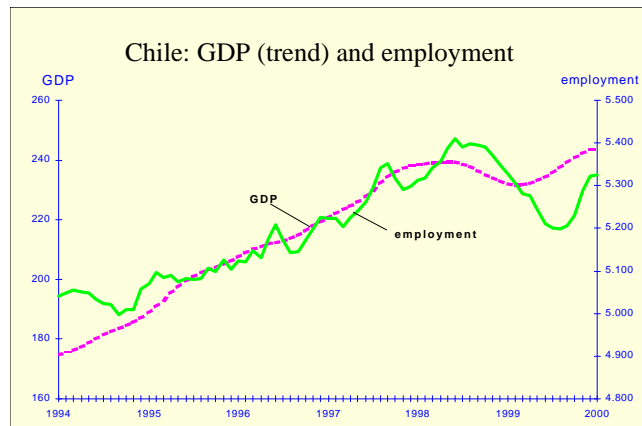


# Outlook for the Chilean Economy

Jorge Marshall, Vice-President of the Board,  
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## I. Back on the growth track

The Chilean economy is back on a growth track. The severe adjustment in economic activity that took place in the second semester of 1998 and first quarter of 1999 is by now gone. Since the second quarter and more clearly in the second semester of 1999, economic activity rebounded strongly, driven by a firmer external scenario, expansionary monetary and fiscal policies and improvement in economic fundamentals. Thus, developments in 1999 removed the external and domestic threats that might have affected the sustainability of high domestic growth and concluded in an important momentum into 2000.



### External scenario

The external scenario has turned more favorable to the domestic economy, although a number of important risks in the global environment are still present. Higher global growth and better prospects for Latin America have improved the outlook for trade and export activities.

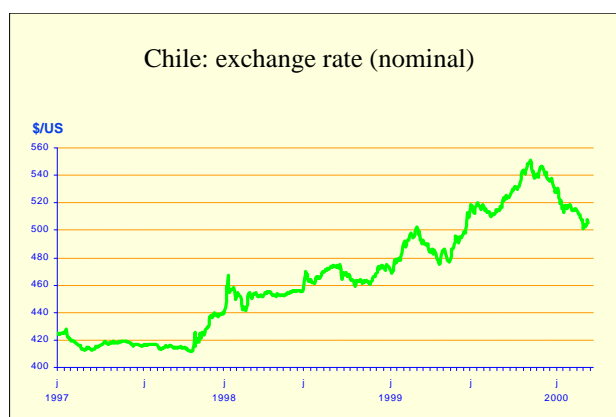
Also, the surge in global industrial production gives support to certain improvements in commodity prices, even though the copper price has flattened out after rising in the third quarter of 1999. As a whole, terms of trade have stopped falling and they are now better than those prevailing a year ago.

Regarding external financial conditions, the cost of external credit significantly decreased due to lower sovereign spreads, which had reached their highest level in early 1999 and declined afterwards. However, the outlook for availability and cost of external finance suggests that they will stabilize at conditions less favorable than those prevailing before the global financial crisis.

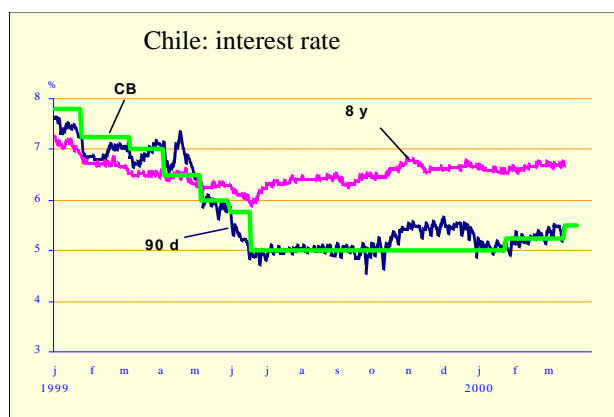
## Macroeconomic policy

In view of financial market stability and less marked effect of the Brazilian crisis in early 1999, monetary and fiscal policies have been instrumental to recent upswing by adopting an expansionary stance throughout 1999. The policy interest rate decreased significantly in the first and second quarters, reaching 5% in June. Public finances eased throughout the course of 1999. Vigorous expansion of monetary aggregates and depreciation of the peso added further demand impulse. Market rates followed the monetary stance until last quarter of 1999. Since then, different domestic and external factors explain the rebound in medium- and long-term rates.

Likewise, the financial stability created the appropriate conditions to extend the exchange rate flexibility. This was initially pursued by widening the exchange rate band and latter through the adoption of a floating regime. The new policy started in September 1999, allowed greater flexibility and let the market assess the exchange rate risk. The initial movement was toward depreciation, but a reversal has taken place since last December. In addition, a better regulation of currency mismatches of banks and actions to deepen and sophisticate foreign currency market have successfully reinforced the floating regime, especially considering the demand for hedging instruments. The Central Bank is entirely satisfied with the functioning of the floating regime and most projections anticipate a continued climate of relative calm in domestic foreign currency markets.



The period of monetary easing started to moderate in January 2000 as the Central Bank increased the interest rate by 25 bps. that was followed by another rise of equal magnitude in our recent March meeting. In the new growth environment and improved external conditions, the Central Bank is closely monitoring the consequences of cost pressures on inflation, especially those deriving from oil price increases. The Central Bank's analysis is looking beyond near-term oil-price effects, recognizing that such specific pressures will inevitably imply a transitory increase in inflation. But also, our projection considers underlying inflation (as measured by the CPI excluding food and energy) to converge towards the middle of our 2 to 4 per cent target range on a 12 to 24 month horizon. The likely course of the output gap and the credibility of the inflation target are both critical to determine the monetary policy reaction in the current scenario. In



particular, a tighter monetary stance would counter any threat to the medium-term outlook for inflation.

The easing of fiscal policy in 1999 counteracted the slowdown in economic activity, mainly through the introduction of job creation programs, housing mortgage subsidies and a decline in revenues due to the recession, while outlays increased by 5.7% in real terms. This policy implied an anti-cyclical increase in the deficit and was possible thanks to a setting of low inflation, negligible public debt and external equilibrium.



The public sector balance should trend to equilibrium in 2000, driven by faster growth, but also helped by revenues from privatization. Total expenditure should grow less than GDP and fiscal budget might close near balance this year. This means that the fiscal stance will move towards a rather restrictive position through the course of 2000 and 2001.

### Stronger fundamentals

After the difficulties of the last two years the Chilean economy resumes growth with stronger fundamentals. Beside the low inflation environment and the external liquidity and solvency, which were never altered in the recent cycle, fundamentals have been reinforced by three important events that had raised some concern during 1999: the important correction in the current account, the high political priority that new authorities assign to restore fiscal surplus and the unbroken soundness of the financial sector. A year ago these three elements were matters of concern in most analysis of economic prospects. Instead, they now support the outlook for sustained growth.

Likewise, results in the recent presidential election renewed endorsement for structural reforms and pro-stability policies, which have been critical for sustaining growth in Chile. But, simultaneously, they also stated a strong claim to spread prosperity more evenly. The balance is a solid confidence in democracy and political institutions.

## II. Recent developments and prospects

### Economic activity

Economic activity bottomed in the second quarter of 1999. Since then, it has been on a positive trend. Growth in the fourth quarter was close to 4% on a twelve-month basis, but above 7% on a quarterly basis (annualized). This acceleration reflects the early-cycle surge that should latter transform in a stable growth path.

The improved international scenario and accumulated depreciation of the peso are supporting the expansion of trade and export activities. Also, different domestic factors

such as lower unemployment, political stability and stronger fundamentals are restoring individuals and business confidence, which in turn drives private demand. Actually, unemployment peaked in August 1999 and has declined since then, with the resulting effect on confidence and spending.

Investment upturn will probably be slower than in previous cycles as a consequence of capacity accumulation, higher indebtedness of the private sector and cost of capital increases. However, recent signs point to an upturn in investment spending while the recovery of commodity prices is also influencing new investments oriented to external markets.

The expansive stance of monetary and fiscal policies, although now on a more moderate path, is still stimulating the current expansion.

In short, economic activity and employment can grow vigorously, without threatening price and wage inflation, due to available capacity. In the medium term, however, demand should approximate potential GDP to avoid inflationary pressures. Last September the Central Bank's growth forecast for 2000 was 5%. Information received since then suggests that there may be more momentum of demand, so we may be looking at a somewhat faster pace of economic expansion for this year.

#### External sector

The current account deficit decreased from 5.7% of GDP in 1998 to 0.1% of GDP in 1999. This is the combined result of import reduction, export increase and a 2% terms of trade deterioration. The service account of the balance of payment also improved, owing to contraction in net earnings of foreign investment.

Terms of trade in 1999 were 11% below the last decade average. If measured at trend prices the current account balance would have shown a surplus of 0.9% of GDP in 1999. This figure indicates that under normal terms of trade, domestic demand can grow vigorously without threatening the external position of the economy. Our forecast for the current-account deficit in 2000 is currently close to 2% of GDP.



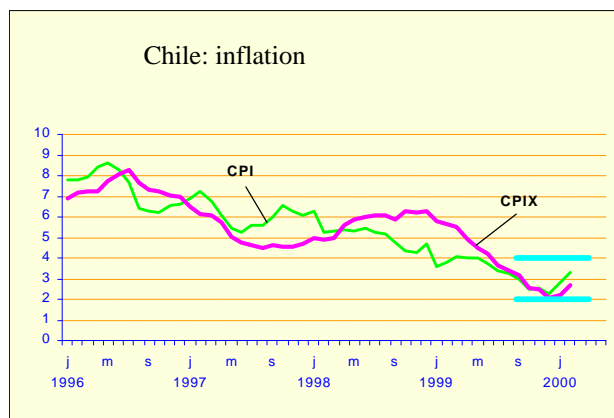
The capital account registered net outflows of around 1% of GDP in 1999. This figure, heavily influenced by the developments of the first quarter of the year, is attributable to increased international investment by domestic residents, lower medium- and long-term credit and short term capital outflows. The first development results from international diversification of portfolio, higher demand for hedging mechanisms and reduction of interest rate differential. These are processes that take place in a context of rapid integration

to world financial markets. After the first quarter capital account tended to normalize, led by foreign investment.

External solvency and liquidity indicators remain solid. For instance, the sum of short-term credit, annual amortization and current-account deficit accounts for 65% of international reserves. External-debt spread and sovereign credit rating also confirm this solid position.

## Inflation

Inflation declined to below the Central Bank target in 1999. The main factors behind this movement were the fall of domestic demand and a low external inflation. These conditions also inhibited the pass-through from exchange rate depreciation to inflation. The effect of the oil price increase, operating in the opposite direction, was attenuated by a domestic subsidy from a price stabilization fund.



Inflation outlook for 2000 is less bright, mainly as a result of the (partial) transfer of higher international oil prices to the public. This will fuel inflation in the first part of the year, but even considering the direct and indirect effects, this should remain as a transitory phenomenon without significant impact on the 12 to 24 month inflation forecast. Inflation in the first months on 2000 is consistent with this analysis. CPI shows a 3.3% twelve-month increase in February, while the underlying figure is 2.7%.

The Central Bank is very sensitive to this inflation outlook, although existing and projected output gap and credibility of the inflation target should keep new pressures under control. In spite of this, the Central Bank stands ready to respond if signs of resurgence of inflation emerge, because this would undermine the momentum of the current economic expansion. The task of monetary policy is particularly difficult facing this type of supply shock, but the new scheme of inflation target and a more forward-looking monetary policy give the Central Bank a more flexible framework to assess the extent and persistence of current disturbances and take the pertinent actions.

## Financial sector

Financial sector performance registered only a moderate deterioration, which is the natural consequence of economic activity slowdown. But this shows the structural good health of this sector. The evolution of financial institutions during 1999 confirms that Chile has a sound and well-capitalized financial sector, which enables it to contribute with confidence to the new phase of economic growth. This conclusion has been stated in a recent international ranking of banking system quality elaborated by a private rating agency.

Aggregate lending follows fairly closely the trend of GDP, with a lag of one or two quarters. This is why lending growth declined until mid 1999 and started to recover in the second semester. In the last two years there has been an important change in the structure of lending, with consumer credit falling drastically, due to stricter provision rules and cautious behavior of both debtors and banks. Commercial credit, instead, showed a moderate descent. Through 1999 money and bank deposits grew strongly, anticipating vigorous lending expansion in 2000 that the banking industry has estimated around 8% to 10% in real terms.

Due to the decline in economic activity, non-performing loans as a percentage of total loans increased until April 1999, when it reached 1.78%. Since then, this proportion steadily declined to 1.67% in December. Also, provisions for absorbing potential losses still exceed non-performing loans. The ratio of provisions to non-performing loans increased from 1.25 in December 1998 to 1.44 in December 1999.

Regarding other solvency indicators of financial institutions, banking after tax profit rate was 9.4% in 1999, below the 11.5% observed in 1998 and the lowest rate in a decade. This reduction in profitability is mainly associated with a sound increase in loan-to-loss provisions and tougher competition that kept margins low in spite of the increase in provisions and write-offs. On the other hand, the risk-adjusted capital-asset proportion has remained at 12.5%, which is well above the 8% minimum.

It is important to note that these safe and good financial indicators reflect the management skills of bankers, as well as the sound and strict banking regulation and the quality of supervision in Chile. The regulatory scheme, which is based on prudential norms and market-oriented structure of incentives, provided the environment for a healthy growth of the financial system in recent years.

### **III. Conclusions**

Recent record and outlook for the Chilean economy confirms the clear upswing in economic activity. A number of external and domestic factors have supported this growth resumption. Chile has benefited from firmer global activity, turnaround in primary commodity prices, relatively low interest rate at home, eased fiscal stance, growing confidence and solid economic fundamentals.

Moreover, Chilean macroeconomic policy has been reviewed in the light of recent experiences. Fiscal policy is clearly committed to restoring in the short run the strength that showed for more than a decade. Monetary policy has adopted a more transparent and forward-looking framework by improving our inflation target scheme. The flexible exchange rate regime is functioning as expected, with continuous low inflation and deeper financial markets, offering adequate hedging mechanisms. Financial system soundness rests on well-capitalized banks, strong management and supervision. International financial integration continues as a gradual process that needs to be carefully monitored.

These steps regarding the management of economic policy will increase confidence and credibility, which in turn reduce uncertainty and stimulate growth. The Central Bank remains committed to delivering low inflation because this is a crucial ingredient for durable and healthy economic expansion.