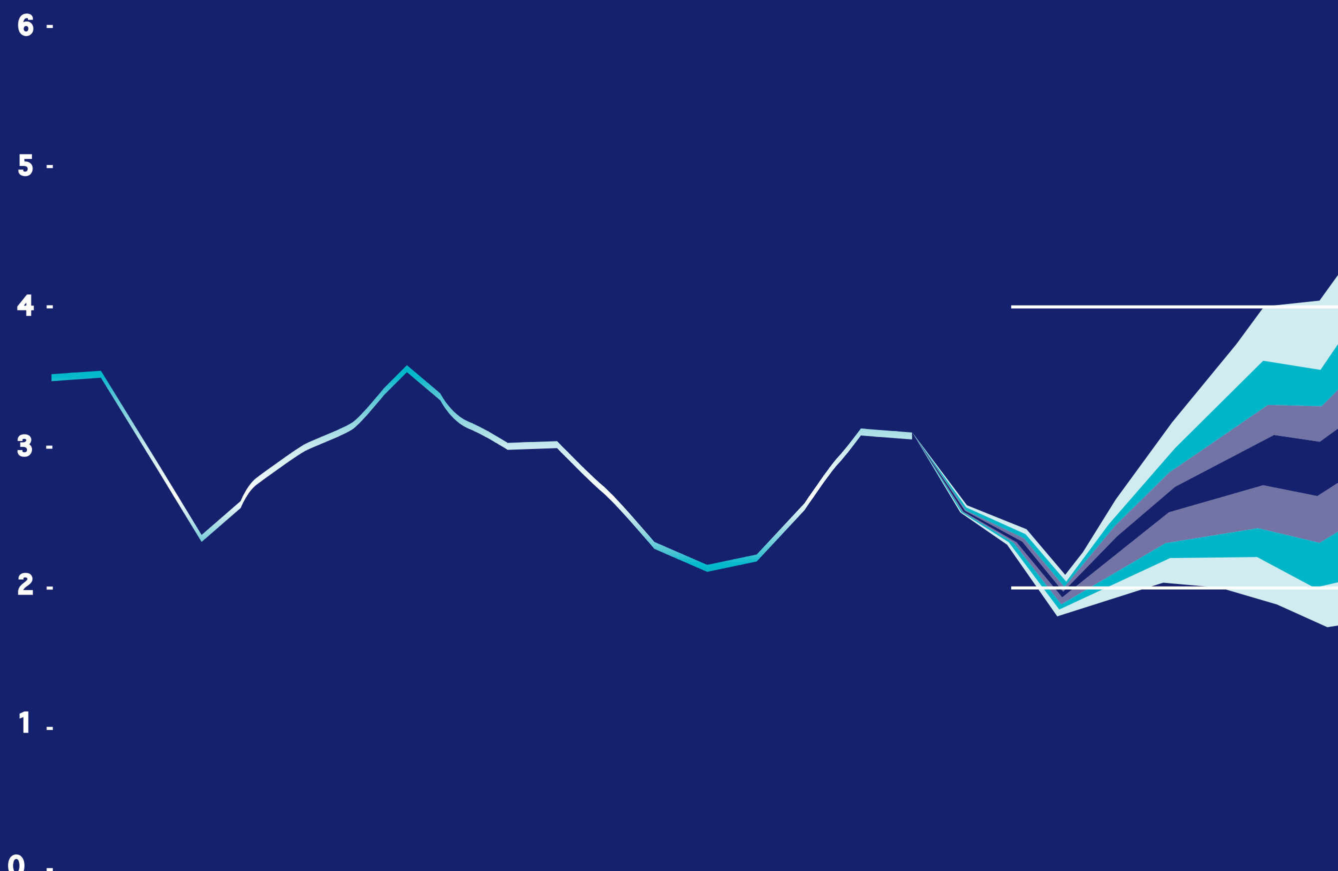
Monetary Policy Report

SEPTEMBER 2007



BANCO CENTRAL
DE CHILE

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

Contents*/

*/ The closing date for figures included in this *Monetary Policy Report* was 27 August 2007, except for Chapter IV, for which the closing date was 29 August 2007.

Preface

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

The main objectives of this *Monetary Policy Report* are: (i) to report and explain to the Senate, the government and the general public the Central Bank of Chile's Board's views on recent and expected inflation and their consequences for the treatment of monetary policy; ii) to publicly disclose the medium-term analytical framework used by the Board of the Central Bank to formulate monetary policy; and (iii) to provide information that can help guide economic agents' expectations regarding future inflation and output trends. This *Report* meets the requirement under 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, and focuses on the main factors that influence inflation. These include 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 provides several boxes that offer more detailed information on issues relevant to evaluating inflation and monetary policy.

The Board approved this *Report* at its meeting on 31 August 2007 for presentation to the Senate's finance commission on 5 September 2007.

The Board

Summary

Since last May, annual CPI, CPIX, and CPIX1 inflation has risen considerably, to near 4%, due mainly to unusually high and simultaneous increases in several specific prices. The baseline scenario assumes that headline inflation will ascend to around 5.5% year on year—partly because of rises already occurred in the CPI—, to then decline toward 3% over the course of 2008. This path mostly reflects the behavior of food prices, given rises in their foreign similes and harsh weather conditions, plus increases in electric power rates. These shocks do not necessarily represent inflationary pressures associated to the business cycle in Chile. At the same time, this year to date has seen strong GDP growth, above projections, stimulated by domestic macroeconomic policies and the international scenario. The level of output is estimated to be now and in coming quarters around its trend. In recent weeks, however, significant adjustments have taken place in asset prices, together with high volatility in international financial markets, deteriorating financial conditions for some emerging economies and threatening world growth, although at the closing of this *Report* no major changes are apparent in the external scenario relevant for the Chilean economy.

The monetary policy has accommodated to changes in the macroeconomic scenario, to ensure that the increase in inflation is transitory and that, given a faster closing of gaps, it approaches 3% within the policy horizon. Thus, the Board went from communicating prospects of a prolonged maintenance of the monetary policy rate (MPR) in May's *Report*, to communicating in June that future rises were likely, to effectively apply increases of 25 basis points in July and August. Market expectations adjusted to the changed scenario. In the last days previous to the statistical closing of this *Report*, the market was foreseeing additional rises in the MPR that amounted to a combined 50 basis points until year's end. These prospects, in any case, were higher and declined as the behavior of international financial markets raised doubts about the solvency of the external scenario and its implications for the Chilean economy.

The baseline scenario in this *Report* considers that a part of the shocks that have affected inflation will not deepen during 2008, that other part will largely revert in coming months and that the output gap will remain closed over the next few quarters. Also, in what remains of 2007, monthly CPI inflation will be less than it was from April to August. Annual CPI inflation, however, due to some extent to recent figures, will continue rising in coming months, to then decline toward 3% over the course of 2008 and remain there until the end of the projection horizon. Economic activity, confirming what

had been stated as an upward risk in May, will grow between 5¾ and 6¼% in 2007, while in 2008 it will do so in the 5.0%-6.0% range. The Board believes that, in this conjuncture, the balance of risks for growth is biased downward, and unbiased for inflation.[1]/

A large part of the change in the inflation scenario derives from the evolution of the prices of some foods. On one hand, dynamism of the world economy sustained for several years— especially high growth in China and India—has driven commodity prices much higher than expected. This episode that in the beginning was visible mainly in products like copper, wood pulp and oil, has quickly and strongly spread to foods, aggravated by worsened supply conditions this year and the use of some goods as inputs in the production of other products, such as biofuels. Thus, already in the first quarter of this year there was a substantial increase in the prices of corn and wheat by-products, and signs of increases in others, such as milk. In this context, May's *Report* considered as a risk that prices in the aforesaid foods could increase more than projected. However, that these increases would be as simultaneous and as large was beyond any forecast based on historical information.

On the other hand, beginning in June, but with increased strength in July, there was a large rise in the domestic prices of perishables, because of harsh weather conditions that the agricultural sector had to endure this winter. This increase, unusually high for this time of the year, hit hardest on a wide variety of products, especially fresh vegetables. To make things worse, scarce hydric resources and natural gas restrictions have also had an effect on electric rates.

Largely because of the price hikes already materialized, here the short-term annualized inflation forecast is raised substantially over projections in May's *Report* and is forecast to deviate, significantly but temporarily, from the tolerance range of 3% plus/minus one percentage point per annum. In any case, this type of deviation has been seen in the past when facing shocks of magnitude similar to the present one. For example, in early 2004, CPI inflation dropped to around -1% annually, with a temporary deviation of almost four percentage points from the inflation target.

Discounting some specific goods, other prices show no significant increase. The inflation measure that excludes prices of energy and all food products —keeping 68% of the full CPI basket— records annual increments of less than 2% at July that are even smaller than in the fourth quarter of 2006. The CPIX1 measure that excludes the prices of foods —keeping 74% of the CPIX1 basket and 52% of the CPI basket— shows annual inflation close to 2% for several months, not too different from the average annual variation of 2006. Trend inflation measures, which in principle reflect more clearly inflation's medium-term prospects, have increased slightly in recent data and are somewhat above 3% annually. Still, it should be noted that a lag exists between the closing of gaps and its effect on inflation, so the fact that other prices in the CPI are increasing at low rates today is not, by itself, an indication of its future dynamics.

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[1]/ In this context, risk means a possible positive or negative occurrence driving the economy significantly away from conditions considered in the baseline scenario.

The medium-term inflation scenario has also brought some news, since the strong GDP growth of the second quarter resulted in output gaps closing faster than foreseen in May. In said quarter, output grew by 6.1% annually, with sectors not related with natural resources growing by 6.5%, and natural resources (i.e., mining, fishing and electricity, gas, and water, EGW) — growing by 1.8% annually, affected by the drop in EGW's value added. Narrow output gaps are also visible in indicators such as seasonally-adjusted unemployment, which is below several estimates of its rate consistent with price stability.

Higher growth for 2007 relies on sustained increases in private consumption and an acceleration of fixed capital investment in the second quarter. Beyond short-term fluctuations due partly to a calendar effect, projections for the rest of the year are that output will continue to grow at a rate not different from that of the first half of this year. For 2008, the baseline scenario considers that output will grow at an average interannual rate somewhat smaller than this year's, but still more than trend GDP, which is expected to grow around 5% annually. These projections are based on the impulse of macroeconomic policies. On one hand, the MPR is currently in the lower end of a range of estimates of its neutral value, so the Board believes that monetary policy continues to provide momentum to the economy. On the other hand, the change in the structural surplus target from 1.0 to 0.5% of GDP, combined with the revision of its parameters, higher costs and the trend of copper production in Codelco and molybdenum prices, will imply a fiscal impulse for 2008 similar to the one implicit in the budget for 2007. It should be noted that, beyond recent changes, the fiscal policy continues to contribute to the country's stability, since it continues to operate within a reference framework where transitory fiscal earnings are saved.

The scenario for economic activity also benefits from domestic demand's continuing growth, based on the low level of unemployment and increased access to the financial system, reflected in high credit growth, still relatively low and stable market interest rates and less restrictive access to credit for SMEs, as shown by the Central Bank's Survey on Banking Credits.

Projections in the baseline scenario consider also that growth in 2008 will draw on a still positive external impulse, even despite recent swings in international financial markets. An episode of tighter credit conditions and an adjustment in risk premiums like the one observed in recent weeks was part of the May *Report's* risk scenario, in principle associated to fears of a weakened sub-prime sector in the US. This risk has not only become true, but has also spread to other segments of the world financial market, creating volatility and, as aforesaid, deteriorating financial conditions in some economies, either developed or emerging. Lately, actions from central banks in developed economies, which have been supplying the necessary liquidity for the normal functioning of the markets, have brought some tranquility. However, effects on the credit market are now thought to be more persistent.

For the time being, market consensus expects the world economy to grow by around 5% annually in 2008-2009. The baseline scenario projects that terms of trade (ToT) will begin gradual normalization in 2008, in line with a steadily declining copper price, from US$3.1 per pound this year, to US$2.7 in 2008 and to US$2.45 in 2009. At the same time, financial conditions relevant for emerging economies are expected not to deteriorate more than they have in recent weeks and remain fairly positive. In this conjuncture, however, downward risks and the variety of possible international scenarios have increased, considering the potential consequences of the recent event of lack of liquidity and upward corrections in the prices of a wide spectrum of more risky assets.

Baseline scenario assumptions

	2005	2006	2007 (f)	2008 (f)	2009 (f)
	(annual change, percent)				
Terms of trade (ToT)	11.3	22.5	2.8	-7.9	-4.6
Trading partners' GDP (*)	3.9	4.5	4.2	4.2	3.9
World GDP at PPP (*)	4.9	5.4	5.1	5.1	4.9
World GDP at market exchange rate (*)	3.3	3.9	3.6	3.6	3.4
External prices (US$)	7.5	5.3	6.9	3.0	2.3
	(levels)				
LME copper price (US¢/lb)	167	305	310	270	245
WTI oil price (US$/barrel)	56	66	67	70	69
Gasoline parity price (US$/m^3) (*)	451	526	567	561	548
Libor US$ (nominal, 90 days)	3.6	5.2	5.3	4.8	4.9

(*) For definition, see Glossary.
(f) Projection.

Source: Central Bank of Chile.

The final effects of this episode on world growth prospects cannot be foreseen yet. At the statistical closing of this *Report*, consensus projections were not fully capturing recent adjustments in foreign markets, nor were they showing any changes aside from minor variations in growth forecasts for the US. Financial markets have reacted with a big change in monetary policy perspectives in developed economies and the US Federal Reserve even put a negative bias on the US economy's growth rate.

The risks of the external scenario offer an array of options with varied implications. There are intermediate scenarios where market adjustment and volatility persist without deepening, with consequences such as a more notorious weakening of the US economy that ultimately affects other economic areas and thus debilitating world growth. This could aggravate the worsening of financial conditions for emerging economies and increase the possibility of an acceleration of commodity price corrections and, therefore, a faster normalization of the ToT. There can be even more negative risk scenarios, whose implications are more difficult to foresee. In the extreme, it is possible that credit and liquidity constraints that have been observed, and that have driven central banks in developed economies to intervene, become more pronounced and hurt the solvency of major entities.

It should be noted that, within the current macroeconomic policy framework, the Chilean economy has been able to smooth the effects of the recent bonanza without generating imbalances, creating the conditions to cushion the possible effects of an unfavorable external setting better than in the past. The former reflects on a large surplus in the current account and in the fiscal account without obvious misalignments in key relative prices; the latter, in that, despite the uncertainty of recent weeks, the effect on Chilean asset prices has been much smaller than in other emerging economies.

Based on the aforesaid elements, this *Report's* baseline scenario considers activity growing between 5¾% and 6¼% this year, and between 5.0% and

6.0% in 2008. Also, after examining alternative events, the Board estimates that the balance of risks for economic activity is biased downward.

Economic growth and current account

	2005	2006	2007 (f)	2008 (f)
	(annual change, percent)			
GDP	5.7	4.0	5¾ - 6¼	5.0 - 6.0
National income	9.2	5.1	5.3	6.6
Domestic demand	11.0	6.0	7.9	6.9
Gross fixed capital formation	21.9	4.0	12.1	5.7
Total consumption	7.5	6.6	7.4	7.1
Goods and services exports	3.5	4.2	9.9	6.6
Goods and services imports	17.7	9.4	14.3	9.7
Current account (% of GDP)	1.1	3.6	5.4	2.6
	(US$ million)			
Current account	1,315	5,256	8,900	4,500
Balance of trade	10,805	22,213	24,900	18,800
Exports	41,297	58,116	67,100	66,600
Imports	-30,492	-35,903	-42,200	-47,800
Services	-636	-922	-1,100	-1,200
Income	-10,645	-19,392	-18,300	-16,400
Current transfers	1,791	3,356	3,400	3,300

(f) Projection.

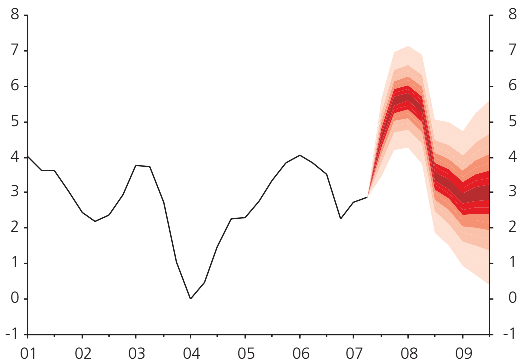
Source: Central Bank of Chile.

The evaluation of trend growth incorporated by the baseline scenario has not changed since May, which, combined with estimated economic growth results in the output gap remaining closed over the next few quarters, considering the implicit instant velocity of expansion. As usual, there is the risk that growth differs from projections or that the economy's trend growth and available gaps, both unobservable variables, deviate from estimates.

On the costs side, excluding the external prices of some foods, no significant changes are observed in imported inflationary pressures with respect to May's forecasts. The nominal exchange rate, with ups and downs, is in a similar level to the closing of May's *Report*, considering the average of the ten working days previous to the statistical closing in both cases. The real exchange rate (RER) shows no major movements either, and is estimated to be at a level consistent with its long-term fundamentals. The baseline scenario uses as a methodological assumption that, over the long run, the RER will not differ materially from the average of the two weeks previous to this *Report's* statistical closing. Such an assumption entails a high degree of uncertainty, especially in light of recent developments in international financial markets and their future path. On the other hand, the prices of oil and its by-products are above May's projections. Although this has significant incidence on the difference between actual and projected inflation to date, it does not weigh much on the recent increase in annual inflation. The baseline scenario assumes that the oil price will hover around US$70 per barrel in coming months, but other settings cannot be ruled out, especially if world growth falls short of projections.

The baseline scenario projects that domestic prices of non-perishable foods (i.e., corn, wheat, dairy products and their by-products) will continue showing mild increases in the very near future, to later grow at a similar pace to the average of remaining prices until the end of the projection horizon. Prices of perishables (i.e., fruits and fresh vegetables) will also increase immediately, but will revert largely before year's end. These assumptions

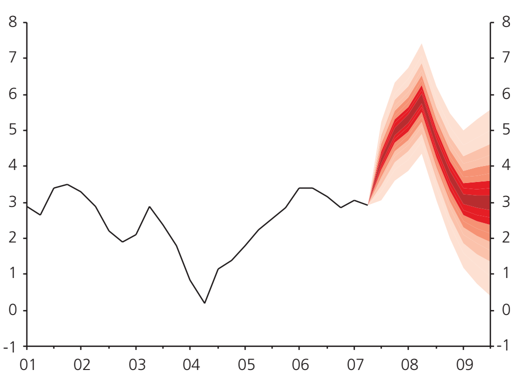
CPI inflation projection (*)
(annual change, percent)



(*) The figure shows the confidence interval for the baseline projection for the respective horizon (colored area). Confidence intervals of 10%, 30%, 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 in coming quarters, the MPR will reach a level similar to that deduced from financial asset prices in the two weeks prior to the closing date for statistics included in this *Report.*

Source: Central Bank of Chile.

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



(*) The figure shows the confidence interval for the baseline projection for the respective horizon (colored area). Confidence intervals of 10%, 30%, 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 in the coming quarters, the MPR will reach a level similar to that deduced from financial asset prices in the two weeks prior to the closing date for statistics included in this *Report.*

Source: Central Bank of Chile.

are subject to significant uncertainty, particularly relating to non-perishable foods. On one hand, given the experience of recent months, it is not possible to rule out that prices continue to rise more than expected. Nor can a sharp reversal within the projection horizon be ruled out either, leading to a big drop in inflation. Once again, this would take particular importance in a context of world growth decelerating more markedly.

The baseline scenario also contemplates that specific shocks that have affected inflation will not spread to other prices aside the normal inflationary inertia implicit in some of them, nor will they affect the formation of medium- and long-term expectations. Nominal salaries continue to grow at annual rates of 4% to 7%, depending on how they are measured, while labor costs are increasing consistently with target inflation. Inflation expectations derived from surveys to the financial sector or from financial asset prices show a sharp increase in very short horizons, but around the target in the medium to long run. The change in the baseline scenario between this and last *Report* is comparable with the adjustment of private sector inflation projections, reflecting widespread surprise from these shocks. As usual with substantial price movements, there is the risk that its propagation is larger, which could happen through higher labor costs, for example. Actually, surveys to consumers and entrepreneurs already show increased concern on expected inflation one year ahead. This is one risk where the Board will place special focus, because confidence in the inflation target is crucial in the determination of trend inflation. It is appropriate to reaffirm that, as it has done in the past, the Board will adopt whatever decisions it deems necessary to maintain its commitment with the inflation target.

No significant variations in the electric generation matrix are expected for the rest of 2007 and during 2008. Although electric generation with fuels instead of hydric and natural gas resources has effects that until now are more evident only in the EGW sector, it has significant incidence on electric power rates. The baseline scenario assumes that, in addition to July's 6% increase in rates, there will be new increments in the rest of 2007—all because of increased costs of electric generation—, with an impact on CPI inflation somewhat greater than half a percentage point. For 2008, the working assumption is that rates will rise again, in a magnitude comparable to the average increase of the period 2004-2005. This scenario is subject to high uncertainty, with results that will depend on the evolution of the energy matrix, fuel prices and increases deriving from the electric power rate, among many factors.

Inflation

	2005	2006	2007 (f)	2008 (f)	2009 (f)
			(percent)		
CPI inflation, average	3.0	3.4	3.9	4.4	
CPI inflation, December	3.7	2.6	5.5	3.1	
CPI inflation, around 2 years (*)					3.0
CPIX inflation, average	2.3	3.2	3.7	4.8	
CPIX inflation, December	2.9	2.7	5.2	3.7	
CPIX inflation, around 2 years (*)					3.0
CPIX1 inflation, average	1.9	2.5	3.9	4.5	
CPIX1 inflation, December	2.6	2.4	5.2	3.3	
CPIX1 inflation, around 2 years (*)					2.9

(*) Average inflation projected for the third quarter of 2009.
(f) Projection.

Source: Central Bank of Chile.

In summary, the baseline scenario foresees annual CPI inflation near 5.5% until mid 2008, then declining to 3% in the second half and remaining relatively constant until the end of the projection horizon, this time the third quarter of 2009. CPIX1 inflation will converge to 3% at a similar pace as headline CPI, while CPIX variation will do so somewhat more slowly. In addition, considering alternative events, the balance of risks for inflation is unbiased.

The Board estimates that, in the most likely scenario, new increases in the MPR will be necessary in coming months to ensure that projected inflation over the policy horizon remains at 3%. As usual, the evolution of the MPR will depend on incoming information and its implications on projected inflation. In particular, the Board will follow closely the evolution of international financial markets and its implications on growth and inflation. The Board considers also that a setting of large shocks in specific prices and scarce gaps as the present one requires special attention, both to the possible propagation to other prices and to medium- and long-term inflation expectations.

Monetary policy decisions in the past three months

Background: *Monetary Policy Report,* May 2007

Based on the information available, at its May meeting the Board concluded that keeping the MPR at 5% was the most appropriate option. The economy had recovered in late 2006 and early 2007 and was well on its way to absorbing idle capacity, backed up by the impulse from macroeconomic policies and favorable conditions abroad. This, combined with controlled costs and on-target inflation expectations, suggested that in the most likely scenario inflation would reach 3% at the end of the projection horizon. Information to date revealed that economic activity and inflation were somewhat higher than forecast last January, some of the risks identified at that time had indeed materialized, and some new ones had arisen. The former included a rise in international commodity prices, particularly copper and gasoline. The latter involved a rise in international food prices. The most likely scenario called for headline inflation to approach 2% during the second and third quarters of this year, partly due to the high basis for comparison given high oil prices in 2006, before falling to around 3% and remaining there until the end of the relevant projection horizon. At the same time, the economy was expected to grow somewhere from 5-6% annually and the balance of risks was biased upward. At the time, markets and analysts considered it highly likely that the monetary policy rate (MPR) would hold for several months, before rising slightly.

Meetings from June to August

At its June meeting, the Board concluded that its best option was to keep the MPR at 5% or raise it by 25 basis points. The outlook for inflation in the coming months had changed considerably and the likelihood of annual inflation remaining at 2% in the short term was fading. Medium- and long-term interest rates were rising significantly, apparently in response to referents abroad and domestic changes in economic activity and inflation, which were both higher than forecast in May. There was a risk of domestic demand speeding up, particularly in the case of private consumption. There was also some risk, however, of eventual restrictions on electric power supply, more cuts to the gas supply, or other shocks that could affect the economy. The relevant external scenario had changed significantly since May: it had become less likely that the US would fall into recession and that there would be a strong, unexpected rise in long-term interest rates in the main economies. The international price of several foods relevant to prices in Chile had continued to rise and the oil price looked likely to exceed previous forecasts. The market had reacted to changes in the macroeconomic scenario, pushing up the yield curve and expecting two or three increases of 25 basis points in what remained of the year, although not at this meeting. Based on this information, the Board decided the best course was to confirm trends in output, expenditure and inflation before changing the MPR, keeping it at 5.0%, but indicating that reports to date made a rise in MPR increasingly likely.

At its July meeting, the Board evaluated keeping the MPR at 5%, or increasing it by 25 or 50 basis points. It concluded that increasing it 25 basis points was less justified or could even be problematic. The surprise of the month was again high inflation, whose immediate causes were associated with foods and fuel. Long-term inflation expectations remained anchored at 3%, suggesting that the market essentially considered these shocks temporary. Economic activity continued to grow above trend, picking up idle capacity more quickly than forecast in May. External financial conditions had changed little since June, although commodity prices continued to rise, moving away from the May baseline scenario. The yield curve was on the rise again, suggesting a 25-basis-point increase in the MPR for that meeting and two or three additional increases up to the first quarter of 2008. The Board chose to increase the MPR by 25 basis points, to 5.25% annually, thus resuming the normal path for monetary policy, assuming that the MPR would remain under its neutral level, inflation would be higher in the short term, and that monetary stimulus should be reduced earlier than previously thought to keep inflation around 3% over the policy horizon. Likewise, the risk of second round effects dropped and inflation expectations remained anchored.

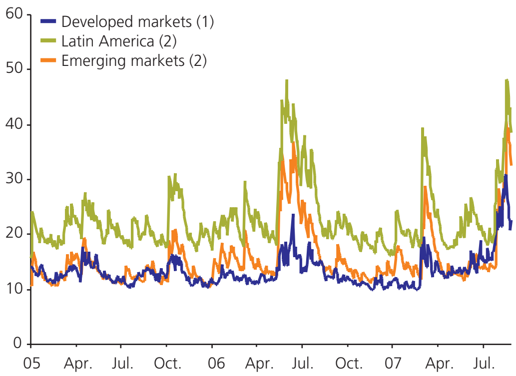
At the August meeting, inflation was well above May projections, given the larger increases in some non-perishable foods, combined with unusual and substantial rises in perishables. Data on economic activity confirmed higher than forecast and above trend growth in the second quarter. International markets were more volatile, risk premiums were up and credit conditions somewhat more restrictive. With this in mind, the Board again raised the MPR by 25 basis points, to 5.5%, and indicated that in the most likely scenario, it would be necessary to keep raising the MPR in the months to come.

I. International outlook

Figure I.1

Volatility in stock exchanges

(percent)



(1) The volatility implicit in options contracts for the S&P500 share index (US).

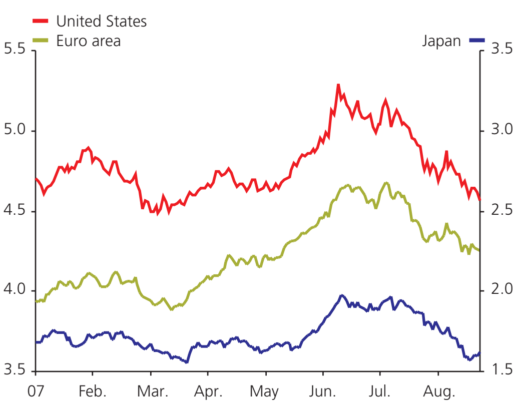
(2) Estimates of past volatility in respective MSCI indices, denominated in dollars.

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 external scenario considered most likely for the Chilean economy, along with the main risks.

International financial markets

In recent weeks there have been some significant corrections to international financial markets, reflecting the spread of the highest-risk mortgage sector crisis in the US to other financial market sectors. This has brought significant changes to risk estimates, a strong correction to financial asset prices, and more restrictive credit conditions, in a highly volatile context (figure I.1).

Faced with a significant leap in demand for international liquidity, arising from the resource needs of investors highly vulnerable to this market correction, central banks in the US, Europe and other developed economies had to inject substantial liquidity. Authorities' response calmed turbulence in the past few days and there was some recovery in asset prices (box I.1).

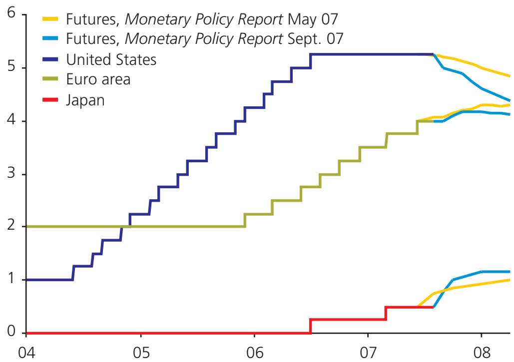
The *flight-to-quality*[1]/ effect, which this correction generated, reversed the increase apparent in the long-term interest rates of developed economies, driven by shifts in growth, in particular. As of the closing date for figures in this *Monetary Policy Report*, the ten-year US Treasury bond rate stood at 4.6%, down 70 basis points from mid-June. This change was closely followed by yields on similar bonds issued by other developed economies (figure I.2).

In recent weeks, the market revised downward its estimates for monetary policy rates in developed economies, revealing expectations that this instrument was being used to complement measures already applied by central banks to deal with current liquidity problems. Similarly, credit restrictions should slow growth (the Federal Reserve recently announced that the risk of growth declining had increased), amidst core inflation indicators that remain relatively under control. Nonetheless, the risk of inflationary pressures, given the limited slack in factor markets, has reduced central banks' room to maneuver. Monetary authorities in the US and Europe report that although they will continue to ensure the availability of funds

[1]/ This occurs when investors, faced with a rise in the perception of risk, seek more secure assets, such as government bonds issued by developed economies.

Figure I.3

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

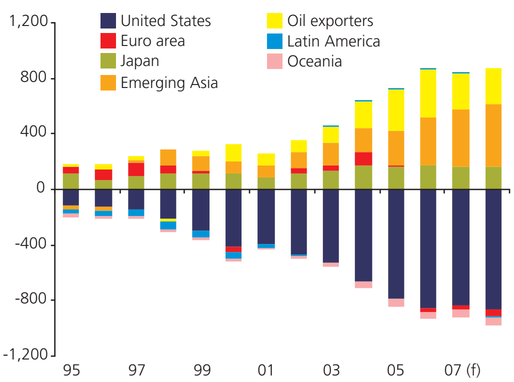


(*) Prepared by the Central Bank of Chile based on futures contracts, on interest rates.
Average for the 10 working days prior to 27 August 2007.

Sources: Central Bank of Chile and Bloomberg.

Figure I.4

Current account balance (*)
(US$ billion)

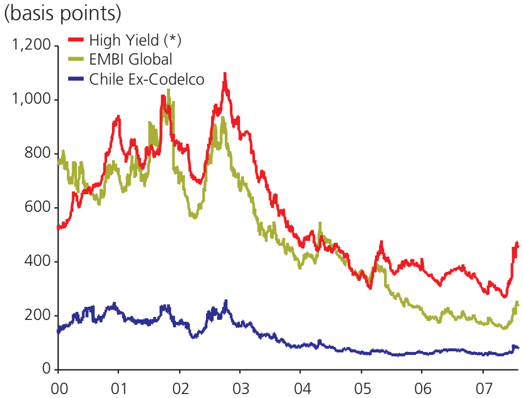


(*) For definition, see Glossary.
(f) Projection.

Source: International Monetary Fund.

Figure I.5

Credit risk premiums
(basis points)



(*) The risk premium on developed markets' corporate bonds with lower than investment grade risk ratings (CCC to BB), according to Standard and Poor's.

Sources: Bloomberg and JP Morgan Chase.

to markets, this will not necessarily involve a shift in the short-term trend in the policy interest rate (figure I.3).

Dollar depreciation apparent in international financial markets up to the second half of July reversed in recent weeks as part of the flight to quality. Lower growth of the US economy compared to the rest of the world, along with expected shifts in interest rates, had contributed to the dollar's loss of value. More recently, however, growing uncertainty has prevailed in financial markets. Risk associated with global imbalance remains and could bring further adjustments to financial conditions (figure I.4).

Emerging financial markets

The events apparent in developed financial markets also influenced emerging markets. Sovereign risk premiums, which until June had remained close to all-time lows, rose sharply. In Chile's case, this was less than other emerging economies, given its risk rating (figure I.5).

In late July, portfolio investment fund flows into emerging economies fell, reversing increases in the weeks following the May *Monetary Policy Report*. Larger flows had initially gone mainly into shares, steadily pushing up indices for emerging economies' stocks. Nonetheless, as with developed economies, these have undergone significant corrections in recent weeks (figure I.6).

Indeed, the latest events suggest a scenario involving less favorable financial conditions for emerging economies than in recent years, which could dampen their growth. This will affect the most vulnerable, particularly those with particularly high current account deficits and foreign debt, above all if the correction apparent to date continues to deepen.[2]/ Moreover, some foci for possible instability remain in some economies, which could generate contagion, especially if financial turbulence increases. Nonetheless, a significant group of emerging economies, particularly in Latin America, has made the most of the favorable financial conditions of recent years to strengthen their external positions. Likewise, government balance sheets have reaped the benefits of the unusually long duration of high commodity prices.

World growth

In line with forecasts, the US economy recovered significantly in the second quarter of this year,[3]/ after slowing abruptly in the first quarter. This recovery was driven mainly by a stronger external sector (a more competitive dollar and strong external demand) and a recovery in non-residential investment. The residential real estate sector experienced a larger and longer correction than forecast, subtracting almost half a percentage point from growth during the second quarter, due to its direct impact on residential investment. Consumption, meanwhile, has lost some of its strength in recent years, affected

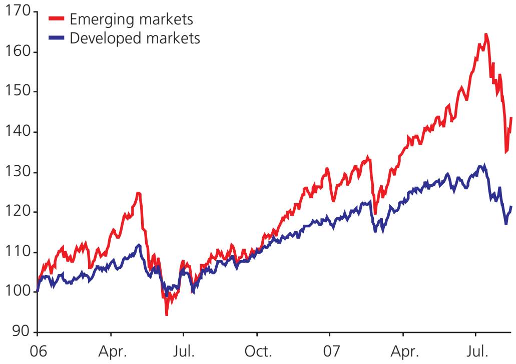
[2]/ Some Baltic economies with high current account deficits could see their financing sources compromised if international liquidity continues to contract and perceptions of risk heighten.

[3]/ As usual at this time of year, along with growth in the second quarter, a review of figures since 2004 was also published. This brought significant corrections to 2006 growth, from 3.3% to 2.9% annually.

Figure I.6

World stock exchanges (*)

(index January 2006 = 100)



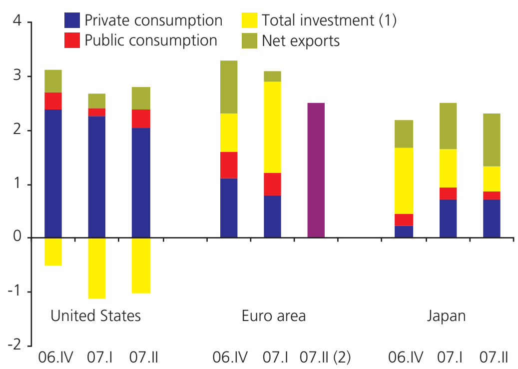
(*) Developed and emerging markets are represented by their respective MSCI indices denominated in dollars.

Sources: Bloomberg and Morgan Stanley Capital International.

Figure I.7

Contribution to annual GDP growth

(percentage points)



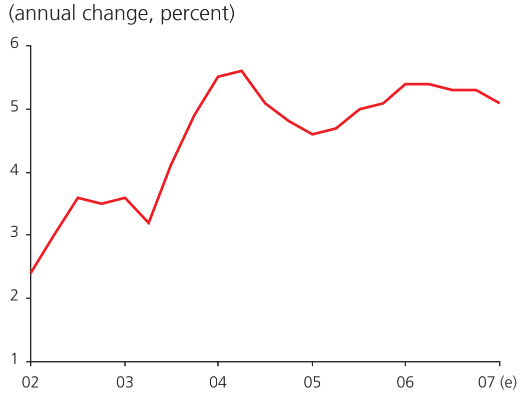
(1) Includes inventories.
(2) A breakdown of demand components for this period is not available.

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

Figure I.8

Quarterly world growth (*)

(annual change, percent)



(*) For definition, see Glossary.
(e) Estimate from the first quarter of 2007.

Source: Central Bank of Chile based on information from Bloomberg, International Monetary Fund and JP Morgan Chase.

by higher fuel prices, lower growth in real estate wealth, and the rise in interest rates. The labor market is starting to show signs of lost strength and consumer confidence has faded, which should slow consumption growth for the rest of this year (figure I.7).

Tighter credit, arising from corrections to the real estate market and corrections to share prices should dampen growth in the US. The baseline scenario assumes that the US economy will grow at just over 2% annually for the rest of the year, which is in line with weaker expectation surveys applied in recent weeks. Nonetheless, the risk of more profound or prolonged corrections to financial markets remains, and these could further limit growth.

Europe has performed well, although growth in the second quarter was lower than forecast. Growth has been driven by domestic demand, especially strong investment. Consumption seems to have bounced back in the second quarter, helped along by a strong labor market. Surveys indicate expectations remain high, although they reveal a more modest slowdown in future output than forecast in May. Recent turbulence in financial markets, however, which has made itself felt throughout the region, could dampen growth.

The Japanese economy has also performed well. With growth averaging 2.4% annually in the first half of 2007, GDP is expected to reach the peak for this cycle during this year. Consumption has been strong and continued to contribute to growth, backed by the lowest unemployment rate in nine years. Non-residential investment has continued to contribute to growth, despite the slowdown in the second quarter, and surveys suggest a positive outlook for this component. Growth has also been driven by external demand, particularly from the rest of Asia.

China's growth so far this year has outperformed already high figures for this decade. GDP growth in the second quarter (11.9%), combined with annual inflation of more than 5%, is unlikely to be sustainable. To contain this expansion, the authorities have continued to apply measures such as increasing interest rates, bank reserve requirements, and specific taxes on some sectors. How this economy returns to a more sustainable growth rate and how this will affect the growth of other economies and commodity prices remain unclear. India, whose economy has grown by almost 9% in recent years, has become another significant motor of world growth. Its strength is based on reforms that have brought robust investment and a strong performance from both consumption and exports.

In the first months of this year, growth in Latin America was driven by improved domestic demand and higher fiscal spending. Persistently high commodity prices, favorable financial conditions and solid external demand have continued to benefit the region's economies. Tighter credit arising from corrections to international financial markets, however, and a probable decline in world growth should reduce growth in the region. In Brazil, the monetary policy rate has fallen steadily in light of on-target inflation and rapidly accumulating foreign exchange reserves. International financial conditions today, however, have hit that economy particularly hard, braking the accumulation of reserves and raising doubts as to the future course of monetary policy. Mexico is more exposed to the US cycle and its growth slowed in step with that of the US, but progress in fiscal reforms should tend to increase tax revenues.

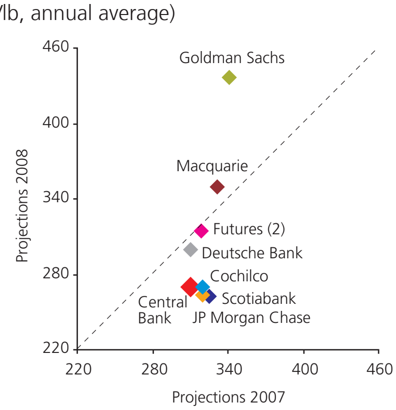
Table I.1
World growth (*)
(annual change, percent)

	Average 1990-99	Average 2000-05	2006 (e)	2007 (f)	2008 (f)	2009 (f)
World	3.2	4.1	5.4	5.1	5.1	4.9
World at market exchange rate	2.4	2.9	3.9	3.6	3.6	3.4
United States	3.1	2.6	2.9	1.9	2.6	3.0
Euro area	2.2	1.8	2.8	2.7	2.3	2.0
Japan	1.5	1.6	2.2	2.4	2.1	1.6
China	10.0	9.4	11.1	11.3	10.6	9.0
Rest of Asia	5.4	4.8	5.4	5.2	5.4	4.7
Latin America	2.8	2.9	5.4	5.0	4.4	4.1
Commodity exporters	2.7	3.1	2.7	3.0	3.0	2.9
Trading partners	3.2	3.2	4.5	4.2	4.2	3.9

(*) For definition, see Glossary.
(e) Estimate.
(f) Projection.

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

Figure I.9
Copper market: dispersion of price projections (1)
(US¢/lb, annual average)



(1) Includes projections from 3 to 24 August 2007.
(2) According to average for the last 10 days prior to 27 August 2007.

Sources: Central Bank of Chile, Bloomberg, Cochilco (2007), Deutsche Bank (2007), Goldman Sachs (2007a), JP Morgan Chase (2007), Macquarie Research (2007), and Scotiabank (2007).

Growth projected for some commodity exporting economies has been corrected upward, thanks to better terms of trade, in particular for Australia and New Zealand. In these economies, as a result of greater uncertainty in financial markets and despite policy interest rate hikes used to control inflationary pressures, the long-term *carry trade*[4]/ has begun to reverse. This increased their currency depreciation, which even led the Central Bank of Australia to intervene in the foreign exchange market for the first time in six years, arguing that the currency was misaligned.

Most recently, expectations for world economic growth have been corrected downward. Nonetheless, it is still early to quantify the total impact of liquidity restrictions and corrections to financial asset prices. The latter are still underway and there is as yet no detailed evaluation of their impact. While for now growth is estimated to be similar to May forecasts, this will probably be corrected downward (figure I.8 and table I.1).

Commodity prices

In recent months, the copper price has fallen below levels reported in the May *Monetary Policy Report*. Although some weeks ago it was higher, because of labor conflicts at some ore deposits, tighter credit has pushed its price down, along with that of other commodities. Notwithstanding, the average price so far this year is higher than forecast in May, so projections have been revised upward. The baseline scenario assumes the price will gradually fall, while production should return to normal, bringing average prices of US$3.10 per pound on the LME in 2007, US$2.70 in 2008 and US$2.45 in 2009. Several risks could influence this scenario, however, particularly a faster than forecast drop in prices should global growth be lower than projected (figure I.9).

The WTI oil price rose significantly to mid-July, approaching US$80 per barrel several times and exceeding May projections. This reflected very strong world demand, particularly from China and the US. In the latter's case, seasonal factors brought a greater than expected increase.[5]/ Similarly, both OPEC and non-OPEC production held steady in recent months and there is still a high risk premium given geopolitical conflicts. Most recently, the oil price has fallen to just over US$70 per barrel, caused by fears about how developments affecting world growth may influence demand, given corrections to international financial markets. Nonetheless, prices should stay high, given that there is no sign of an increase in OPEC production quotas and expansion projects in non-OPEC countries are behind schedule. Based on information from futures contracts, average prices are projected to reach US$67 per WTI barrel in 2007, US$70 in 2008, and US$69 in 2009 (box I.2). As usual, these projections are subject to much uncertainty and may well change. In particular, a renewal of geopolitical risks and a more intense than forecast hurricane season in the northern hemisphere could push these figures higher, while more corrections to financial markets and tighter credit could push them down (figure I.10).

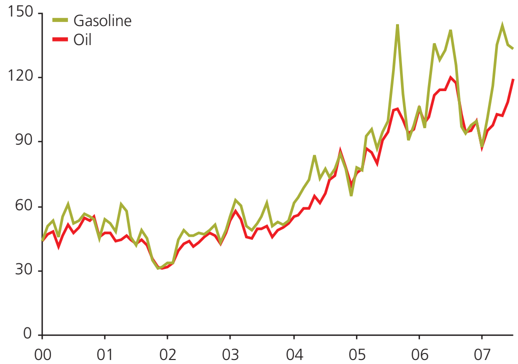
[4]/ Operation in which investors acquire debt in economies with low interest rates and then invest these resources in other more profitable economies, creating pressure to depreciate the former's currency and to appreciate the latter's.

[5]/ Since mid-February 2007, there has been a positive differential between the Brent and the WTI oil prices, unusual in both magnitude and sign. This reflected an atypical abundance of WTI oil in US storage centers as some refineries paralyzed, but has returned to normal as refinery operations have recovered.

Figure I.10

WTI oil and gasoline prices

(index December 2006=100)

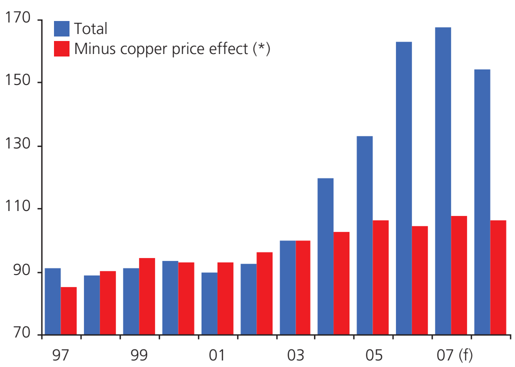


Source: Bloomberg.

Figure I.11

Terms of trade

(index 2003=100)



(*) Terms of trade minus copper price effect were estimated using the London Metal Exchange copper price (2003) as a reference.
Other potential effects on price and quantity not considered.
(f) Projection.

Source: Central Bank of Chile.

Table I.2

World inflation (*)

(average annual change in local currency, percent)

	Average 1990-1999	Average 2000-2005	2006 (e)	2007 (f)	2008 (f)	2009 (f)
United States	3.0	2.7	3.2	2.7	2.4	2.3
Euro area	2.3	2.2	2.2	2.0	2.0	2.0
Japan	1.2	-0.5	0.2	0.0	0.4	1.8
China	7.8	1.2	1.5	3.6	3.5	3.3
Australia	2.5	3.3	3.5	2.3	2.8	2.5
New Zealand	2.1	2.5	3.4	2.3	2.4	2.6
Argentina	253.7	8.6	10.9	9.0	9.9	10.6
Brazil	854.8	8.4	4.2	3.5	3.5	3.7
Mexico	20.4	5.7	3.6	3.9	4.0	3.5
EPI	1.9	3.8	5.3	6.9	3.0	2.3

(*) For definition, see Glossary.
(e) Estimate.
(f) Projection.

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

In recent months, the US gasoline market has posted unusually high seasonal demand due to limited refinery capacity. One result was that the gasoline price soared in the weeks following the close of the last *Monetary Policy Report*. Then, once refinery conditions returned to normal, levels fell to almost 10% less than peaks registered in early May. Nonetheless, the price is still more than 40% higher than the average in January of this year and has gone beyond the projections considered most likely in May. After rising to US$35 per WTI barrel in mid-May, the gasoline refinery margin[6]/ fell back to its historic average (US$5).

Despite higher production in Latin America, the NBSK wood pulp market is still suffering from tight supply, given the exit of northern hemisphere producers. This, combined with solid demand, has kept the price historically high, at around US$800 per metric ton. This is not expected to fall until 2008 and then only slightly, as new production plants come on-stream in Brazil and Uruguay. Fishmeal prices, meanwhile, have fallen almost 20% since May, basically due to demand factors. Specifically, problems with consuming industries in China have reduced demand, combined with substitution effects. The decline in short-term stocks combined with lower production in South America could boost prices. The molybdenum price remains near all-time highs, given limited capacity for expansion of production, restrictions on Chinese exports (important world supplier) and higher demand from the US steel industry. High prices should hold due to lack of significant new investment.

The cycle of high commodity prices has also been apparent in recent months in the case of several foods. Prices for wheat, corn, soya bean oil and powdered milk have reached a ten-year peak and are expected to remain high for a long time. Milk has risen almost 150% in the past 12 months, while wheat has risen more than 80% in the same period (box I.3).

Unlike forecasts in the May *Monetary Policy Report*, the baseline scenario assumes that the terms of trade will rise again in 2007, and will not return to normal until 2008-2009. Risk remains, however, that these high commodity prices may fall more suddenly due to lower demand in the case of less favorable world growth (figure I.11).

World inflation

In recent months, core inflation measures have been more contained in the main developed economies, unit labor costs have continued to post moderate growth and most recently global liquidity has declined. This has tended to mitigate concerns about core inflation compared to some months back. Nonetheless, inflationary risk remains, given the limited slack in factor markets and sharp rises in food and fuel prices. Note that the effect of the increase in food prices on inflation has been found in other emerging economies, as well as Chile's (figure V.6).

Given higher actual inflation and more intense dollar depreciation than forecast in May, the baseline scenario assumes a rise in the external price index (EPI) of 6.9% in 2007, 3.0% in 2008 and 2.3% in 2009 (table I.2).

[6]/ The refinery margin or crack spread refers to the cost of refining oil into gasoline and other by-products. See also the May 2007 *Monetary Policy Report*, box I.1, page 20.

Box I.1: **Crisis in the subprime market and international financial markets**

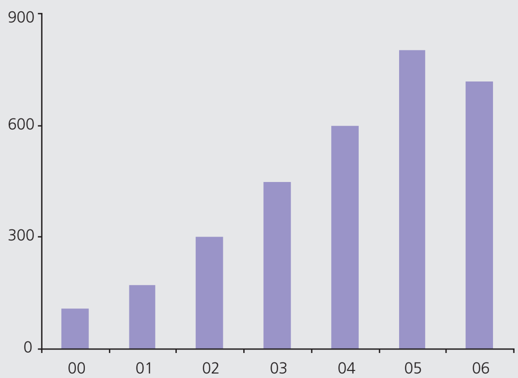
The purpose of this box is to review the main information on the recent crisis and corrections to the high-risk (subprime)7/ mortgage market in the United States, its financial effects on other markets, and its medium-term macroeconomic implications.

In the past decade, the subprime mortgage market posted strong growth (figure I.12), coming to represent a significant percentage of new loans. Thus, the share held by the higher risk subprime and Alt-A8/ categories over total annual mortgage loans rose from 10% in 2003 to almost 50% in 2006.

Figure I.12

US: Subprime mortgage loans

(US$ billion)



Source: Bloomberg.

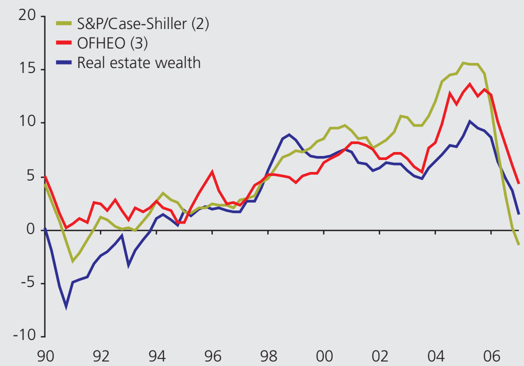
Among other factors, automated credit evaluation and the rapid development of securitization operations favored the growth of these credits.9/The latter spread mortgage risk around more evenly, favoring expansion of the riskier market segments. Some macroeconomic factors, such as sound economic performance and rising productivity, which led to higher wages, also contributed. Another factor was the significant rise in housing prices, associated with speculative operations in this market.

In this context, the reversal of the cycle favorable to housing prices, a rise in interest rates and the high percentage of credits at variable interest rates brought a speedy increase in non-payment and liquidation rates (figures I.13 and I.14). This decline in the subprime portfolio has become more and more evident, bringing with it the bankruptcy of several financial institutions specializing in this kind of credit.

Figure I.13

US: Housing prices and real estate wealth (1)

(annual change, percent)



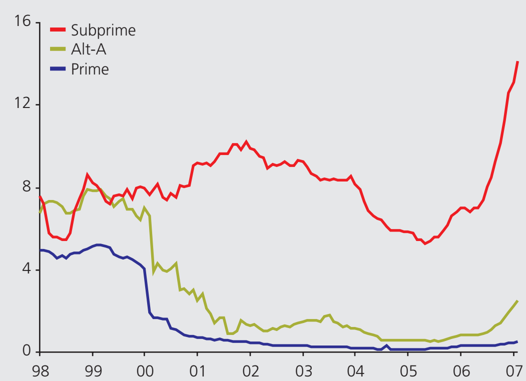
(1) National indices of single family housing prices, corrected for quality.
(2) Prepared by Standard & Poor's, Fiserv and MacroMarkets LLC.
(3) Prepared by Office of Federal Housing Enterprise Oversight of United States.

Sources: Bloomberg and US Federal Reserve.

Figure I.14

US: Non-performing mortgage loans at variable rate

(percentage of total credits in each segment)



Source: Citigroup.

7/ These are loans to individuals who do not meet certain credit standards, thus making them riskier.

8/ Alt-A mortgage loans fall between prime and subprime categories. These credits go to debtors meeting certain prime standards, but who did not provide all the income information required.

9/ This is the structuring of financial instruments supported by flows from different kinds of assets.

Financial effects and propagation

The crisis in the subprime market has spread to other financial markets. The most direct impact has been felt by the divisions of investment banks and institutions providing mortgage lending of this nature or buying these assets after their securitization and classification by rating agencies.[10]/ The impact was particularly hard felt in the market for commercial papers issued by these institutions, which also hurt investment fund liquidity, which in turn hampered the normal functioning of market transactions.

This spread to other markets has mainly taken place through: (i) the flight-to-quality process, which moreover produces a significant downward correction to developed economies' government bond yields; (ii) liquidity problems in monetary markets, given the uncertainty faced by institutions making loans amongst themselves; (iii) sudden changes in investors' perception of risks affecting different assets, especially those offering high returns; and (iv) tight credit in the commercial market securitized by mortgage-backed securities.

Emerging financial markets have seen sovereign premiums rise, stock markets fall, currencies depreciation against the dollar, and long-term interest rates increase.

Central banks in the main economies have reacted strongly to the contracting liquidity that has come with market adjustments, thus seeking to ensure the availability of funds for financial institutions and to safeguard the fluidity of capital market transactions. These measures are comparable to those applied in the 1998 crisis, in 2000 when technological bubble burst, and in September 2001, after the terrorist attacks in the United States.

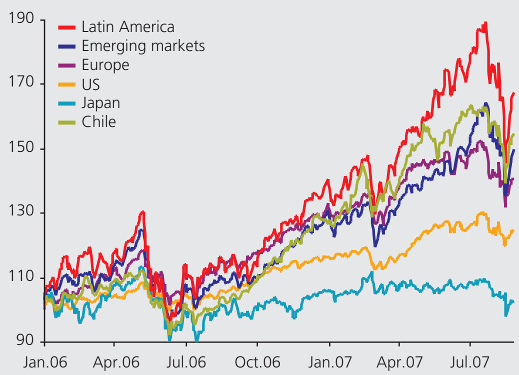
The US Federal Reserve has also used other, less common, instruments to ensure normal market functioning, particularly a 50 basis-point cut to the discount interest rate applied to financial institution loans, thus extending this kind of greater liquidity to a broader segment of the market, without providing longer term liquidity.

On medium-term prospects, this crisis could hurt world growth, given more restrictive credit conditions, combined with the drop in financial wealth and the probability of additional corrections to US housing prices. This could lead to weaker consumption and investment in the US, thereby affecting growth in the US and the world. It is more likely, however, that these effects will be controlled.

Figure I.15a

Stock exchanges (*)

(expressed in dollars, index 02/01/2006=100)



(*) Emerging markets, Latin America, Europe and Chile are from Morgan Stanley Capital International (MSCI). US from Dow Jones index, and Japan from Nikkei index.

Sources: Bloomberg and Morgan Stanley Capital International.

Figure I.15b

Impact on stock exchanges

(accumulated change from date indicated to 27 August, percent)

Sources: Bloomberg and Morgan Stanley Capital International (MSCI).

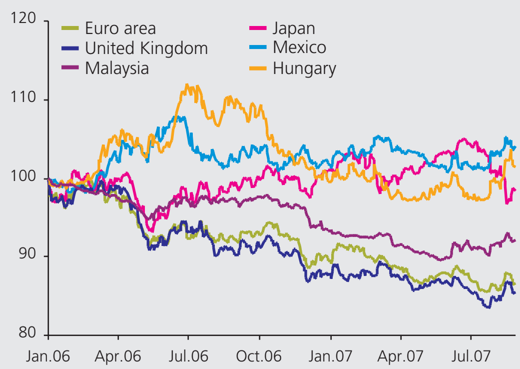
Nonetheless, given the better global macroeconomic fundamentals, the effects of this episode seem to be under control as compared to similar adjustments in the past. In this context, the impact on financial variables in Chile has been less than in other emerging economies (figures I.15a to I.18b).

[10]/ These include HSBC Finance, New Century Financial Corp, Countrywide Financial and Citimortgage, which accounted for more than 25% of total subprime lending in 2006.

Figure I.16a

Exchange rates

(local currency per dollar, index 02/01/2006=100)



Source: Bloomberg.

Figure I.16b

Impact on foreign exchange markets

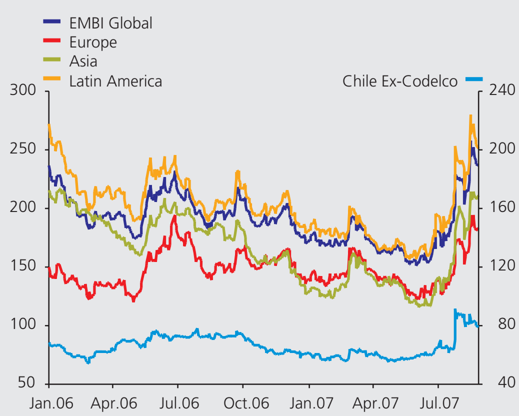
(accumulated change from date mentioned to 27 August, percent)

Source: Bloomberg.

Figure I.17a

Sovereign premiums

(basis points)

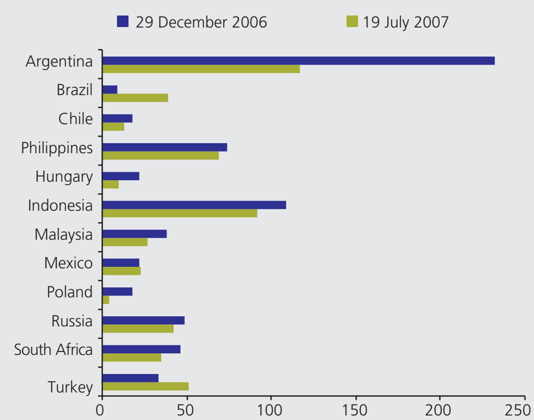


Sources: Bloomberg and JP Morgan Chase.

Figure I.17b

Impact on emerging bond markets

(accumulated change from date mentioned to 27 August, basis points)

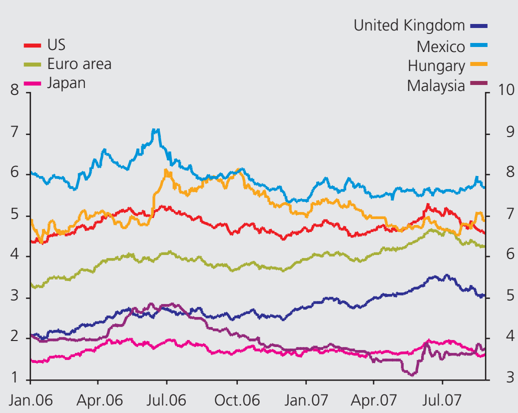


Source: Bloomberg.

Figure I.18a

Long-term interest rates

(percent)

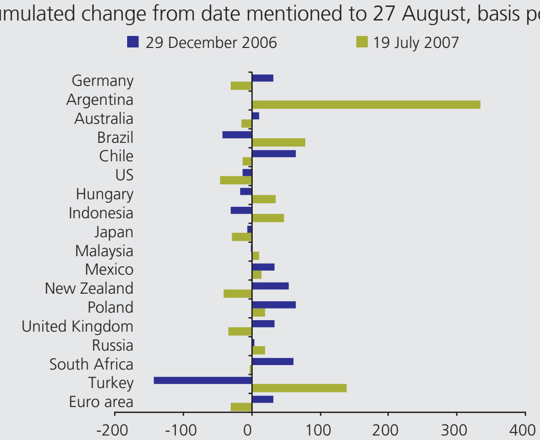


Source: Bloomberg.

Figure I.18b

Impact on local government bond markets

(accumulated change from date mentioned to 27 August, basis points)



Source: Bloomberg.

Box I.2: **Fuel price projections**

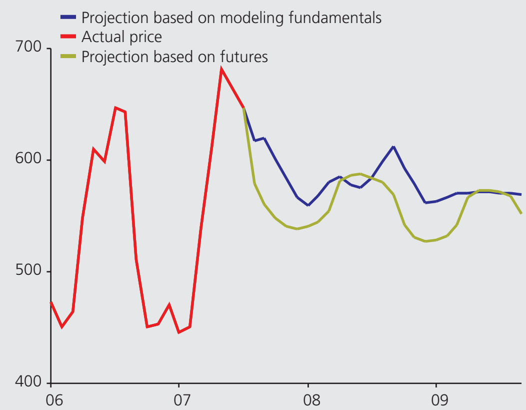
The international WTI price for oil and its derivatives are important inputs when defining the baseline projection scenario, particularly for inflation. The Central Bank normally projects these prices using a model based on price fundamentals that takes into consideration lags, manufacturing production in the US and stocks, among other factors.[11]/ Beginning with this *Monetary Policy Report*, however, this practice has been changed in favor of using a projection based on futures prices. To cushion daily movements, the average WTI oil and gasoline prices in futures contracts trading on the New York stock exchange during the ten working days prior to the projection will be used. This methodological change could have some effect on projections, although to date differences in the average oil and gasoline price and therefore in inflation projected over the usual policy horizon are of a secondary nature (figure I.19). It should be noted, however, that should this change have been applied before, differences would have been greater.

This new method is in line with the practice of central banks in developed economies[12]/ and institutions such as the International Monetary Fund, which use futures-based methods for their projections. In any case, fundamental models will still be used for analysis, especially to evaluate risk scenarios and to understand the dynamic behind futures.

Figure I.19

Gasoline parity price (*) and projections

(US$/m^3, monthly amounts)



(*) For definition, see Glossary.

Sources: Central Bank of Chile and Bloomberg.

However, both fundamental models and futures market failed to predict strong changes on international oil prices, wich implied significant inflation deviation from baseline scenario projections of last *Monetary Policy Reports*.

[11]/ See García and Jaramillo (2007).

[12]/ For exampe, the European Central Bank, the Bank of Sweden, the Bank of Norway, the Bank of England and the Bank of Canada.

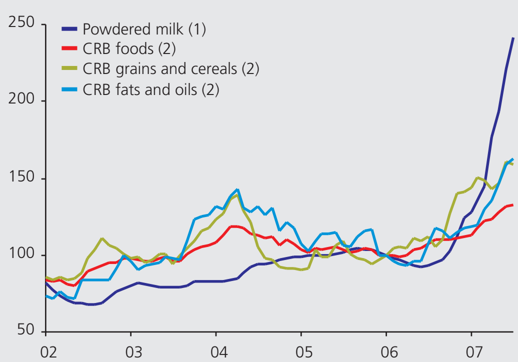
Box I.3: **Changes in international food prices**

Starting in the last quarter of 2006, international food prices began to rise steadily. This was reflected, for example, in a significant increase in the food price index prepared by the Commodity Research Bureau (CRB). Increases have affected all products, but have been particularly strong in international prices for grains,[13]/ oils and dairy products (figure I.20).

Figure I.20

Food prices

(index January 2006=100)



(1) Calculated by using weights for prices in Oceania, Europe and the US according to their exports.
(2) Indices calculated by the Commodity Research Bureau (CRB).

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

Both demand and supply factors are behind these unusual increases, and some are likely to persist. On the demand side, growth in consumption in Asia and some other emerging economies stands out. This has been particularly strong this year and is linked to higher income associated with higher prices for other commodities. On the supply side, there has been a significant rise in production costs associated with higher energy prices, combined with adverse weather in some important producing regions.

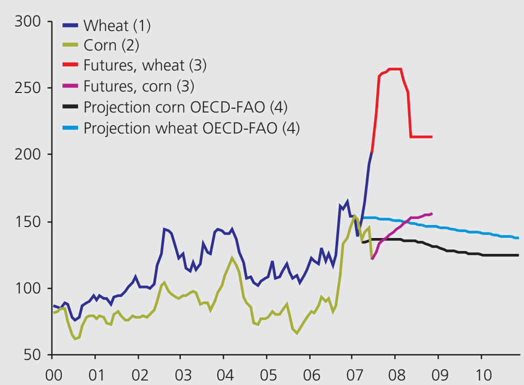
In the case of dairy products, the low prices that prevailed in the past decade have turned around, rising 150% in the last 12 months. Negative impacts from the drought in Oceania have been particularly important, since this is one of the world's largest producers.[14]/ Moreover, the elimination of subsidies in Europe has gradually pushed that region's less efficient producers out of the market.

In terms of grains, aggregate price indices reveal a 40% increase since mid-2006 and a further increase in recent months, despite the fact that futures prices through May assumed a reduction (figure I.21). This trend reflects bad weather in Europe and Oceania, combined with a focus on sowing corn, particularly in the US, for biofuel production.

Figure I.21

Wheat and corn prices

(US$/ton)



(1) Price for Soft Red Winter N° 2 wheat, Chicago exchange.
(2) Price for Yellow N° 2 corn, Chicago exchange.
(3) Average for the 10 working days prior to 27 August 2007.
(4) Based on seasonal OECD-FAO prices. Projection from April 2007.

Sources: Bloomberg and OECD-FAO (2007).

Prospects for food prices

For the time being, food prices are expected to remain high, although they should decline slightly over time, as limits on capacity fade in a context of high demand.

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[13]/ For more details on the international grain market, see box I.2, *Monetary Policy Report*, May 2007, page 21.

[14]/ Australia and New Zealand account for almost one-third of world exports. Europe, meanwhile, accounts for 20%, while the US provides about 30% of world exports.

In the case of grains, prices are expected to stay high for some time. This is different from forecasts in May, when they were expected to gradually fall. Faced with increased use of land to cultivate corn, the prices for other agricultural products, especially dairy, will also rise.

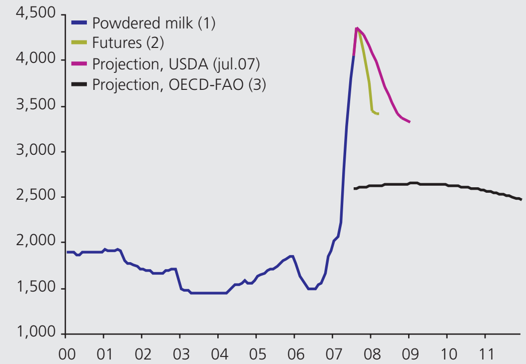
Futures contracts for milk suggest that prices will gradually fall, but remain substantially higher than they were in the past (figure I.22). This primarily reflects the absence of idle capacity. It is estimated that only after about four years could there be more significant declines in prices, consistent with new investment projects coming on-stream.

Agricultural prices may fall more quickly however, given the risk of a sharper slowdown in world growth. This will depend on the extent of tighter credit conditions apparent in international financial markets, the result of the spread of problems in the US subprime mortgage market.

Figure I.22

Milk price

(US$/ton)



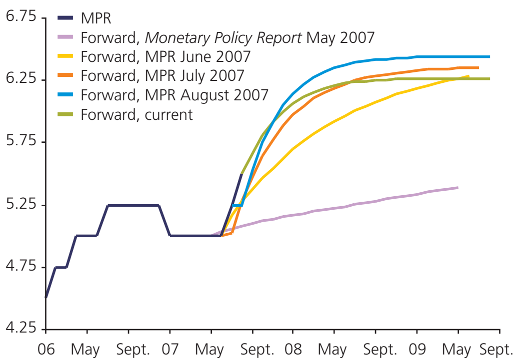
(1) Price of skim milk powder, Chicago exchange.
(2) Average for the 10 working days prior to 27 August 2007.
(3) Based on seasonal OECD-FAO prices. Projection from April 2007.

Sources: Bloomberg, US Department of Agriculture (USDA) and Odepa.

II. Financial markets

Figure II.1

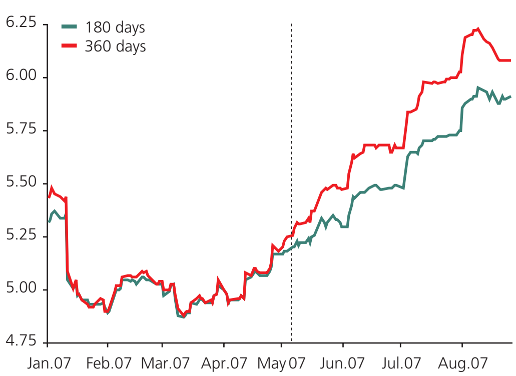
MPR and the forward curve
(percent)



Source: Central Bank of Chile.

Figure II.2

Swap rates (*)
(percent)



(*) For definition, see Glossary.

Source: Central Bank of Chile.

This section reviews recent trends in financial markets' main variables from a monetary policy perspective.

Monetary policy

The changes in the macroeconomic environment in recent months have taken monetary policy from an approach based on the long-term maintenance of the monetary policy rate (MPR) in May to an increase in June and further increases, of 25 basis points, in July and August. The Board's decision was necessary to allow projected inflation to remain at 3% over the policy horizon, since idle capacity was being taken up more swiftly than forecast in May and supply shocks had affected specific product prices (mainly foods), generating a significantly higher likelihood of inflation than forecast in the latest *Monetary Policy Report*. This, moreover, meant that if the nominal MPR had been kept the same, the real impulse to the economy would have been greater than required.

Market expectations regarding the MPR have adjusted to changes in the macroeconomic scenario. The most significant part of the correction occurred in June, when the rate expected for December 2008, deduced from the forward curve (and calculated using the MPR, swap rates one year's hence and yields on 2-, 5- and 10-year BCPs) rose more than 80 basis points over May. In the months that followed, the largest change was in the pace the MPR was expected to rise in the short term. Thus, expectations for the MPR for December 2007 went from practically 5% in May to 6% in August. After July's financial turbulence expectations regarding the MPR grew more moderate, especially for next year. Financial asset prices in the two weeks prior to the closing date for this *Report* remained consistent with a MPR of 6% in December of this year and 6.25% in 2008 (figure II.1). Swap rates, in particular, which in May stood at around 5.25% for different maturities, rose significantly in the second week of August. As this *Report* closed, they had reached 5.9% to 180 days and 6.1% to 360 days (figure II.2). Overall, it should be remembered that financial asset prices contain implicit risk premiums whose size is hard to determine exactly, and which could become more important in events of higher volatility like the one currently experienced.

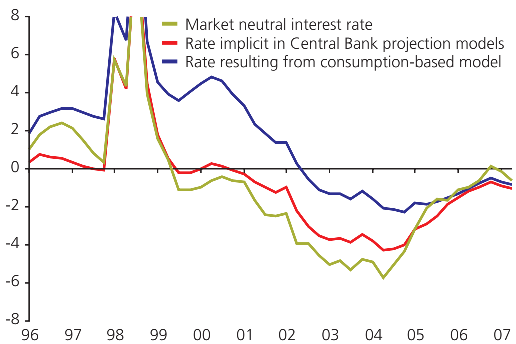
Market expectations for the MPR, expressed in the Central Bank's expectations survey (*Encuesta de Expectativas*, EEE) point to a lower level than deduced from financial asset prices, suggesting, in early August, that the MPR would rise to 5.75% in December of this year and 6% at the end of 2008, up 50 basis points in both cases over expectations last May.

Currently the MPR is in the lower part of the range of estimations for its neutral value, so the Board has concluded that monetary policy is still providing some

Figure II.3

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

(percent)



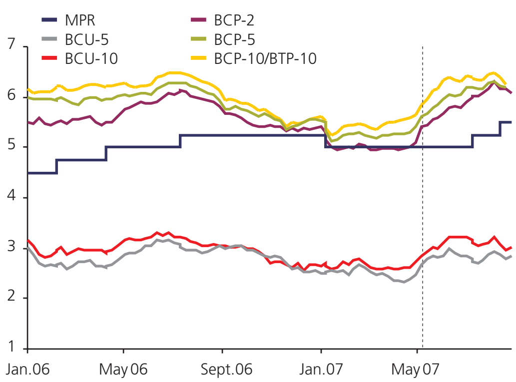
(*) Calculated as the nominal MPR minus expected inflation, according to Central Bank surveys.

Source: Central Bank of Chile.

Figure II.4

MPR and interest rates on Central Bank documents

(weekly average, percent)

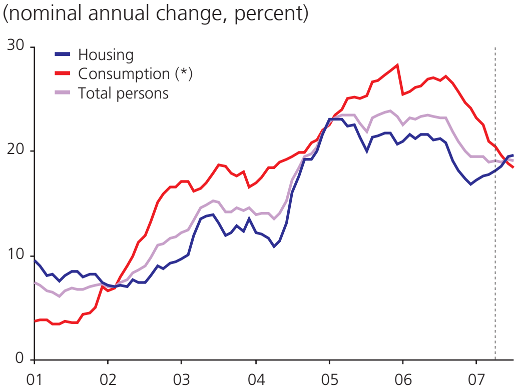


Source: Central Bank of Chile.

Figure II.5

Personal loans

(nominal annual change, percent)



(*) As of January 2004, individuals' overdrawals included.

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

impulse to the economy (figure II.3). It also estimates that in the most likely scenario, it will continue to increase the MPR in coming months to keep projected inflation at around 3% over the policy horizon. As usual, the changes in the MPR will depend on the information gathered and its implications for projected inflation. In particular, the Board will pay attention to trends in international financial markets and what these imply for the inflation and growth scenario. The Board also believes that faced with strong shocks to specific prices and limited idle capacity, as is the situation today, it must monitor events with particular care, to detect both possible spreading to other prices and effects on medium- and long-term inflation expectations.

Financial conditions

Interest rates on peso documents issued by the Central Bank rose significantly from May to early August. This mainly reflected some surprises in terms of domestic inflation and its implications for monetary policy expectations. In the two weeks prior to the closing date for figures included in this *Report*, despite some decline, rates on nominal papers, depending on the maturity, were from 40 to 90 basis points higher than they were on the closing date for the previous *Report*. Meanwhile, rates on documents in UF have fluctuated less, and are from 10 to 30 basis points higher than last May (figure II.4).

In recent months, lending to the private sector has continued to grow in nominal terms at high, stable annual rates of more than 17%. By component, it is clear that lending to individuals has grown throughout the year at nominal rates of almost 19% annually, although their composition has changed, reflecting a stronger performance from mortgages, while growth of consumer credits has faded (figure II.5). Average interest rates on consumer credits rose in recent months, while those for credit cards rose even more. This rise could be attributed to the passing along of the higher slope of the yield curve or of riskier customers entering the system. According to the bank credit survey (*Encuesta sobre Créditos Bancarios*), the higher credit risk of bank clients may have led financial institutions to increase the requirements for approving consumer loans (figure II.6). Meanwhile, interest rates on mortgage loans rose, although there were no major changes in the spread between these and the risk-free (or prime) rate (table II.1).

Table II.1

Lending rates
(360-day base, percent)

		Consumption		Rates LCH (3)				Commercial	
	MPR	TPP (1)	Credit cards (2)	Rate 4-5% and Dur: 5-6	Spread on BCU-5	Rate 5-6% and Dur: 5-6	Spread on BCU-5	Prime (4)	TPP (1)
2004 Average	1.87	24.3	33.4	4.0	1.6	4.4	1.9	1.6	7.4
2005 Average	3.44	26.0	34.1	3.7	1.4	4.3	1.9	3.4	9.7
2006 Average	5.02	27.5	38.7	3.9	1.2	4.2	1.5	5.1	10.4
2007 Jan.	5.09	28.1	39.5	3.7	1.2	4.2	1.7	4.8	10.0
Feb.	5.00	28.9	40.5	3.7	1.1	4.1	1.5	5.0	10.0
Mar.	5.00	27.2	41.4	3.6	1.1	4.1	1.6	5.0	9.7
Apr.	5.00	27.8	40.6	3.5	1.1	4.0	1.6	4.9	9.8
May	5.00	28.0	40.1	3.7	0.9	4.1	1.4	4.9	9.9
Jun.	5.00	28.0	41.7	3.9	1.0	4.3	1.4	5.0	9.7
Jul.	5.16	28.8	41.8	3.8	1.1	4.2	1.5	5.2	9.7

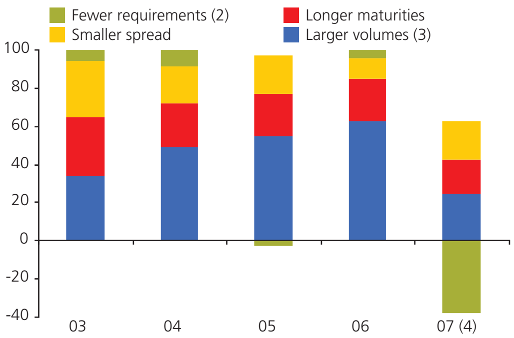
(1) Average weighted rate.
(2) Series published by the SBIF, for peso operations maturing in more than 90 days worth up to UF200.
(3) Mortgage rates for the issue indicated.
(4) Rate charged preferred customers or those with the best credit rating (calculated as the lowest average monthly rate reported daily by banks).

Sources: Central Bank of Chile, Santiago Chamber of Commerce and Superintendency of Banks and Financial Institutions.

Figure II.6

Conditions on consumer credits (1)

(percent)



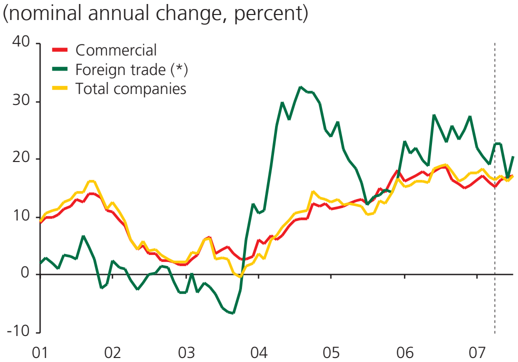
(1) Annual average from net responses, contribution to total. Negative values indicate more restrictive conditions.
(2) Includes questions about the minimum standard required to approve a credit.
(3) Includes questions on the maximum credit, ceiling on credit card use and minimum payment required.
(4) Information through the second quarter.

Source: Central Bank of Chile, Survey about bank credit.

Figure II.7

Corporate loans

(nominal annual change, percent)



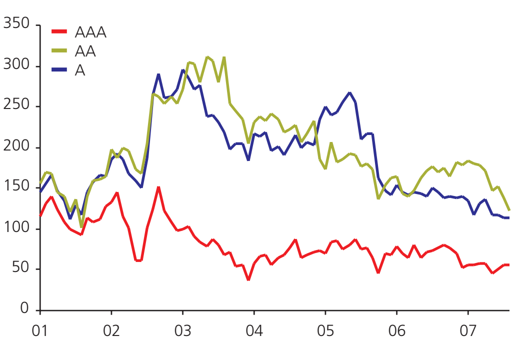
(*) In dollars, using the nominal exchange rate on the last working day of the corresponding month.

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

Figure II.8

Corporate bond spreads by risk rating (*)

(monthly average, basis points)



(*) August 2007 data provisional.

Sources: Central Bank of Chile and LVA Indices.

Nominal growth in corporate borrowing also remained high, over 17% annually in July. Commercial credits also continued to perform strongly, at the same time as foreign trade loans grew at rates similar to the first quarter with their usual volatility (figure II.7). According to the latest bank credit survey (*Encuesta sobre Créditos Bancarios*), through the second quarter, this all occurred in a climate marked by more flexible standards for approving corporate loans, in particular for small and medium-sized firms (SMEs), and (according to information through July), interest rates charged firms remained stable. The survey also found that demand grew stronger in all credit segments, both from households and companies, which is in line with the evaluation that financial conditions have favored high growth in domestic demand.

In terms of other sources of corporate financing, information available to July indicates that accumulated corporate bond issues were up more than 17% from the same month of 2006. The total amount involved in issues expected from now until year's end, however, is lower than expected in May, with totals for 2007 expected to fall below those of 2006. Meanwhile, according to preliminary information through August, the latest volatility only moderately affected spreads paid by companies, which remain low compared to their historic levels, with the scenario remaining favorable to corporate bond issues (figure II.8). At the same time, in the stock market, share issues in the first semester were higher than the same period in 2006, and amounts trading daily on the Santiago exchange remained on average higher than last year.

The local stock market, as with most world markets, saw an important decline after recent liquidity problems in international markets, the reevaluation of global credit risk and investors' willingness to demand riskier assets. In recent weeks, however, most of this fall was reversed, so that compared to the last *Monetary Policy Report*, the selected share index (IPSA) had accumulated a 0.5% in pesos and a 0.8% decline in dollars, which was less than world markets overall and contrasts with the rise in Latin American markets during the same period (figure II.9). Even with events in recent months, on the closing date for figures in this *Monetary Policy Report*, the IPSA had accumulated a profitability of 21.4% in pesos and 23.5% in dollars.

Monetary aggregates have continued to rise at high rates, even higher than in the early months of this year. Thus, the different measures for money have continued to grow since late 2006, particularly M3, which has posted the highest annual growth rates since 1998 (figure II.10). Expansion velocity for the different aggregates has stabilized at high nominal rates, of from 15% to 20%.

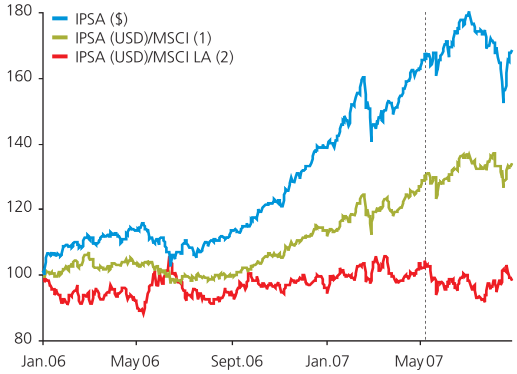
In short, strong credit, low corporate debt spreads compared to recent years, and higher growth in monetary aggregates altogether suggest financial conditions that favor growth of domestic demand, despite turbulence in international financial markets and a slight rise in the interest rates that banks charge the public.

Foreign exchange rate

With some fluctuations, peso/dollar parity remains similar to last May. This is based on the averages for the two weeks prior to the closing date

Figure II.9

Stock exchange indicators
(index 02/01/2006=100)

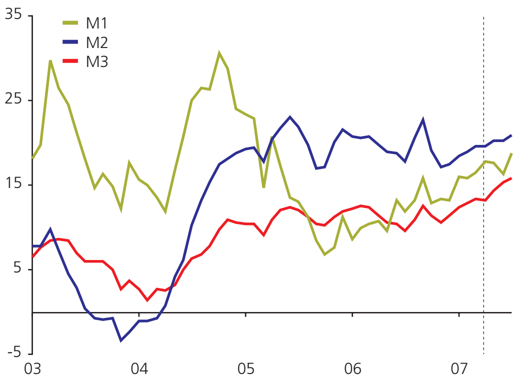


(1) World share index, Morgan Stanley Capital International.
(2) Share index for Latin America, Morgan Stanley Capital International.

Sources: Central Bank of Chile and Bloomberg.

Figure II.10

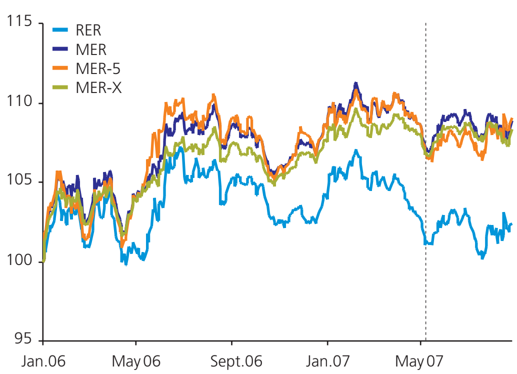
Monetary aggregates
(nominal annual change, percent)



Source: Central Bank of Chile.

Figure II.11

Nominal exchange rate (*)
(index 02/01/2006=100)



(*) For definition, see Glossary.

Source: Central Bank of Chile.

for figures included in this *Monetary Policy Report* and the previous one. Until late June, the peso had depreciated against the dollar, bringing the exchange rate to around 530 pesos per dollar. Parity then fell until late July, in line with the dollar's performance on international markets, the rise in the copper price and changing expectations regarding the MPR in Chile. In the past month, its increase has been associated with the volatility affecting international financial markets, which also contributed to a decline in the copper price. This rise, however, has been lower than that for other emerging and commodity exporting countries' currencies (box I.1).

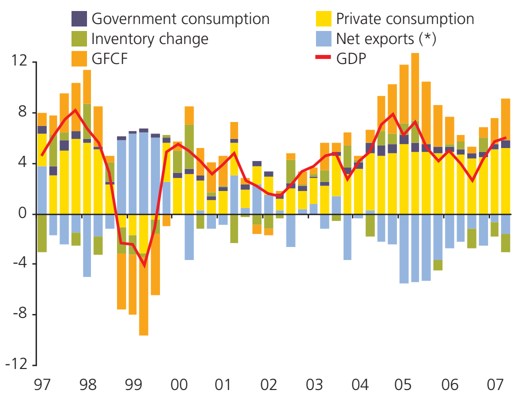
The multilateral exchange rate (MER), which reflects parities against the main trading partners' currencies, and the MER-X (which excludes the dollar from the MER currency basket) remained similar to last May (figure II.11). Meanwhile, the real exchange rate (RER) has remained about the same since early in the year, while the RER-5 has tended to decline slightly since April. The average RER for the past two weeks is considered consistent with its long-term fundamentals and the baseline scenario includes the methodological assumption that in the long term it will not stray far from this value, although this assumption is subject to significant degrees of uncertainty, especially given recent and future events affecting international financial markets.

III. Aggregate demand

Figure III.1

Contribution to GDP growth

(percentage points)



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

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 goods and services markets, and the most likely behavior of output.

Aggregate demand

So far in 2007, economic growth points to idle capacity being picked up more swiftly than forecast last May. The baseline scenario for this *Monetary Policy Report* projects this year's GDP will grow somewhere from 5.75% to 6.25% for this year. In the second quarter of 2007, domestic demand rose at an annual rate that was one percentage point more than growth in the previous quarter and 1.4 percentage points more than last year's average.[1]/ Among its components, gross fixed capital formation grew more quickly in the second quarter and private consumption rose more swiftly than in the second half of 2006, as it did in the first quarter of 2007 (figure III.1). Altogether this has pushed final domestic demand (minus inventory change) higher in 2007, for the third quarter in a row (table III.1).

Table III.1

Aggregate demand

(weight within GDP, real annual change, percent)

	Weight 2006	2006 I	II	III	IV	Year	2007 I	II	I half year
Domestic demand	104.1	7.8	6.2	3.6	6.6	6.0	6.4	7.4	6.9
Final domestic demand (minus inventory change)	102.7	7.7	5.7	5.1	5.5	6.0	7.7	9.0	8.4
GFCF (Gross fixed capital formation)	24.1	9.5	2.0	1.8	3.3	4.0	8.7	13.9	11.4
M&E (Machinery and equipment)	10.5	17.4	-0.4	1.7	1.0	4.3	8.9	19.1	14.1
C&O (Construction and other works)	13.6	4.2	4.0	1.9	5.2	3.8	8.6	10.0	9.3
Other	80.0	7.3	7.5	4.1	7.6	6.6	5.7	5.5	5.6
Private consumption	66.6	7.7	7.5	6.7	6.7	7.1	7.8	8.0	7.9
Durable	7.4	22.0	22.9	17.3	12.3	18.2	13.6	17.9	16.0
Non-durable	29.4	6.1	6.7	5.8	6.8	6.4	7.7	6.7	7.2
Services	29.8	6.6	4.9	5.0	5.1	5.4	6.6	6.8	6.7
Government consumption	11.9	3.9	3.5	3.5	3.4	3.6	4.7	4.9	4.8
VE (Inventory change, % of GDP) (*)		1.4	1.5	1.2	1.4	1.4	1.1	0.8	0.8
Goods and services exports	37.8	5.5	3.0	6.2	2.3	4.2	9.4	11.8	10.6
Goods and services imports	41.9	12.9	8.7	8.2	8.3	9.4	10.9	14.9	12.9
GDP		**5.0**	**4.0**	**2.6**	**4.3**	**4.0**	**5.8**	**6.1**	**5.9**

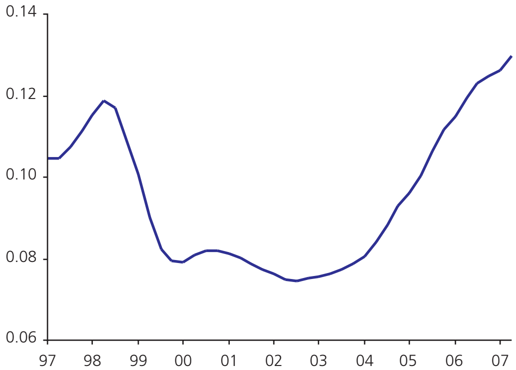
(*) Inventory change over GDP accumulated in four quarters.

Source: Central Bank of Chile.

[1]/ As per the usual policy of reviewing quarterly national accounts, on 23 August a new estimate for GDP for the third quarter of 2007 was published.

Figure III.2

Durable to non-durable consumption ratio (*)
(moving year)

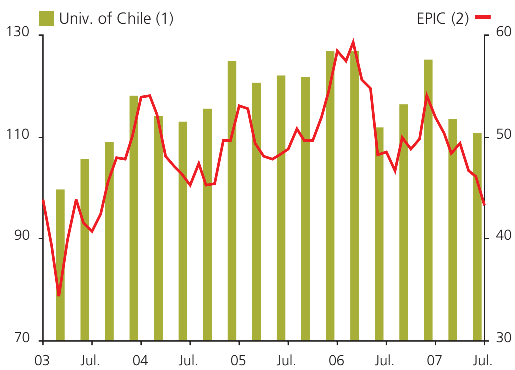


(*) Includes non-durable consumption and services.

Source: Central Bank of Chile.

Figure III.3

Consumer perceptions
(indices, positive over negative replies)

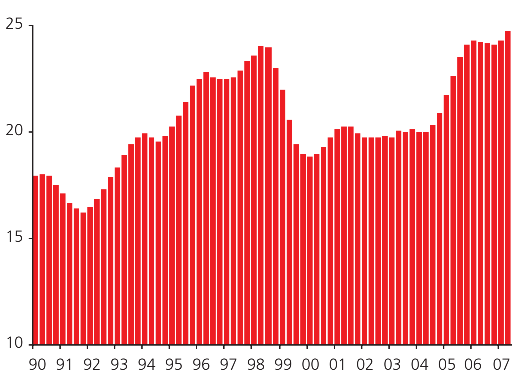


(1) Index March 2001=100.
(2) Value index over (under) 50 points indicates optimism (pessimism).

Sources: Adimark and Univ. of Chile.

Figure III.4

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



Source: Central Bank of Chile.

Private consumption[2]/ and inventories

In the second quarter of 2007, private consumption, which has been favored by trends in credit and the strong labor market, continued to post high annual growth rates. Among its components, non-durable consumption grew at around 7% in the first half, while durable consumption rose 16% annually on average.[3]/ Expenditure on both durable goods and services consumption stood out for the pace of their increase this year. The ratio of durable to non-durable consumption continued to rise, reaching levels higher than those achieved prior to the crisis at the end of the past decade, revealing the ongoing accumulation of durable goods (figure III.2).

Unlike consumption figures, consumers' perceptions have worsened during the year. The economic perceptions index (*Índice de Percepción de la Economía*, IPEC) fell to 43.3 in July (from 52 in January), remaining at pessimistic levels from March onward, its poorest in four years. At the same time, in June, the consumer confidence index published quarterly by the University of Chile fell for the second time in a row (figure III.3). Nonetheless, it is not clear whether there is any relationship between consumer confidence indicators and consumers' behavior.

For 2007, the baseline scenario forecasts that private consumption will grow by more than 7%, somewhat more than estimated in the May *Monetary Policy Report*. This is based on growth of consumer goods imports, still favorable financial conditions, and a strong labor market. Nonetheless, there are some risk factors that should be mentioned. In particular, the possibility that the increase in energy costs, which pushed rates up in July, may recur, with a greater than forecast impact on private disposable income and therefore household spending, cannot be ruled out. For now, the lack of rainfall and more restrictions on natural gas have boosted fuel imports for electric power generation substantially and, compared to 2006, has involved a net transfer abroad of about one percentage point of private disposable income in the first half of 2007 (box IV.1).

For the moving year ending in the second quarter of 2007, the change in inventories totaled 0.8% of GDP, measured at constant prices, down from the first quarter. Meanwhile, the business confidence indicator (*Indicador Mensual de Confianza Empresarial*, IMCE) shows that inventories, for both the wholesale and retail trade and manufacturing, have remained somewhat higher than is desirable so far this year. Nonetheless, perceptions regarding wholesale and retail trade inventories are moving closer to the point considered neutral.

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[2]/ The components of private consumption (using 2006 weights) are: durable (11%), non-durable (44%) and services (45%). Non-durable consumption includes both non-durable goods and services.

[3]/ In recent months, the National Statistics Bureau (INE) reviewed historic information on the consumer goods sales index (*Índice de Ventas de Bienes de Consumo*, IVBC), which is the input for calculating private consumption indicators. This has low magnitude effects on the figures published in National Accounts, mainly in terms of shifting some of other domestic demand from consumption to inventories. These changes do not influence the measure at origin of GDP, since the wholesale and retail trade is measured using other indicators and its effect on the VAT collected is of a secondary nature.

Figure III.5

Capital goods imports and investment in machinery and equipment

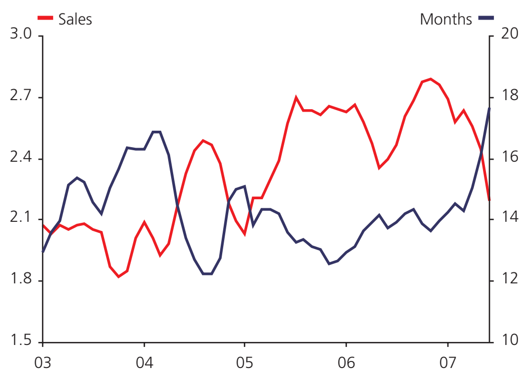
(index 2003=100, real annual change, percent)

Source: Central Bank of Chile.

Figure III.6

New housing in Greater Santiago (*)

(thousands of units sold; number of months of stock)



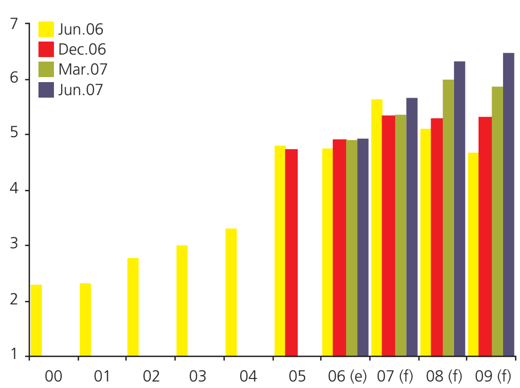
(*) Moving average for seasonally adjusted series.

Sources: Central Bank of Chile and *Cámara Chilena de la Construcción*.

Figure III.7

Total investment survey (*)

(US$ billion)



(*) Excludes telecommunications and real estate sectors.
(e) Estimate.
(f) Proyected.

Source: *Corporación de Desarrollo Tecnológico de Bienes de Capital.*

Gross fixed capital formation (GFCF)[4]/

After low growth in 2006 and some recovery early in 2007, gross fixed capital formation performed surprisingly well in the second quarter. Thus, the annual rise in gross fixed capital formation went from 1.8% in the third and 3.3% in the fourth quarter of 2006, to 8.7% in the first and 13.9% in the second quarter of this year. Altogether, in the second quarter investment in fixed capital reached 24.7% of GDP at constant prices (figure III.4).

Capital goods imports posted higher annual growth rates than in the first quarter of the year, although they've remained relatively stable since March (figure III.5). Annual growth of investment in construction and engineering works has been greater than in 2006. This is reflected in a significant rise in sales figures for construction inputs, largely supported by investment in engineering works. In terms of building, data from the Chilean Chamber of Builders (*Cámara Chilena de la Construcción*) shows that the stock of new buildings sold between March and June of this year fell by around 17%, while stock has remained practically constant, thus boosting the number of months to use up available stock from 14 to 18 in this same period (figure III.6). Nonetheless, other sources offer a more optimistic outlook. Information from the Collect company shows a significant rise in new homes sold: 12.5% annually in the second quarter (up from -5.3% the previous quarter), while the number of months to exhaust stock is similar to last March. At the same time, mortgage loans continue to rise apace.

The June edition of the CBC (*Corporación de Bienes de Capital*) investment survey corrected total investment for three years 2007-2009 upward from March (figure III.7). Moreover, there were changes in the sectoral composition, with more total investment going into energy and less into public works concessions, the latter mainly reflecting rescheduling of interurban highway projects. The investment component within construction and engineering was corrected downward for 2008, although for this year it remains higher than previously estimated.

Thus, the prospects for investment for the rest of the year are promising, and the baseline assumes higher growth than projected in the May *Monetary Policy Report*. Investment will be favored by the closing of idle capacity, good growth prospects, companies' liquidity flows, and access to financing in favorable conditions. At the same time, business expectations (IMCE) reveal more optimism compared to last May, when these were already within the optimistic range.

Fiscal policy

As of June 2007, spending of the Central Government's total budget[5]/ had accumulated a one-year surplus of 8.9% of GDP, up from 8.1% for the previous quarter. Based on the information available as this *Monetary Policy Report* closed, it is estimated that real expenditure should grow about 8.5%

[4]/ The components (2006) of GFCF are: construction and other works (56%) and machinery and equipment (44%). The components of construction and other works are: building and engineering works (56%) and other works (44%).

[5]/ Includes Central Government budgetary and extra-budgetary.

in 2007, compared to 2006. So far this year, expenditure remains similar to historic averages. Considering the new scenario for the copper price this year and compliance with the structural surplus target, the overall surplus should amount to somewhat more than the 7.1% of GDP estimated by fiscal authorities last June.

On the 2008 budget, the new reference price for copper, which has gone from US$1.21 to US$1.37 per pound, is in line with the high price on international markets and the analysis that it will gradually fall. Growth of trend GDP, set at 5%, is consistent with the assumptions in this *Report's* baseline scenario. Moreover, the change in the structural surplus target from 1.0% to 0.5% of GDP, combined with the review of its parameters, Codelco's higher costs, trends in this firm's copper production and the price of molybdenum all add up to fiscal impulse in 2008 remaining similar to the level implicit in the 2007 budget. It should be noted that aside from some recent changes, fiscal policy continued to contribute to the country's stability, in the sense that temporary fiscal revenues go to savings.

Exports and imports

The balance of trade closed the first half of 2007 with a surplus worth almost US$15 billion. Total exports by value reached US$17.920 billion in the second quarter of 2007 (about US$34.4 billion accumulated so far this year). Annual growth in trade by volume has continued to rise and in the second quarter of this year reached 13.6%, well above the previous quarter (table III.2). This was mainly driven by the volume of mining exports, up 18.8% in this period.

Table III.2

Foreign trade

Exports

		Value US$ million	Annual change, percent											
			Total			Mining			Manufacturing			Agriculture		
			Value	Vol.	Price	Value	Vol.	Price	Value	Vol.	Price	Value	Vol.	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
2006	I	13,621	43.9	7.4	34.0	70.5	6.9	59.5	16.7	8.6	7.4	-0.1	-2.1	2.0
	II	15,140	48.8	0.2	48.5	73.0	-5.8	83.6	18.5	5.1	12.7	15.5	7.1	7.9
	III	15,679	54.1	5.7	45.8	73.9	2.6	69.5	27.3	9.4	16.4	7.3	0.3	6.9
	IV	13,677	19.2	-3.6	23.6	22.4	-6.8	31.3	14.0	-2.1	16.5	22.2	16.6	4.8
2007	I	16,522	21.3	7.3	13.0	19.8	4.8	14.3	27.9	12.5	13.7	17.4	12.3	4.6
	II	17,920	18.4	13.6	4.2	21.9	18.8	2.6	11.5	5.2	6.1	16.6	6.4	9.5

Imports

		Value US$ million	Annual change, percent											
			Total			Consumption			Capital			Intermediate		
			Value	Vol.	Price	Value	Vol.	Price	Value	Vol.	Price	Value	Vol.	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
2006	I	9,012	24.1	15.3	7.6	17.9	15.1	2.4	17.5	16.8	0.6	26.4	13.4	11.5
	II	9,378	18.4	10.8	6.8	27.4	25.5	1.5	-2.7	-5.3	2.8	20.9	10.1	9.7
	III	10,003	15.5	9.4	5.6	16.4	13.8	2.3	-1.5	-2.5	1.0	19.2	10.3	8.1
	IV	10,017	13.1	12.4	0.6	11.2	11.3	-0.1	9.9	9.4	0.5	14.9	14.0	0.7
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	11,233	19.8	17.4	2.0	14.2	11.8	2.2	21.3	20.4	0.7	22.6	19.6	2.6

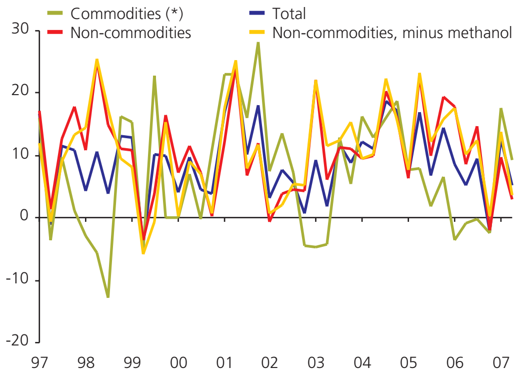
Source: Central Bank of Chile.

The annual growth rate by volume of manufactured exports in the second quarter reached 5.2%, less than half the rate in the previous quarter. This reflected a drop in fishmeal shipments and, to a lesser degree, the impact of

Figure III.8

Manufacturing exports

(real annual change, percent)



(*) Includes: Fishmeal, salmon and trout, wood pulp and wood.

Source: Central Bank of Chile.

natural gas restrictions on methanol production, which was not completely offset by the larger volume of wood pulp exports. Thus, a closer look at manufacturing exports reveals that commodities (including wood pulp) grew by almost 10% in the second quarter, while the different commodities (including methanol) grew substantially less (figure III.8).

In the first half of the year, agricultural exports by volume rose more than in 2006. Nonetheless, unusual winter frosts will probably reduce exports in the second half.

Total imports reached US$11.233 billion in the second quarter of 2007 (totaling US$21.318 billion so far this year). Annual growth by volume for the second quarter of 2007 rose to 17.4%, reflecting strong domestic demand and growth in demand for imported fuel. Capital goods imports during this same period also stood out, posting a rise in annual growth, by volume (20.4%). High and sustained growth of consumer goods imports was in line with private consumption, especially spending on durable goods. Intermediate goods also rose sharply (19.6%), reflecting fuel imports, unfavorable rains in the first half, and restrictions on natural gas, which required more imports for electric power generation (box IV.I).

The balance of payments current account closed the first half of 2007 with a surplus of US$6.473 billion, or 5.4% of GDP for the moving year ending in the second quarter. The second quarter produced a surplus of US$3.085 billion, thanks to surpluses in the goods (US$7.419 billion) and transfers (US$807 million) accounts. These were partially offset by deficits in the income (-US$4.726 billion) and services (-US$415 million) accounts. The baseline scenario for this *Monetary Policy Report* projects that the current account will end 2007 with a surplus of 5.4% of GDP, up from May projections, largely due to the higher copper price and larger export volumes. This indicates that an important part of additional revenues thanks to unusually high export prices is being saved, because they are perceived as temporary. This to a large degree reflects a fiscal expenditure policy based on structural revenues.

IV. Output and the labor market

Table IV.1

Gross domestic product

(real annual growth, percent)

	Weight	2006					2007		
	2006	I	II	III	IV	Year	I	II	Half I
Agriculture, livestock, and forestry	3.8	4.3	6.9	1.0	9.6	5.4	4.4	6.1	5.2
Fishing	1.2	3.1	-2.3	-5.2	-4.5	-1.9	7.0	8.1	7.5
Mining	7.5	0.1	3.7	-3.4	0.0	0.1	6.1	5.4	5.7
Manufacturing	16.5	7.5	0.6	-0.7	2.9	2.5	3.8	4.8	4.3
EGW	2.9	6.4	12.0	4.3	7.0	7.4	3.0	-10.7	-3.7
Construction	7.0	4.4	4.1	2.2	5.0	3.9	8.1	9.4	8.8
Wholesale and retail trade (1)	10.1	5.9	5.8	5.4	3.8	5.2	6.4	7.5	6.9
Transportation	6.8	5.3	4.3	3.1	6.2	4.7	5.8	7.5	6.6
Communications	2.6	11.4	8.5	9.1	10.7	9.9	13.3	14.5	13.9
Natural resources (2)	11.6	2.0	4.9	-1.7	1.1	1.6	5.4	1.8	3.6
Other (2)	83.0	5.4	3.7	3.0	4.5	4.1	5.7	6.5	6.1
Services (2)	62.7	5.0	4.3	4.1	4.7	4.5	6.3	6.9	6.6
Total GDP (3)	**100.0**	**5.0**	**4.0**	**2.6**	**4.3**	**4.0**	**5.8**	**6.1**	**5.9**

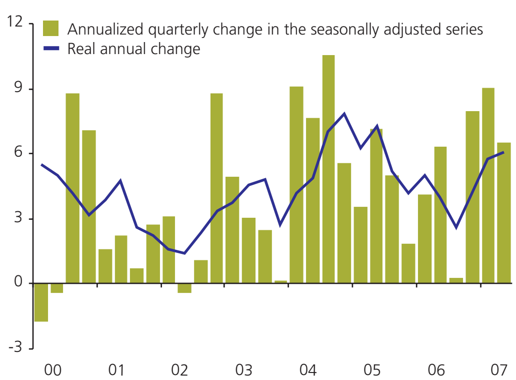
(1) Includes restaurants and hotels.
(2) For definitions, see Glossary.
(3) Total GDP is the sum of natural resource and other GDP, net VAT collected, import duties, minus bank charges.

Source: Central Bank of Chile.

Figure IV.1

Gross domestic product

(percent)



Source: Central Bank of Chile.

This chapter reviews changes in GDP by sector of origin and changes in employment, to evaluate price pressures on factors and goods markets, along with short-term prospects for output.

Total GDP

In the first half of 2007, idle capacity was picked up more quickly than forecast in the May *Monetary Policy Report*. Annual GDP growth reached 5.8% in the first quarter and 6.1% in the second[1]/ (table IV.1). Growth in the second quarter was favored by a solid performance from service sectors (wholesale and retail trade and construction), in line with the strength of consumption and investment. This was offset by lower output from electricity, gas and water (EGW) and a part of manufacturing that depends on natural gas. In fact, growth of natural resource-related sectors, including EGW, reached just 1.8% annually in the second quarter, while the annual increase for other sectors reached 6.5%. On expansion velocity, output in the first half maintained the accelerated achieved in late 2006 (figures IV.1 and IV.2).

The baseline scenario projects that although GDP growth will bounce around somewhat in the short term, in the second half of 2007 it will be similar to the first half of the year, partly due to the calendar effect. This conclusion is based mainly on growth expected from the mining sector, given the low basis for comparison for the same period in 2006, along with persistently strong output from service sectors. Altogether, compared to the present, annual expansion should slow in the third quarter, and then rise again toward year's end. Thus, the baseline scenario assumes that annual output will rise somewhere between 5.75% and 6.25% in 2007.

Natural resource GDP

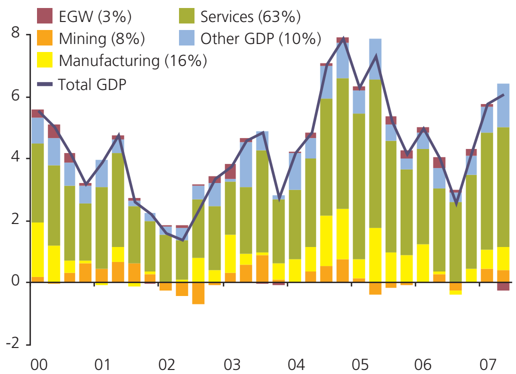
In the first half of 2007, growth of natural resource-related sectors (mining, fishing and EGW) slowed, largely reflecting a fall in EGW annual output, the result of restricted gas supply and the replacement of hydropower with thermal power to generate electricity (figure IV.3). EGW therefore contributed -0.3 percentage point to growth in the second quarter, whereas it contributed 0.15 on average from 2004-2006. For the rest of the year, the outlook for electric power generation looks similar to trends in the first half (box IV.I).

[1]/ According to the usual publication policy for quarterly national accounts, a new estimation for GDP in the first quarter of 2007 was published on 23 August.

Figure IV.2

Gross domestic product (*)

(contribution to GDP growth, percent)



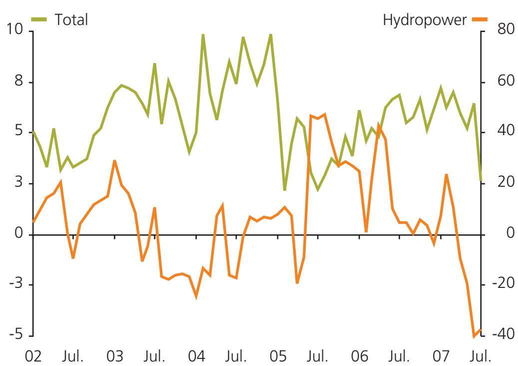
(*) Figures in brackets are weights for each sector within 2006 GDP.

Source: Central Bank of Chile.

Figure IV.3

Electric power generation

(real annual change, percent)

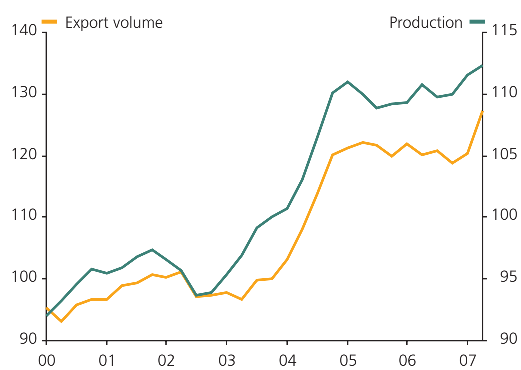


Source: *Centro de Despacho Económico de Carga* (CDEC).

Figure IV.4

Mining (*)

(index 2003=100)



(*) Moving annual average.

Sources: Central Bank of Chile and National Statistics Bureau.

Meanwhile, mining production rose 5.7% in the first half (figure IV.4). The baseline scenario forecasts this will rise on average in the second half, reflecting both the low basis for comparison in 2006 and the consolidation of new projects starting up this year. Fishing was the exception this half, as it posted a steady rise throughout this period, reflecting mainly the low basis for comparison in 2006, particularly in the case of extractive fishing and thanks to the sustained strength from cultivation centers. Similarly, this sector's annual output is expected to remain high.

Other GDP

In the first half of 2007, sectors excluding those involving natural resources grew more and more quickly than in 2006 (averaging 6.1% in the first half compared to 4.1% in 2006). For the second half of this year, these sectors' GDP should continue to post high growth rates, driven mainly by service sectors.

Manufacturing

In the first half of 2007, as forecast last May, annual growth in the manufacturing sector continued to rise. Aside from a solid performance from virtually all subsectors, a strong performance from wood pulp production, which is included in the supply sectors, contributed, as did a rise in capacity apparent in this sector. According to manufacturing production figures from INE, wood pulp production contributed 2.4 percentage points to overall growth of the manufacturing sector in this half. In contrast, output from the basic chemicals subsector fell, reflecting the impact of restricted natural gas on methanol production. This was behind the decline in tradable sectors' annual growth (figure IV.5). Meanwhile, sectors associated with investment again posted slightly positive rates as they did in the last quarter, after falling in the first part of the year.

Manufacturing sectors producing tradable goods and competing with imports posted positive annual changes approaching 10% (figure IV.6).

For the second half of the year, manufacturing is expected to perform better, driven by both domestic and external demand. These prospects, nonetheless, assume that manufacturing's annual growth will slow somewhat, reflecting lower methanol production, maintenance in some subsectors' production lines, and fewer working days for this period. Toward year's end this should pick up again, once maintenance is done.

In the second quarter, manufacturing employment as reported by different sources (INE, AChS and Sofofa) was very consistent. Sectoral employment was growing at between 4% and 6%. Information for July from INE suggested this growth was slowing.

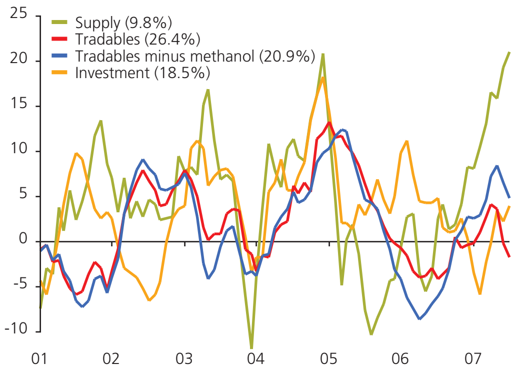
Wholesale and retail trade and other services

The wholesale and retail trade sector, like others in the service sector, grew well above the aggregate rate for the economy in the first half of this year: 6.9% annually, revealing a substantial acceleration. This sector's performance was complemented by growth in consumption and investment. For the rest

Figure IV.5

Manufacturing production (1) (2)

(moving quarterly average for seasonally adjusted series, index 2003=100)



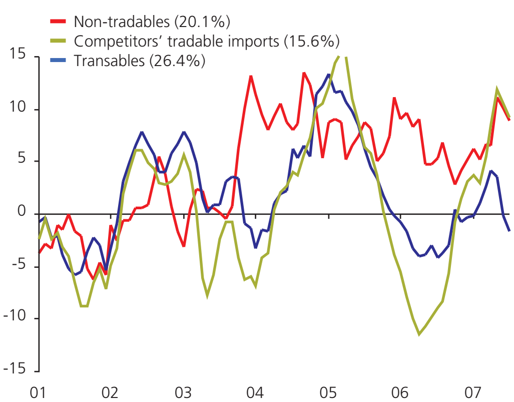
(1) Figures in brackets are the weights for each subsector over total manufacturing in 2006.
(2) For manufacturing definitions, see Glossary.

Sources: Central Bank of Chile and National Statistics Bureau.

Figure IV.6

Manufacturing production by grouping (1) (2)

(moving quarterly average for seasonally adjusted series, index 2003=100)



(1) Figures in brackets are the weights for each subsector over total manufacturing in 2006.
(2) For manufacturing definitions, see Glossary.

Sources: Central Bank of Chile and National Statistics Bureau.

of this year, this sector is expected to remain strong, again favored by the bright outlook for consumption and investment. This performance projection is also supported by employment figures from AChS, which particularly for the second quarter point to an annual rise of almost 7%. Moreover, at the margin, INE data also shows greater growth in this sector's employment.

Transportation and communications, meanwhile, posted annual growth of more than 8% in the first half. Financial and business services did likewise. In both cases this trend reflected stronger domestic demand. According to the baseline scenario, this strength should hold throughout the second half of 2007.

Construction

In the two first quarters of 2007, the construction sector continued the recovery forecast in the May *Monetary Policy Report*, with annual growth outperforming the aggregate and rising from one quarter to the next. This trend was apparent in significant growth in figures for the sales of construction inputs and is primarily sustained by investment in engineering works. At the same time, information from interviews with different firms reveals significant development of the real estate sector in several regions, combined with a high growth rate for mortgage loans. The baseline scenario assumes that this solid performance will continue and is based in part on information from the CBC's investment survey, which points to significant strength from engineering works.

Annual growth in this sector's employment, based on figures from INE, held steady at around 5% in the second quarter. However, figures for July were lower, and consistent with those from AChS and the Chilean Chamber of Builders (*Mutual de la Cámara Chilena de la Construcción*) whose rates were slightly positive.

Agriculture, livestock, and forestry

This sector grew more than 5% in the first half of the year, similar to its average in 2006. In light of bad weather this winter, however, it may grow less in the second half, particularly agriculture. This would also affect sector exports.

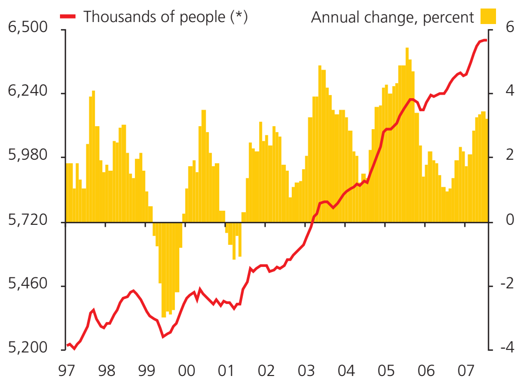
Employment, participation and unemployment

The labor market has revealed a steady closing of gaps, with the seasonally adjusted unemployment rate for the moving quarter ending in July[2]/ down more than half a percentage point from earlier in the year and below several estimates consistent with price stability. Likewise, the annual growth rate for employment has risen. Data from the moving quarter ending in July posted significant growth for the fourth month running in annual terms: over 3% (around 200,000 people), up from a 2006 average of 1.6% (slightly

[2]/ Since June 2007, 12-month comparisons using INE figures come from a uniform sample taken using the same sampling framework. For more details, see the September 2006 *Monetary Policy Report*, box IV.1: New INE employment figures, page 39.

Figure IV.7

National employment



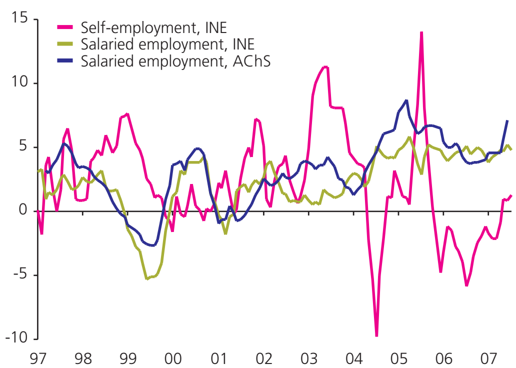
(*) Seasonally adjusted series.

Sources: Central Bank of Chile and National Statistics Bureau.

Figure IV.8

Employment by occupational category

(annual change, percent)

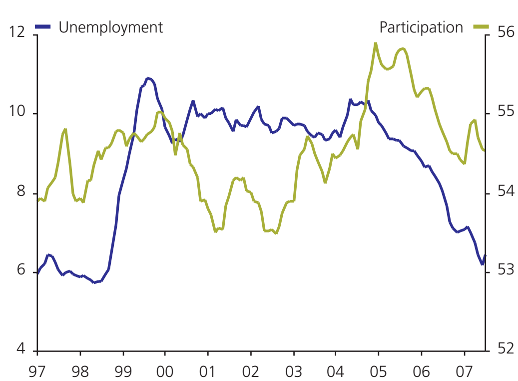


Sources: *Asociación Chilena de Seguridad* and National Statistics Bureau.

Figure IV.9

Unemployment rates and participation

(seasonally adjusted series, percent)



Sources: Central Bank of Chile and National Statistics Bureau.

more than 100,000 people on average, figure IV.7). Salaried employment continued to post annual growth rates of around 5%, as it has since late 2004. Data collected on a case-by-case basis suggests the possibility that the new law governing outsourcing has positively affected the formalization of employment. Meanwhile, after falling for almost 18 months, annual rates for self-employment have risen slightly (figures IV.8).

After recovering since late 2006, annual growth of the labor force has stagnated for the past five periods, remaining at just over 1%. After rising in April, in July the seasonally adjusted participation rate fell to levels of earlier in the year, part of a decline that has dragged on since it peaked in early 2005 (figures IV.9).

In the moving quarter ending in July, the seasonally adjusted national unemployment rate reached 6.5% (down 0.6 percentage point from the first quarter of 2007). The forecast of reduced idle capacity based on INE's labor market data is consistent with data from the University of Chile's survey, which points to strong employment and a decline in Greater Santiago's unemployment rate.

Box IV.1: **Energy: current status and prospects**

In recent years, international energy costs have risen significantly. This is reflected in the higher oil price, which in the case of the WTI stood at nominal prices of US$10 per barrel by the late 1990s and in the past 12 months has approached US$80. In Chile, the impact has been amplified by growing restrictions on natural gas from Argentina, which began in 2004 and reached critical levels in 2006. This effect has been further augmented this year by some shortages of water for generating electric power, due to a deficit in rainfall in the first half.

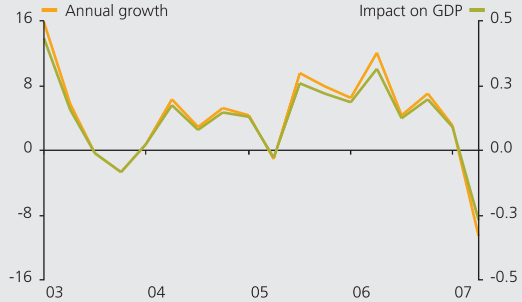
Impact on output

In 2006 it was impossible to precisely identify the full impact of these higher energy costs, given the conversion of a significant number of firms using natural gas as their input.[3]/ This year, the impact is more obvious, because it has directly affected the aggregate value of electric power generation and manufacturing using gas as its main input. In fact, in the second quarter of 2007, annual output from the Electricity, Gas and Water (EGW) sector fell almost 11%, contributing -0.3 percentage point to quarterly GDP growth (figure IV.10). This reflects the fact that annual hydro power generation fell 24% in this period (-37% annually in July, figure IV.3). Manufacturing's performance was affected by natural gas shortages, since this is one of the main inputs for producing methanol, contributing -0.2 percentage point to GDP growth in the second quarter (table IV.2).

Figure IV.10

EGW

(real annual change, percentage points)



Source: Central Bank of Chile.

Table IV.2

Impact on GDP

(impact on GDP, period growth, percentage points)

Direct impact	Average impact 2004-2006	2007 I	2007 II	2007 Half I
EGW	0.15	0.09	-0.30	-0.10
Methanol	0.06	-0.03	-0.22	-0.12
Total	**0.21**	**0.06**	**-0.51**	**-0.23**

Source: Central Bank of Chile.

Impact on private disposable income

Replacing natural gas and hydropower with other fuel also boosted imports significantly in the first half of this year, especially bituminous coal (*hulla*) and diesel oil, which rose by 44% and 66% annually in volume, respectively. In this same period and given fuel prices, imports by value of soft coal and diesel oil also rose, by 53% and 58%, respectively, year on year. Thus, on the income side, without considering the impact that could be attributed to the rise in imports by value on economic growth, we estimate this situation has involved a real net transfer of resources abroad worth about one percentage point of private disposable income in the first half of 2007 (table IV.3 and figure IV.11), considerably more than occurred for the same reasons during the same period in 2006.

Table IV.3

Spending increase due to the use of alternative fuel in the first half of each year (1)

(nominal value as a percentage of Private disposable income)

	2007 vs 2006		2006 vs 2005	
	US$ million	%	US$ million	%
Total change in value	**592**	**1.22**	**153**	**0.36**
Growth impact (2)	74	0.15	51	0.12
Total shocks	519	1.06	102	0.24
Price impact (3)	160	0.33	197	0.46
Substitution impact	358	0.74	-95	-0.22

(1) Fuel alternatives include diesel, soft coal, gasoline and other.
(2) Estimated as the growth effect on the economy of the amount imported valued at prices from the previous year, including a unit elasticity assumption.
(3) Estimated as the price difference for imported fuel by the quantity imported the previous year.

Source: Central Bank of Chile.

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[3]/ A review of these effects was published in the *Monetary Policy Report* of January 2007. See box IV.1: Quantification of the impact of higher energy costs on output, pages 39-40.

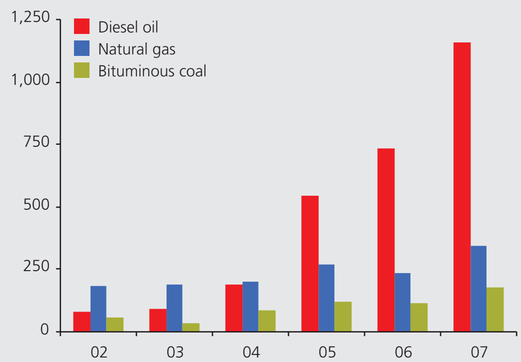
Impact on inflation

Electric power generation using higher cost fuel has, moreover, significantly affected the price paid by the free and regulated customers. In July, electric power rates rose by 6% for this reason. This was outside the usual setting of power generation rates in terms of both timing and size. Combined with other increases this year, this situation pushed households' annual electric utility rate up by 20% as of July, and directly added 0.37 percentage point to headline inflation (figure IV.12). Moreover, natural gas for household consumption also rose some 8%, explaining 0.04 percentage point in higher CPI for the same period.

Figure IV.11

Non-crude oil fuel imports

(US$ million cif, as of first half of each year)

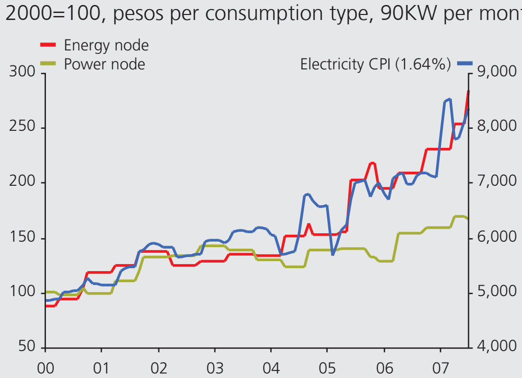


Source: Central Bank of Chile.

Figure IV.12

SIC node prices and electric utility rates (1) (2)

(index 2000=100, pesos per consumption type, 90KW per month)



(1) The node price is the price at which generators sell electricity to distributors when the destination is a regulated customer.

(2) Figure in brackets indicates weight within CPI price basket.

Sources: *Comisión Nacional de Energía* and National Statistics Bureau.

Prospects

For the future, the electric power sector scenario will depend on growth in demand, the timing and implementation of investments in this sector, and water levels, among other factors.

According to its June review, the CBC's investment survey suggests that investment in the energy sector should rise significantly (52% of total investment) in 2008, less (47%) in 2009.[4]/ This reflects the situations described above, impulse from government policies, and a steady rise in demand for energy, which has generated the incentives necessary to reconvert natural gas technologies and boost generation capacity for the coming years.

The baseline scenario assumes new increases to energy rates for the rest of the year, associated with the usual review of node prices in October and possible additional increases associated with indexation.[5]/ The rise in the marginal cost of electric power generation will also affect the energy costs of those companies that are free customers of generators and are not quantified within the CPI. These have established contracts indexed to this variable that could boost production costs, compress margins and general possible inflationary pressures.

As has been the rule in recent quarters, this scenario is subject to enormous uncertainty. The effects that rains and snowfall in recent weeks will have on electric power generation in the second half remains to be seen. Likewise, uncertainty remains regarding cutbacks to natural gas from Argentina, oil price trends, and implementation of investment projects that have been announced.

[4]/ Minus real estate and telecommunications sectors.

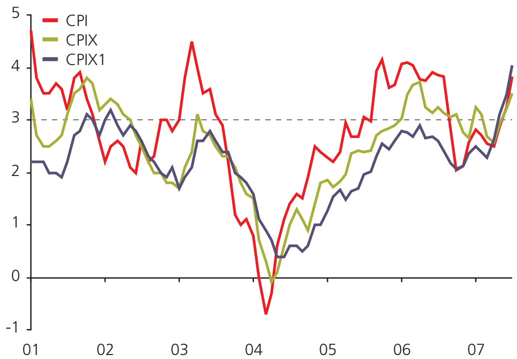
[5]/ One factor that determines the energy node price is the marginal cost of electric power generation, which rose substantially in the first half of 2007.

V. Recent inflation and cost trends

Figure V.1

CPI, CPIX and CPIX1 inflation (*)

(annual change, percent)



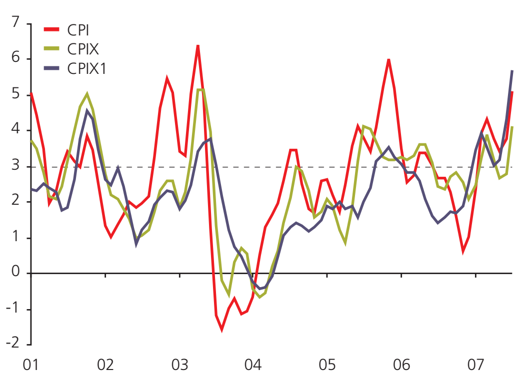
(*) For definitions, see Glossary.

Sources: Central Bank of Chile and National Statistics Bureau.

Figure V.2

Expansion velocity, CPI, CPIX and CPIX1

(percent)



(*) For definitions, see Glossary.

Sources: Central Bank of Chile and National Statistics Bureau.

This section examines recent trends affecting the main components of inflation and costs, identifying different sources of inflationary pressures under current conditions and probable changes in the short term.

Recent inflation trends

The different inflation indicators have posted significant changes since last April. The annual CPI rose from 2.5% in April to 3.8% in July, while the CPIX and CPIX1, which in April were rising 2.6% annually, posted annual increases of 3.5% and 4.0%, respectively (figure V.1). The After averaging 3.5% in the first four months of the year, CPIX1 expansion velocity also rose significantly, approaching an annualized 6% in July. Similarly, CPI expansion velocity has also moved above levels of the first quarter of the year (figure V.2).

After the strong rise in monthly CPI inflation in recent months, at around 1% in June and July, a series of supply shocks, originating abroad and in Chile were identified, which have affected prices of some perishable and non-perishable foods and, to some degree, certain energy products (box V.1, figures V.3 and V.4).

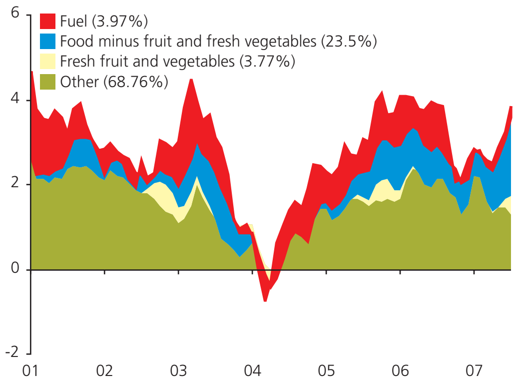
In the case of perishable foods, price hikes mainly affected products associated with wheat, corn and milk. By April, wheat and corn by-product prices had already risen significantly. Although they continued this ascent in May and July, it slowed and remained roughly in line with forecasts. In the case of dairy products, prices rose significantly (17%) in May and July, with annual inflation reaching 31% as of July (figure V.5). In both cases, the main factor between domestic price increases was the shift in prices abroad. Reasons varied. On one hand, demand from markets such as China and India was up, amidst lesser supply due to the droughts affecting the main world producers (box I.3). On the other, increased demand for biofuel has also pushed up the prices on inputs, among them corn and wheat.[1]/ Moreover, the passthrough velocity of international milk prices to the domestic market has risen significantly so far this year. While in early 2007, estimates suggested a statistical lag of two to three months, today the passthrough seems to be virtually immediate, according to information from companies in this sector.

[1]/ For a description of events in these markets see the May *Monetary Policy Report*, box I.2, Recent trends in international agricultural prices, page 21.

Figure V.3

Impact on annual CPI inflation (*)

(percentage points)



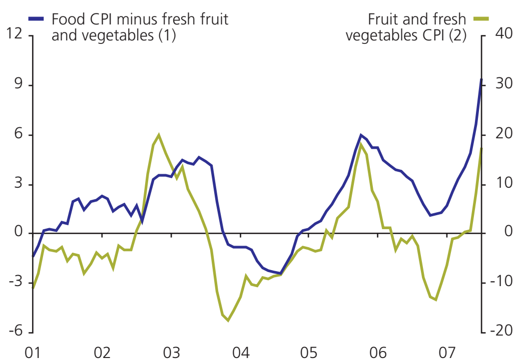
(*) In brackets, weight within CPI.

Sources: Central Bank of Chile and National Statistics Bureau.

Figure V.4

Food CPI

(annual change, percent)



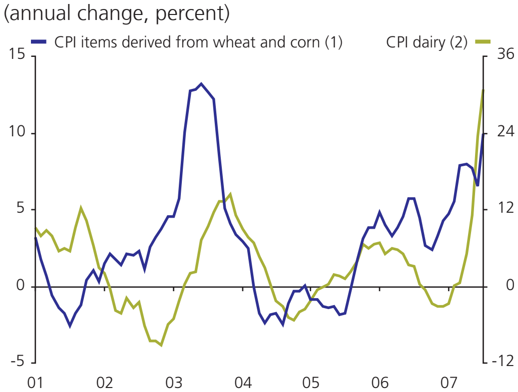
(1) 23.5% of total CPI.
(2) 3.77% of total CPI.

Sources: Central Bank of Chile and National Statistics Bureau.

Figure V.5

Food subgroup CPI

(annual change, percent)



(1) Includes: bread, eggs and noodles and other pastas. 3.19% of total CPI.
(2) Includes milk, cheese and other dairy products. 2.03% of total CPI.

Sources: Central Bank of Chile and National Statistics Bureau.

This price rise has affected world inflation measures, with varying intensity depending on the relative importance of these products within each economy's consumption basket and the type of product included. Thus, although obviously not completely comparable, the CPI for food in China, Brazil and Mexico rose by similar or even greater amounts than Chile's (figure V.6).

The baseline scenario assumes that non-perishable food prices experiencing price hikes in recent months, particularly dairy products, will continue to rise somewhat in the short term, before rising at rates similar to the average for other prices until the end of the projection horizon.

Starting in June and strengthening in July, there was also a significant price rise in perishables. This reflected bad weather, which has hurt agriculture this winter, especially damaging frosts. The current price rise is highly unusual for this time of the year. It has been significant and affected a wide range of products, but especially fresh vegetables (figure V.7). In any case, as usual when this happens and given the stage in the production cycle, the projected baseline scenario assumes these prices will rise in the short term, but then decline significantly toward year's end.

Although in early 2007 food prices were already rising, particularly for products derived from corn and wheat and to some extent dairy products, the magnitude and occurrence of a set of shocks at the same time since May has been higher than any forecasting exercise could predict based on past information. Thus, although the May baseline scenario considered a longer duration for high food prices a risk (in fact, the projection assumed that in the short term there would be no significant changes, despite the increases already registered) the size of the actual shock and therefore the change in projections is well above any past correction or the level that any standard projection model could detect. Keeping in mind annual inflation through July and the project in the May baseline scenario, these events pushed annual CPIX1 inflation, 1.1 percentage points higher than forecast. Given the CPIX1' weight within the CPI (69.7%), plus the rise in non-durables, the difference from the May projection is almost 1.4 percentage points in the case of the CPI (table V.1).

Moreover, oil and gasoline prices have once again been higher than projected. While it did not influence the strong increase in annual inflation in recent months, this factor explains a significant part of the difference between current projections and the May projection for this variable. The per barrel cost of crude oil rose again, to over US$70 (US$65 as the May *Monetary Policy Report* closed), even approaching US$80 in July, although it fell slightly as this *Report* closed. The international gasoline price, meanwhile, is lower than in May, but still higher than projected in that baseline scenario. The current baseline scenario assumes a higher oil price for 2007 and 2008 than in May, which should reach a higher long-term value earlier than forecast.

In recent months regulated prices have also shifted significantly. Unlike in the May baseline scenario, which assumed that transfers between buses would cost an additional 20 pesos by August, there have in fact been no changes to bus fares. There is uncertainty about when and based on what considerations

Table V.1

Annual inflation as at July 2007
(percentage points)

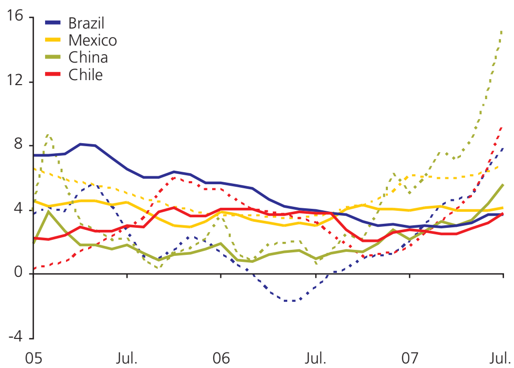
	Weight CPI	Projection (*)	Actual	Difference
Food	18.2	1.22	2.32	1.10
Other CPIX1	51.5	1.52	1.72	0.19
CPIX1	**69.7**	**2.74**	**4.04**	**1.29**
CPIX1 impact on CPIX		2.09	3.07	0.98
Fares	5.5	0.25	0.44	0.19
Other CPIX	17.1	-0.02	0.00	0.01
CPIX	**92.3**	**2.32**	**3.51**	**1.18**
CPIX impact on CPI		2.14	3.23	1.09
Food and vegetables	3.7	-0.09	0.51	0.60
Combined	4.0	-0.50	0.08	0.59
CPI	**100.0**	**1.55**	**3.82**	**2.28**

(*) The annual inflation projection included in the baseline scenario of the May *Monetary Policy Report* 2007.

Source: Central Bank of Chile.

Figure V.6

CPI and food CPI inflation (*)
(annual change, percent)

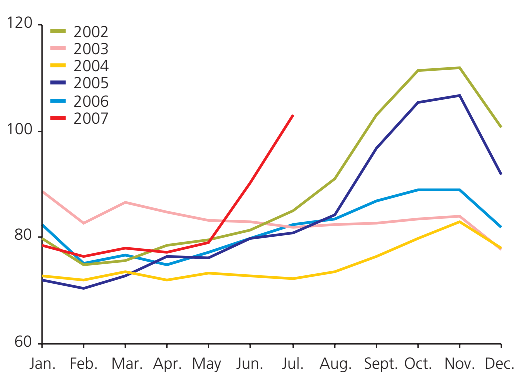


(*) Solid lines represent total CPI and dotted lines food CPI.

Sources: Bank of Mexico, Bloomberg, Instituto Brazilero de Geografía y Estadística and National Statistics Bureau.

Figure V.7

Fresh fruit and vegetables CPI to CPI ratio
(index, December 1998=100)



Sources: Central Bank of Chile and National Statistics Bureau.

these will eventually be changed. The baseline scenario estimates that they will remain similar for the rest of 2007 and begin to rise in 2008, using a formula similar to that used previously by the transportation system.

Lack of rain in the first half of the year and restrictions on natural gas also increased the higher cost inputs going into electric power generation, especially diesel, significantly increasing generation costs, which have strongly affected the costs assumed by free customers and household utility rates. The baseline scenario assumes that the 6% rise in rates (July) will be followed by additional increases in 2007, all reflecting higher generation costs. Their impact on headline inflation will be somewhat more than half a percentage point. For 2008, the working assumption is that rates will rise again, by a magnitude similar to the average rise for 2004-2005. This scenario is subject to enormous uncertainty, with results depending on developments in the energy matrix, fuel prices, and further increases in electric utility rates, among other factors.

Other prices included in the CPIX, but not the CPIX1 (other regulated rates, indexed prices, fresh meat and fish) have behaved more or less in line with May forecasts.

Beyond the current price situation, measures for trend inflation, which in principle better reflect the prospects for medium-term inflation, have risen according to recent data, to over 3% annually (figure V.8).

In recent months, moreover, the gap apparent at the end of 2006 between goods and services inflation (total and core) has closed. This gap, which had reached about five percentage points in January for totals and three percentage points for core measures ended July with a larger rise in goods inflation and stable annual growth in services inflation (figure V.9). As mentioned in May, given the size of this differential, this situation raised questions about its implications for future inflation. Statistical data shows that core service inflation, which early in the year was growing faster than core goods inflation, lasted somewhat longer. The fact that this gap closed with a larger rise in goods inflation supports this analysis.[2]/

It is important to note, however, that aside from the rise in specific prices, other CPI components posted no relevant changes to their usual patterns. Measures that exclude food and energy from the CPI basket show no acceleration of annual inflation for 2007. The CPI measure, minus energy and food prices, which leaves 68% of the CPI basket, posted an annual rise that was less than 2% as of July, which was even lower than the fourth quarter of 2006. Moreover, the CPIX1 measure, which excludes food prices, leaving 74% of the CPIX1 and 52% of the CPI basket, posted annual inflation that remained at 2.3% for several months and similar to the average annual change in 2006 (figure V.10).

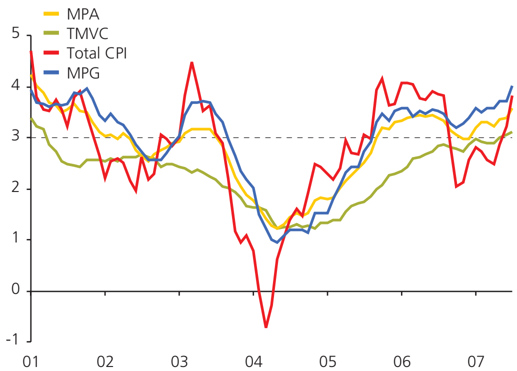
This supports the argument that a significant part of the strong rise in inflation at the moment and the substantial increased expected in the shortest term

[2]/ May *Monetary Policy Report* 2007, box V.2: Goods and services CPI, page 42.

Figure V.8

Inflation trend indicators (*)

(annual change, percent)



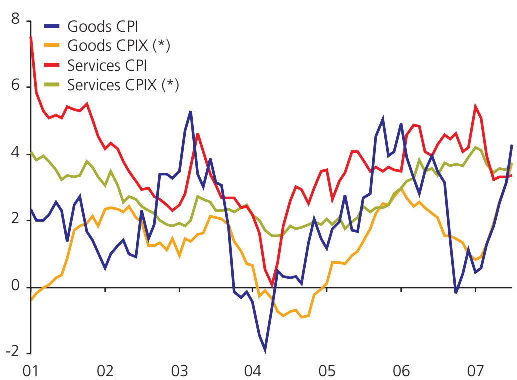
(*) For definitions, see Glossary.

Sources: Central Bank of Chile and National Statistics Bureau.

Figure V.9

Goods and services CPI

(annual change, percent)



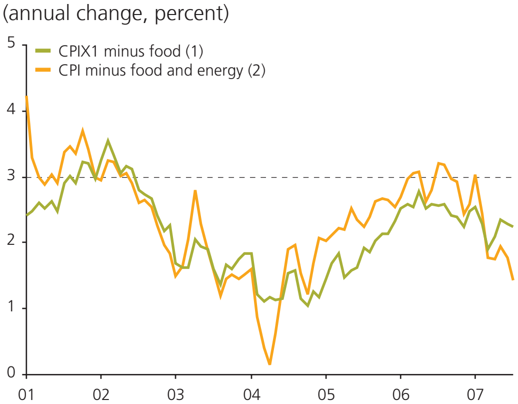
(*) For definitions, see Glossary.

Sources: Central Bank of Chile and National Statistics Bureau.

Figure V.10

CPI minus several components

(annual change, percent)



(1) Excludes food, fuel, public services, buses, indexed and financial services, leaving 74% of the CPIX1 basket and 52% of the total CPI basket.
(2) Excludes food and energy, leaving 68% of the total CPI basket.

Sources: Central Bank of Chile and National Statistics Bureau.

scenario mainly responds to specific shocks reflecting higher international prices for some foods and bad weather, and not necessarily demand factors, so there is insufficient evidence to associate these with shifts in the economic cycle. In any case, it is important to remember that CPI measures that isolate the prices with the largest increases are useful for understanding the specific conditions affecting inflation, but do not necessarily serve as guides to monetary policy actions. This is because these measures may hide inflationary pressures that are developing in other sectors. For example, the increase in food and fuel prices may have compressed spending on other goods, pushing their prices downward, which would be consistent with the lower CPI when food and energy are not included. A brake on higher food and fuel prices could therefore make other prices rise, which would bring inflationary pressures that would appear once the former returned to normal. There is also the risk of second round effects with negative effects on inflation expectations and the effectiveness of monetary policy. These could involve rises in other prices, caused, for example, by upward pressure from labor costs as a result of inflationary expectations. Finally, the lag that exists between the absorption of idle capacity and the actual rise in inflation should also be remembered, so basing projections on prices that are not rising much at this time could introduce forecasting errors.

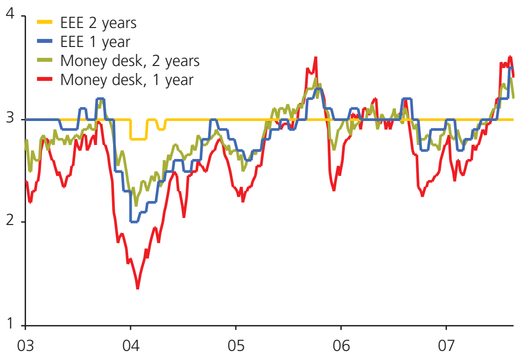
This *Report's* baseline scenario assumes that in the short term inflation will be considerably higher than forecast in May, with annual CPI inflation reaching around 5.5% toward mid-2008. The change in the baseline scenario since May is comparable to corrections to private sector inflation projections and reflects the general surprise these shocks have generated. Results from the Central Bank's economic expectations survey (*Encuesta de Expectativas Económicas*, EEE), applied to a group of analysts, found they expected inflation to stand at 2.9% in December 2007 (very similar to the 2.8% assumed in the May *Monetary Policy Report*). By August, however, this projection stood at 4.8%.

Similarly, inflation expectations over longer periods move toward 3%, in line with the conclusion that most of these shocks will have a one-off effect on price levels, so that by 2008 annual inflation should decline. Thus, while through December of this year the private sector expects inflation to reach almost 5% annually, it should fall to around 3.5% one year hence. In particular, the survey at money desks suggests inflation should stand at 3.4% one year hence (figure V.11). Toward the second year, inflation is expected to approach the target, with money desks anticipating 3.2% and the EEE 3%. The inflationary compensation in forwards to one year (that is, the differential between nominal interest rates and those indexed to the UF expected for operations to one year implicit in financial prices or one-on-one compensation assumes inflation will be 3.3%. For longer periods, it stands at somewhat more than 3%. In particular, the five on five inflationary compensation is 3.2% (3% in July), a figure similar to values observed in other periods when inflation temporarily rose to 4% (figure V.12). Clearly, forward compensations are lower than the differentials for nominal and indexed bond yields in the medium and long term, because these also include short-term compensation. In any case, it should be noted that financial asset prices contain implicit risk premiums whose magnitude is difficult to determine precisely, and which can become more important in highly volatile episodes such as the current one.

Figure V.11

Inflation expectations

(percent)

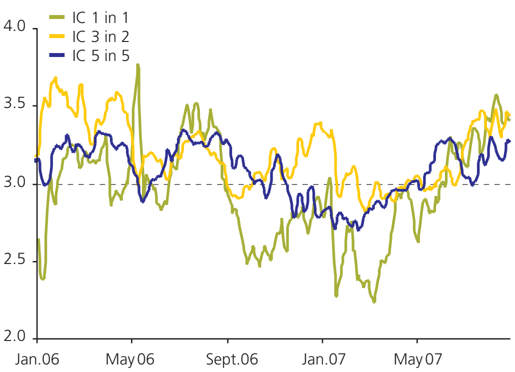


Source: Central Bank of Chile.

Figure V.12

Average forward inflationary compensation

(moving weekly average, percent)

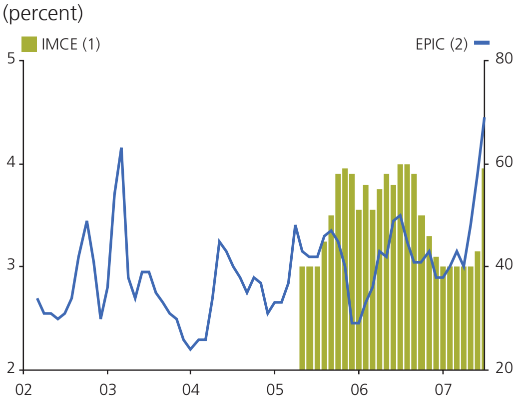


Source: Central Bank of Chile.

Figure V.13

Consumer and business expected inflation

(percent)



(1) Answers to the question: *¿cuál es su expectativa de inflación para los próximos doce meses?* (What is your expectation for inflation in the next 12 months), in the survey of the manufacturing and wholesale and retail trade sectors.

(2) Percentage of those surveyed who believe inflation will climb "a lot" in the next 12 months.

Sources: Adimark and Icare/Universidad Adolfo Ibáñez.

It is also worth noting that private, non-financial sector agents' perceptions also reveal a significant rise in expected inflation. Adimark's consumer survey (EPIC) from July revealed a record number of those surveyed expected prices would climb "a lot" in the next 12 months (figure V.13). Similarly, the July business survey (IMCE) found that those surveyed in the wholesale and retail trade and manufacturing expected inflation 12 months hence to reach almost 4% (up from an average of 3% in the first half of 2007). This outlook for short-term inflation expectations makes it necessary for the Board to be particularly carefully about monitoring the possible propagation of the effects from these shocks to other prices.

Cost pressures and margins

Wholesale and producer prices

Annual growth in the Producer Price Index (PPI) bounced around somewhat but basically continued to decline from high levels in mid-2006. Through July, the annual change stood at 3.0%, far below the 24.2% posted one year earlier and the 14.1% of late 2006. A significant part of the smaller rise in the PPI was associated with the basis for comparison, given the copper price in the first half of 2006. In fact, the annual change in the PPI's mining and quarrying category was -2.5%, substantially lower than that posted one year earlier (92.9%). PPI prices reflected in the CPIX1, meanwhile, posted a higher annual change, rising from between 3.5% and 4.5% in the first four months of the year to 5.8% in July.

Annual growth in the Wholesale Price Index (WPI) was similar to total PPI, rising 3.9% annually in July (7.9% in December 2006). As mentioned, the passthrough of these declines to CPI is not direct, because some of the products included in the WPI or PPI are not in the CPI, and because of the functioning of stabilization funds, margins and fixed taxes within prices to consumers.

Trade margins

Indirect measures for margins derived from different aggregates of the CPI, WPI and PPI are similar or slightly higher than those in the May *Monetary Policy Report*, in line with medium-term trends in recent years. Altogether, shifts in different measures for retail margins do not seem to reveal any inflationary pressures due to the lagging in effects from cost rises (figure V.14).

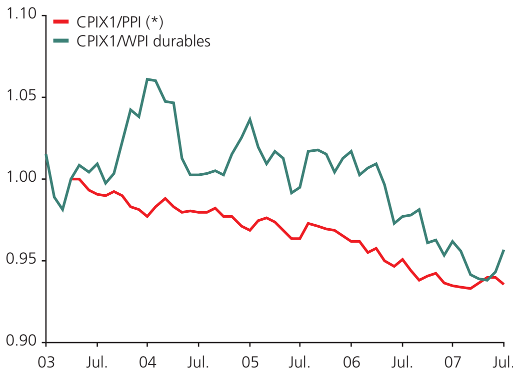
Imported inflation

Aside from the higher price of oil derivatives and some foods, no major changes in cost pressures from imported inflation appear. Although it has bounced around a great deal since last May, the peso whether measured against the dollar or a currency basket remains at levels similar to the closing date for both the May and the September *Monetary Policy Reports*, using the average for the two weeks prior to the closing date for figures. The real exchange rate (RER) has not changed significantly either. The rise in the unit value index (*Índice de Valor Unitario*, IVUM) for imports of consumer goods rose 2.2% in the second quarter of 2007, returning to values similar

Figure V.14

Indirect measures for margins

(ratio, April 2003=1)



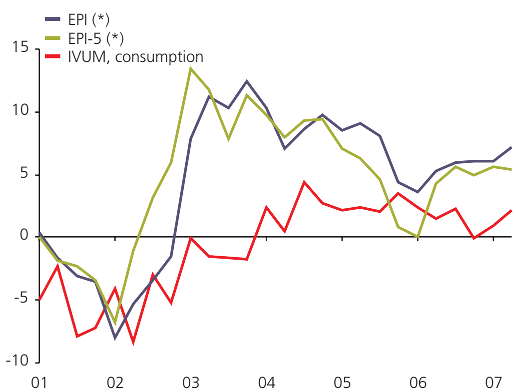
(*) A sample of PPI products also present in the CPIX1 (46% of the CPIX1).

Sources: Central Bank of Chile and National Statistics Bureau.

Figure V.15

External inflation in dollars

(annual change, percent)



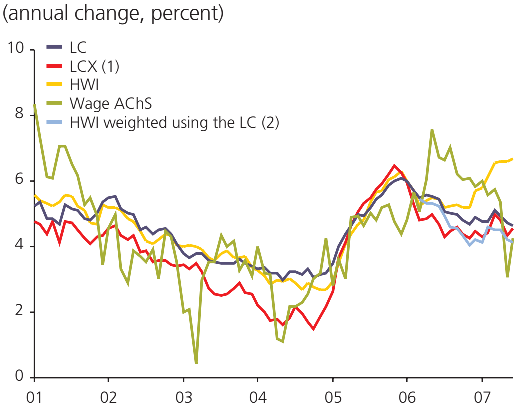
(*) For definitions, see Glossary.

Source: Central Bank of Chile.

Figure V.16

Nominal wages

(annual change, percent)



(1) For definitions, see Glossary.
(2) For definitions, see box V.2.

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

to the second half of 2006 (figure V.15). The annual change in the EPI, which had risen in the first quarter, rose again in the second, while the EPI-5 remained stable.

Wages and unit labor costs

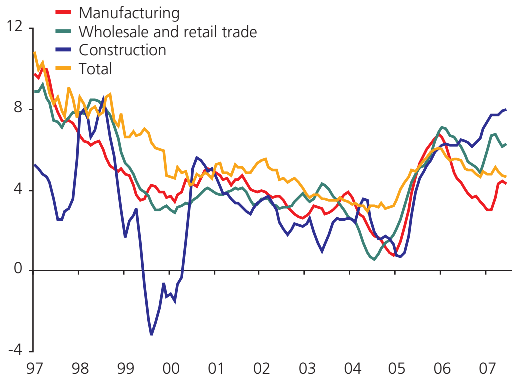
Annual growth in nominal wages measured using labor costs (LC) has fallen slightly since March to 4.7% as of June. In the same period, the hourly wage index (HWI) remained high: 6.7% as of June (figure V.16). The annual rise in nominal wages measured by Chilean Association for Occupational Safety and Health (*Asociación Chilena de Seguridad*) fluctuated significantly in recent months, although its June level (4.3%) was lower than at the end of the first quarter (5.7%, box V.2). Expansion velocities for all indicators, meanwhile, showed lower instant growth than at the end of the first quarter. By sector, annual growth in wages varies widely (figure V.17). The rise in the annual change in labor costs for construction stands out. This sector's employment levels and wages post a relatively significant correlation with the stage in the economic cycle. In this sense, the acceleration apparent in this sector's wages could point to a lack of idle capacity in the labor market.

In this scenario of rising wages, unit labor costs (ULC), which subtract productivity growth, rise at rates close to 3% (figure V.18). Their expansion velocity continues to rise, posting positive figures and, in several cases, amounts higher than an annualized 3%. The rise in ULCs when average productivity for salaried employment alone is considered is particularly noteworthy. For total employment, productivity is more benign and changes in ULC less significant. In any case, using the information available it is impossible to decide which measure is most appropriate.

Figure V.17

Nominal labor costs by sector

(annual change, moving quarterly average, percent)

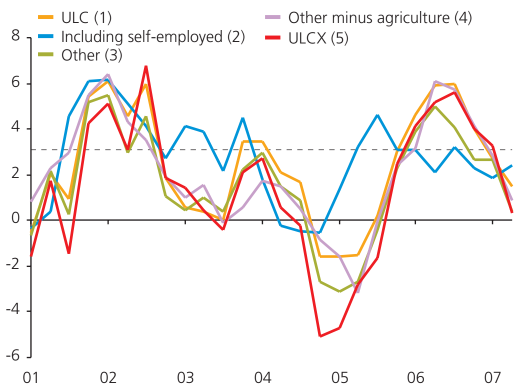


Source: National Statistics Bureau.

Figure V.18

Unit labor cost

(annual change, percent)



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

Sources: Central Bank of Chile and National Statistics Bureau.

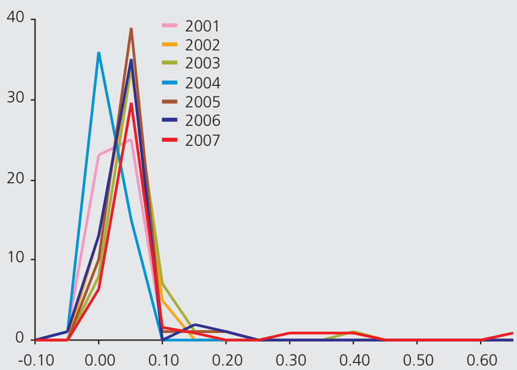
Box V.1: **Supply shocks and inflation**

In 2007, a series of unusual shocks have affected specific prices, both by their magnitude and by their occurrence at the same time. These have also strongly influenced total and core inflation measures. In the last quarter of 2006, the international price of certain foods rose significantly, a phenomenon which initially affected primarily wheat and corn, but then spread to milk and its by-products (box I.3). Bad weather also affected domestic agriculture, and most recently drove up fresh fruit and vegetable prices beyond the usual seasonal fluctuations. Moreover, higher fuel prices and a rise in the cost of electric power generation pushed up household utility rates (box IV.1). Altogether, these elements contributed 2.6 percentage points to annual headline inflation in July (3.8%). More than 60% of this effect involved foods included in the CPIX1, which represent 26% of this sub-basket.

It is important to underline that these increases affected a small number of products, whose inputs are wheat, corn and milk. The distribution of foods' incidence in the CPIX1 reveals isolated increases to the right of the curve. This is contrary to previous episodes, for example in 2003,[3]/ when the distribution of foods moved leftward as the result of a price wage between supermarkets, before returning to its usual position (figure V.19).

Figure V.19

Distribution of annual incidence of foods within CPIX1 (*)
(number of products, percentage points)



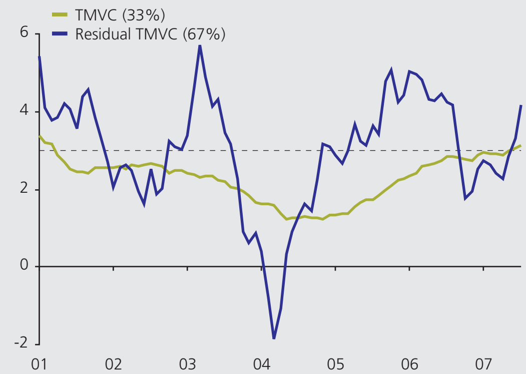
(*) Annual incidence through July of each year. 52 articles from the food group used.

Sources: Central Bank of Chile and National Statistics Bureau.

The unusual intensity of these recent shocks is also apparent in the rise in the part removed from the measure that excludes the most volatile elements from the CPI basket (TMVC).[4]/ The least volatile components post a slight rise (almost 3%) in annual inflation so far this year (figure V.20).

Figure V.20

TMVC and residual trend inflation measure (*)
(annual change, percent)



(*) Between brackets each component's share in total CPI.

Sources: Central Bank of Chile and National Statistics Bureau.

Despite the magnitude of these shocks, if we examine the volatility of total inflation, we can see that it has not risen significantly compared to previous periods, even without considering the significant increase in fluctuations in monthly inflation posted in 2003 and most of 2004 (figure V.21). However, if we break down this volatility to identify the contribution from fuel, food and other products included in the basket, it is clear that the volatility contributed by food (27% of total CPI) has been larger in the past six years, reaching over 35% in July. Although it declines in the most recent measure, the contribution from fuel (4% weight) averages almost 70% so far in 2007. Other products (69% of the basket, including all covariance) contributes an average 14% to the total volatility of monthly CPI inflation. Thus, despite the limited rise in volatility and given the recent accumulation of inflationary shocks, there has been an important redistribution within this measure, with food's contribution rising and fuel's declining (figure V.22).

The implications of these shocks for future inflation will depend,[5]/ among other factors, on how long they last and how they pass through to other prices. We can assume that the shocks from perishable food prices (fruits and vegetables) will probably not last, given their seasonal nature and crop characteristics. Meanwhile, those from fuel and non-perishable foods will probably be longer lasting.

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[3]/ Given the construction of annual incidence, this phenomenon is visible in the line for 2004.

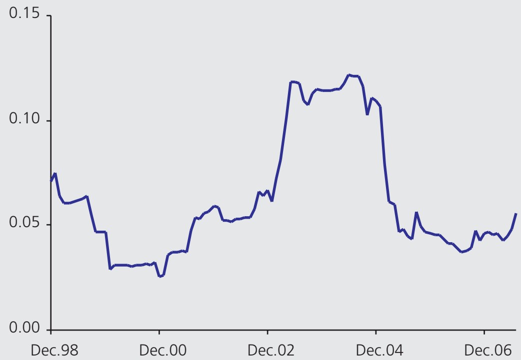
[4]/ Details of this measure are available in the May *Monetary Policy Report* 2007, box V.1, page 41.

[5]/ Possible effects on the best monetary policy response to supply and demand shocks are discussed in the September *Monetary Policy Report*, 2004, Summary box: Monetary Policy and Supply and Demand Shocks, pages 14-16.

Figure V.21

Monthly CPI inflation volatility (*)

(percent)



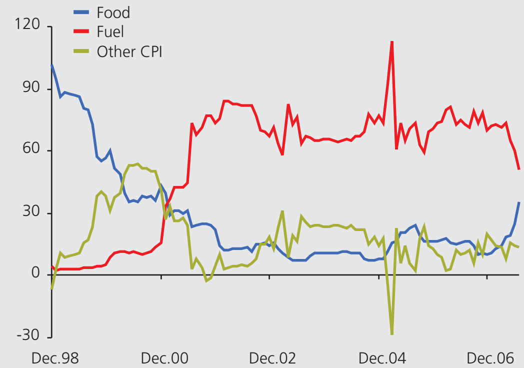
(*) Monthly change in seasonally adjusted CPI obtained using a moving window of 24 months.

Sources: Central Bank of Chile and National Statistics Bureau.

Figure V.22

CPI inflation volatility breakdown (*)

(percent)



(*) For seasonally adjusted data. Covariances between the different combinations of components have been included under Other CPI. In each period, contributions add up to 100%.

Sources: Central Bank of Chile and National Statistics Bureau.

Box V.2: **Alternative wage measures**

Labor costs account for a significant proportion of business costs, so trends significantly affect the prices set for goods and services. Growth in wages that is higher than the sum of increases in productivity and the inflation target is the source of this pressure. This box presents the wage measures that the Central Bank analyzes to evaluate inflationary pressures from labor costs.

The main measures that the Bank watches are wage indices (HWI) and labor costs (LC), published by the National Statistics Bureau (*Instituto Nacional de Estadísticas*, INE). These indices are calculated monthly based on the wage survey (EREM), whose last method change involved a splice starting in January 2006. Aside from the usual uncertainty associated with these statistics and their splicing, the EREM has become less representative, because although the procedure calls for replacing companies that stop reporting during a lengthy period, the sampling framework used to select replacements has not been updated since 2002. Moreover, this survey does not include agriculture.

Because of this, it is important to keep an eye on alternative wage measures that can serve as a contrast to the above, especially when they diverge, as they have since April 2006.[6]/ In this context, an index using HWI components and the LC weighting was constructed.[7]/ Its results confirm that the main differences reflect the weights used to calculate each index (figure V.16).

Other alternative wage measures are:

- The LCX, calculated by the Central Bank, which excludes community, social and personal services, EGW, and mining from the LC, and focuses on those sectors most sensitive to demand pressures.
- The Chilean Association for Occupational Safety and Health (*Asociación Chilena de Seguridad*, AChS) publishes the average wage subject to contributions for its affiliated companies. This measure is constructed by calculating the annual change in wages using only those companies reporting in the current month and the same month of the previous year. Wages fall within the legal minimum and maximum subject to contributions, UF60. Moreover, since these are averages, there is no data disaggregated by sector.
- Private pension fund managers (*Administradoras de Fondos de Pensiones*, AFP) report, with a two-month lag, affiliates' average wages subject to contributions. These wages also fall between the minimum legal wage and the maximum subject to taxation.
- The University of Chile calculates the median income for jobs reported in its survey of employment and unemployment, applied quarterly. Questions about employees' wages are included only in the March and June surveys, and since people rather than companies provide the responses, income could be underestimated.

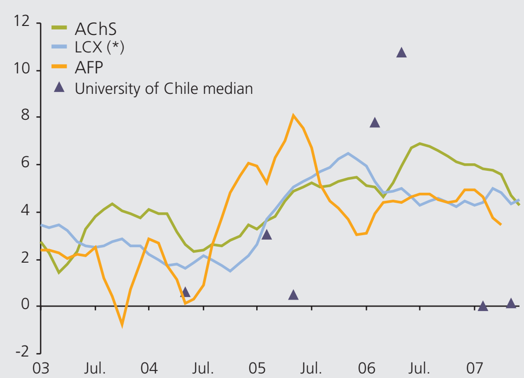
From 2003 to January 2004, almost all wage measures revealed growth was slowing down. From 2005 to early 2006, the annual rates of change increased, then income growth began to decline. A statistical analysis of the data reveals that the AFPs tend to report income trends a semester ahead, while the AChS and the University of Chile tend to report a semester later (figure V.23). More recently, all measures except the HWI show lower rates of annual growth compared to early 2006.

In short, it is hard to precisely determine the right measure for labor costs. Because of this, the Board's evaluation of the inflationary pressures on the cost side considers the range of sources described here, giving more weight to the LC than the HWI.

Figure V.23

Annual growth of other nominal wage measures

(percent)



(*) For definitions, see Glossary.

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

[6]/ See box V.3: Hourly wage index (HWI) and labor cost (LCI) wage statistics, May *Monetary Policy Report* 2007, page 43.

[7]/ For the LC, the weighting factors reflect the relative importance of the costs of different types of employees (professionals, technicians, etc.) within each firm to companies' total labor costs, while in the case of the HWI, the weighting factor is the proportion of hours worked by each group of employees to the total hours worked in a company.

VI. Inflation scenarios

This section presents the Board's evaluation of Chile's economic prospects for the next two years. It provides projections for the most likely trajectories of inflation and growth, and points out the most significant risks. These projections are based on the methodological assumption that the monetary policy rate (MPR) will, over coming quarters, follow a path similar to the one that can be inferred from the prices of financial assets over the past two weeks. This is a working assumption and does not commit future monetary policy, which will adjust to the evolution of the macroeconomy and inflation projections. Aside from this assumption, projections depend on a set of events that make up the baseline scenario, so this chapter also presents the Board's evaluation of the balance of risks for both output and inflation.

External scenario

The baseline scenario in this *Report*, with information available at its statistical closing, considers that during 2008 the Chilean economy will continue to reap the benefits of a growth-stimulating external scenario. Nonetheless, episodes of volatility in international financial markets observed in recent weeks sound a cautious note and negatively bias the external scenario, although the magnitude of their possible effects cannot be quantified with the information available.

The baseline scenario considers, in line with market consensus, that the world economy will continue to show high growth rates in the period 2008-2009, with trading partners' GDP growth averaging 4.1%. This setting assumes a slowdown of the US economy during this year, to then resume growth closer to the trend. The terms of trade, contrary to projections, will increase again this year and will begin declining only in 2008, at a lower pace than foreseen earlier. These forecasts rely on the assumption that copper price will average US$3.1 per pound this year, US$2.7 in 2008 and US$2.45 in 2009, gradually converging to its estimated long-term level.

Given recent events in world financial markets, there is more uncertainty than usual around this scenario. There is the possibility that market adjustment and volatility persist without deepening, causing a more notorious weakening of the US economy and affecting other economic zones, debilitating world growth. This setting could further deteriorate financial conditions for emerging economies, increasing the possibility of acceleration of commodity price corrections and a faster normalization of the terms of trade. There can be other risk scenarios whose implications are more difficult to foresee. In the extreme, it is possible that credit and liquidity constraints that have been observed, and that have driven central bank intervention in developed economies, become even more pronounced. Their effects on projections would depend on the shape that the deterioration of the external scenario could take. Although domestic inflation would tend to decrease because of a widening of the output gap—caused by a drop in external demand, worsened financial conditions, reduced export prices and adverse effects on expectations—and a decline in the prices of goods such as oil and foods, the possibility of increased financial risks and deteriorated terms of trade driving a peso depreciation that attenuates said effect cannot be ruled out.

Aggregate demand

The baseline scenario considers that domestic demand will grow in 2007 and 2008 in the range of 7% to 8% annually. It is worth highlighting in this projection that consumption will continue to grow at annual rates similar to recent ones, and for the year 2007 somewhat above May's estimates. This projection considers that the composition of the increase in private consumption will remain fairly stable, and that annual consumption growth—durable and non-durable—will also change little from the last few quarters. Gross fixed capital formation is projected to increase during 2007 at higher annual rates than considered in the last *Report*. Aside from actual figures for the second quarter, that already exceeded May's forecasts, capital goods imports are projected to post during the second half the same variation rates of recent months. The scenario for gross fixed capital formation is based, among other factors, on the stage of development of various projects in the energy sector and the results of the investment survey that, in its June revision, revised upward the value of investments planned for this year. Therefore, the ratio of fixed capital investment to GDP at prices of 2003 will increase to 25.5% during this year and will stay close to it in 2008.

The domestic demand scenario relies on the low level of unemployment and ongoing good financial conditions, plus the impulse provided by macroeconomic policies. The MPR, despite recent increases, is in the low end of a range of estimates for its neutral level, so the Board estimates that it continues to be a driving force in the economy. Also, the change in the fiscal surplus target from 1.0% to 0.5% of GDP and the revision to its parameters, combined with Codelco's increased costs and production behavior, and the price of molybdenum, will imply a fiscal impulse for 2008 in line with the budget for 2007.

The baseline scenario assumes that, during 2007, volume exports will largely outperform 2006, with significant growth in mining and manufacturing shipments, both associated to increased capacity in their respective sectors. Mining exports, in particular, will go from registering slightly negative variation rates in 2006 to growing close to 13% this year. Agricultural exports will also increase in 2007 at higher annual rates than last year's. It is possible, however, that given this winter's harsh weather conditions, agricultural activity will slow down in the second half, hurting the sector's exports. Overall, dollar exports will be higher than foreseen in May because of both more volume and higher prices, particularly for copper. Meanwhile, goods imports will record an increase in volume, also greater than in 2006. In line with the scenario for consumption and investment, purchases of consumer goods will increase at a rate similar to last year's, while capital goods will show stronger growth. The rise in volume imports of fuels also stands out, consistently with electric generation's response to natural gas restrictions and lack of hydric resources. All considered, the trade balance is forecast to close 2007 with a balance of US$24.90 billion, exceeding May's estimates. For 2008, volume sales abroad are projected to be less dynamic than this year. This tendency will extend to every export category, although more strongly to mining. Imports will also grow less than projected in 2007, especially those related with capital and consumer goods.

The current account of the balance of payments is expected to close 2007 with a surplus of 5.4% of GDP, exceeding May's projections by far. This reflects the fact that a big portion of earnings coming from export prices, unusually high and thought not to be persistent have been saved, largely due to a fiscal spending policy based on structural income. Toward 2008, consistently with projected normalization of the terms of trade and less dynamic external conditions than this year, the current account should post a much smaller surplus: 2.6% of GDP. Measured at trend prices, for 2007 and 2008 the current account is expected to post a deficit of around 3% of GDP[1]/.

Economic activity and gaps

The baseline scenario maintains May's evaluation of trend GDP growth around 5% for the period 2007-2009. This figure is also similar to the recent estimate of the Experts Committee called by the Ministry of Finance to revise the parameters of the fiscal budget for 2008. The closing of gaps during the course of the second quarter of 2007, combined with the trend growth assumption and the economic growth scenario considered the most likely, will keep the output gap closed over the projection horizon. As usual, the risk persists of economic growth differing from expectations or of the economy's trend growth and available gaps, both unobservable variables, differing from today's projections.

Tight output gaps are also visible in the conjuncture's evaluation of the labor market. Employment has continued growing at average rates above 3%, with stronger growth in salaried employment. The rate of unemployment, seasonally adjusted, is below the levels of the beginning of the year and below several estimates for its level consistent with price stability.

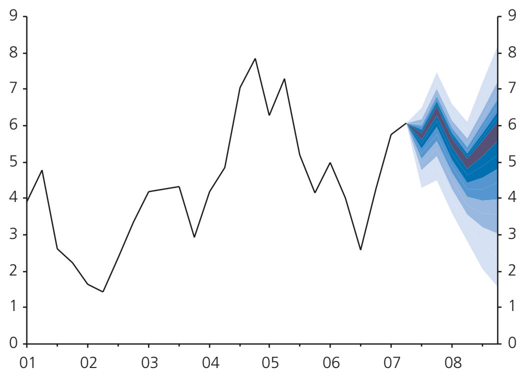
As aforesaid, the baseline scenario considers that the economy will continue to benefit from an external scenario that stimulates output. However, in the present conjuncture and with the information available at the closing of this *Report*, the magnitude of the effects that the volatility of international financial markets can have on the external scenario considered the most likely is hard to predict.

All considered, the baseline scenario contemplates output growth in 2007 between 5¾% and 6¼%, and between 5.0% and 6.0% in 2008. Also, taking into account possible alternative events, the balance of risks for output is biased downward (figure VI.1).

[1]/ This calculation considers long-term prices for copper and oil of US$1.2 per pound and US$56 per barrel, respectively.

Figure VI.1

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



(*) The figure shows the confidence interval for the baseline projection for the respective horizon (colored area). Confidence intervals of 10%, 30%, 50%, 70% and 90% are ranged around the baseline scenario. These intervals summarize the Board's risk assessment for future economic growth. The baseline scenario is constructed using the methodological assumption that in coming quarters, the MPR will reach a level similar to that deduced from financial asset prices in the two weeks prior to the closing date for statistics included in this *Report*.

Source: Central Bank of Chile.

Cost pressures

On the costs side, apart from the sharp rise in the world prices of some foods, no changes are observed in imported inflation pressures. The real exchange rate (RER) has remained fairly constant since the closing of May's *Report*, considering the average for the ten working days prior to the statistical closing. This level is consistent with the equilibrium RER. The baseline scenario uses as a methodological assumption that, in the long run, the RER will not differ much from its average for the two weeks prior to the statistical closing of this *Report*. This assumption is subject to a high degree of uncertainty, especially in light of recent developments in international financial markets and their future trend.

The price of oil and its by-products is above projections in last *Report*. Although it has significant incidence in the difference between actual inflation and May's projection, it is not a key determinant of the recent increase in annual inflation. Ahead, the baseline scenario considers that oil prices will hover around US$70 per barrel over the projection horizon, but other scenarios cannot be ruled out, especially if world growth falls short of projections.

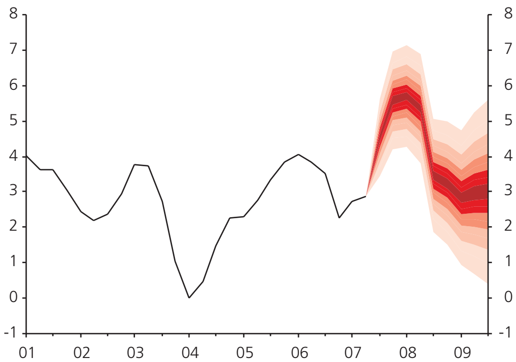
The baseline scenario contemplates that the increase in domestic prices of non-perishable foods (i.e., corn, wheat, milk and dairy products) will continue posting slight rises in the very near future, to later grow close to the average of the other prices until the end of the projection horizon. Prices of perishables (i.e., fresh fruits and vegetables) will also increase in the very near future, but are foreseen to show a substantial reversal before year's end. These assumptions are subject to high uncertainty. On one hand, given the experience of recent months, it cannot be ruled out that these prices may increase above projections. On the other hand, given the unusual magnitude of the shock, it cannot be disregarded that prices may have a drastic reversal within the projection horizon, leading to a significant drop in inflation. In the present context, the potential implications on domestic inflation if world prices of the goods that have pushed inflation up in recent months reverse substantially in a worsened external scenario become more important.

Labor costs are increasing consistently with the inflation target, with salaries growing between 4% and 7% annually depending on how they are measured, with average productivity increasing at a rate close to 2%. There is the risk, however, of the present price shock spreading to other prices more than expected, which could occur, for example, through higher labor costs. This is one risk where the Board will put special attention, because confidence in the inflation target is crucial in the determination of trend inflation. In this sense, it is appropriate to reaffirm that, as it has done in the past, the Board will adopt whatever decisions it deems necessary to maintain its commitment with the inflation target.

For the rest of 2007 and 2008 no big variations are foreseen in the electric generation matrix. While the effects of generating electric power with fuels instead of natural gas and hydric resources are more evident only in the electricity, gas, and water sector, it has significant incidence in electric rates. The baseline scenario assumes that, in addition to July's 6% increase in rates, there will be new increments in the rest of 2007—all because of increased costs of electric generation—, with an impact on CPI inflation somewhat

Figure VI.2

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

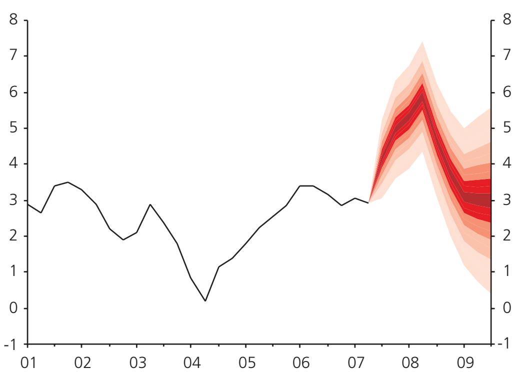


(*) The figure shows the confidence interval for the baseline projection for the respective horizon (colored area). Confidence intervals of 10%, 30%, 50%, 70% and 90% are ranged around the baseline scenario. These intervals summarize the Board's risk assessment for future inflation. The baseline scenario is constructed using the methodological assumption that in the coming quarters, the MPR will reach a level similar to that deduced from financial asset prices in the two weeks prior to the closing date for statistics included in this *Report*.

Source: Central Bank of Chile.

Figure VI.3

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



(*) The figure shows the confidence interval for the baseline projection for the respective horizon (colored area). Confidence intervals of 10%, 30%, 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 in the coming quarters, the MPR will reach a level similar to that deduced from financial asset prices in the two weeks prior to the closing date for statistics included in this *Report*.

Source: Central Bank of Chile.

greater than half a percentage point. For 2008, the working assumption is that rates will rise again, in a magnitude comparable to the average increase of the period 2004-2005. This scenario is subject to high uncertainty, with results that will depend on the evolution of the energy matrix, fuel prices and increases deriving from the electric power rate, among many factors.

Inflation scenario

The baseline scenario projects annual inflation to continue rising in coming months. CPI inflation should stand around 5.5% until mid 2008, partly due to price increases already in place. This short-term inflation scenario is materially different than the one considered most likely in January and May of this year, owing to the unusual shocks endured in recent months and also reflecting changes occurred in the global macroeconomic scenario (box VI.1).

After the temporary deviation foreseen for the next several months, annual CPI inflation will decline toward 3% in the course of 2008 and will remain fairly constant until the end of the projection horizon, this time the third quarter of 2009. In the baseline scenario, CPIX1 inflation will converge to 3% at a similar pace as headline CPI, while CPIX variation will do so somewhat more slowly. In addition, considering possible alternative events, the balance of risks for inflation is unbiased (figures VI.2 and VI.3).

Trend inflation projection is based on medium- and long-term inflation expectations in line with the target, output gaps remaining closed until the end of the projection horizon, labor costs growing consistently with target inflation and an RER not very different from its average for the two weeks prior to the statistical closing.

The Board estimates that, in the most likely scenario, new increases in the MPR will be necessary in coming months to ensure that projected inflation over the policy horizon remains at 3%. As usual, the evolution of the MPR will depend on incoming information and its implications on projected inflation. In particular, the Board will follow closely the evolution of international financial markets and its implications on growth and inflation. The Board considers also that a setting of large shocks in specific prices and scarce gaps as the present one requires special attention, both to the possible propagation to other prices and to medium- and long-term inflation expectations.

Box VI.1: **Changes in the baseline projection scenario**

The macroeconomic scenario has undergone substantial changes in the past 12 months and monetary policy has responded according to the implications for both the baseline scenario and risks. Output has gone from a surprising deceleration phase in the third quarter of 2006, which saw idle capacity increase, to a scenario of greater acceleration than forecast and the absorption of idle capacity in the second quarter of 2007. After falling to almost 2% toward the end of 2006, headline inflation has risen significantly in recent months, approaching 4% annually as of last July. Similarly, after growing at annual rates of less than 3% for five and one-half years, the annual CPIX1 rose 4% in July. This box describes the main changes in the baseline scenario in the past 12 months, reviews the factors leading to changes in inflation projections, and compares current corrections to those of the past.

Table VI.1

Projected economic growth and current account for 2007

	Sept. 06	Jan. 07	May 07	Sept. 07
	(annual change, percent)			
GDP	5¼ - 6¼	5.0 - 6.0	5.0 - 6.0	5¾ - 6¼
Balance of risks to output	Balanced	Balanced	On the rise	Falling
Domestic demand	5.4	6.3	6.8	7.9
- Total consumption	6.0	6.4	7.0	7.4
- Gross fixed capital formation	5.5	6.9	8.0	12.1
	(percentage of GDP)			
Current account	2.2	-0.1	3.4	5.4

Source: Central Bank of Chile.

The economic growth scenario has fluctuated significantly in the past 12 months. In September 2006 the economy was traveling a path of foreseeable deceleration in economic output, characterized by a sharp plunge in the growth of investment in fixed capital and a weak performance from different manufacturing sectors that compete with imported products. This was occurring in a context marked by consumption holding steady at around 7%, but with a large portion involving imports. Thus, growth estimates for 2006 were corrected downward, from an expected rate of somewhere between 5.25% and 6.25% in September 2005 to between 4.75% and 5.25% in September 2006, estimated at 4% today. Meanwhile, growth projections for 2007 went from somewhere between 5.25% and 6.25% in September 2006 to between 5% and 6% in January and May of this year, and now stand at between 5.75% and 6.25% in this *Monetary Policy Report* (table VI.1).

Thus, in early 2007 the scenario involving actual and projected lower growth for 2006 and 2007 had revealed an unexpected widening of the capacity gap, consistent with the limited rise in CPIX1 inflation for several quarters. The January CPI inflation projection recognized this, and together with a substantial decline in the oil price and lower CPIX1 inflation than projected in September, created a scenario in which CPI inflation could even be less than 2% in mid-2007, and should remain low for several months (table VI.2). In fact, public debate in March concluded that the impulse from a temporary rise in accelerated depreciation was necessary, given the weak economy.

Table VI.2

Changes in average projected, CPI inflation,
(percentage points)

	Jan.07	May 07	Sept.07
Starting projection (1)	3.4	2.0	2.4
Sources of changes in the projection:			
A. Actual data			
Actual CPIX1 inflation	-	0.1	0.4
Fuel	-	-	0.1
Transportation	-	-0.1	-
Non-durables	-	-	0.3
B. Future scenario reviewed			
Change in gap	-0.4	-	-
Fuel	-0.6	0.3	0.2
Transportation	-	-0.1	-
Non-durables	-	-	0.2
Other (2)	-0.4	0.2	0.3
Final projection (3)	2.0	2.4	3.9

(1) Projection included in the previous *Monetary Policy Report*.
(2) Includes the effect of actual inflation in projections.
(3) This is the projection included in the corresponding *Monetary Policy Report*.

Source: Central Bank of Chile.

For May, there were already some changes to the output scenario, which nonetheless were sufficiently incipient to be considered more of a risk than a central element within the baseline scenario, as reflected in the upward bias that the Board assigned to the projection for economic activity at that time. On the inflation side, in the first four months there had been mixed changes to specific prices, with transportation falling (due to the implementation of Transantiago) and a rise in fuel and some food prices, reflecting the rise in international wheat and corn prices especially. Thus, although in May inflation was lower than projected in January, the prospects for 2007 suggested it would rise, although CPI was expected to remain below 3% throughout 2007.

Since May, a series of events, reviewed in detail in this *Monetary Policy Report*, have significantly changed the outlook for inflation in the short term. On one hand, output rose at a faster rate than forecast in the second quarter. This absorbed idle capacity more quickly than expected, which is consistent with more inflationary pressure in the medium term. Nonetheless, the biggest change reflected specific price shocks, particularly from foods, whose prices rose significantly, leading to monthly inflation of around 1% for some months.

The origin of these shocks included a significant external component. The ongoing favorable international outlook caused commodity prices such as copper and oil to rally. Already, in previous years, inflation projections had changed significantly due to a rise in the prices of oil and its by-products. From September 2006 to 2007, the average per barrel WTI oil price projected for this year was corrected downward and then upward, by US$10, amounting to significant fluctuations in fuel inflation.

Moreover, from mid-2006 on, this pressure from external demand on food prices in international markets began to affect domestic prices for some foods and spread, given their use in other production processes (biofuel) and less favorable supply conditions, particularly due to the weather. Thus, corn, wheat and especially milk prices soared, an effect that quickly passed through to the local market. This also affected inflation measures in other economies, particularly Brazil, China and Mexico (figure V.6). In Chile, moreover, bad weather this winter drove fresh fruit and vegetable prices up in recent months. The impact of these shocks on short-term inflation prospects is considerable. Using average annual CPI inflation as a reference, the value for 2007 is now 1.5 percentage points higher than in May, with almost 80% of this change due to news about specific foods and non-durables, with more than half this difference already apparent (table VI.2).

The current change to projections is significantly larger than in the past, reflecting the unusual size of recent shocks and the impact of several occurring at the same time (figure VI.4). This substantial change in the baseline scenario reflects a similar shift in private sector inflation projections, which according to the August economic expectations survey have set CPI inflation in December two percentage points higher than forecast in May. GDP, which has also been corrected upward continually this year, is expected to follow a similar path.

Figure VI.4

Difference in average inflation projection for each year
(percentage points)

(*) Uses the data included in this *Report* as December 2007 figure.

Source: Central Bank of Chile.

Appendix A: Central Bank of Chile balance sheet

As usual in the September *Monetary Policy Report*, this Appendix reports on the current status and projections for the main items within the Central Bank of Chile's financial statements and their relationship to policies applied. As described on other occasions, the current structure of assets and liabilities in the Central Bank balance sheet was determined by the financial crisis of the 1980s and the accumulation of foreign exchange reserves in the 1990s.

Assets consist mainly of foreign exchange reserves and fiscal promissory notes, while liabilities consist mainly of the monetary base and domestic debt securities issued to finance, in a non-inflationary fashion, part of the rescue of the banking system in the 1980s, and the accumulation of foreign exchange reserves in the 1990s. Note that the Central Bank's accounting equity is negative.

In the long term, the level and composition of balance sheet assets and liabilities determines the Central Bank's flow of financial profits or losses. In particular, given the greater size of liabilities and the composition of the balance sheet, inflows and outflows produce a deficit. It should be noted that it is normal in emerging economies, such as Chile's, for the cost of financing Central Bank promissory notes to exceed international interest rates. However, this gap has closed as Chile's inflation has approached that of industrialized countries with solid fiscal conditions.

Moreover, currency mismatch present in the balance sheet means that book results are very sensitive to shifts in the exchange rate. In fact, book profits in 2006, before provisions, largely reflect the rise in the exchange rate that year. The Central Bank's asset position in foreign currency reflects the accumulation of foreign exchange reserves, which in turn offer some benefits, since these serve as insurance against instability.

The Central Bank has negative equity and its results yield deficits on average due to the combination of several factors, mainly: (i) the amount of starting capital established by Article 5 of the 2nd transitory article in the Basic Constitutional Act governing the bank, which stipulates the amount that the Central Bank should have received, was never delivered; (ii) the economic value of the starting capital was substantially less than posted in financial statements in 1989; (iii) expenditures to purchase and maintain foreign exchange reserves in the past 15 years; and (iv) foreign exchange revaluations produced losses in the Bank's foreign currency assets.

It is important to emphasize that the Central Bank deficit is the result of this negative equity and is in fact a quasi-fiscal deficit, which from a macroeconomic perspective should be considered an expenditure by the consolidated public sector.

The expected changes to the balance sheet presented here are based on assumptions compatible with those of this *Monetary Policy Report*. Moreover, commercial bank deposits with the Central Bank are projected to decline, as a result of the new conditions governing the technical reserve requirement established in Law 20,190 on modernization of capital markets. Treasury deposits remain at operation levels achieved in July 2007. As is known, financial surpluses have been invested outside the Central Bank, according to criteria established in the 2006 law governing fiscal responsibility. Finally, the 2008 balance sheet projection assumes an additional capital contribution from the government, similar to those provided in 2006 and 2007. Without this additional contribution, the equity deficit would fall just 0.2% of GDP, instead of the projected 0.7%.

So far in 2007, the size of the balance sheet has continued to fall, reflecting the drop in Treasury deposits. For the remainder of the year, additional reductions are expected, the result of a decline expected in bank deposits with the Central Bank, result of recent changes in capital market legislation (table A.1).

In 2007 there have been no foreign exchange operations and balance sheet projections assume this situation will continue. This also assumes that servicing on the remaining documents indexed to the exchange rate (BCD) will continue to take place in pesos. The balance sheet projection also includes servicing the last US$390 million of these securities, which fall due in the first half of 2008.

The Central Bank's efforts to reduce the size of its balance sheet, along with the decline in the gap between domestic and foreign interest rates, have brought a steady decline in its nominal deficit, since 2006. This year, however, that process has stopped (table A.1).

Calculations of the deficit include corrections to the Chilean peso (changes in the UF), expenditures on administration and interest as such. This corresponds to nominal interest in pesos. This does not include losses and gains arising from shifts in exchange rates or revaluations of fixed assets. Moreover, this excludes income from interest and corrections from accrued assets whose servicing program has not been defined.

The nominal result forecast for 2007 should be similar to 2006. The tendency for the nominal deficit to stop falling stopped because of larger changes in the UF, which pushed the costs of indexed promissory notes higher, and a projected decline in the monetary base and other low cost bank liabilities, because of regulatory changes affecting the technical reserve. The deficit would have been greater without the capital contributed in late 2006 and mid-2007.

Capital contributions from the General Treasury increase foreign currency assets with no counterpart in liabilities, that is, they improve the Bank's position in foreign currency. Given yields on reserves, these help to improve overall results on an ongoing basis.

From a long-term perspective, while a rise in the deficit is foreseeable as the Central Bank normalizes its monetary policy rate, provided fiscal accounts remain solid, most of the decline in the interest rate gap (country risk premium) apparent in recent years should be permanent.

Balance sheet projections assume less use of instruments providing short-term liquidity to the financial system (repos, liquidity line and swaps) due to changes in the law governing technical reserves. As a result, there should be a slight decline in the monetary base and a more pronounced drop in the foreign currency balances that banks hold in the Central Bank. This last should reduce foreign exchange reserves without affecting the Bank's net position payable in foreign currency (tables A.1 and A.2).

The projected balance sheet for 2008 is generally based on assumptions about longer-term conditions. With no foreign exchange operations and assuming a moderate decline in banks' foreign currency deposits, foreign exchange reserve growth should reflect interest accruing and the capital contribution from the General Treasury to the Central Bank. Moreover, the monetary base should resume growth consistent with economic output and interest rates. This growth, combined with a recovery of funds outstanding due to subordinate debt and other credits, should allow the bank to rescue promissory notes worth almost 360 billion pesos. Thus, in the projection, the final stock of Central Bank promissory notes should fall from 9.8% in late 2007 to 9.4% of GDP in late 2008.

Despite projections that interest rates should continue to return to normal, the nominal result projected for 2008 should improve, thanks to the additional equity, coming from government capital contributions and lower inflation projected for next year, which compared to 2007, should reduce the cost of UF-denominated promissory notes.

Table A.1

Central Bank balance sheet: results summary
(percentage of GDP)

	2003	2004	2005	2006	Jul-07	2007 (f)	2008 (f)
Assets	30.9	25.5	20.3	17.9	14.7	12.9	13.0
Foreign exchange reserves	18.6	15.4	13.1	13.4	11.2	9.9	10.2
Fiscal promissory notes and other loans to government	8.0	5.7	3.2	1.8	1.6	1.6	1.5
Monetary policy instruments	1.3	1.7	1.7	1.2	0.6	0.0	0.0
Other	3.1	2.7	2.3	1.5	1.3	1.3	1.2
Liabilities	32.0	27.6	24.0	20.7	16.8	15.0	14.4
Promissory notes with secondary market	25.5	20.8	15.5	11.1	9.6	9.8	9.4
Policy instrument with banks	1.5	1.9	3.0	2.8	2.4	0.5	0.3
Other liabilities with banks	0.1	0.1	0.6	0.7	0.4	0.4	0.4
Other liabilities except monetary base	0.7	0.8	0.5	1.6	0.4	0.4	0.4
Monetary base	4.1	4.0	4.4	4.4	4.1	3.9	3.9
Capital (A+B)	-1.1	-2.1	-3.6	-2.8	-2.2	-2.1	-1.4
A. Revalued starting capital	1.7	-1.0	-1.9	-3.2	-2.5	-2.6	-2.0
B. Net result	-2.8	-1.2	-1.7	0.0	-0.1	0.1	0.2
Non-financial	0.0	0.0	0.0	-0.1	0.0	-0.1	-0.1
Net interest and change in UF	-0.7	-0.5	-0.3	-0.6	-0.1	-0.1	0.0
Due to change in exchange rates	-2.0	-0.6	-1.4	0.6	0.0	0.1	0.1
Revalued capital	0.0	0.0	0.1	0.1	0.1	0.1	0.1
C. Capital contribution	0.0	0.0	0.0	0.4	0.4	0.4	0.5
Memorandum							
Nominal result (1)	-0.8	-0.6	-0.5	-0.2	-0.1	-0.3	-0.1
Position payable in foreign currency (2)	24.1	16.4	9.6	9.6	9.2	9.5	10.0
Position expressed in foreign currency (3)	17.0	13.3	8.9	9.0	8.7	9.3	10.0

(1) Includes administrative expenditures and net costs due to interest and UF indexation. Does not include losses or gains due to exchange rate variation, interest or corrections accrued on assets whose servicing program is not defined, revalued capital and fixed assets due to monetary correction.
(2) Assets minus liabilities payable in foreign currency.
(3) Position in foreign currency minus liabilities in Chilean pesos indexed to the exchange rate.
(f) Projection.

Source: Central Bank of Chile.

Table A.2

Central Bank of Chile balance sheet: flows (1)
(billions of Chilean pesos)

	2003	2004	2005	2006	Jul-07	2007 (f)	2008 (f)
1. Foreign exchange reserves	-502	-329	691	689	-792	-2,260	275
2. Policy instruments in Chilean pesos	304	2,899	3,130	654	203	47	379
2a. of which: indexed to the exchange rate	47	1,887	1,327	81	16	239	214
3. Central Bank promissory notes in dollars	-203	-1,319	117	1,293	0	0	0
4. Other operations in pesos except monetary base (2)	408	-74	-92	-21	-82	-102	-103
5. Other operations in foreign currency (3)	103	-942	-3,246	-2,138	793	2,261	159
Monetary base (change = 1+2+3+4+5)	111	235	599	477	123	-55	710
Memorandum							
Position payable in foreign currency (foreign exchange operations = 1+3+5)	-601	-2,589	-2,439	-156	1	1	434
Position expressed in foreign currency (= 1+2a+3+5)	-554	-702	-1,112	-75	17	240	649

(1) Foreign exchange flows. Balances are, moreover, affected where applicable by interest, inflation adjustments and price changes.
(2) Servicing of Treasury promissory notes in UF, servicing of subordinated debt and other operations in Chilean pesos.
(3) Bank and fiscal deposits and other operations in foreign currency.
(f) Projection.

Source: Central Bank of Chile.

Box A.1: Evaluation of Central Bank of Chile foreign currency reserve management

In March of this year, the Central Bank of Chile requested that International Monetary Fund (IMF) send a technical assistance mission to conduct an independent evaluation of its management of foreign exchange reserves.[1]/ This box describes the main characteristics and results of this evaluation.

The request for technical assistance, the first of its kind made by a Central Bank to the IMF, was part of the Board's usual practice of obtaining external evaluation of its foreign exchange reserve management.

The evaluation, carried out in late April, reviewed compliance with guidelines for managing foreign currency reserves recommended by the IMF in 2001.[2]/ The areas evaluated included the objectives of reserve management, their scope and coordination, transparency and accountability, the institutional framework, the framework for risk management and operations in efficient markets.

The IMF mission concluded that the Central Bank meets all its recommendations for managing foreign exchange reserves, and that it is suitably equipped to fulfill this role and its role as fiscal agent. It considers the Bank an example to other central banks in terms of transparency and accountability for reserve management. A summary of the IMF evaluation results is presented below[3]/ (table A.3).

[1]/ A description of Central Bank management of foreign currency reserves is provided on the website, at www.bcentral.cl/operaciones-financieras/reservas-internacionales/pdf/gestion_reservas.pdf.

[2]/ Available at www.imf.org.

[3]/ The results are available in Spanish at: www.bcentral.cl/prensa/notas-prensa/pdf/02082007.pdf.

Table A.3

Evaluation of Central Bank of Chile foreign currency reserve management: summary of results

Results of IMF evaluation, by subject matter	IMF comments
The objectives of reserve management are clear and based on a solid regulatory framework.	The level of foreign exchange reserves has been suitably evaluated based on a cost-benefit analysis of reserve maintenance, according to the established objectives. The operating framework is well developed and ensures that liquidity, market and credit risk is prudently controlled, including a careful balance between Central Bank assets and liabilities.
Measures in terms of public transparency and accountability meet standards and in several areas are examples worthy of imitation by other central banks.	It is satisfying to see that the Central Bank aims to establish similarly high standards for transparency for the management of public funds handled by the Central Bank as the government's fiscal agency.
The structure of internal government management is solid and rests on a firm system of control, with a clear assignation of responsibilities and an appropriate level of management reporting.	Although functions are clearly defined within the Central Bank, it could be useful to review operational dependencies in the front, middle and back offices and/or functional responsibilities in the middle office to ensure the efficient formulation of policies and separation of operating dependencies.
The Central Bank has a well developed framework for risk management, supported by suitable systems and human resources.	The level of information provided to the Board is appropriate and the strategic profile of investment is appropriately evaluated, monitored and reviewed. Operational compliance with investment policies is permanently monitored and procedures applied are solid and professional, in terms of both internal investment activities and external managers.
Assets are invested in deep and liquid markets and there is ongoing follow-up to ensure the Board's investment strategy is followed.	This ensures that foreign exchange reserves are effectively available as a function of the policy objectives guiding reserve management. At the same time, throughout the years, the Central Bank has been able to generate reasonable gains within the restrictions applied to ensure liquidity and limit financial risk.

Sources: Central Bank of Chile and International Monetary Fund.

Appendix B: Main Central Bank of Chile measures in 2007

January

03 The Central Bank of Chile presented its open-market securities auction schedule for 2007. For the purpose of auctioning off these debt instruments, the schedule continued with the practice of holding one auction per month, begun in 2006, for both Central Bank bonds in pesos (BCP) maturing in two and five years, and Central Bank bonds expressed in unidades de fomento (BCU), an inflation-indexed account unit, falling due in five and ten years.

Moreover, the Bank reported on a request from the Ministry of Finance for it to act as fiscal agent in placing and managing debt instruments to be issued by the General Treasury (*Tesorería General*) in 2007, to be charged to the respective legal authorization for borrowing, contained in the national budget law.

11 At its monthly monetary policy meeting, the Central Bank's Board agreed to cut the monetary policy interest rate from 5.25% to 5% annually.

23 As per the powers entrusted to it under Article 35, No. 1 of its Basic Constitutional Act, the Central Bank's Board replaced regulations governing the deposit of funds and financial intermediation applicable to banking firms established in Chile. The new regulations are organized on the basis of fundamental criteria, consistent with modernizing, strengthening and simplifying regulations. In this sense, new instruments for public deposits are included; the law promotes the application of standards, recommendations and good international practices to elements associated with these operations; and organized regulations by principles or categories. The main changes in this sense involve modernization of rules governing the interest rates and currencies in which time deposits can be made; making regulations governing prepayments of deposits more flexible, along with those referring to short-term financial intermediation; the inclusion of structural notes as time deposit instruments for banks with A-ratings for solvency; the homologation of minimum periods for sales involving buy-back clauses; and the replacement of regulations governing "selling short" for one aiming to regulate securities lending operations.

Moreover, other rules were changed to coordinate and facilitate application of these new regulations and in this sense, it should be noted that an authorized indexation system based on practices generally accepted in international markets was included for bank operations, governing the parities for foreign currencies.

To ensure that banks have a prudent period for adapting their policies, procedures, management systems and risk control to the new regulations, it was scheduled to come into effect on 2 April 2007.

February

22 The Board of the Central Bank of Chile (Resolution 1321-01-070222), accepted its role as fiscal agency entrusted to it by the Ministry of Finance by Executive Decree (*Decreto Supremo* 1,383), published in the Official Gazette (*Diario Oficial*, 17 February 2007, under Law 20,128 governing fiscal responsibility, for the management and investment of special funds for social and economic stability and pension reserves (*Fondo de Estabilización Económico y Social, Fondo de Reserva de Pensiones*) covered by this law.

28 The Board of the Central Bank of Chile (Resolution 1322-01-070228) accepted the role of fiscal agency for the placement of bonds issued by the General Treasury in local capital markets, including servicing of these securities, on their respective maturities.

March

22 The Board agreed to change rules applied to operations involving debt instruments issued by the Central Bank of Chile in the primary lending market, in which institutional investors participate. This measure came into effect on 2 April 2007.

26 At a special meeting and in reference to resolutions made at Bank of Chile shareholders meetings referring to capitalization of profits and the issue of payment-free shares for 30% of the surplus from the 2006 fiscal year, and making use of the option provided by Article 31 of Law 19,396 on Subordinated Debt,

the Board of the Central Bank of Chile (Resolution 1326E-070326) decided that all surpluses owed to the Central Bank as creditor in this case should be paid in cash.

29 The Central Bank's Board (Resolution 1327-01-070329) established the policy governing the foreign exchange regime applicable to special contracts for exploring or operating hydrocarbons, made by the government of Chile with foreign investors, as per Article 19 N°24 of the Chilean Constitution of the Republic, Decree Law 1,089 (1975) and its modifications, whose text was set by DFL N°2 (Mining Ministry, 1986).

April

19 In a context of institutional transparency, the Central Bank's Board (Resolution 1330-01-070419) agreed to establish a committee for audits and compliance, to advise it on compliance with institutional goals regarding corporate governance, in its role as directors and senior management of the Bank.

Similarly, in the same session, the Board established the statute governing said committee, which will be responsible for reporting to the Board on the effectiveness of the Bank's internal control systems, the effects on its equity and reputation involved in complying with its obligations, and the results of its evaluations of the reliability, integrity and timeliness of financial statements.

At its session on 31 May, the Central Bank's Board appointed the members of this committee, all independent professionals with outstanding reputations.

May

10 The Central Bank's Board (Resolution 1333-01-070510), interpreted the former Chapter XXVI of Title I of the Compendium of Foreign Exchange Regulations (*Compendio de Normas de Cambios Internacionales*) regarding foreign exchange agreements made by the Bank with investors and clarified the scope of its application, establishing that this special regulation, adopted under Article 47 of the Bank's Basic Constitutional Act is not applicable to capital increases and payments made by receiving bodies after the elimination of this Chapter.

Notwithstanding, to avoid affecting any eventual rights of investors, the option was provided, for this occasion only, of applying existing foreign exchange agreements to payments from capital increases agreed upon by receiving entities up to 31 August 2007 and that are subscribed and paid up to 31 August 2008.

June

21 The Central Bank's Board (Resolution 1340-02-070621) agreed to allow family allowance agencies (*Cajas de Compensación y de Asignación Familiar*) to invest in the shares of private companies covered by Article 183-C of the Labor Code and its associated regulations, whose sole purpose is to certify the amount and status of compliance by contractors with their obligations to their employees, including eventual legal indemnity for termination of the labor contract. In any case, and to avoid conflicts of interest, investment in these financial instruments was limited to the condition that the agency subscribing or purchasing them not become the controlling interest of the company issues the respective shares.

July

12 At its monthly monetary policy meeting the Central Bank's Board agreed to increase the monetary policy interest rate by 25 basis points, to 5.25% annually.

31 The Central Bank's Board agreed to extend the ceiling on pension fund managers' investment in foreign securities to 35%. Similarly, the Board increased the ceiling on investment in foreign currency without foreign exchange coverage for each type of pension fund, to 43% for Fund Type A; 28% for Fund Type B; 22% for Fund Type C; and, 17% for Fund Type D.

The new ceilings on investment came into effect on 9 August 2007.

August

09 At its monthly monetary policy meeting, the Central Bank's Board agreed to increase the monetary policy interest rate by 25 basis points, to 5.5% annually.

Resolution 1350-01-070809, adopted in the same session, officially announced the invitation to bid and approved the applications guidelines applicable to the public competition for applications to replace the alternate member of the tribunal for the defense of free competition, in light of Mrs. Blanca Palumbo Ossa's voluntary resignation.

Tables and figures index

Tables

Figures

Glossary

Commodity exporting economies: Australia, Canada and New Zealand.

CPIGX: Goods price index, minus fuel and fresh fruit and vegetables, leaving 92.5% of the total goods basket.

CPISX: Service price index excluding utilities and transit fares, leaving 79.7% of the total service basket.

CPIX: Core consumer price index. CPI excluding prices for fuel and fresh fruit and vegetables, leaving 92% of the total basket.

CPIX1: CPIX minus fresh fish and meat, regulated utility rates, indexed prices and financial services, leaving 70% of the total basket.

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

EPI: External Price Index, external prices relevant to Chile, calculated using information from Bloomberg, Consensus Forecast and the International Monetary Fund. External inflation is calculated using wholesale price indices (WPI) expressed in US dollars (or the CPI, where the WPI is not available), for countries included in the multilateral exchange rate (MER) index. Both the WPI and exchange rates are included in the form of monthly changes, weighted according to their share of trade with Chile, minus oil and copper.

EPI-5: EPI using prices from: Canada, the US, Japan, the United Kingdom and the Euro area.

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

GDP, NR: Gross Domestic Product, natural resources (EGW, mining and fishing).

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

GDP, services: Includes the following sectors: construction, wholesale and retail trade, transportation and communications, financial and business services, home ownership, personal services, and public administration services.

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

LCX: LC minus community, social and personal services, EGW and mining.

M1: Currency plus non-financial private sector checking accounts net of float and demand deposits other than checking accounts and demand savings deposits.

M2: M1 plus time deposits, time savings deposits, mutual funds with investment in debt instruments lasting up to one year and deposits in savings and credit cooperatives, minus time deposits belonging to these mutual funds and savings and credit cooperatives.

M3: M2 plus deposits in foreign currency, Central Bank of Chile documents, Treasury bonds, mortgage bills, bills of trade, company bonds, quotas of other mutual funds and AFPs (voluntary saving), minus those where mutual funds and AFPs have invested their M3 assets.

MER: Multilateral Exchange Rate. This represents a measure for the nominal value of the peso against a broad basket of currencies with the same weightings as the RER. For 2006, ordered by their weight: Germany, Argentina, Belgium, Brazil, Canada, China, Colombia, South Korea, Spain, United States, Finland, France, Italy, Japan, Mexico, The Netherlands, Peru, United Kingdom, Sweden, Taiwan and Venezuela.

MER-5: The multilateral exchange rate for: Canada, the US, Japan, UK and the Euro area.

MER-X: MER minus the US dollar.

MPA: Pruned average CPI, excluding items posting the largest and smallest monthly changes.

MPG: Pruned average CPI, excluding subgroups posting the largest and smallest monthly changes.

Oceania: Australia and New Zealand.

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

Parity gasoline price: Reference price for importing gasoline, calculated using quotations of similar quality to those in effect in Chile, in relevant markets (America, Europe and Asia). Also includes, maritime shipping, insurance rate, duties and other.

RER: Real exchange rate. This represents a measure for the real value of the peso against a basket of currencies. It is constructed using MER countries.

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

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

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

Sectors, non-tradables: Includes manufacturing sectors involved in production or consumption not linked to foreign trade.

Sectors, supply: Includes manufacturing sectors producing wood pulp and fish meal.

Sectors, tradables: Includes manufacturing sectors producing goods traded internationally.

Swap rate: The fixed interest rate exchanged for the average observed interbank interest rate, on an amount of capital for a specific period in the future.

TMVC: Trim of Most Volatile Components, trimmed average CPI, minus the most volatile components.

Trading partners' growth: Growth of Chile's main trading partners, weighted according to their share of total 2006 exports. The countries included receive 94% of total exports.

ULCX: ULC using only formal sector employment, wages and output, minus natural resource sectors.

World growth at market exchange rate: Growth measured using the market exchange rate. Each country is weighted according to its dollar denominated GDP, published in the IMF's 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). Projections of World growth for 2007-2009 were calculated using a sample of countries representing 87% of world GDP. This assumes 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

CdeR: *Compilación de referencia* (Benchmark compilation, national accounts)

CC.NN.: National Accounts

MPR: Monetary Policy Rate

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