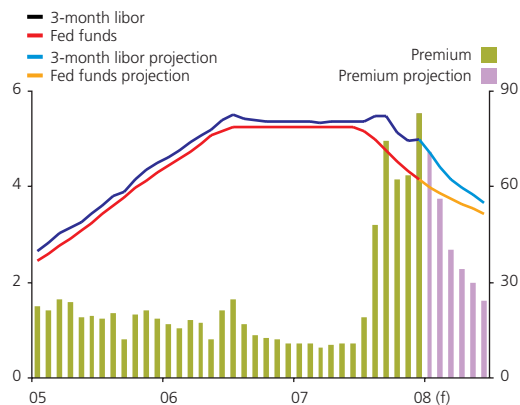
The perception of higher risk has increased demand for safer dollar-denominated liquid instruments, triggering a significant drop in interest rates on dollar-denominated long-term bonds. This, together with later indicators of slower activity, was reflected in a fall in 10-year-bond rates of nearly 70 basis points since the last *Report* (that is, comparing the average of the last ten working days prior to the closing date for statistics of each *Report*). Bonds in euros showed practically no change (figure I.2).

The central banks of several developed economies have taken different actions to address the liquidity shortage problems that have persisted in the markets. In particular, the U.S. Federal Reserve, the Bank of England, the Swiss National Bank and the Bank of Canada announced coordinated operations aimed at increasing the supply of liquidity in the short term. They

^{1/} Estimated losses were initially around US\$75 billion, while and in the worst-case scenario was US\$150 billion. Today, estimates are in the range of US\$200–600 billion.

Figure I.3

Liquidity in world markets: U.S. short-term premiums (monthly averages, percent, basis points)

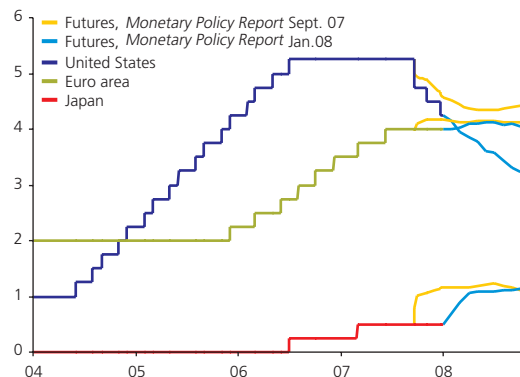


(f) Projections based on futures contracts, considering the average of the 10 working days prior to 8 January 2008.

Source: Bloomberg.

Figure I.4

Expected monetary policy rates in developed economies (*) (percent)



(*) Prepared by the Central Bank of Chile based on futures contracts on interest rates. Futures consider the average of the last 10 working days prior to 27 August 2007 and to 8 January 2008, respectively.

Sources: Central Bank of Chile and Bloomberg.

have also extended loan maturities and widened the range of instruments that can be used as collateral^{2/} (figure I.3).

The liquidity problems and the subsequent downward risk in growth have driven some central banks to cut the monetary policy rate. Since the last *Monetary Policy Report*, the U.S. Federal Reserve has reduced its monetary policy rate consecutively at each of its meetings, to 4.25% at the close of this *Report* (that is, 100 basis points below its August rate). Concern about inflation continues, however, particularly regarding the high prices of energy and other commodities. As per futures contracts, expectations for the fed funds rate have been markedly revised downward for 2008 with respect to a few months back. In the euro area and Japan, prospective hikes revealed in September have been pushed back. Other central banks have also cut their monetary policy rate—including the Bank of England and the Bank of Canada—or have postponed previously forecast increases (figure I.4).

The U.S. dollar continued to depreciate in world markets, accumulating a loss of 8% in multilateral terms in 2007 (figure I.5). One contributing factor was the slow growth of the U.S. economy relative to other economies. Both the depreciation of the dollar and the subprime crisis have helped reduce the excess spending of the United States, and they therefore act as a mechanism for correcting global imbalances (figure I.6).

Emerging financial markets

Unlike previous events, the present turbulence has manifested mainly in developed markets. Although emerging markets have seen an increase in their asset price volatility, no liquidity problems have occurred thus far. A scenario has been configured, however, where financing conditions for these economies are less favorable than a few months ago, while sovereign premiums have risen, especially since mid-October (box I.1), and market capitalization has fallen sharply since the end of that month, in line with reduced portfolio investment flows to emerging economies. Their currencies have strengthened against the dollar, also within a context of high foreign exchange volatility. The worsened financing conditions have translated into fewer sovereign loans in international markets in the second half of 2007.

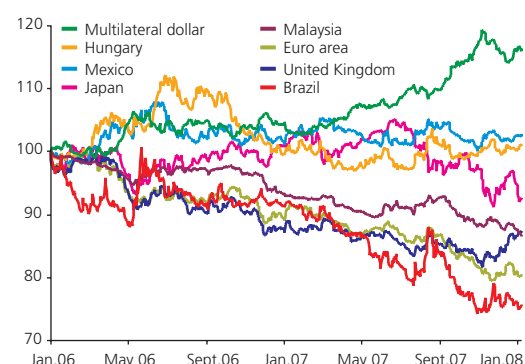
By the time being, only moderate corrections have been observed in financing conditions for emerging economies, but there is a higher risk of deterioration, particularly in economies that seem more vulnerable and in greater need for external funds. This becomes more important in a scenario of acute recession in the world economy resulting in a drop in commodity prices. It must be kept in mind, however, that many emerging economies have taken advantage of the recent bonanza to improve their debt structures and fiscal positions, among other factors, making them more resilient to external shocks (box I.2).

^{2/}For further detail on intervention tools used by central banks, see the Central Bank of Chile's *Financial Stability Report*, second half 2007, box I.1.

Figure I.5

Currency parities (*)

(index 2 Jan 2006=100)



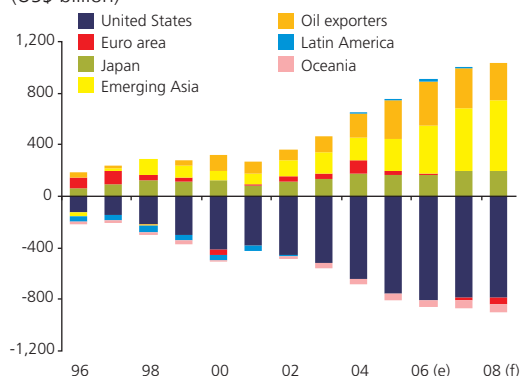
(*) Parity with respect to the U.S. dollar. An increase denotes a depreciation.

Sources: Bloomberg and U.S. Federal Reserve.

Figure I.6

Current account balance (*)

(US\$ billion)



(*) For further detail on definition, see Glossary.

(e) Estimate.

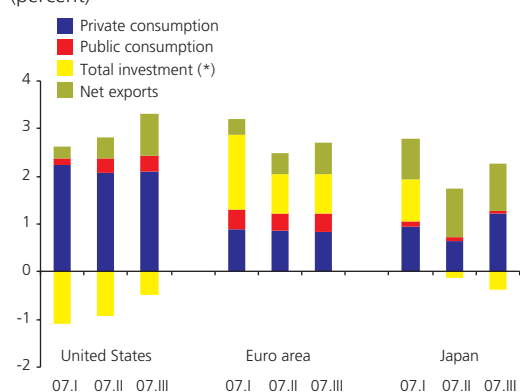
(f) Projection.

Source: International Monetary Fund.

Figure I.7

Contribution to annual GDP growth

(percent)



(*) Includes inventory changes.

Sources: European Central Bank, Bureau of Economic Analysis and Cabinet Office.

World growth

Growth prospects for the U.S. economy have worsened significantly since the last *Report*. Third-quarter numbers showed an annualized quarterly growth of 4.9% and an annual growth of 2.8%—driven by consumption and the external sector—but liquidity problems, tighter lending restrictions, high fuel prices and reduced household financial and real-estate-related wealth are resulting in a substantial deterioration of consumer expectations. This, combined with a downward trend in job creation, has affected the dynamics of private consumption, which is the main driver of economic growth in the U.S. Meanwhile, the adjustment of the real estate sector has continued to deepen for longer than forecast, with sliding housing sales and prices. The rate of subprime mortgage defaults rose to 16.3% of total loans outstanding in the third quarter. Non-residential investment has also begun to show some signs of slowdown at the close of 2007.

Looking ahead, the baseline scenario foresees a significant slowdown in U.S. growth. Compared with projections in the last *Report*, growth for 2008 and 2009 are expected to be 1.2 percentage points lower, approaching 1.8% and 2.6% per year, respectively. This projection is not risk free, and its realization will largely depend on the ultimate extent of the subprime crisis, the degree of transmission of financial turmoil to the real economy and the measures adopted by policymakers to address it. Also, the significant inventory build-up in the third quarter accentuates the risk of a downturn, given the possibility of a slowdown in consumption and investment. The probabilities of this economy entering a short-lived recession in 2008 have thus risen, although this is not an assumption of the baseline scenario.^{3/}

The euro area also had a positive performance in the third quarter of 2007, growing 2.7% annually. This economy has expanded in the past few quarters based largely on the strength of domestic demand. In recent months, however, surveys of business and consumer expectations have revealed a deterioration, partly because of the effects of the subprime crisis, but also as a result of high fuel prices and their impact on disposable income. This suggests that the good performance in the third quarter will not be repeated, a condition already apparent in some indicators such as retail sales. Projected annual growth for the region has thus been corrected downward by 0.6 percentage point for 2008.

Japan also grew above forecasts in the third quarter of 2007, based on the contribution of net exports and dynamic private consumption. The latest figures have been mixed, however. The external sector remains dynamic, but domestic consumption is lagging in the face of a weak labor market and wages that remain contained. In addition, various expectations surveys reveal a weaker outlook. Growth projections for 2008 have therefore been corrected downward by 0.7 percentage point relative to September's baseline scenario, with the expectation that the economy will recover in 2009 (figure 1.7).

Emerging Asia has remained dynamic, driven mainly by China and India. In China, however, inflation has risen sharply to 6.9% per year, aggravating

^{3/} Applying the methodologies of Wright (2006) and Estrella and Mishkin (1998), the probability of the United States entering a recession in 2008 rose from close to 30% in August 2007 to around 40% at year's end.

concerns about the sustainability of current growth rates. To handle this situation, policymakers have taken steps to reduce the growth rate of credit and output, but the effects are not yet visible. India seems to have grown by over 8% per year in 2007, thanks to the good performance of domestic demand, enhanced by economic reforms. Large capital inflows to this economy have prompted authorities to increase the reserve requirements of banks.

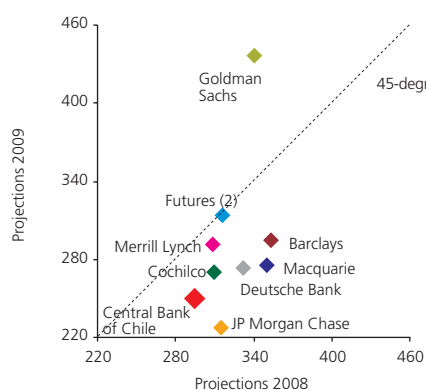
The Latin American economies have recorded a surprisingly positive performance in the past few months. In most cases, growth has been boosted by strong domestic demand, backed by high commodity prices and the ongoing fiscal stimulus. This justifies a slight revision upward of growth estimates for the region in 2007, relative to the *September Report*. Even so, projections for 2008 are that the world deceleration will restrain growth in the region, in particular in those economies that trade the most with the U.S., including Mexico, Venezuela and Colombia. The projection for this region has a downward bias, given the possibility that the U.S. slowdown will be worse than expected and will affect commodity prices and financial markets.

Growth in Australia and New Zealand increased significantly in 2007, driven both by the strength of investment and by public and private consumption. Estimates for 2008 suggest that both economies will be moderately less dynamic because of the application of more contractionary monetary policies to address persistent inflationary pressures, among other factors. While the carry trade began to unwind after the burst of the subprime bubble in the U.S., it has regained importance in recent months, with the consequent appreciation of their currencies. Consequently, the large current account deficits continue to be a concern in both countries, particularly in light of the strong domestic demand.

In short, expected growth for the global economy has been revised downward, particularly for 2008. The great uncertainty about the scope of the subprime crisis and related losses has generated a wide dispersion in market projections and introduced a downward bias in the risk balance of the world growth projection in the baseline scenario. For the moment, changes are most visible in forecasts for developed economies, while projections for emerging markets have incorporated the uncertainty about how they will be affected by the slowdown of the former, particularly the U.S. (table I.1).

Figure I.8

Copper market: dispersion of price projections (1)
(US¢/lb, annual average)



(1) Includes projections reported from 28 November 2007 onwards.

(2) Futures consider average of the last 10 working days prior to 8 January 2008.

Sources: Central Bank of Chile, Barclays (2007), Bloomberg, Cochilco (2008), Deutsche Bank (2007), Goldman Sachs (2007), JP Morgan Chase (2007), Macquarie Research (2008) and Merrill Lynch (2007).

Table I.1

World growth (1) (2)
(annual change, percent)

	Average 1990-99	Average 2000-05	2006	2007 (e)	2008 (f)	2009 (f)
World	3.2	4.1	5.4	5.3	4.8	5.0
World at market exchange rate	2.4	2.9	3.9	3.7	3.1	3.4
United States	3.1	2.6	2.9	2.2	1.8	2.6
Euro area	2.2	1.8	2.8	2.6	1.7	1.9
Japan	1.5	1.6	2.4	1.8	1.4	2.1
China	10.0	9.4	11.1	11.4	10.2	9.6
Rest of Asia	5.4	4.8	5.4	5.6	5.1	5.6
Latin America	2.8	2.9	5.4	5.4	4.5	4.2
Commodity exporters	2.7	3.1	2.7	3.1	2.5	2.9
Trading partners	3.2	3.2	4.5	4.3	3.7	3.8

(1) For definitions, see Glossary.

(2) PPP world growth figures subject to revision. The IMF will adjust growth figures based on new estimates of PPP weights. This is estimated to potentially result in growth reduction close to half a percentage point due to the reduced weight of China and India. These IMF figures will expectedly be published on 25 January 2008.

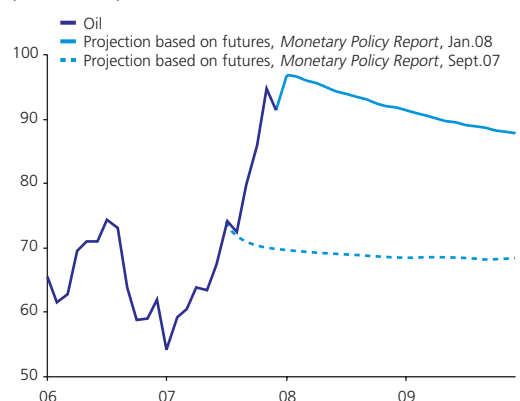
(e) Estimate.

(f) Projection.

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

Figure I.9

Prices of WTI oil and futures (*)
(US\$/ barrel)

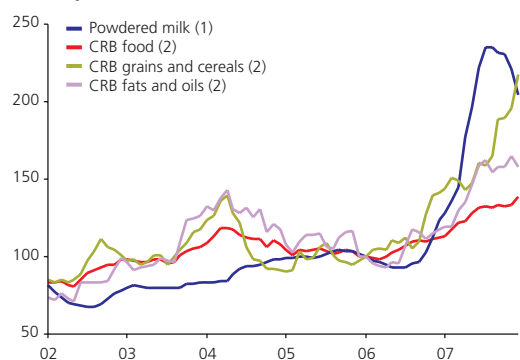


(*) Futures consider average of the last 10 working days prior to 27 August 2007 and to 8 January 2008, respectively.

Sources: Central Bank of Chile and Bloomberg.

Figure I.10

Food prices
(January 2006=100)



(1) Export-weighted prices in Oceania, Europe and the U.S.

(2) Indices calculated by Commodity Research Bureau (CRB).

Sources: Bloomberg, CRB and Oficina de Estudios y Políticas Agrarias (Odepa, Ministry of Agriculture).

Commodity prices

Since the close of September's *Monetary Policy Report*, the copper price has recorded large swings, and recent figures place it above US\$3/lb. It went above US\$3.7 in the first two weeks of October, owing to downtime and strikes at various mining sites. A sharp fall followed, mainly associated with the perception that copper consumption slowdown in developed countries will not be offset by the continuing strong demand of emerging economies. On the supply side, considerable downward corrections were made to world production projections after September, primarily because of the delayed startup of a number of new projects. This led to an upward revision of price projections in the baseline scenario, mainly for the current year, to US\$2.95 and US\$2.5 per pound on the London Metal Exchange (LME) for 2008 and 2009, respectively (figure I.8).

The WTI oil price increased, contradicting forecasts, oscillating between US\$90 and US\$100 per barrel since November. Underlying these movements are fundamental factors relating to low production growth that has not matched increased demand, in a context of severe geopolitical risks. Furthermore, the winter season in the northern hemisphere has drawn down crude oil inventories more than expected. Speculation surrounding OPEC's production decisions has introduced additional volatility into the price. Based on prices implicit in futures contracts, the baseline scenario considers an average price of US\$93 per barrel for 2008 and US\$88 for 2009, which is more than 30% above projections in the previous *Report*. These figures may be revised upward, however, if the prices recorded at the statistical close of this *Report*—approaching US\$100 per barrel—continue to hold. The world price of gasoline increased nearly 20% since the last *Report*. Although the summer is over in the northern hemisphere—the season of most intensive use of gasoline—the market has been affected by tighter-than-normal constraints in refining capacity^{4/} resulting from various accidents at refineries (figure I.9).

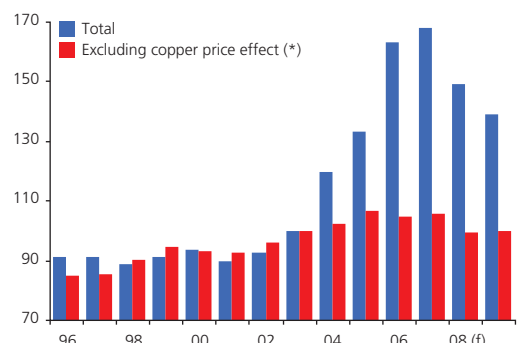
The price of NBSK pulp increased in recent months, to over US\$850 per metric ton. Demand growth has remained strong, especially due to consumption in China. On the supply side, the departure of some producers from the northern hemisphere market has combined with the delayed startup of new plants. Looking ahead, a price reduction is expected as a result of the world economic slowdown and new plants coming online. The price of fishmeal is where it was at the close of September's *Monetary Policy Report*, following a number of swings. Demand for this product continues to be strong, as the high price of grains has led to a more intensive use of fishmeal in animal feed. The price of molybdenum has remained high, with tight supply and dynamic demand. For the next few quarters, the price is expected to decline only slightly from its current figures, which stand today at record highs.

The behavior of food prices has been mixed. Grain quotes continued on a steep upward trend, in the face of steadily growing demand, supply constraints^{5/}

^{4/} Refineries typically carry out maintenance operations in September-October, after the season of heavy gasoline use and before the period of intensive fuel refining for home heating. A similar slowdown occurs in April-May.

^{5/} Demand has been associated with increased biofuel consumption, among other factors. Supply has been affected by bad weather and export restrictions on large producers in an attempt to rein in price increases in domestic markets. See also *Monetary Policy Reports* of May 2007, box I.2, and September 2007, box I.3.

Figure I.11

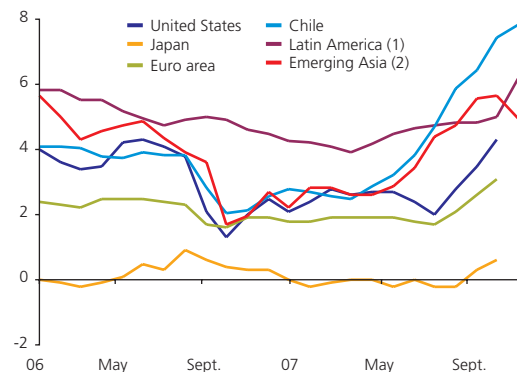
 Terms of trade
(2003=100)


(*) Terms of trade less copper price effect are calculated using the London Metal Exchange price of 2003 as a reference. No other potential price or quantity effects are considered.

(f) Projection.

Source: Central Bank of Chile.

Figure I.12

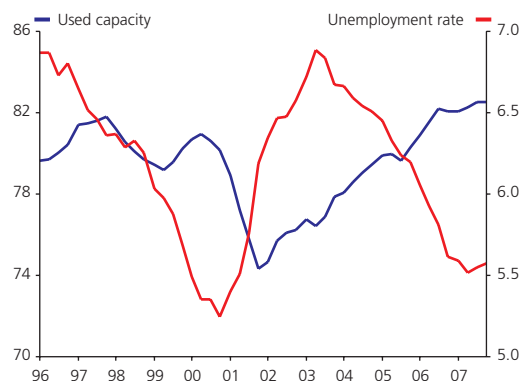
 Headline CPI inflation
(annual change, percent)


(1) Geometric average including Argentina, Brazil, Mexico and Peru.

(2) Geometric average including China, Indonesia, Singapore and Taiwan.

Sources: Each country's central bank and Bloomberg.

Figure I.13

 Slack in developed economies' factor markets (*)
(percent)


(*) Economies of the U.S., the euro area and Japan, weighted by GDP at PPP.

Sources: Bloomberg and International Monetary Fund.

and increased maritime transport costs. Thus, the prices of wheat and corn rose nearly 30% since the last *Report*. The baseline scenario assumes that wheat will begin to decline slowly in 2008, reflecting a significant increase in cultivated land, while corn price will gradually fall as suppliers react to high prices. Both will remain well over their averages for the past ten years, however. The powdered milk price has declined with respect to the last *Report*, in a continuingly tight market (figure I.10).

The baseline scenario assumes that the terms of trade will normalize in 2008 and 2009 at a faster pace than forecast in September, in the face of reduced world growth estimates. Projected commodity prices are highly uncertain, and they could fall more than expected if a faster-than-forecast global deceleration results in reduced demand. They could also remain high or even resume growth, however, as has recently been the norm (figure I.11).

World inflation

The acceleration of CPI inflation has been a generalized phenomenon throughout the world, particularly since the second half of 2007 (figure I.12). Changes in energy prices have transmitted into higher inflation, and food price increases are even more frequent, although magnitudes vary from country to country (box I.3). Risks of stronger inflationary pressures are still present, insofar as the degree of transmission of price variation increases. Furthermore, factor markets are tight for the moment, striking a note of caution (figure I.13).

Considering that domestic inflation rates in the rest of the world are mainly higher than foreseen in September and that the dollar will depreciate further than expected, the baseline scenario assumes that in 2008 the external price index (EPI) will increase more than twice as fast as estimated in the last *Report* (table I.2).

Table I.2

World inflation (*)

(average annual change in local currency, percent)

	Average 1990-99	Average 2000-05	2006	2007 (e)	2008 (f)	2009 (f)
United States	3.0	2.7	3.2	2.8	2.6	2.3
Euro area	2.3	2.2	2.2	2.1	2.3	2.0
Japan	1.2	-0.5	0.2	0.0	0.4	0.7
China	7.8	1.2	1.5	4.6	4.1	3.4
Australia	2.5	3.3	3.5	2.4	2.9	2.7
New Zealand	2.1	2.5	3.4	2.4	2.8	2.6
Argentina	253.7	8.6	10.9	8.8	9.7	10.9
Brazil	854.8	8.4	4.2	3.6	4.1	4.1
Mexico	20.4	5.7	3.6	4.0	4.3	3.7
EPI (*)	1.9	3.8	5.3	7.9	7.1	2.1

(*) For definitions, see Glossary.

(e) Estimate.

(f) Projection.

Source: Central Bank of Chile, based on Consensus Forecast and International Monetary Fund.

Box I.1: Credit default swap premiums and sovereign premiums

Recent episodes of financial turmoil in global markets have underscored the importance of analyzing emerging market risk premiums. This box examines two measures that assess the implicit risk perception of market players in these economies and compares the information they deliver.

The most common way of measuring emerging economies' risks is the EMBI Global sovereign premium prepared by JP Morgan Chase investment bank. This index measures the return differential of emerging countries' sovereign dollar-denominated debt in international financial markets with respect to U.S. Treasury bonds of comparable maturities. It thus reflects the excess return demanded by international investors from governments and serves as a benchmark when issuing new debt securities. One of its main drawbacks, as a measure of sovereign risk, is that liquidity premiums affect its calculation.⁶ This weakness has been exacerbated in the current conjuncture, depriving changes in the EMBI Global index of part of their informational content regarding countries' sovereign risk assessment.

Consequently, closer attention is being paid to the premium on credit default swap (CDS) contracts. This is a more straightforward measure of the sovereign risk trend, as it does not include liquidity premiums, since the benchmark rate of return on this contract is the swap rate in dollars in the U.S.⁷ This instrument is a contract providing insurance against default on the associated debt, issued by a company or government. In case of default, the CDS issuer pays the holder thereof, in whole or in part, the loss related with the underlying loan or bond.

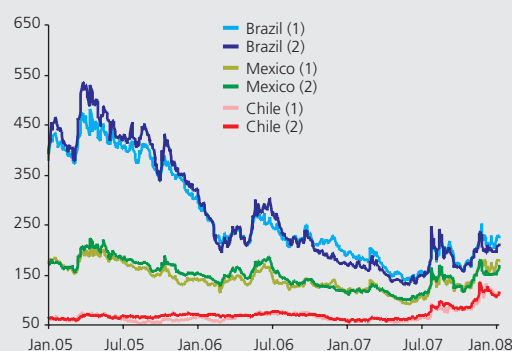
The EMBI Global sovereign premium and the CDS premium on emerging market bonds must be highly correlated, since an emerging economy's sovereign premium can be proxied by the sum of a CDS contract premium on its bonds plus the market liquidity premium. This is usually measured as the difference between the U.S. swap rate and the yield of a U.S. Treasury bond of the same maturity, a financial variable known as the swap spread (figure I.14).

In terms of levels, however, a CDS premium more directly measures the implied probability of default that markets assign to emerging economies. Thus, the greater increase in the EMBI Global sovereign premiums of these economies in recent months relative to their CDS contract premiums is mostly associated with the increase in the markets' global liquidity

premium resulting from the subprime crisis (figure I.15). Finally, in line with the lower sovereign risk perceived for Chile, the level of its CDS premium is well below that of other emerging economies. This is consistent with the current A+ rating given our country by Standard & Poor's risk-rating firm.

Figure I.14

Compared risk premiums across Latin American economies (basis points)

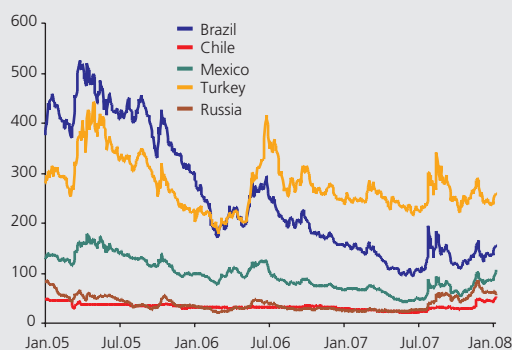


(1) EMBI Global sovereign premium prepared by JP Morgan Chase investment bank. Data for Chile excludes bonds from Codelco.
(2) Credit default swap premium plus swap spread.

Sources: Bloomberg and JP Morgan Chase.

Figure I.15

Evolution of CDS premiums in selected emerging economies (basis points)



Source: Bloomberg.

⁶ Global market liquidity does not correspond to the individual liquidity of an asset. The latter can be measured through the differential between the asset's bid and ask prices. In the case of Chile, this differential appears fairly large, meaning that Chilean bonds are relatively illiquid.

⁷ The interest rate resulting from a swap operation between variable-income and fixed-income flows between two parties.

Box I.2: Sensitivity of emerging economies to a deterioration of the international scenario

The unfolding and possible reach of the subprime crisis in the U.S. biases downward the risk balance for the world growth projection in the baseline scenario in this *Report*. A deepening of this crisis could lead to a further slowdown in U.S. output in coming quarters, with negative effects on the other regions. This box analyzes the sensitivity of emerging economies to a worsening of international conditions.

Two channels can be identified whereby an extension of the developments and effects of the subprime crisis in the U.S. influence the rest of the economies. One is associated with international trade and considers the impact of reduced U.S. external demand on the dynamics of the other economies. The other is the financial channel deriving from the high degree of integration of emerging economies into international markets. This mechanism is mainly related to higher external financing costs for emerging economies and the negative effects on the prices of their financial assets.

As for the former transmission channel, a panel of vector autoregression (PVAR) is estimated to evaluate the impact on world trade of a potential worsening of manufacturing output in the U.S.—the world’s largest importer and whose imports are highly procyclical^{8/}. The PVAR specification is:

$$z_{i,t} = \Gamma_0 + \Gamma_1 z_{i,t-1} + \Gamma_2 z_{i,t-2} + \Gamma_3 z_{i,t-3} + \Gamma_4 z_{i,t-4} + f_i + e_t,$$

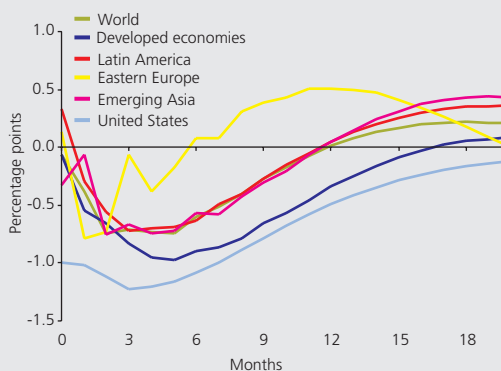
where $z_{i,t}$ is a vector of five variables: U.S. manufacturing output, U.S. total imports from country i , total exports of country i , manufacturing output of country i and the real exchange rate of country i . The term f_i captures country fixed effects. Manufacturing output and total exports are proxies for each country’s economic activity.^{9/}

The estimated impulse-response functions indicate that a U.S. manufacturing slowdown has a significant effect on the dynamics of the rest of the economies, reducing growth in both total exports and manufacturing output (figures I.16 and I.17). With the exception of Eastern European economies, no material differences appear in the responses of the various regions to a manufacturing output shock in the U.S. These responses are negative and statistically significant between three and nine months after the shock. The maximum impact is felt four months after the shock: a 1 percentage point drop in the U.S. manufacturing growth rate could lead to a maximum reduction of around 0.8 percentage point in developed economies’ manufacturing output and of 0.7 percentage point in emerging markets.

In financial terms, effects on emerging economies’ assets have been rather limited since the onset of the subprime crisis. Risk premiums have increased, however, and stock markets have adjusted downward. This is in line with the greater probability of a weakened scenario for the world economy.

Figure I.16

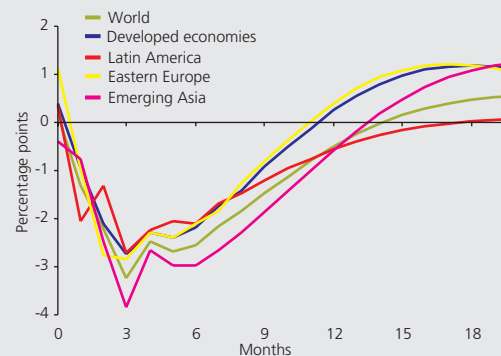
Selected economies’ response of exports output to negative manufacturing production shock in the U.S.



Source: González and Moreno (2007).

Figure I.17

Selected economies’ response of exports to negative manufacturing production shock in the U.S.



Source: González and Moreno (2007).

^{8/} DU.S. imports accounted for around 20% of total world imports in the period 2001–05. Evidence of its procyclical nature can be found in IMF (2007a).

^{9/} One limitation of this type of methodology is that it considers only linear effects. Data covers the period from 1998 to 2007, in monthly frequency, for a selection of 17 emerging and 5 developed economies. Data covers from 1998 onward based on availability, to avoid possible structural changes and to better model the economies’ response according to their present economic structure. For further detail, see González and Moreno (2007).

To evaluate the second transmission channel, a VAR is estimated for financial prices.^{10/} The regression includes the emerging economies' sovereign premiums (EMBI Global), an emerging market stock index (the MSCI index), an indicator of perceived risk in international markets (the VIX, a measure of the implied volatility of S&P 500 index options) and an indicator of international market liquidity (10-year swap spread).

The results show that a 10 percentage point increase in the VIX^{11/} causes a rise in the EMBI Global of nearly 40 basis points and a drop of around 8% in the MSCI index. In addition, lower overall liquidity in financial markets, as measured by a further increase in the swap spread of 30 basis points, raises the EMBI Global by about 60 basis points and pulls down the MSCI by around 10%. A shock combining an adjustment to agents' perceived risk and a reduction in overall liquidity would result in an increase of close to 100 basis points in the EMBI Global and a fall of about 11% in the MSCI.

Thus, the results support the notion that an economic deterioration in the U.S. would have a detrimental effect on the other economies' output. As for the financial channel, results suggest that a more complex international setting would lead to a significant increase in emerging economies' financing costs,^{12/} given their recent global integration and the subsequent redirection of portfolio investment funds to their assets (figures I.18 y I.19). However, emerging economies have been improving their macroeconomic fundamentals in recent years: (i) the external liability position is healthier, as a result of the higher proportion of debt issued in local currency and reduced exposure in foreign currency; (ii) the favorable terms of trade have been used to strengthen the fiscal position; and, (iii) most of these economies have implemented more flexible exchange rate regimes. These elements help make the economies less vulnerable to a negative shock in the world economy.

Figure I.18

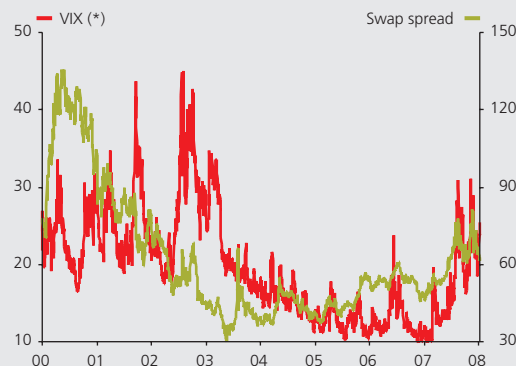
Index of emerging stock exchanges and sovereign premiums (index 3 Jan 2000=100, basis points)



Sources: Bloomberg, JP Morgan Chase and Morgan Stanley Capital International.

Figure I.19

Stock exchanges' implied volatility and liquidity premiums (percent, basis points)



(*) Volatility implicit in options in the S&P 500 index of the U.S.

Source: Bloomberg.

^{10/} The effects of possible quantity constraints, such as a sudden stop of capital inflows, are not explicitly considered.

^{11/} This is a moderate increase in the indicator, considering that in earlier financial turmoil episodes, it rose by up to 20 percentage points above current levels.

^{12/} Within the context of greater financial turmoil, a sharp drop in the U.S. reference interest rate can be expected, and this would partly reduce the rise in the sovereign spread. Nevertheless, the 100 basis points rise in the EMBI Global that results from this exercise is significant, considering that it currently stands near 250 basis points.

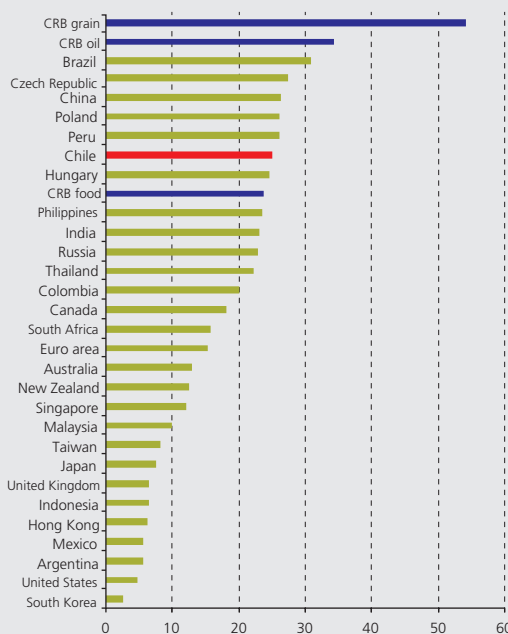
Box I.3: Food prices and their impact on inflation: an international comparison

In 2007, Chile's CPI inflation rose to levels well above the tolerance range for the inflation target. One of the main factors behind this increase was a substantial rise in food prices, which explained 3.8 percentage points of annual CPI inflation as of December 2007. This box carries out a cross-country comparison of how the sharp food price increase in world markets has affected inflation in various economies.

The rise in world food prices reflects global demand and supply factors.¹³ As of December 2007, the CRB food price index grew 24% per year, while grain and oil prices rose 54% and 34%, respectively. Food price increases vary significantly in different economies. Measured in U.S. dollars, Chile is in the group with the greatest increases (figure I.20). In any event, an important part of the increase is due also to last winter frosts, which raised the price of perishables; this accounts for nearly 20% of food inflation at the end of 2007.

Figure I.20

Food price indices (*)
(annual change in U.S. dollars, percent)



(*) Figures as of October, November, or December, as available.

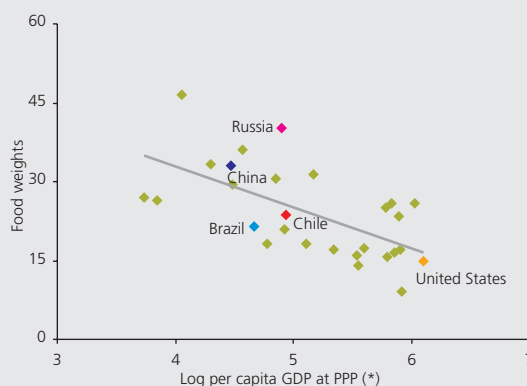
Sources: Each country's central bank, Bloomberg, Commodity Research Bureau (CRB), each country's statistics bureau and International Monetary Fund.

The countries with the sharpest food price increases also have significantly higher headline and core inflation.¹⁴ This

is particularly the case in emerging economies, where food has a higher weight in the CPI basket (figure I.21). The increase in headline inflation goes beyond the direct effect of the weighting of this component, which can be seen in the majority of the economies in the sample.¹⁵ Thus, this greater incidence of food on inflation seems to be associated with differences in the magnitude of the shock in the domestic scenario.

Figure I.21

Per capita GDP and food weight in headline CPI in selected economies (index, percent)



(*) Considers $\text{Log} = \text{Ln}(\text{per capita GDP at PPP}/100)$.

Sources: Each country's central bank and statistics bureau and International Monetary Fund.

When the food component is removed from inflation in each of the economies in the sample, Chile registers a smaller price increase than might be inferred from its unusually high food inflation. If energy prices are also removed from the index, the results show a comparatively moderate increase in other prices in Chile¹⁶ (figures I.22 and I.23).

¹³/ For further details, see *Monetary Policy Report*, September 2007, box I.3.

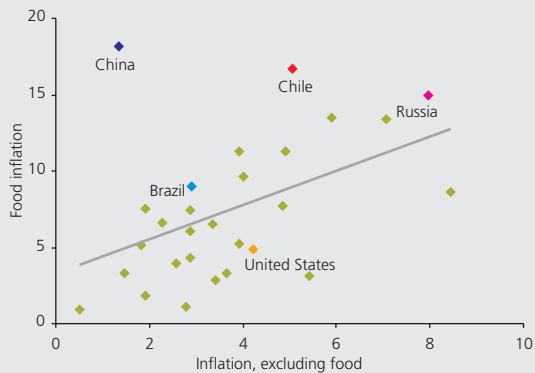
¹⁴/ The definition of core inflation varies across economies.

¹⁵/ Economies are identified in figure I.20.

¹⁶/ Some economies in the sample do not have complete data for all the estimates, so samples vary for different figures.

Figure I.22

CPI inflation excluding food, and food CPI inflation in selected economies
(annual change, percent)

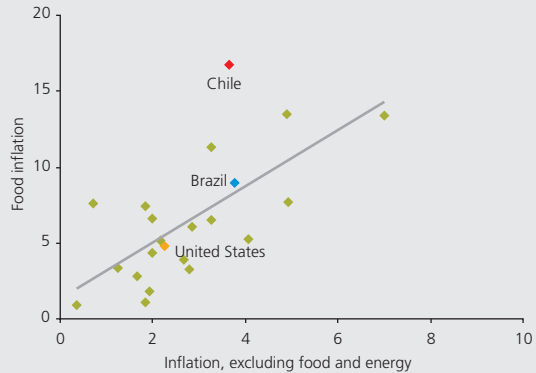


Sources: Each country's central bank and statistics bureau and International Monetary Fund.

To measure the food price shock's pass-through to other prices, we take the ratio of inflation less food over food inflation. This measure is close to 0.6 for the average economy in the sample, versus 0.3 for Chile.^{17/} Chile's degree of pass-through has thus been relatively small, considering the magnitude of the food price shock in the domestic market.

Figure I.23

CPI inflation excluding food and energy, and food CPI inflation in selected economies
(annual change, percent)



Sources: Each country's central bank and statistics bureau and International Monetary Fund.

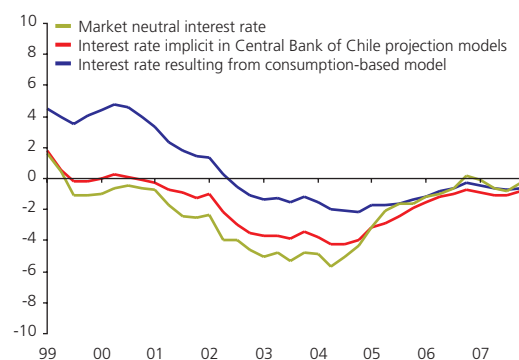
^{17/} This exercise is valid in a context of a global price shock. In a situation of price stability, this indicator is not as useful.

II. Financial markets

Figure II.1

Real interest rate gap: Real MPR (*) less indicated neutral interest rate

(percent)



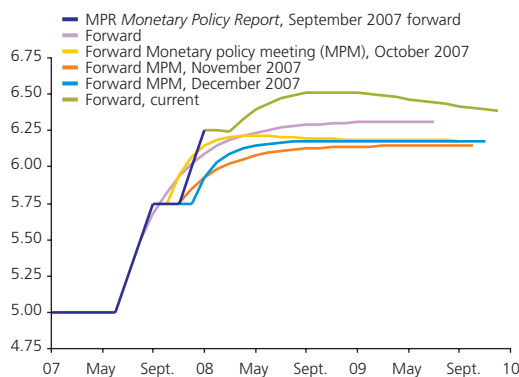
(*) Calculated using the nominal MPR less expected inflation as per Central Bank of Chile surveys.

Source: Central Bank of Chile.

Figure II.2

MPR and forward curve

(percent)



Source: Central Bank of Chile.

This section reviews recent trends in the main financial market variables from a monetary policy perspective.

Monetary policy

The news since last September's *Report* depicts a macroeconomic scenario in which annual inflation continues to grow in the short term, but with limited inflationary pressures in the medium term. Moreover, the international scenario is characterized by significantly higher adverse risks.

In such a setting, to ensure inflation convergence to 3% annually in the relevant horizon, monetary policy was adjusted by raising the monetary policy rate (MPR) by 25 basis points in September and December 2007 and January 2008, to 6.25% annually (figure II.1).

Based on information from the two weeks prior to the statistical closing of this *Report*^{1/}, expectations regarding MPR changes in 2008 vary in magnitude depending on the source, from no increase to up to two further hikes of 25 basis points. Expectations deduced from the forward curve indicate that the MPR is estimated to reach 6.5% in December 2008 (figure II.2). Swap rates, in turn, anticipate one or two additional increases of 25 basis points during the year (figure II.3). Lastly, the January Economic Expectations Survey predicts that the MPR will record no further changes after the last increase, remaining at 6.25% until the end of 2008.

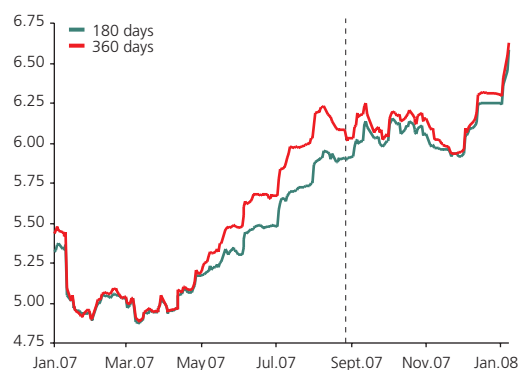
Looking ahead, the baseline scenario projects an MPR trend similar to what is inferred from the price of financial assets in the two weeks prior to the statistical closing of this *Report*. This is a working assumption and does not involve a restriction for the future evolution of monetary policy, which will be adjusted to accommodate the evolution of the macroeconomic scenario and its implications for projected inflation.

Financial conditions

Interest rates on nominal Central Bank notes increased significantly in recent weeks, particularly after the disclosure of data on output and inflation in early January. Thus, compared with the levels prevailing at the statistical closing of each *Report*, the rates on two-, five- and ten-year peso bonds (BCP-2, BCP-5 and

^{1/} The closing date for statistics included in this *Report* was 8 January 2008. Note that financial asset prices contain implied risk premiums whose size is difficult to determine.

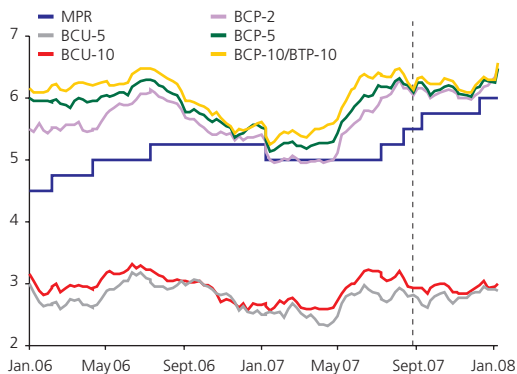
Figure II.3

 Swap rates (*)
(percent)


(*) For definition, see Glossary.

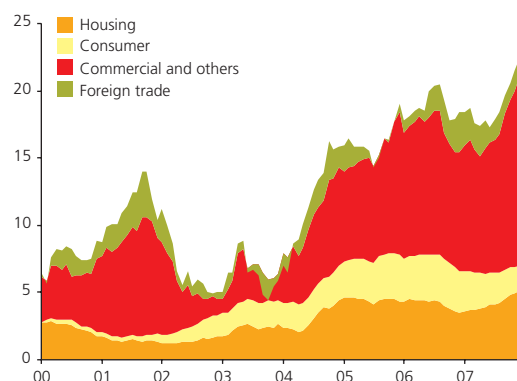
Source: Central Bank of Chile.

Figure II.4

 MPR and interest rates on Central Bank notes
(weekly average, percent)


Source: Central Bank of Chile.

Figure II.5

 Total banking loans
(incidence in annual nominal growth by type of loan, percentage points)


Sources: Central Bank of Chile and Superintendency of Banks and Financial Institutions.

BCP-10) are now around 40 basis points higher than they were in September. Rates on indexed notes, meanwhile, have recorded no big movements (figure II.4). The local market has been fairly shielded from the effects of the severe turbulence in developed economies' financial markets. This is clear in the movements in the peso and UF yield curves, which responded to idiosyncratic factors such as month-to-month inflationary surprises, output developments and changes in monetary policy prospects.

In recent months, credit to the private sector continued to grow strongly in nominal terms, exceeding 20% (figure II.5). In real terms, credit growth slowed slightly, from just over 15% in early 2007 to about 13% at the end of the year. Consumer loans showed the biggest slowdown, with a reduction in the nominal average annual growth rate from around 26% in 2006 to somewhat below 19% in 2007, with data standing at 15% annually in the margin (figure II.6). This is one factor backing the assessment that private consumption is likely to grow at a slower pace in the quarters ahead. In addition, the interest rates that banks charge for such operations increased in the last month of 2007 (table II.1). The survey on bank lending for the third quarter further indicates that the higher relative credit risk of bank customers seemingly led to tighter standards for consumer loan approval (figure II.7). At the same time, although the growth in the bank consumer loan stock—which is the most significant portion of household debt—has slowed, credit issued by other entities, such as retail stores, has increased faster than at the beginning of the year.

Tabla II.1

 Lending rates
(360-day base, percent)

	MPR	Consumer rates		Mortgage rates (3)				Commercial TPP (1)
		TPP (1)	Credit cards (2)	Rate 4-5%/ Dur: 5-6	Spread on BCU-5	Rate 5-6%/ Dur: 5-6	Spread on BCU-5	
2004 Average	1.87	24.3	33.4	4.0	1.6	4.4	1.9	7.4
2005 Average	3.44	26.0	34.1	3.7	1.4	4.3	1.9	9.7
2006 Average	5.02	27.2	37.3	4.1	1.2	4.3	1.5	10.7
2007 Average	5.31	28.5		3.7	1.0	4.2	1.5	10.1
2007 Jun.	5.00	28.0	41.7	3.9	1.0	4.3	1.4	9.7
Jul.	5.16	28.8	41.8	3.8	1.1	4.2	1.5	9.7
Aug.	5.43	27.8	41.9	3.8	0.9	4.4	1.5	9.8
Sept.	5.63	28.9	42.3	3.7	1.0	4.1	1.4	10.7
Oct.	5.75	29.0	43.0	3.7	1.0	4.1	1.3	10.8
Nov.	5.75	29.0	43.7	3.6	0.9	4.1	1.3	10.8
Dec.	5.89	30.0		3.7	0.8	4.1	1.2	10.6

(1) Weighted average rate.

(2) Series published by SBIF, for peso operations maturing in over 90 days on amounts equivalent to or under UF200.

(3) Mortgage bill rates for the issue indicated.

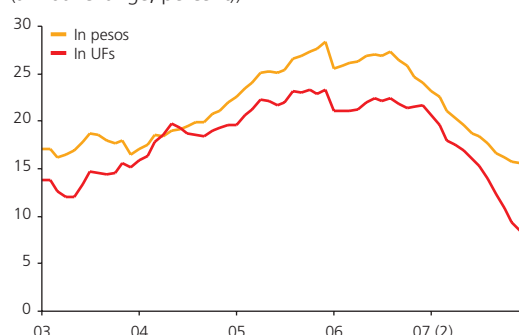
Sources: Central Bank of Chile, Santiago Stock Exchange and Superintendency of Banks and Financial Institutions.

Unlike consumer loans, housing loans increased steadily throughout 2007 in nominal terms (figure II.8). This increase, however, is strongly linked to the currency denomination of these loans (UFs), in a context of high inflation. Discounting the inflationary effect, the growth in the stock of housing loans increased less. The available data on the number of debtors and the average amount owed similarly present no major changes in 2007. Interest rates on mortgage bonds recorded no significant variation in the last part of 2007, and the spread over the risk-free rate declined slightly.

Nominal growth in commercial loans also remained strong and increased with respect to mid-2007, approaching 24% annually in December. In

Figure II.6

Consumer loans (1)
(annual change, percent)



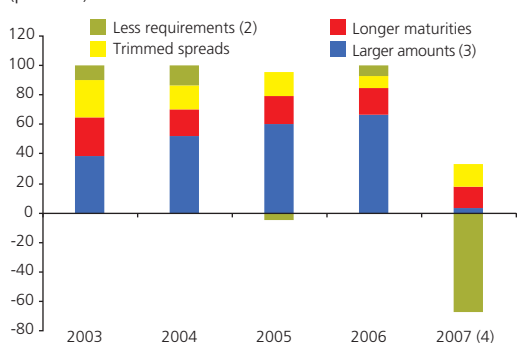
(1) From January 2004 onwards, includes personal overdrafts.

(2) December figures are provisional.

Sources: Central Bank of Chile and Superintendency of Banks and Financial Institutions.

Figure II.7

Lending standards for consumer loans (1)
(percent)



(1) Annual average of net responses, contribution to total. Negative figures denote tighter conditions.

(2) Considers questions about minimum standards required for credit approval.

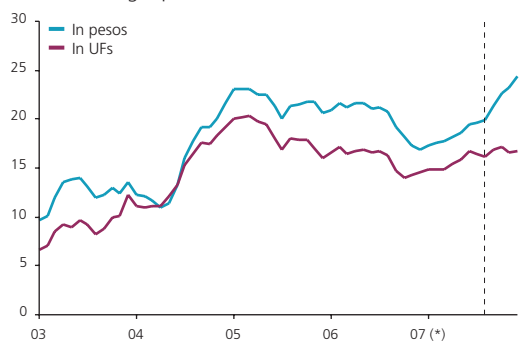
(3) Considers questions about maximum loanable amount, credit card limit, and minimum payment required.

(4) Information through the third quarter.

Source: Central Bank of Chile, Survey on banking loans.

Figure II.8

Housing loans
(annual change, percent)



(*) December figures are provisional.

Sources: Central Bank of Chile and Superintendency of Banks and Financial Institutions.

contrast to consumer interest rates, commercial credit rates have remained fairly constant since September. The real increase in these loans has risen slightly since the beginning of 2007. As for other sources of corporate financing, the available data indicates that corporate bond issues were nearly 22% lower in 2007 than in the previous year. This result contrasts with forecasts in mid-2007, when bond placements were expected to outperform their historic highs of 2001.

In the stock market, yields reacted to the external financial turmoil, reversing part of the increase of the first half of 2007 and, more importantly, demonstrating significantly higher volatility. Thus, while the IPSA and IGPA accumulated increases on the order of 29% and 22%, respectively, in the first six months of the year, the variation in these indices was close to -12% and -7% in the second half. This situation was exacerbated in the early days of 2008. Measured in dollars, the fall in the Chilean stock exchange indices has been greater than in stock indicators at the world and Latin American levels (figure II.9).

The annual growth rate of monetary aggregates experienced no major changes in the past few months. It remained in the range of 15–22%, depending on the definition (figure II.10). Its velocity of expansion showed no big variation, either.

In sum, financial conditions have become somewhat less favorable. Growth in monetary and credit aggregates continues to be high, although lending standards surveys reveal increasingly stringent requirements, and interest rates charged by banks increased in the margin. The episode of external turbulence has had limited effects in domestic markets so far, and its impact is largely visible in greater stock market volatility.

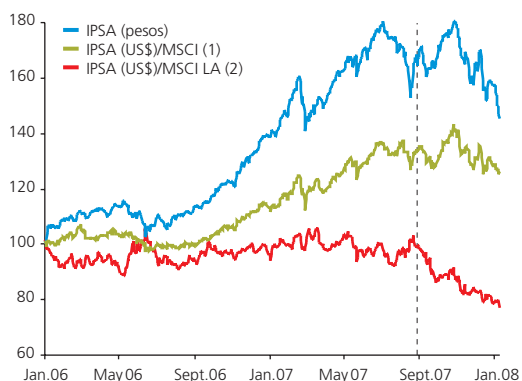
Exchange rate

The peso has appreciated about 5% since September, that is, considering the average of the ten working days prior to the statistical closing of that and this *Report*. The drop in the nominal exchange rate has followed, with swings, the trend of the U.S. dollar in world markets. When estimated against a broad currency basket, the peso appreciation is significantly lower. The total multilateral exchange rate (MER) and the rate excluding the U.S. dollar (MER-X) have fallen much less than the bilateral parity (table II.2). The appreciation of the peso, while lower in comparative terms, has also occurred within a context of widespread appreciation of the currencies of emerging economies. The Brazilian real appreciated 11.5% against the U.S. dollar in the same period in which the peso appreciated 5%. In addition to the drop in the exchange rate with respect to the previous *Report*, its volatility also increased compared with the first half of 2007.

The period of peso appreciation coincided with opposing movements in Chile's MPR and the monetary policy reference interest rate, the U.S. Fed Funds rate. Although movements in the nominal parity can theoretically be explained by the actual and expected interest rate differential, this nominal exchange rate appreciation seems not to be grounded on a widening differential. From a historical perspective, the current size of the gap between the MPR and the Fed Funds rate is smaller than the average for the period 2001–2006 (figure II.11).

Figure II.9

Stock indices
(index 2 Jan 2006=100)

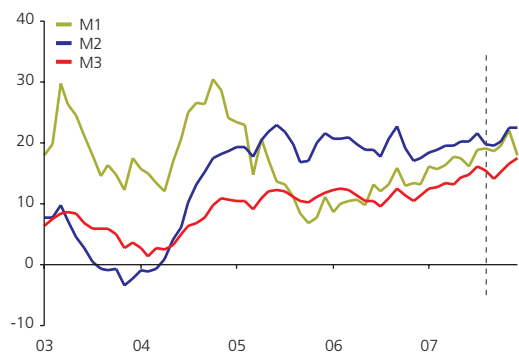


(1) World stock index, Morgan Stanley Capital International.
(2) Latin American stock index, Morgan Stanley Capital International.

Sources: Central Bank of Chile and Bloomberg.

Figure II.10

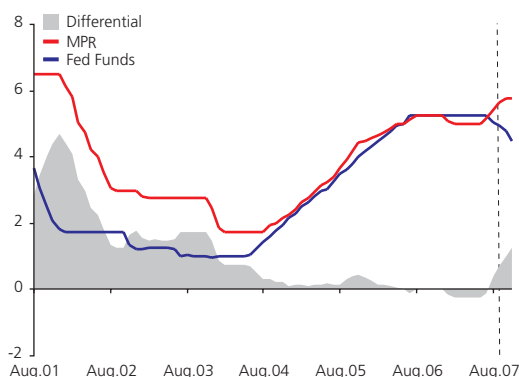
Monetary aggregates
(nominal annual change, percent)



Source: Central Bank of Chile.

Figure II.11

Interest rate differential
(percent)



Sources: Central Bank of Chile and U.S. Federal Reserve.

Tabla II.2

Observed, multilateral and real exchange rate
(OER: pesos per U.S. dollar, monthly average; MER, MER-5 and MER-X:
2 Jan 1998=100; RER and RER-5: 1986=100) (1)

	OER	MER	MER-5	MER-X	RER (3)	TCR-5 (3)
Jul. 07	519.80	105.12	131.44	100.98	94.42	81.72
Aug. 07	522.92	105.11	132.63	100.79	93.42	81.09
Sept. 07	516.91	104.74	132.39	100.66	93.37	81.23
Oct. 07	501.44	103.20	129.72	99.61	92.09	79.43
Nov. 07	506.95	105.68	133.56	102.37	92.22	82.26
Dec. 07	499.28	103.63	130.59	100.26	89.15	79.18
Jan.08 (2)	496.63	103.66	130.81	100.45		

(1) For definition, see Glossary.
(2) Average at 8 January.
(3) Provisional figures.

Source: Central Bank of Chile.

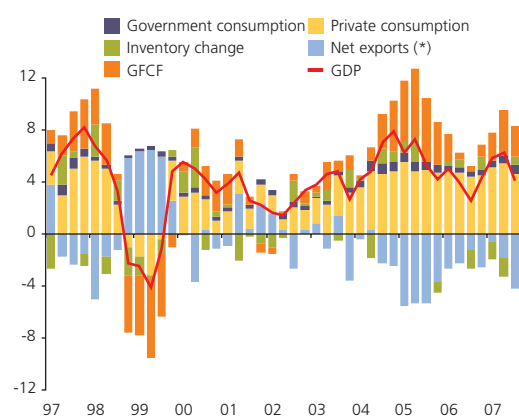
The gap between the two rates is typically positive, because of risk differentials and especially inflation differentials: the Chilean target (3%) is one percentage point higher than the U.S. Federal Reserve's implicit target. Furthermore, for the purposes of market transactions, the relevant differential is between the Chilean interbank rate—which is very much aligned with the MPR—and the Libor, and this differential is smaller than the differential between the MPR and the Fed Funds rate.

The real exchange rate (RER) also fell to just over 89 (base index: 1986 = 100), considering the average for the ten working days prior to the statistical closing of this Report. This figure is marginally below the range of values considered consistent with its long-term fundamentals, so the working assumption in the baseline scenario is a slight tendency to real depreciation, with limited effects on projected inflation.

III. Aggregate demand

Figure III.1

Contribution to GDP growth
(annual change, percentage points)



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

Source: Central Bank of Chile.

Table III.1

Aggregate demand
(weight in GDP, real annual change, percent)

	Weight 2006		2007			
	2006	Year	I	II	III	Accum.
Domestic demand	104.1	6.0	6.4	7.8	7.8	7.3
Final demand (exc. inventories)	102.7	6.0	7.9	9.4	7.2	8.2
GFCF	24.1	4.0	9.6	14.6	9.5	11.2
M&E	10.5	4.3	9.3	19.6	10.4	13.1
Construction & other works	13.6	3.8	9.7	10.9	8.8	9.8
Other	80.0	6.6	5.4	5.8	7.3	6.2
Private consumption	66.6	7.1	7.9	8.4	6.8	7.7
Durables	7.4	18.2	14.3	16.3	12.5	14.3
Non durables	29.4	6.4	7.8	6.9	6.0	6.9
Services	29.8	5.4	6.6	7.8	6.1	6.9
Government consumption	11.9	3.6	4.7	4.9	5.0	4.9
Inventory change (*)	1.4	1.4	1.1	0.7	0.8	0.8
Goods and services exports	37.8	4.2	9.2	11.6	4.1	8.4
Goods and services imports	41.9	9.4	10.4	15.3	13.0	12.9
GDP	100.0	4.0	5.9	6.2	4.1	5.4

(*) Inventory change over GDP accumulated in four quarters.

Source: Central Bank of Chile.

This section reviews recent trends in domestic and external demand, as well as short-term prospects, to explore possible inflationary pressures arising from the goods and services markets. The most likely behavior of output is also assessed.

Aggregate demand

According to available data for the second half of 2007, output grew less than in the first half and less than forecast in September's *Report*.^{1/} Domestic demand posted sustained growth, grounded on still-dynamic investment and strong consumption growth. Domestic spending grew 7.8% annually in the third quarter of 2007, the same as in the previous quarter. Among its components, gross fixed capital formation registered 9.5% annual growth in the period. Private consumption continued to rise at a strong pace in the same period, albeit somewhat less intensely than in earlier quarters; this coincided with the decrease in private disposable income due largely to higher inflation. Inventory change in the moving year ending in the third quarter of 2007 was 0.8% of GDP. Final domestic demand (less inventories) increased 7.2% annually, less than in the previous quarter but significantly more than GDP. Thus, at the end of the third quarter of 2007, the slower GDP growth with a strongly increasing domestic demand was due primarily to the slowdown in exports of goods and services: 4.1% annually, averaging 10.4% in the first half (figure III.1 and table III.1).

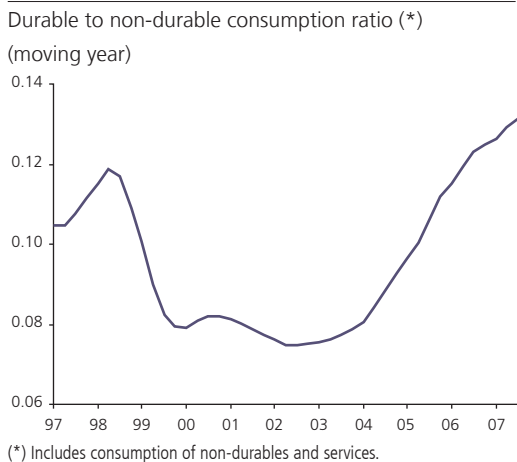
Private consumption^{2/} and inventories

Private consumption remained strong in the third quarter of 2007, going from growth rates around 8% annually in the first half to just below 7%. Fourth quarter figures show good consumption performance, reflected in a sharp increase in consumer goods imports and partial goods sales indicators that showed higher annual growth than in the third quarter. This was particularly visible in October: the consumer growth indicators for September were significantly affected by the lower number of working days in the month, an effect that the usual seasonal adjustments apparently did not capture in full.

^{1/} In accordance with the systematic revisions policy of the quarterly national accounts, on 23 November a new estimate for GDP in the second half of 2007 was issued. Newly revised figures will be published on 24 March 2008.

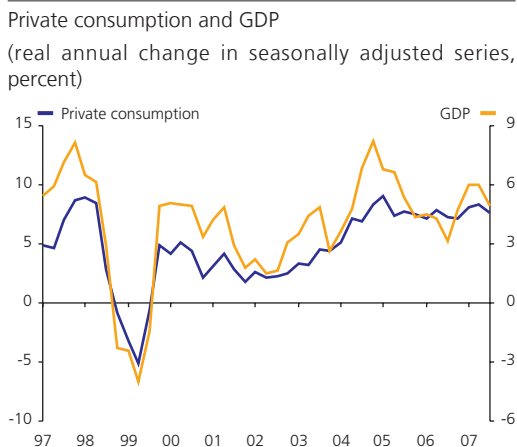
^{2/} Private consumption components are as follows (2006 weights): durables (11%), nondurables (44%) and services (45%). Nondurable consumption includes nondurable goods and services.

Figure III.2



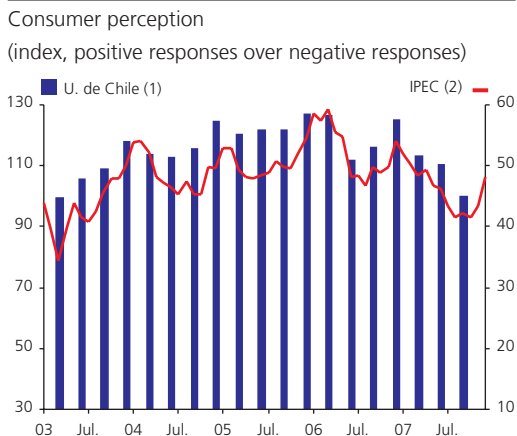
Source: Central Bank of Chile.

Figure III.3



Source: Central Bank of Chile.

Figure III.4



(1) Index March 2001=100.
(2) Index value above (below) 50 points indicates optimism (pessimism).

Sources: Adimark and U. de Chile.

By component, nondurable consumption grew around 6% annually in the third quarter, while durable consumption increased slightly more than 12% annually. The ratio between durable and nondurable consumption continued on an upward trend, reflecting a process of durable goods accumulation that has been sustained longer than expected. This process is probably influenced by favorable financial conditions and relative prices that have improved access to markets (figure III.2).

In the third quarter of 2007, private disposable income declined from the previous quarter, after being flat in the second. Private consumption continued to increase—in line with low unemployment and good domestic financial conditions—although somewhat less dynamically than in early 2007. The stability displayed by consumption in the face of less disposable income is consistent with developments of recent years, whereby annual private consumption growth is much more stable than private disposable income and GDP (figure III.3). This probably reflects households' capacity to cushion transitory falls in income with access to credit. Despite the good outlook for consumption so far, consumer perceptions remained pessimistic. The economic perception index (IPEC), in particular, stands below its neutral figure of 50 (figure III.4).

Total consumption growth in 2007 is thus estimated at 7.3% annually, similar to forecasts in September's *Report*. The baseline scenario assumes that annual consumption growth will slow in the coming quarters, as a result of less disposable income, a slowdown of consumer loans, a weaker labor market and a less favorable external scenario. In addition, the normal unfolding of the consumer credit cycle, considering its current degree of market penetration, probably will not be able to continue driving consumption in the face of an income slowdown. Private consumption is thus projected to grow somewhat more than 5.5% annually in 2008.

Gross fixed capital formation (GFCF)^{3/}

Gross fixed capital formation (GFCF) continued to perform well in the third quarter of 2007, growing 9.5% annually. Accordingly, the moving year ending in the third quarter posted fixed capital investment of 25.1% of GDP at constant prices (figure III.5).

Among investment components, GFCF in machinery and equipment continued to grow strongly, at 10.4% annually as of the third quarter. Capital goods imports, the main reference, performed similarly, with a significant increase in level (figure III.6). Annual growth of investment in construction and engineering works was also high. This has been reflected in increases in sales of construction inputs, largely supported by investment in engineering works.

The September investment survey of the CBC (*Corporación de Desarrollo Tecnológico de Bienes de Capital*) posted a significant increase in total investments for the three-year period 2007–2009 since the June survey. The

^{3/} GFCF components are as follows (2006 weights): construction and other works (56%) and machinery and equipment (44%). Construction and other works is broken down into building and engineering works (56%) and other works (44%).

Figure III.5

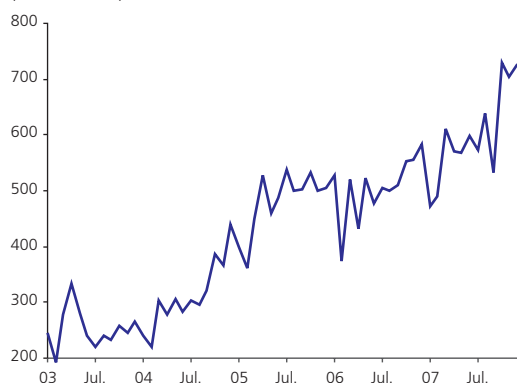
Gross fixed capital formation
(percent of GDP in pesos of 2003, moving year)



Source: Central Bank of Chile.

Figure III.6

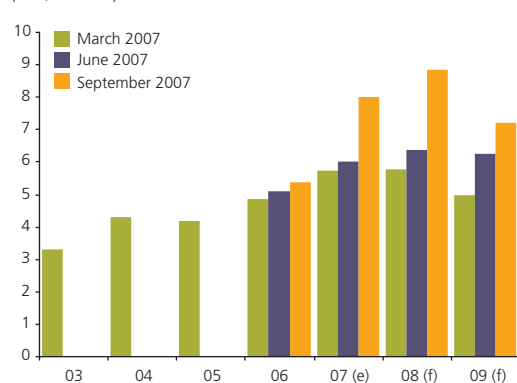
Imports of capital goods
(US\$ million)



Source: Central Bank of Chile.

Figure III.7

Total investment survey (*)
(US\$ billion)



(*) Excludes telecommunications, real estate and manufacturing sectors.

(e) Estimate.

(f) Projection.

Source: Corporación de Desarrollo Tecnológico de Bienes de Capital.

mining and energy sectors stand out for big upward revisions in prices, in line with the persistently high prices in those sectors (figure III.7). While corrections to survey figures grow larger as the end of the year approaches (which explains part of the change for 2008-2009 relative to June), September's revision is the largest in a long time, compared with the same month in past years. Furthermore, seen two years ahead, the correction is larger than the average for the last five years (figure III.8).

Corporate profits stayed high in 2007, but without the increases of 2006. In the moving year ending in the third quarter of 2007, the profitability of listed companies reporting the standardized financial statement (FECU)—as measured by the period's earnings after taxes, over equity—was 19.4%, driven by mining. When mining is excluded, profitability is 12% (figure III.9).

In sum, GFCF growth in 2007 is estimated at 12.8% per year, which is slightly above projections in September's *Report*. This is equivalent to a fixed capital accumulation of 25.8% of GDP. For 2008, the baseline scenario considers annual growth in investment of just over 8%. This projection is grounded, among other factors, in the steady growth of corporate profits and the substantial number of mining and energy projects planned for this year.

Fiscal policy

As of September 2007, the total Central Government's budget execution reached a surplus accumulated in one year of 8.9% of GDP, unchanged from the end of the previous quarter. As of November 2007, budget income accumulated over one year grew 14.9% annually, exceeding the rate of the two previous months. Accumulated budgetary expenses recorded a high growth rate of 8.7% per year in the same period. At the end of 2007, fiscal surplus approached an estimated 9% of GDP, which was more than expected by the fiscal authority in September.

The baseline scenario of this *Report* assumes that in 2008, fiscal spending will continue to follow the structural surplus rule of 0.5% of GDP. According to the budget approved in Congress, fiscal spending will grow throughout 2008 at a real rate of 8.9% annually, to end the year with an overall balance of 4.8% of GDP.

Exports and imports

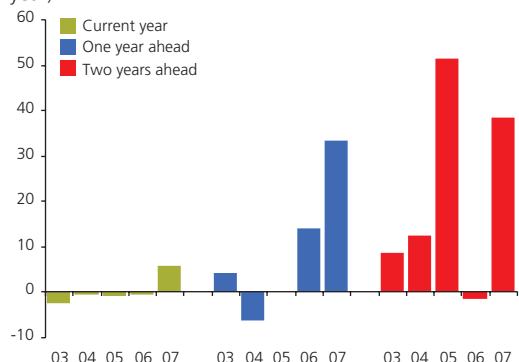
The trade balance closed 2007 at US\$24.50 billion, which is higher than in 2006. This result was particularly influenced by the high copper price and the rise in the WTI oil price at the time of greatest fuel demand. Total fob exports amounted to nearly US\$68.30 billion, with an increase of 17.5% annually. Total cif imports amounted to almost US\$47.00 billion, thus recording an increase of 22.3% in annual terms (table III.2).

The slowdown in annual GDP growth in the second half of 2007 relative to the first half was due, to a large extent, to the performance of exports. The annual average growth rate of export volume dropped by almost 50% from the first half to the second. This poor result is explained primarily by reduced annual growth in mining output and reduced manufacturing exports, which is consistent with the slowdown in manufacturing, in particular methanol and wood production. Thus, the growth rate of the volume of goods exports in 2007 is estimated at nearly 7% annually, exceeding the figure for 2006.

Figure III.8

Total investment survey (1) (2)

(percent correction between surveys at September each year)



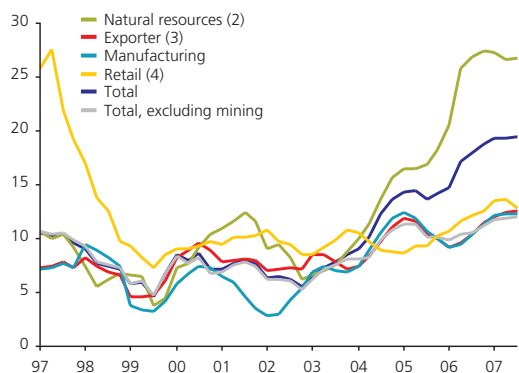
(1) Considers correction to investment data in current year, next year and two years ahead, obtained from surveys at September each year with respect to the survey at June of same year.
 (2) Excludes telecommunications, real estate and manufacturing sectors.

Source: Corporación de Desarrollo Tecnológico de Bienes de Capital.

Figure III.9

Corporate profits (1)

(annual moving average, percent)



(1) Profit of the year over equity.

(2) Includes electric power, forestry, mining, sanitary services and gas sectors.

(3) Includes food, forestry and manufacturing sectors.

(4) Includes retail sales and supermarkets.

Sources: Central Bank of Chile and Superintendency of Securities and Insurance (Fecu).

Tabla III.2

Foreign trade

Exports

	Value US\$ million	Annual change, percent											
		Total			Mining			Manufacturing			Agricultural		
		Value	Volume	Price	Value	Volume	Price	Value	Volume	Price	Value	Volume	Price
2005 Year	41,297	27.0	5.0	20.9	36.6	-0.6	37.4	17.4	11.2	5.6	7.3	8.3	-0.9
2006 Year	58,116	40.7	2.3	37.5	57.9	-0.9	59.4	19.1	5.1	13.3	8.8	3.7	4.9
2007 Year	68,296	17.5			19.5			14.2			14.1		
2007 I	16,627	22.1	7.3	13.8	21.0	4.8	15.5	27.9	12.5	13.7	17.4	12.3	4.6
II	18,229	20.4	13.3	6.2	25.2	18.4	5.7	11.5	5.2	6.1	16.6	6.4	9.5
III	16,618	6.0	0.8	5.2	4.6	-1.8	6.5	5.9	2.8	3.0	30.4	18.2	10.3
IV	16,821	23.0			30.0			13.8			-13.0		

Imports

	Value US\$ million	Annual change, percent											
		Total			Consumption			Capital			Intermediate		
		Value	Volume	Price	Value	Volume	Price	Value	Volume	Price	Value	Volume	Price
2005 Year	32,735	32.1	21.2	9.0	28.6	25.4	2.5	53.8	51.0	1.9	30.2	14.6	13.6
2006 Year	38,409	17.4	11.7	5.1	17.6	15.8	1.5	5.3	4.0	1.2	20.1	11.8	7.5
2007 Year	46,966	22.3			19.7			19.0			25.9		
2007 I	10,085	11.9	11.0	0.8	17.2	16.1	1.0	10.7	10.0	0.6	9.8	9.1	0.6
II	11,219	19.6	17.3	2.0	14.2	11.8	2.2	21.3	20.4	0.7	22.4	19.3	2.6
III	12,305	23.0	20.0	2.5	22.9	20.9	1.6	14.9	13.5	1.2	26.9	22.7	3.4
IV	13,358	33.4			23.6			27.8			43.9		

Source: Central Bank of Chile.

During the third quarter of 2007, imports of both consumer and capital goods continued to grow strongly, consistently with the behavior of consumption and investment. Intermediate imports posted a high growth rate (22.7% in real annual terms), related to greater fuel purchases as a result of worsened hydrologic conditions and restrictions on the natural gas supply. This, coupled with fourth quarter data at hand, results in an estimate for the growth in goods imports for 2007 of 17% annually, which is higher than in 2006.

The current account of the balance of payments closed 2007 with an estimated positive balance of around US\$6.40 billion. The accumulated surplus of 3.8% of GDP falls short of projections in September's *Report*. The baseline scenario of this *Report* foresees that the current account will end 2008 with a deficit of 0.5 of GDP—less than projected in September—mainly because of the less favorable external scenario and faster terms-of-trade adjustments.

IV. Output and the labor market

Table IV.1

Gross domestic product
(real annual growth, percent)

	Weight 2006	2006		2007			Accum.
		Year	I	II	III		
Agricultural-forestry	3.8	5.4	4.9	6.3	-1.1	4.4	
Fishing	1.2	-1.9	7.0	8.1	-0.5	5.4	
Mining	7.5	0.1	6.0	5.4	4.1	5.2	
Manufacturing	16.5	2.5	3.6	4.8	0.1	2.8	
Electricity, gas & water	2.9	7.4	3.4	-9.6	-20.2	-8.6	
Construction	7.0	3.9	9.1	10.1	8.1	9.1	
Retail (1)	10.1	5.2	6.4	7.3	4.4	6.1	
Other services	45.6	4.5	6.0	6.5	5.5	6.0	
Natural resources (2)	11.6	1.6	5.5	2.0	-2.4	1.7	
Other (2)	83.0	4.1	5.7	6.6	4.4	5.6	
Total GDP (3)	100.0	4.0	5.9	6.2	4.1	5.4	

(1) Includes restaurants and hotels.

(2) For definitions, see Glossary.

(3) Total GDP is the sum of GDP of natural resources, other GDP, net VAT collected, import duties, less banking charges.

Source: Central Bank of Chile.

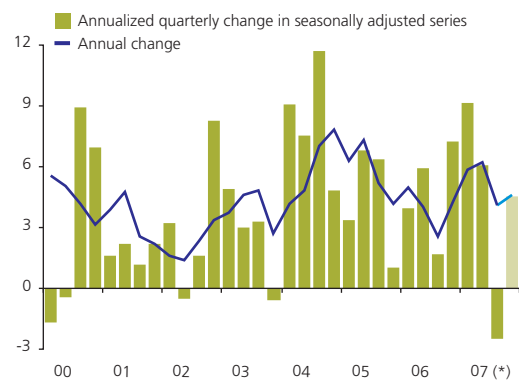
This chapter reviews GDP behavior based on sectors of origin and the evolution of employment, with the objective of evaluating price pressures in goods and factors markets, as well as the short-term outlook for output.

Total GDP

GDP grew by an estimated 5.2% in 2007, with a sharp slowdown in the second half.^{1/} Output growth was slower in the second half than in the first, and slower than forecast in September. This was due both to a deepening of the same factors that had a negative effect in the first half—mainly in electricity, gas and water (EGW) and in manufacturing areas that depend strongly on natural gas—and to poor performance in some specific industrial areas and reduced dynamism of some services (table IV.1 and figures IV.1 and IV.2). Other factors in the slowdown include lower-than-expected mining growth (the high projections reflected the low basis of comparison of the third quarter of 2006 and the assumption that mining companies would function at full capacity in accordance with their operating plans) and the fewer working days in the third quarter compared with the same period the year before. These circumstances had their counterpart in reduced net external demand, stemming from the lower mining and manufacturing exports and higher imports, especially of fuels.

Figure IV.1

Gross domestic product
(real annual growth, percent)



(*) Fourth quarter of 2007 figure, projected.

Source: Central Bank of Chile.

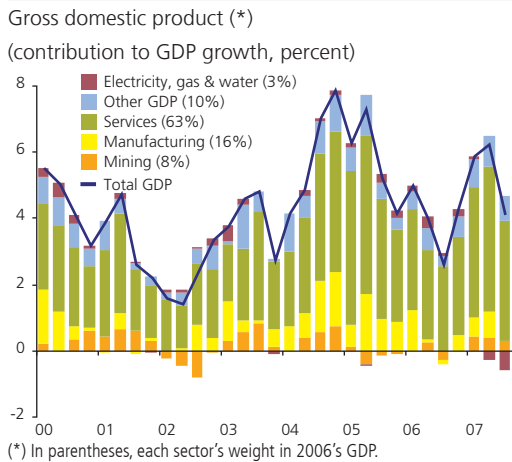
This year, output will grow between 4.5% and 5.5%, with a downward biased risk balance. This risk is lower than forecast in September, partly reflecting the current external conditions. This projection is based on reduced growth in retail and other services, which is consistent with the expected behavior of consumption, and moderate growth in manufacturing and mining.

Natural resources GDP

The reduced production of natural resource sectors—namely, mining, EGW and fishing—played a significant role in the output slowdown in the second half of 2007. The impact of EGW on total GDP for the year was an estimated -0.3 percentage point. This difference was more significant in the second half of 2007. Underlying this performance are some elements that were difficult to anticipate earlier in the year, such as the nearly null provision of natural gas from Argentina and unfavorable hydrologic conditions (figure

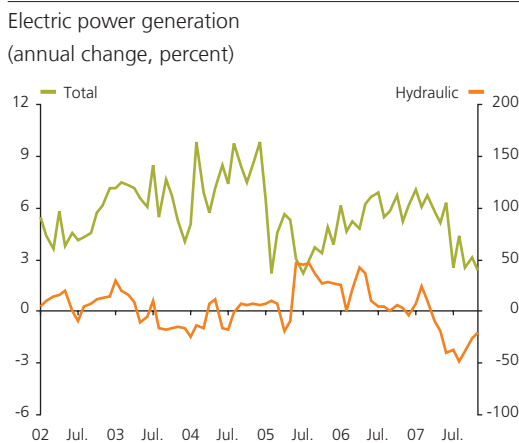
^{1/} In accordance with the systematic revisions policy of the quarterly national accounts, a new estimate for the first half of 2007 was published on 23 November, in which the previous estimate was adjusted marginally upward due to corrections in agriculture and construction. Newly revised figures will be released on 24 March 2008.

Figure IV.2



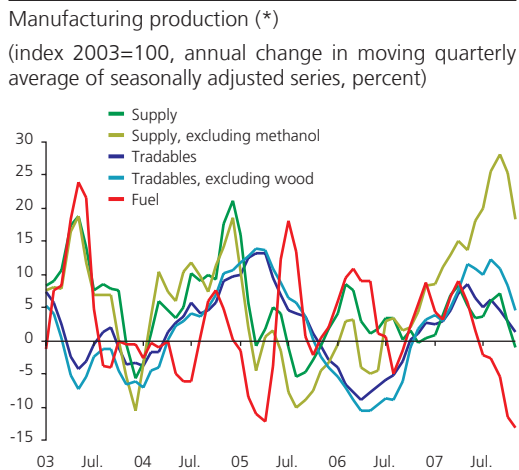
Source: Central Bank of Chile.

Figure IV.3



Source: Centro de Despacho Económico de Carga (CDEC).

Figure IV.4



(*) Indicators calculated with INE's disaggregated manufacturing output figures, adjusted by weights in national accounts.

Sources: Central Bank of Chile and National Statistics Bureau.

IV.3). If 2007 had had the same composition of hydraulic and thermal power generation as in 2006, GDP growth would have been almost 0.4 percentage point higher in the year based on EGW alone. This results from estimating EGW growth of 1.4% using the matrix of the preceding year, combined with the reversal of the fall that occurred in 2007. For 2008, the baseline scenario assumes no relevant changes in natural gas shipments from Argentina or in hydrologic conditions with respect to last year.

The greater demand for substituting other energy resources for gas and water resulted in higher fuel imports. Combined with higher fuel prices, this increase explains the large rise in import duties and, therefore, some decimals more of GDP at market prices in the second half of 2007.

Mining growth in the third quarter was surprisingly lower than expectations, which were estimated using the low basis for comparison in the same period a year before. Moreover, the mining companies apparently did not operate at full capacity, contradicting their reported operating plans. Had this sector produced as the companies planned, GDP for the third quarter of 2007 would have been 0.6 percentage point higher. Underlying this trend are the low ore content of extractions and production problems in some corporations, associated with strikes or accidents. This coincided, furthermore, with reduced exports from the sector in the third quarter. The baseline projection assumes that new mining projects will begin operations in the second quarter of 2008, slightly increasing the sector's contribution to GDP for the year as compared with 2007.

Other sectors' GDP

Weak output in the third quarter also showed up in other sectors' GDP. Considering this period only, other sectors' output growth was 1.75 percentage points less than the average for the first half. The baseline scenario assumes that, in the next few quarters, these sectors will post higher GDP growth rates than total GDP.

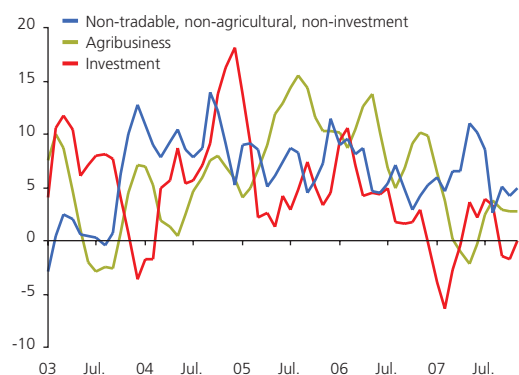
Manufacturing

Manufacturing registered almost no growth in annual terms in the third quarter of 2007. Further cuts in the natural gas supply and their impact on methanol production caused a reduction of 0.3 percentage point, on average, in total GDP growth and around 1.5 percentage points in manufacturing GDP. At the same time, fuel production was down, as a result of maintenance downtime at some plants. Repercussions of the U.S. subprime crisis slowed growth in the wood industry (figure IV.4), although annual wood pulp production continued to grow strongly. Producers of tradable goods, other than timber companies, posted higher growth rates than the average for the sector (figure IV.5). Nontradables, meanwhile, recorded higher growth rates in the second half than in the first, which could be partly attributed to consumption performance.

Another element explaining low output in the third quarter was the smaller number of working days (three days fewer than the third quarter of 2006), partly stemming from the mid-week occurrence of the Independence days (18–19 September). This factor alone is estimated to have eroded nearly 2 percentage points from the sector's annual growth for the quarter.

Figure IV.5

Manufacturing production (*)
(index 2003=100, annual change in moving quarterly average of seasonally-adjusted series, percent)

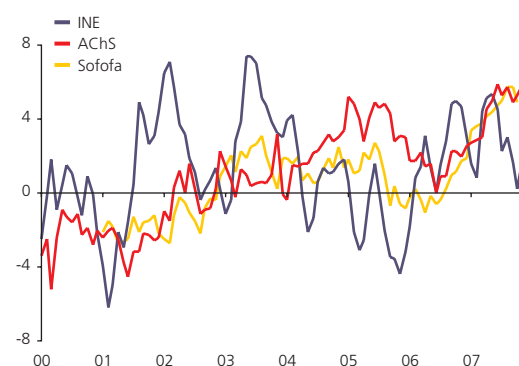


(*) Indicators calculated with INE's disaggregated manufacturing output figures, adjusted by weight in national accounts.

Sources: Central Bank of Chile and National Statistics Bureau.

Figure IV.6

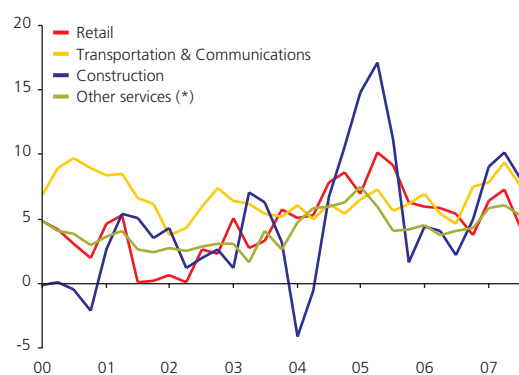
Employment in manufacturing industry
(annual change, percent)



Sources: Asociación Chilena de Seguridad (AChS), National Statistics Bureau (INE) and Sociedad de Fomento Fabril (Sofofa).

Figure IV.7

Services sectors
(annual change, percent)



(*) Includes financial and entrepreneurial services, personal services and public administration.

Source: Central Bank of Chile.

Still, the potential effect that the higher cost of energy may have had on manufacturing must be taken into account, although it is difficult to quantify exactly.

The baseline scenario forecasts that manufacturing will tone down growth in the coming quarters, considering vegetative growth in wood pulp as no new increases in installed capacity are foreseen. Methanol production is projected to maintain its current levels, with negative annual variation rates in the first half. In contrast, fuel production is expected to resume higher growth. This will combine with lower demand for the sector, both domestically and internationally.

Regarding manufacturing employment, some discrepancies appeared in statistics reported by different sources (INE, AChS and Sofofa): while INE showed low annual growth rates, Sofofa and AChS reported the highest annual variation in their recorded history (around 5.5%) (figure IV.6).

Retail sales and other services

Sales grew less in the second half of the year than in the first half, in line with consumption trends and fewer working days in the third quarter of 2007 than the year before (figure IV.7). The biggest contraction was in the wholesale trade of raw materials and nondurable goods (e.g., food, tobacco and beverages), coinciding with reduced industrial production of these goods. Nonetheless, car sales continued to grow strongly. Since the baseline scenario foresees a smaller increase in consumption in coming quarters, the sector's activity is also projected to moderate growth. The retail trend is similar to that derived from retail employment figures provided by AChS, dropping from annual growth rates of around 7% in the second quarter to about 4.5% in recent months. Employment figures by INE, while increasing, are more unstable, fluctuating between 2.2% and 5.6% in the last five months (figure IV.8).

The transportation sector also posted a slight decline in its annual growth rate during the third quarter, although it is still above the aggregate. The figure for communications approached a strong 15%; this is mainly explained by sustained growth in mobile telephony. In line with the slowdown in domestic demand projected in the baseline scenario for this year, these sectors will moderate their growth rates.

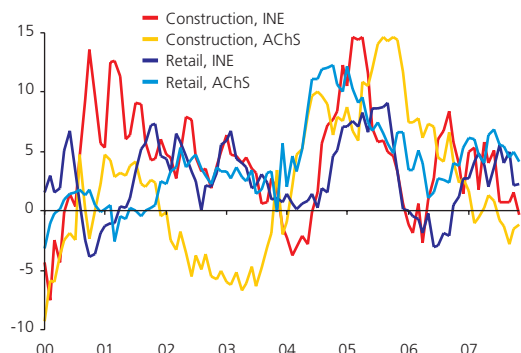
Construction

As foreseen in September's *Report*, the construction sector outperformed overall GDP growth—and will continue to do so—largely as a result of dynamic investment in engineering works. The sector's evolution is also consistent with certain indicators (such as the Imacon) or some of their components, as well as the significant private real estate development recorded in several regions of the country. In line with investment projects included in the *Corporación de Desarrollo Tecnológico de Bienes de Capital* (CBC) survey, the sector will continue to contribute to GDP growth this year. Investment in the energy and mining sectors are particularly strong, apparently in response to the persistently high prices for these products.

Annual growth in employment and output are divergent in this sector. INE figures indicate annual variations in employment of around 1% in

Figure IV.8

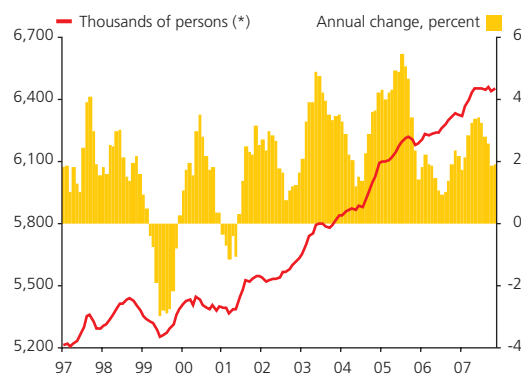
Employment in retail and construction
(annual change, percent)



Sources: *Asociación Chilena de Seguridad* and National Statistics Bureau.

Figure IV.9

National employment

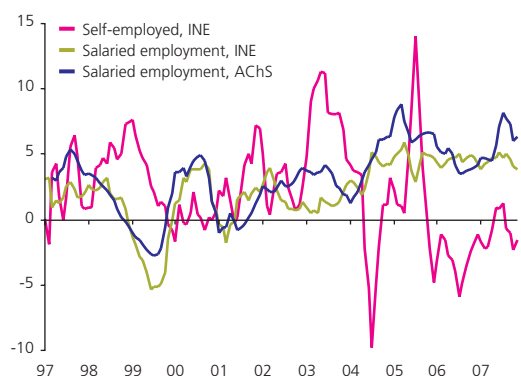


(*) Seasonally adjusted series.

Sources: Central Bank of Chile and National Statistics Bureau.

Figure IV.10

Employment by occupational category
(annual change, percent)



Sources: *Asociación Chilena de Seguridad* and National Statistics Bureau.

the second half, although the marginal data for November is -0.3% . The employment variation reported by AChS for the same period is negative, averaging -1.5% .

Agriculture and forestry

Output fell 1.1% in agriculture and forestry in the third quarter of 2007. This decline is largely attributed to livestock results, associated with reduced production of pork and poultry and the fall in forestry activity stemming from weak timber production. Fruit production recorded positive results for the quarter despite the effects of winter frosts, which more than offset the weak performance of agriculture over the same period.

Employment, participation and unemployment

The labor market has progressively been showing signs of less rigidity. After suffering some stagnation up to July 2007, the labor force grew more than 2.0% annually in the moving quarter ending in November, for the third month in a row (this rate is equivalent to just over 160,000 people on average in the past three months). Also, the participation rate has trended upward since August, although not quite at the maximum levels attained in mid-2005. The unemployment rate thus increased for the fifth consecutive month, from a seasonally adjusted 6.3% in the moving quarter ending in June, to 7.6% in November. The level of the unemployment rate is within the range of NAIRU estimates.

Job creation appears less dynamic, going from 3% annual growth between March and September to less than 2% in October and November, with a velocity of expansion around zero (figure IV.9). Although employment composition has continued to change, salaried employment also grew less in October and November than in preceding months, at 4% annually. Self-employment, with the exception of the period from May to July, continues posting negative annual variations, reaching -1.6% in November (figure IV.10). AChS data shows a similar trend for salaried employment, but with higher variation rates: 6.3% per year in November, versus an average of 7.8% per year in the third quarter.

V. Recent inflation and cost trends

This section examines recent trends of the main components of inflation and costs, identifying different sources of inflationary pressures at the present time and most likely short-term evolution.

Recent inflation trend

Annual inflation continued on an upward path in the latter months of 2007, to well above the tolerance range for the inflation target. The CPI ended the year with an annual change of 7.8%, while the CPIX and CPIX1 recorded an increase of 6.3% annually (figure V.1). In monthly terms, CPI inflation figures after September's *Report* were unusually and unexpectedly high, with the exception of October. In the case of the CPIX1, monthly changes in the fourth quarter were smaller than in the preceding quarter, leading to a decline in its growth rate at the end of the year (figure V.2).

The gap between annual CPI inflation and core measures in the second half of 2007 reflects the growing importance, first, of soaring prices of perishable foods, and, later, of energy, notably fuel and electricity. This contrasts with developments in the first half, when both items were less significant in explaining increased inflation and nonperishable foods dominated (figure V.3).

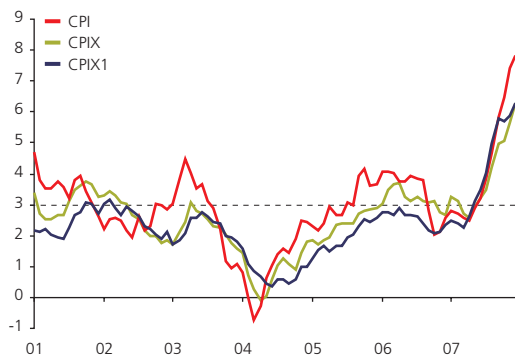
Food price increases continued to dominate in annual inflation acceleration during the last months of 2007. Nonperishable food price hikes continued to be concentrated in wheat and corn by-products, a trend that is global in nature, as described in September's *Report*. Therefore, a key factor explaining domestic price trends is the behavior of comparable international prices. The prices of fresh fruit and vegetables, in turn, were affected by bad weather conditions last year; their annual rate of change began to ease in November, and negative monthly variations were posted in the last two months of 2007. Worldwide, Chile is among the economies with the biggest increases in domestic food prices measured in dollars, but at the same time the transmission to other prices has proved to be comparatively small (box I.3).

The baseline projection assumes a reversal of nonperishable price trends in the short run, moderating the recent increases but ending at levels above those assumed in the September *Monetary Policy Report*. Prices of perishable foods—fresh fruit and vegetables—are expected to continue normalizing and should approach historical averages over the first half of this year, consistently with usual seasonal trends.

Prices of oil and fuel again exceeded forecasts. This had a strong effect on annual headline inflation, particularly from October onward. The WTI oil

Figure V.1

CPI, CPIX and CPIX1 inflation (*)
(annual change, percent)

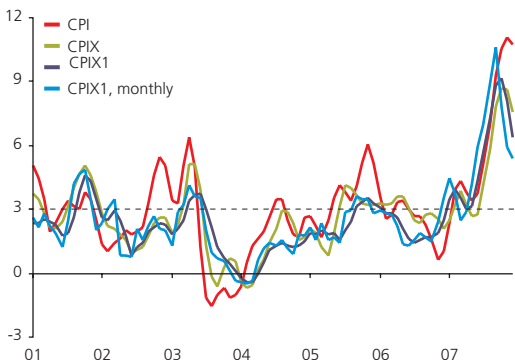


(*) For definition, see Glossary.

Sources: Central Bank of Chile and National Statistics Bureau.

Figure V.2

Velocity of CPI, CPIX and CPIX1 expansion (*)
(percent)

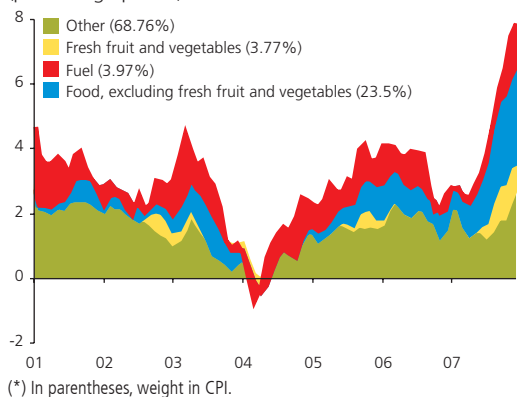


(*) For definition, see Glossary.

Sources: Central Bank of Chile and National Statistics Bureau.

Figure V.3

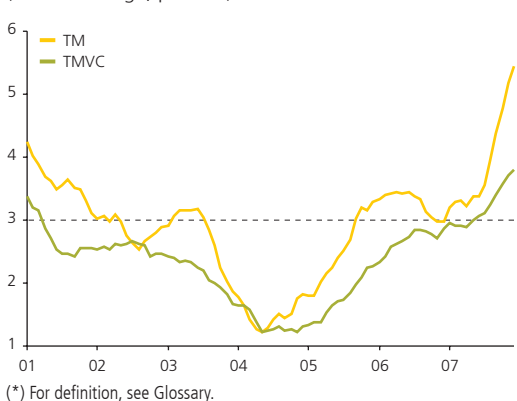
Incidence in annual CPI inflation (*)
(percentage points)



Sources: Central Bank of Chile and National Statistics Bureau.

Figure V.4

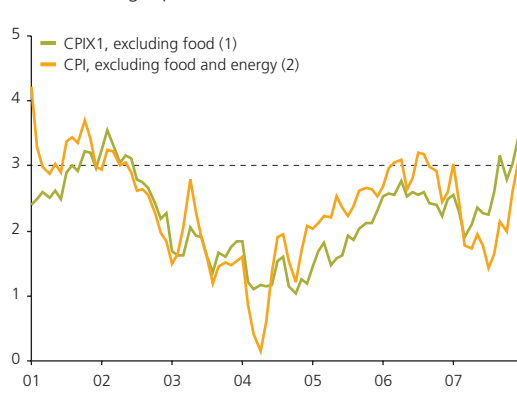
Trend inflation Indicators (*)
(annual change, percent)



Sources: Central Bank of Chile and National Statistics Bureau.

Figure V.5

CPI, excluding various components
(annual change, percent)



(1) Excludes food, fuel, public utilities, bus fares, indexed items and financial services, keeping 52% of the total CPI basket.
(2) Excludes food and energy, keeping 68% of the total CPI basket.

Sources: Central Bank of Chile and National Statistics Bureau.

price increased, with swings, from around US\$70 per barrel at the end of August to nearly US\$100 by the statistical closing of this *Report*. Considering recent developments and prospects in this market, the present baseline scenario foresees substantially higher WTI oil prices this year and next than were expected in September, implying a higher path for domestic fuel prices. In this context, the governmental fuel price stabilization fund has granted subsidies almost continuously from September to date, thus attenuating domestic price increases in gasoline and diesel fuel.

Another factor in the higher inflation of recent months was the increase in the prices of some home repair services, which coincided with higher wages in the construction sector. Lower pharmaceutical prices had the opposite effect until November. This may be reflecting hard competition among the large drug-store chains, given narrowing sales margins in these products (as measured by the CPI/PPI ratio).

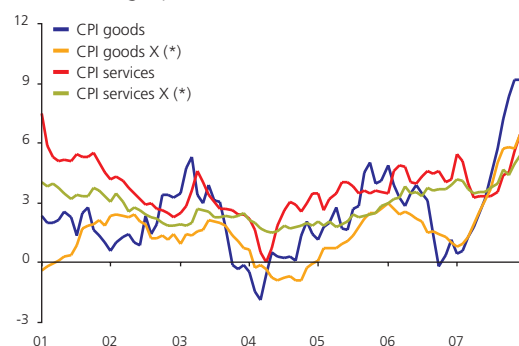
The hike in electricity rates has been another important source of inflationary pressure. From the September *Report* to date, the rate in the Central Grid *Sistema interconectado central* (SIC) increased 16.2%, accumulating a variation of just over 40% in the year. In recent years these increases have permeated other regions. In the Northern Grid *Sistema interconectado del Norte Grande* (SING), for example, node price adjustments have been of comparable magnitude and, in some cases, larger than those in the SIC. The baseline scenario assumes that the node price increase decreed last November will become effective in the first quarter of this year. Fares for the new public transportation system in Santiago, in turn, have been unchanged since February 2007. The baseline scenario assumes that fares will follow a trend similar to the path derived by applying the adjustment formula used for the former system, without implying a recovery of the adjustments that were not made in 2007. This assumption is subject to a high degree of uncertainty, particularly because of changes being implemented within the system. In any case, a scenario in which fares incorporate increases that failed to be applied in 2007 would have a one-time effect on the price level and thus would not constitute a medium-term inflationary source.

Annual inflation ended 2007 well above earlier projections by both the Central Bank and the private sector. Comparing actual inflation in December and projections in the baseline scenario of September, the difference in annual CPIX1 change was 1.1 percentage points. Somewhat less than half of this difference is accounted for by higher food prices. The annual increase in the CPIX, meanwhile, was 1.3 percentage points more than forecast, mainly due to the incidence of products included in the CPIX1 and higher meat prices. Finally, the largest difference occurred in headline CPI, which exceeded projections by 2.3 percentage points. The CPIX also featured a larger than expected increase in the prices of fuel (0.7 percentage point) and fresh fruit and vegetables (0.4 percentage point) (table V.1).

Inflation in 2007 responded to a series of unusually strong shocks to certain prices, as evidenced in a comparison of their average increases in the 2000s with figures for 2007 (table V.2). In particular, nonperishable food rose around 15% annually in 2007, as opposed to an average of just under 2% between 2000 and 2006. Fresh fruit and vegetables posted an average annual price change of almost -2% in the period 2000-06—even considering high-price years like 2002 and 2005—and then soared more than 30% last year. Electricity rates rose an average of 23% in the year—and almost twice as much as if

Figure V.6

CPI goods and services
(annual change, percent)



(*) For definition, see Glossary.

Sources: Central Bank of Chile and National Statistics Bureau.

Figure V.7

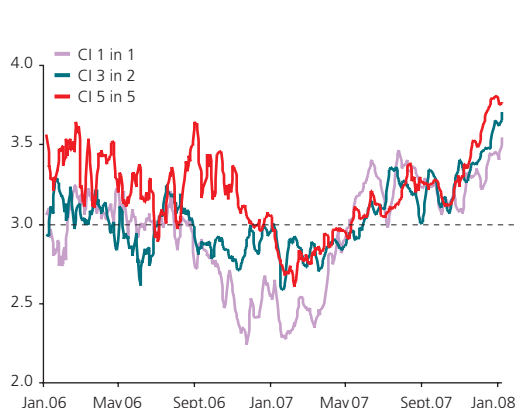
Expected inflation
(percent)



Source: Central Bank of Chile.

Figure V.8

Forward inflation compensation from swap rates
(moving weekly average, percent)



Source: Central Bank of Chile.

the starting point is the price in December 2007. This compares with an average increase of less than 6% between 2000 and 2006. Fuel prices, in contrast, increased only modestly, in annual terms, over the trend for the past few years: 18% in 2007, versus 13% average between 2000 and 2006. This rise was concentrated in the latter part of the year; nonetheless, most market players expected a slight decline in oil prices last year. In sum, given the irregularity of these price increases over their averages, they can explain five to six percentage points of total inflation in 2007. In any case, most prices posted similar increases to those shown in the past, while others had the opposite effect, particularly the public transportation fare in Santiago.

Table V.1

Annual inflation through December 2007
(annual change, percentage points)

	Weight in CPI	Projection (*)	Actual	Difference
Food	18.2	3.20	3.64	0.44
Other CPIX1	51.5	2.03	2.65	0.63
CPIX1	69.7	5.23	6.29	1.06
Incidence CPIX1 in CPIX		3.98	4.79	0.82
Utility rates	5.5	1.28	1.12	-0.16
Other CPIX	86.8	-0.18	0.40	0.59
CPIX	92.3	5.07	6.31	1.25
Incidence of CPIX in CPI		4.66	5.81	1.15
Fruit & vegetables	3.8	0.39	0.83	0.44
Comb.	4.0	0.49	1.17	0.68
CPI	100.0	5.54	7.82	2.27

(*) Annual inflation projection included in baseline scenario of September 2007's *Monetary Policy Report*.

Sources: Central Bank of Chile and National Statistics Bureau.

Table V.2

CPI components' annual inflation
(annual change, percentage points)

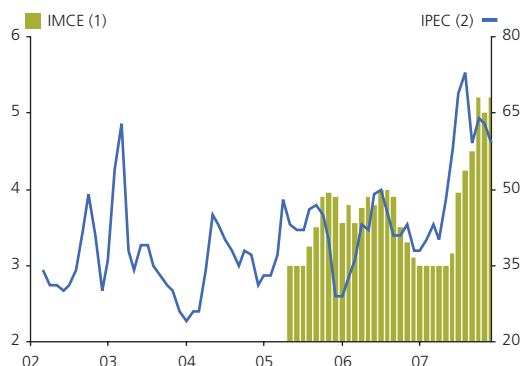
	Weight in CPI	Avg. 2000-06	Dec-07	Incidence	CPI points
Food	18.2	1.86	14.57	3.64	2.55
Housing	6.0	3.57	8.74	0.91	0.63
Household goods	8.1	-1.04	-0.09	-0.04	-0.02
Clothing	7.9	-3.66	-0.85	-0.08	-0.06
Transport	7.0	3.61	4.38	0.77	0.54
Health care	9.4	3.74	1.93	0.28	0.19
Education and recreation	11.1	3.74	3.97	0.78	0.54
Others	2.0	5.14	6.80	0.04	0.03
CPIX1	69.7	2.08	6.29	6.29	4.40
Incid. CPIX1 in CPIX				4.79	
Meat	4.9	2.95	9.36	0.46	0.42
Utility rates	5.5	5.88	16.17	1.12	1.03
Indexed	7.1	1.39	3.44	0.24	0.22
Bus fare	2.7	9.47	-7.41	-0.35	-0.32
Financial services	1.9	-8.93	7.03	0.06	0.05
CPIX1	92.3	2.46	6.31	6.31	5.81
Incidence of CPIX in CPI				5.81	
Fruit & vegetables	3.8	-1.78	33.37	0.83	0.83
Fuel	4.0	13.13	17.89	1.17	1.17
CPI	100.0	2.89	7.82	7.82	7.82

Sources: Central Bank of Chile and National Statistics Bureau.

Trend inflation measures and measures excluding various CPI components have risen steadily in recent months. The trimmed mean (TM) rose more than 5% annually, and the TMVC—which excludes the more volatile prices—stood at 3.8% (figure V.4). A similar trend is shown by inflation indicators excluding CPI components that have recently recorded significant increases. Thus, the CPI excluding food and energy—which leaves 68% of the standard CPI basket—

Figure V.9

Inflation expectations of consumers and entrepreneurs (percent)

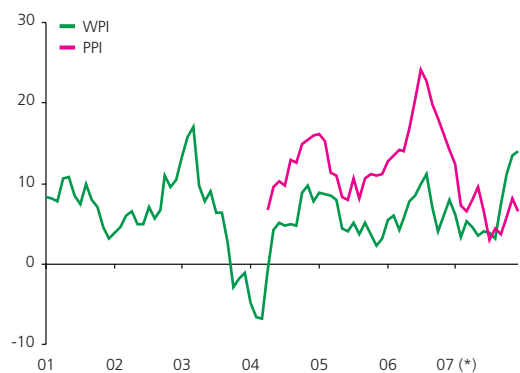


(1) Monthly index of entrepreneurial confidence. Reply to question: ¿what is your inflation expectation for the next twelve months? in the survey to retail and manufacturing sectors.

(2) Economic perception index. Percentage of respondents believing that inflation will rise "much" in the next twelve months.

Sources: Adimark and Icare/Universidad Adolfo Ibáñez.

Figure V.10

 PPI and WPI
 (annual change, percent)


(*) December WPI is the first figure under new base year, November 2007=100.

Source: National Statistics Bureau.

yields an annual inflation of 3%, compared with an 1.4% annual increase as of July. The CPIX1 excluding food—which leaves 52% of the CPI basket—rose to 3.4% annually (2.3% in July), a level not seen since 2002 (figure V.5).

Annual CPI inflation increased for both goods and services in recent months. While goods inflation exceeded services inflation by a considerable magnitude, inflation of services excluding regulated rates reached 5.4% annually in December. This is particularly interesting since, from a statistical perspective, this indicator is more persistent than core goods inflation (figure V.6).

Inflation expectations

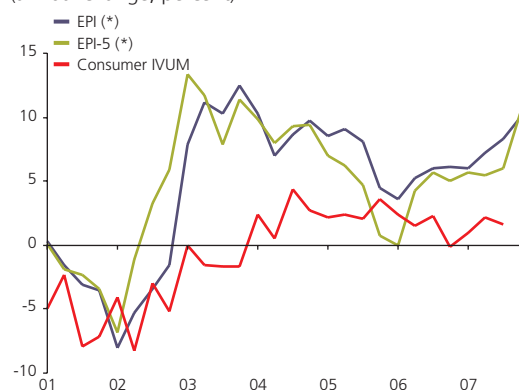
Consistently with latest figures on monthly inflation and the expected decline in the future, market analysts have revised upward their inflation projections for late 2008, but they continue to expect it to fall substantially from current levels. The Central Bank's Economic Expectations Survey shows that annual inflation expected for December 2008 jumped from 3.2% in August to 4.0% in January, while expected inflation 24 months ahead went from 3.0% to 3.3%. The survey of money desk operators similarly reveals expected inflation of 4.2% one year ahead and 3.5% the second year, albeit with large swings in the past few months. Both figures exceed expectations at the statistical closing of September's *Report* for similar horizons (figure V.7). Regarding expectations inferred from financial asset prices, one-year-ahead forward inflation compensation in a one-year horizon, calculated through swap rates, assumes a rate of 3.5% beyond usual fluctuations, which is slightly higher than expected for the same horizon at the statistical closing of September's *Report* (3.3%). At longer horizons, however, inflation compensation has shown larger increases, with 3 in 2 shifting from 3.1% to 3.7%, and 5 in 5 going from 3.2% to 3.8% (figure V.8). The increase in inflation compensation measures of recent weeks is consistent with the recent growth in demand for indexed instruments denominated in UFs. This increase, in turn, reflects a number of factors, most notably the greater appetite for these securities on the part of institutional investors that use them to hedge their overseas operations. Also, usual changes in demand for these securities at times of major surprises in month-to-month inflation must be taken into account.

When linking inflation compensation with inflation expectations, one must not overlook the fact that financial asset prices include premiums whose precise magnitude is difficult to determine and which may become more significant during episodes of high volatility like the present one. These premiums imply that the level and movements of inflation compensation might not necessarily reflect expectations. Uncertainty about the future, particularly regarding inflation, introduces a risk premium in the valuation of financial assets used to calculate inflation compensation. There is also a liquidity premium stemming from investors' preference for holding certain types of securities in case they need to restructure their investment portfolios. A further premium for imperfect substitution originates in the difficulty of exchanging available financial instruments in the event of changes in the relative supply and demand of nominal and indexed bonds. Thus, while inflation compensation has an important information content on inflation expectations, both its level and its short-term fluctuations must be interpreted with caution.^{1/}

^{1/}For further detail, see *Monetary Policy Report*, January 2006, box VI.1, "Inflation compensation and inflation expectations."

Figure V.11

External inflation in U.S. dollars
(annual change, percent)

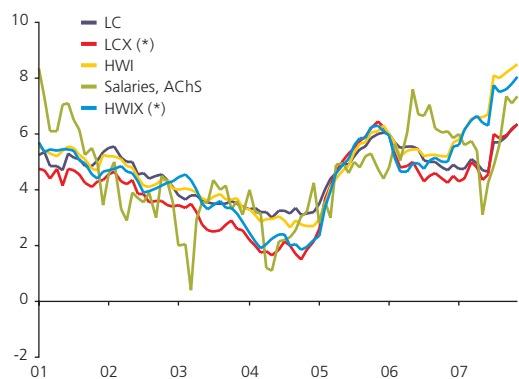


(*) For definition, see Glossary.

Source: Central Bank of Chile.

Figure V.12

Nominal wages
(annual change, percent)

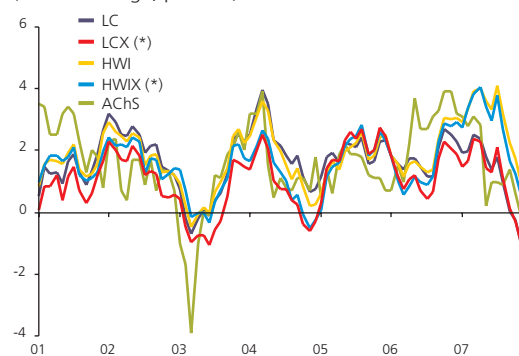


(*) For definition, see Glossary.

Sources: Asociación Chilena de Seguridad, Central Bank of Chile and National Statistics Bureau.

Figure V.13

Real wages
(annual change, percent)



(*) For definition, see Glossary.

Sources: Asociación Chilena de Seguridad, Central Bank of Chile and National Statistics Bureau.

Private nonfinancial market agents maintain a persistent concern about inflation among consumers, and inflation projected by entrepreneurs twelve months ahead has increased. Accordingly, Adimark's consumers' economic perception index shows that a large share of respondents still believes that inflation will rise "a lot" in the next twelve months, despite a marginal decline. Also, in the monthly index of entrepreneur's confidence (índice mensual de confianza empresarial), IMCE, expected inflation twelve months ahead went from an average of 3% in the first half of 2007 to somewhere around 4% in July and just over 5% in the latest round (figure V.9).

Margins and cost pressures

Wholesale and producer prices

The producer price index (PPI) increased 6.5% annually in December, after slowing steadily from mid-2006 to July 2007, when it grew 3% per year (figure V.10). In monthly terms, the PPI components with the greatest role in the rise of recent months are methanol, energy distribution, some fruits and vegetables, and (lately) fuel. Milk, which was one of the products contributing the most to the increase in the PPI and CPI until September, shows negative monthly contributions in the latest figures.

The wholesale price index (WPI) has recorded a sustained increase in its annual growth rate above the PPI rate, rising from 3.1% in August to 14% at the end of December.^{2/} Indirect margin measures derived from different aggregations of the CPI, WPI and PPI continued to decline. Retail margins have also narrowed with respect to their previous-year levels, according to FECU data for the third quarter of 2007.

Imported inflation

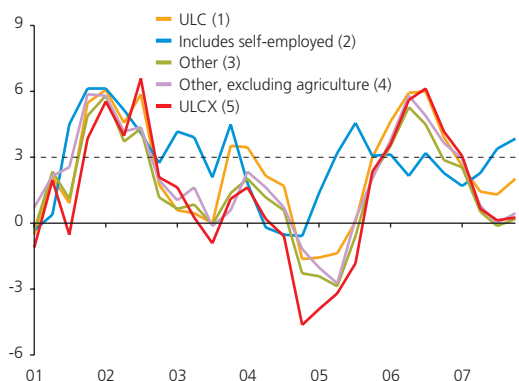
Imported inflationary pressures have seen significant developments in recent months. On one hand, the external food prices that pushed up inflation in 2007 have recorded mixed results. Dairy products benefited from good production seasons in the main suppliers around the world, causing price reductions that have partly been replicated domestically. Grain prices, in contrast, have continued to rise, particularly for corn and wheat. Oil and derivatives prices increased again, and prospects for the short and medium term point to a higher price than foreseen in September. On the other hand, the peso/dollar parity dropped by around 5% since September (considering the average of the ten working days prior to the statistical closing of each *Report*). The dollar depreciation in international markets and higher inflation around the world have resulted in a significant increase in external inflation relevant for Chile. Thus, the EPI and EPI-5 remained on the upward path they have been on since early 2006, to approach 10% annually in both cases. This trend contrasts with that of consumer IVUM, which maintains an annualized rate of variation below 2% as of the third quarter of 2007 (figure V.11).

^{2/} A new WPI is being published in December, with a change in the base year from June 1992 to November 2007 and corresponding adjustments to the basket of goods and its weights. For further detail, see the INE's special offprint, available at www.ine.cl.

Figure V.14

Unit labor cost

(annual change, percent)



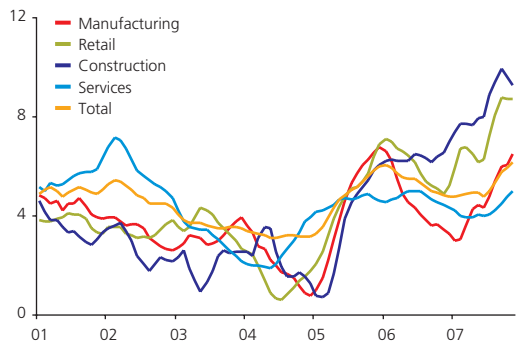
- (1) Total nominal labor cost, hours of actual salaried work, salaried employment and total GDP.
- (2) Analogous to Total, replaces salaried employment with national employment.
- (3) Includes other LC, other salaried employment, other GDP (excluding EGW, mining and fishing) and actual hours of salaried work.
- (4) Analogous to Other LC, excluding the agricultural sector from other salaried employment and other GDP.
- (5) For definition, see Glossary.

Sources: Central Bank of Chile and National Statistics Bureau.

Figure V.15

Nominal wages by sector

(annual change, moving quarterly average, percent)



Source: National Statistics Bureau.

Wages and unit labor costs

After dissimilar performances in 2006 and early 2007, the various measures of nominal wages posted substantial increases in their annual growth rates in July, and they continued to rise in the following months, albeit at a more moderate pace. The annual increase in labor costs (LC) was 6.3% in November, after ending the second quarter with a variation of 4.7%, while the hourly wage index (HWI) rose by 8.5% annually in November, compared with a 6.7% increase in June. Figures from the Chilean association of occupational safety (*Asociación Chilena de Seguridad, AChS*) differ, with steadily increasing growth rates between June and September and thereafter with annual rates just above 7% (figure V.12).

Wage increases so far are estimated to be consistent with usual indexation clauses and with the evolution of the labor market in recent years (box V.1). However, slow growth in real terms indicates that nominal wages could increase their current growth rates in the coming months (figure V.13). Furthermore, although annual growth rates of unit labor costs (ULC) are still in line with the inflation target, there is a risk that high inflation could cause larger-than-expected wage increases, which could detach ULC increases from the target. Additionally, price shocks could pass through to wages even less than they have in the past, given their transitory nature (figure V.14).

Across sectors, nominal wage increases are widespread, although some sources highlight the significant increase in wages in the construction sector, which is consistent with information from various firms in the sector indicating a shortage of available labor (figure V.15). The price-level correction negotiated between the government and public employees (6.9%) is in line with the increase considered in the baseline projection of September. Also, it does not exert significant additional pressure on costs, given the present context of inflation and wage increases in the private sector.

Box V.1: Wages and indexation

In Chile, most employment contracts include automatic indexation clauses to past CPI variation. In 2006, according to the Labor Department's fifth labor survey, 79.7% of surveyed firms corrected wages by a magnitude equal to or greater than the CPI change. This causes inflation fluctuations to be largely transmitted to wages, thus contributing to the spread of specific CPI shocks to other prices in the basket through the cost mechanism, adding to their persistence.

An important factor to monitor, for the purposes of implementing monetary policy, is whether the observed wage dynamics respond to the usual indexation clauses set forth in contracts. In practice, in the present conjuncture it is particularly important to assess whether wages are increasing beyond legal indexation. This box presents a methodology for such follow-up.

Assuming that in Chile a proportion α_1 of workers have their wages revised automatically by past inflation each quarter (four times a year), while a fraction α_2 do so every two quarters, a fraction α_3 every three quarters and a fraction α_4 once a year, wage dynamics can be characterized as follows:

$$\begin{aligned}
 w_t - w_{t-12} = & \frac{\alpha_1}{3} \sum_{i=0}^{11} (p_{t-i} - p_{t-i-3}) + \frac{\alpha_2}{6} \sum_{i=0}^{11} (p_{t-i} - p_{t-i-6}) \\
 & + \frac{\alpha_3}{9} \sum_{i=0}^{11} (p_{t-i} - p_{t-i-9}) + \frac{\alpha_4}{12} \sum_{i=0}^{11} (p_{t-i} - p_{t-i-12}) \\
 & + \beta(q_t - q_{t-12}) + \varepsilon_t
 \end{aligned} \quad (1)$$

where w_t is the log of measured wages in month t , p_t is log CPI, q_t denotes other wage adjustment factors such as productivity and labor market slack, and ε_t is a stochastic error not correlated with wages.^{3/} Instead of proceeding to the econometric estimation of the parameters in (1), which runs into some difficulties related to the high correlation between regressors (multicollinearity), the specification parameters are calibrated such that 70% of contracts index wages to six-month CPI inflation, while the remaining 30% index wages to nine-month inflation.^{4/} Therefore, (1) can be written as follows:

$$\begin{aligned}
 w_t - w_{t-12} = & \frac{0}{3} \sum_{i=0}^{11} (p_{t-i} - p_{t-i-3}) + \frac{0.7}{6} \sum_{i=0}^{11} (p_{t-i} - p_{t-i-6}) \\
 & + \frac{0.3}{9} \sum_{i=0}^{11} (p_{t-i} - p_{t-i-9}) + \frac{0}{12} \sum_{i=0}^{11} (p_{t-i} - p_{t-i-12}) \\
 & + \beta(q_t - q_{t-12}) + \varepsilon_t
 \end{aligned}$$

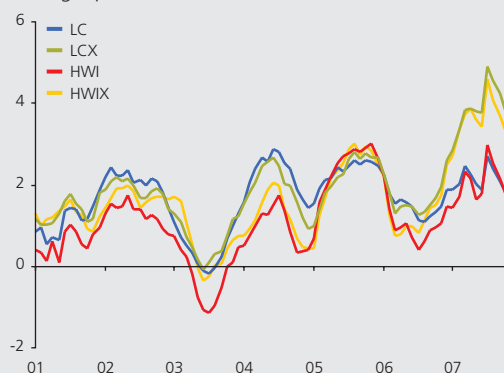
So:

$$\begin{aligned}
 (w_t - w_{t-12}) - \left[\frac{0.7}{6} \sum_{i=0}^{11} (p_{t-i} - p_{t-i-6}) + \frac{0.3}{9} \sum_{i=0}^{11} (p_{t-i} - p_{t-i-9}) \right] \\
 = \beta(q_t - q_{t-12}) + \varepsilon_t
 \end{aligned} \quad (2)$$

The consistency check from (2) consists in evaluating the path of the left-hand side of the equation, taking into account possible fluctuations in productivity and labor market conditions.

Figure V.16

Increase in wages and inflation correction (*)
(annual change, percent)



(*) Corresponds to left-hand side of (2), and can be the measure for salaries, alternatively: LC, LCX, HWI, or HWIX.

Source: Central Bank of Chile.

The proposed measure has fluctuated most of the time within the 0–2% range (figure V.16). In 2007, wages measured through labor costs (LC) do not appear to be increasing beyond usual indexation. The mild increase observed may be associated with a tight labor market. The hourly wage index (HWI) has increased more within this indexation structure, which can be attributed to unusual discrepancies between these measures.

^{3/} These residuals have an MA(12) autocorrelation structure.

^{4/} This calibration is based on the average adjustment reported by the Labor Department and casuistic evidence.

^{5/} *Monetary Policy Report* May 2007, box V.3.

VI. Inflation scenarios

This section presents the Board's assessment on the prospects of the Chilean economy for the next two years, including analysis and decisions in the monetary policy meeting of 10 January 2008. It shows projections for the most likely paths for inflation and growth, pointing out the relevant risks. These projections are prepared using the methodological assumption that, in coming quarters, the monetary policy rate (MPR), will move along a path similar to the one that can be inferred from the prices of financial assets over the last two weeks. This is a working assumption that does not imply commitment of future monetary policy, which will adjust depending on the evolution of the macroeconomic scenario and inflation projections. Projections are also conditions to a set of events that make up the baseline scenario, so the Board's assessment on the balance of risks for output and inflation is also shown.

External scenario

In 2008, growth of the world economy and of trade partners will be, consistently with the median of market projections, less than it was between 2004 and 2007, although still above the average for the 2000s so far. This considers that the effects of the subprime crisis will result in a significant deceleration, albeit transitory. Other developed economies, such as Japan or the euro area, will also be less dynamic. In the baseline scenario, the larger part of emerging economies will not be affected; in particular, China and India will continue to post annual growth rates of around 10%.

Commodity prices will remain high, but will gradually normalize during 2008 and 2009. The copper price is projected to average US\$2.95 per pound this year, and 2.50 per pound in 2009. The WTI oil price, based on futures data, should average US\$93 in 2008 y and US\$88 in 2009, both figures exceeding September forecasts. Also, food prices will also follow a downward trend over the next two years, so the baseline scenario does not foresee that they could become an additional source of pressure on domestic prices. Thus, the terms of trade (TOT) will begin normalizing this year, with a decline of the order of 11%. From a historic perspective, terms of trade level will remain high.

In the midst of these financial turbulences in developed markets, financial conditions relevant to emerging economies will be somewhat less favorable than in the past, but will not result in a material deterioration of sovereign premiums. Thus, projections in this *Report* assume that the impulse deriving from the external scenario relevant to the Chilean economy will be milder than in recent years.

Risks within this scenario, however, have increased substantially. In particular, because the range of possible alternative scenarios is wide and has a negative bias. The main causes for concern are the extent of the possible effects of financial turbulences in the real sector of developed economies, and, even worse, in the world at large. In case a scenario of strong deceleration of the world economy and significant decrease in commodity prices comes up, the impact on emerging economies, including Chile, will be harder.

Aggregate demand

The baseline scenario foresees a slowdown of domestic demand in 2008 with respect to the last few years, but will continue to outpace output growth. This projection considers that, in particular, consumption will post lower growth rates than in 2007, affected by the somewhat lagged impact of households' disposable income, the deterioration of the external scenario and slowdown in credit and employment. Also, the normal unfolding of the consumer credit cycle, considering the degree of market penetration it has attained in the population, will hardly continue to push consumption before a weakened income level. This projection, however, is subject to high uncertainty, both because consumption could prove more persistent than anticipated, as it has been in recent years, and because it might fall deeper than foreseen as a reaction to the aforesaid developments.

Investment will also grow less than last year, although it is projected to approach 27% of GDP in 2008, almost a full percentage point more than in 2007. This projection is grounded on the large amount committed for mining and energy projects this year, and on the sustained increase in corporate profits. Corporate loans continue to grow strongly and interest rates available to them show no significant increases. The baseline scenario for this *Report* considers that in 2008 government spending will continue to be based on the structural surplus rule of 0.5% of GDP. By and large, according to the budget approved in Congress, government spending will increase this year at a real annual rate of 8.9%, and will close with a global balance of around 5% of GDP.

As for net external demand, the baseline scenario forecasts total volume exports growing around 5% per annum in 2008, driven by manufacturing and agricultural shipments that will show a slight increase above the overall figure. In turn, volume imports of goods should increase around 8.5% per annum, with capital goods purchases still growing strongly and consumer goods moderating in line with the scenario for total consumption. All considered, exports are expected to amount to somewhat more than US\$68 billion in the year, not very different from the 2007 figure. The drop in the copper price is the main explanation for the lower increase in export value. Imported goods, in turn, will amount to nearly US\$52 billion, the rise in value being partly explained by the higher price of oil and derivatives.

The current account of the balance of payments is estimated to have ended 2007 with a surplus of 3.8% of GDP. In the baseline scenario, this balance is reduced to somewhere around -0.5% of GDP. Underlying this reduction are the deterioration of the terms of trade—mainly because the oil price has shown a slower reversal than has the copper price—and still strong imports.

If measured at trend prices, the current account is projected to post a deficit in 2007 and 2008 of around 3% to 4% of GDP^{1/}.

Output and gaps

The Board's assessment of trend economic growth has not changed since last September. The baseline scenario is constructed using the assumption that this figure will stand around 5% in the period 2007-2009. In addition, this assumption is consistent with the estimation conducted by the Experts Committee summoned by the Finance Ministry for the revision of parameters of the 2008 budget. The baseline scenario assumes that the level of actual GDP will be very close to trend during most of the relevant horizon. As usual, there is the risk of actual or trend growth differing from projections.

In the labor market, annual growth in employment has slowed down, while the labor force has increased, driving up the seasonally adjusted rate of unemployment. This latter variable is currently within the range of estimates believed to be consistent with price-level stability.

The baseline scenario assumes that during 2008 there will be no significant changes in shipments of natural gas from Argentina or in hydrologic conditions with respect to 2007. Risks in this area are particularly important because of the potential effects on output and inflation of a scenario of even higher electric rates and/or reduced energy availability. Further increases in these costs may have important implications in manufacturing activity and in other economic sectors.

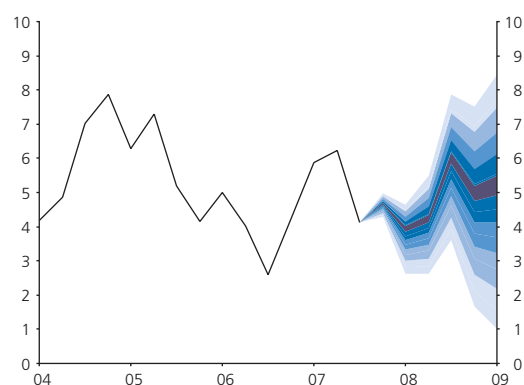
Considering all the above, the baseline projection in this *Report* forecasts GDP growth in the range of 4.5%-5.5% for the year, with a downward biased risk balance. The smaller range for growth foreseen for this year—compared to September projections—together with its risks balance, largely reflects the effect of a less favorable external scenario on Chile's prospects for growth.

Cost pressures

Projections also assume that imported costs will not be a significant source of additional inflationary pressures during the next two years. Uncertainty around this assumption is increased by doubts on the evolution of the external scenario relevant to the Chilean economy. It cannot be ruled out that, if the deceleration of the world economy exceeds forecasts international commodity prices, especially for food, copper and oil, may drop substantially, aside from causing a reduction in demand for Chilean exports. The counterpart of this scenario is an increase in the exchange rate and a possible negative incidence on economic growth, whose net effect on inflation is difficult to estimate and that will also depend on the true size of existing gaps. Anyway, it can neither be ruled out that the prices of food and especially of oil remain high or even post further increases, as has recently been the rule. In addition, estimates suggest that the current level of the real exchange rate—considering the average of the two weeks prior to the closing date for statistics in this *Report*—is marginally below the range of

Figure 1

Quarterly GDP growth scenario (*)
(annual change, percent)



(*) The figure shows confidence intervals for the baseline projection for the respective horizon (colored area). Confidence intervals of 10%, 20%, 50%, 70% and 90% are ranged around the baseline scenario. These intervals summarize the Board's risk assessment for economic growth. The baseline scenario is constructed using the methodological assumption that the MPR will, over coming quarters, follow a path similar to the path that can be inferred from financial asset prices prevailing in the two weeks prior to the closing date for statistics in this Report.

Source: Central Bank of Chile.

^{1/} This calculation considers long-term prices of US\$1.37/lb for copper, and US\$60/barrel for oil.

values believed to be consistent with its long-term fundamentals. Therefore, the baseline scenario uses as a working assumption a slight tendency to real depreciation, with a very limited effect on projected inflation.

The baseline projection also considers that the present level of inflation will not spread into other prices beyond the usual inflationary inertia. It also assumes that, in the next few quarters, nominal salaries will grow at annual rates above current ones and that said rates will decline in the medium term, responding primarily to indexation, usual lags and an expected increase in productivity. However, it cannot be ruled out that propagation may not behave as anticipated. For example, a scenario may be configured where high inflation translates into greater than expected growth in salaries, leading to an increase in unit labor costs incompatible with target inflation. It may also happen that propagation ends up being even smaller than historic figures, considering the transitory nature of shocks.

The baseline scenario assumes that, as shown by figures of recent months, prices of perishable food—fresh fruit and vegetables—will continue to normalize, to return during the second half of this year to levels closer to historic averages. It also considers that public transportation fares in Santiago will move along the path similar to the one resulting from applying a similar formula to that used in the previous transportation system, although not recovering the increases that were not implemented in 2007. This assumption is subject to high uncertainty, especially because of changes being made to the transport network. It should be noted that if fares recover the increases not applied, this would cause a once-and-for-all effect on the price level, not an acceleration of medium-term inflation. The baseline scenario considers also that the increase in the knot price of electricity decreed last November will become effective during the first quarter of 2008, and that this rate will remain fairly unchanged for the rest of the year.

Inflation scenario

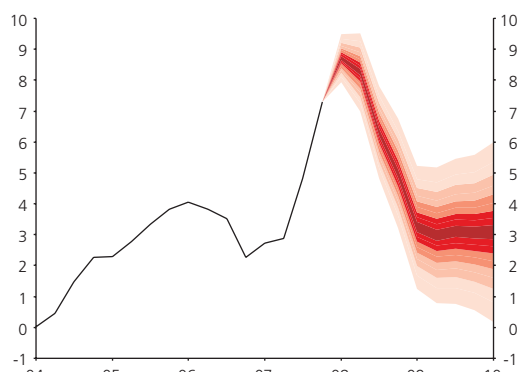
The baseline scenario considers that annual CPI inflation will continue along an upward path over the course of the first quarter of this year, and will remain for all of 2008 above the tolerance range, partly reflecting the recent oil price increase and the lagged correction in electric rates, but also responding to significant increases in indexed prices. Considering that the period from June to December 2007 showed the highest concentration of high monthly CPI changes—accumulating an inflation of 5.8%—, annual CPI inflation can be expected to begin converging to target from mid-2008 onwards, to enter the tolerance range by early 2009, and hovering around 3% until the end of the projection horizon, that is, between the last quarter of next year and the first quarter of 2010. Overall, all possible alternative events considered, the balance of risks for inflation is unbiased.

Annual CPIX1 inflation will remain below headline inflation in the next few months, but its convergence to 3% will be slower than that of CPI. This, because inflationary inertia is greater in prices included in the CPIX1 than in those that are not, such as fresh fruit and vegetables. Thus, annual CPIX1 inflation is forecast to reach 3% only toward the end of the relevant projection horizon.

As aforesaid, the projected path for inflation is grounded on medium- and long-term inflation expectations in line with the target, on a level of actual

Figure 2

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



(*) The figure shows confidence intervals for the baseline projection for the respective horizon (colored area). Confidence intervals of 10%, 20%, 50%, 70% and 90% are ranged around the baseline scenario. These intervals summarize the Board's risk assessment for future inflation. The baseline scenario is constructed using the methodological assumption that the MPR will, over coming quarters, follow a path similar to the path that can be inferred from financial asset prices prevailing in the two weeks prior to the closing date for statistics in this Report.

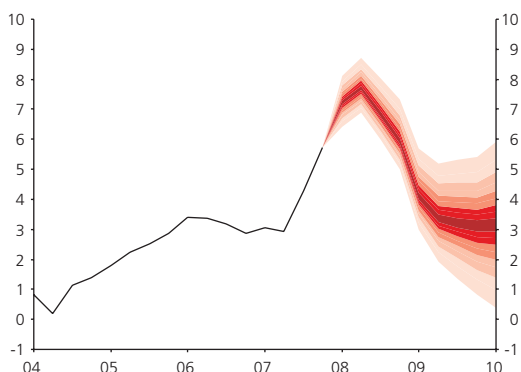
Source: Central Bank of Chile.

GDP very close to its trend during a large part of the projection horizon, on labor costs growing consistently with target inflation, and on a real exchange rate with a slight tendency to depreciation, with very limited effects on projected inflation.

These projections are also based on the methodological assumption that, in coming quarters, the MPR will move along a similar path to the one that can be inferred from the prices of financial assets over the last two weeks prior to the closing date for statistics included in this Report. The Board considers it opportune to state that, while the future path of the MPR will depend on incoming information and its implications on projected inflation, further adjustments may be necessary in order to ensure convergence of inflation to the target. Particularly important to this end will be the unfolding of the international scenario, the evolution of output gaps and the possible propagation of recent inflationary shocks to other prices.

Figure 3

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



(*) The figure shows confidence intervals for the baseline projection for the respective horizon (colored area). Confidence intervals of 10%, 20%, 50%, 70% and 90% are ranged around the baseline scenario. These intervals summarize the Board's risk assessment for future inflation. The baseline scenario is constructed using the methodological assumption that the MPR will, over coming quarters, follow a path similar to the path that can be inferred from financial asset prices prevailing in the two weeks prior to the closing date for statistics in this Report.

Source: Central Bank of Chile.

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Glossary

Carry trade: Operation whereby investors borrow in low-interest-rate countries to invest those resources in more profitable economies, creating pressures for a currency depreciation in the first and for depreciation in the second.

Commodity exporting economies: Australia, Canada and New Zealand.

CPIX: Core consumer price index. Equal to the CPI less fuel and fresh fruit and vegetables, leaving 92% of the total CPI basket.

CPIX1: CPIX less fresh fish and meat, regulated utilities, indexed prices and financial services, leaving 70% of the total CPI basket.

Emerging Asia: China, Hong Kong, India, Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan and Thailand.

EPI: External price index of prices relevant to Chile, calculated using WPI (or CPI, depending on availability) in U.S. dollars at countries included in measured MER and their share in trade with Chile, excluding crude oil and copper.

EPI-5: EPI using prices from Canada, the euro area, Japan, the UK and the U.S.

Expansion velocity: For monthly data, the annualized monthly change in the moving quarterly average of the seasonally adjusted series. For quarterly data, the annualized quarterly change is the seasonally adjusted series.

Flight to quality: A phenomenon describing that, in the face of an increase in perceived risk, investors shift to safer securities, such as government bonds from developed economies.

GCPIX: Goods price index excluding fresh fruit and vegetables, leaving 51.2% of the total CPI basket.

HWI: Hourly wage index.

HWIX: HWI less community, social and personal services, EGW and mining.

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

LCX: Labor cost less community, social and personal services, EGW and mining.

MER: Multilateral exchange rate, representing a measure of the nominal value of the peso with respect to a wide currency basket, with the same weights as the RER. For 2007: Argentina, Belgium, Brazil, Canada, China, Colombia, Ecuador, France, Germany, Italy, Japan, Mexico, the Netherlands, Peru, South Korea, Spain, Sweden, Taiwan, the UK, the U.S. and Venezuela.

MER-5: MER considering the currencies of Canada, the euro area, Japan, the UK and the U.S.

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

Natural Resource GDP: Electricity, gas & water, mining and fishing.

Oceania: Australia and New Zealand.

Oil exporting economies: Saudi Arabia, United Arab Emirates, Kuwait, Norway, Russia and Venezuela.

Other GDP: Corresponds to agriculture/forestry, manufacturing, construction, retail, transportation and communications, financial and entrepreneurial services, housing ownership, personal services and public administration sectors.

RER: Real exchange rate, representing a measure for the real value of the peso against a currency basket. It is built using MER countries' currencies.

RER-5: RER using the MER-5 currency basket.

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

SCPIX: Services price index excluding utility rates and subway and bus fares, leaving 35.5% of the total CPI basket.

Sectors, investment: Includes manufacturing sectors producing goods linked to gross fixed capital formation.

Sectors, non-tradable: Includes manufacturing sectors that, because of their productive or consumption characteristics are not involved in foreign trade.

Sectors, supply: Includes producers of wood pulp, fishmeal and methanol.

Sectors, tradable: Includes all manufacturing sectors producing goods traded internationally.

Swap rate: The fixed interest rate exchanged for the average observed interbank rate on specified capital amount and period to maturity.

TMA: Trimmed CPI mean that excludes items with greatest and smallest monthly variations.

TMVC: Trim of most volatile components. Trimmed CPI mean excluding most volatile items.

Trading partners' growth: Growth of Chile's main trading partners, weighted by their share in total exports. Countries considered are the destination of 94% of total exports.

ULCX: Unit labor cost including only salaried employment, and wages and output less natural resource related sectors.

World growth at market exchange rate: Growth measured using the market exchange rate. Each country is weighted according to its dollar GDP published by the IMF in World Economic Outlook.

World growth: Regional growth weighted by share of world GDP at PPP, published by the IMF in World Economic Outlook (WEO, April 2007). World growth projections for 2007-2009 were calculated using a sample of countries representing around 87% of world GDP, and assuming 6.0% growth for the remaining 13%.

Abbreviations

BCP: Central Bank bonds in pesos

BCU: Central Bank bonds in UFs

BTP: Treasury bonds in pesos

CCNN: National Accounts

CdeR: Benchmark compilation

MPR: Monetary policy interest rate

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