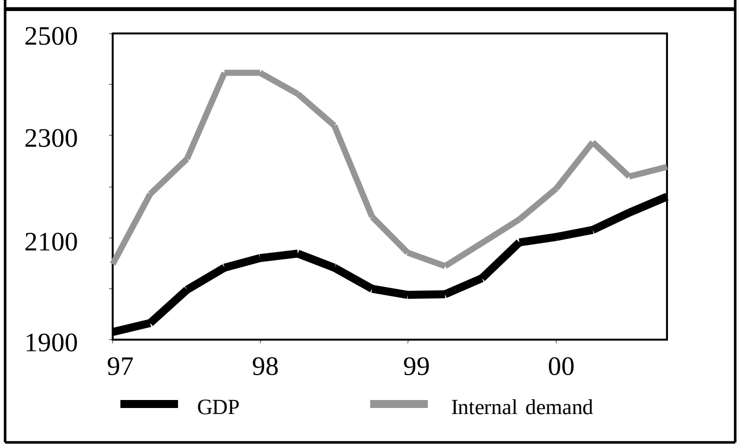
Outlook for the Chilean Economy

Jorge Marshall, Vice-President of the Board, Central Bank of Chile. Address to the Seventh Annual Latin American Banking Conference, Salomon, Smith & Barney, New York, March 7-8, 2001.

I am honored to participate in the 7th Latin American Banking Conference. Which gives me opportunity to share with you some views on the recent economic developments and the outlook for the Chilean economy.

Last year, GDP grew 5.4%, headline inflation reached 4.5% in December, while core inflation edged up to 3.4%. Moreover, fiscal accounts ended 2000 in balance and are on track towards the achievement of a “structural” surplus of 1% of GDP this year. The current account deficit is low, at 1.3% of GDP, with a stable outlook. These figures show that the current account and fiscal imbalances that were incubating before the slowdown of 1999 have been fully corrected. With stronger fundamentals the economic activity started to pick up in the second half of 1999. Since then, most of the attention of monetary policy has focused on the rise in oil prices and accelerating inflation, the weaker than expected growth of domestic demand and the impact of the US business cycle.

GDP and Internal Demand
(thousand of millions of pesos, seasonally adjusted series)



During the second half of 1999 there was a sharp rebound in growth and employment that apparently indicated that a sustained expansion could be on the cards. These expectations, together with the rapid increases in oil prices, led the Central Bank to take action, raising the policy rate from 5% to 5.5% during the first quarter of 2000. The objective of these moves was entirely achieved as the inflation increase last year was mainly due to the hike of oil prices, along with the exchange rate depreciation influence on some regulated prices. The overall pass-through of depreciation to inflation has been small and has made no noticeable impact on medium-term inflationary expectations. Core inflation has remained within the 2% to 4% target range and inflationary pressures began to ease by the third quarter of 2000.

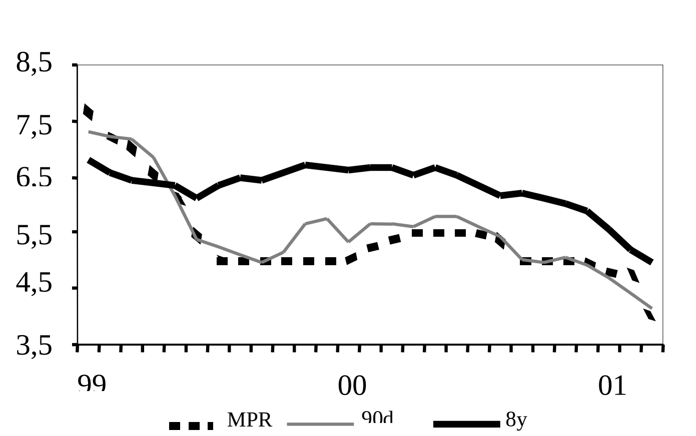
The small pass-through has been a characteristic of most economies operating with a floating exchange rate system and inflation targets. In the case of Chile, our opinion is that this is due to several factors, amongst which are more competitive markets, credibility of monetary policy and consolidation of the floating regime. These circumstances are expected to prevail in the near future. However, it is also true that cyclical considerations have played a role in limiting a persistent increase in inflation expectations. Particularly, a more cautious behavior of households, the slow expansion of fixed capital formation and the fiscal consolidation program held back domestic spending over the course of 2000.

Fiscal policy has been relatively restrictive since early 2000, as the administration tries to generate a 1% of GDP "structural" surplus in 2001, which is part of a strategy to apply a rules-based counter-cyclical fiscal policy. The procedure estimates tax revenues according to long-term GDP and copper price trends and then fiscal spending is adjusted in order to yield a 1% of GDP surplus. The actual balance might differ from the “structural” one depending on how the economy performs relative to its potential and on the current copper price. For 2000 the “structural” surplus was estimated at 0.4% of GDP, while the actual surplus was 0.1%.

Private consumption is still being influenced by persistent and high unemployment. Jobs usually lag economic growth. But this pattern was only observed in the second semester of 1999, while throughout 2000 employment stagnated in absolute terms, in spite of the expansion of GDP. The precise factors behind this phenomenon are difficult to identify, but they may be associated to capital and labor market imperfections, which delay the sectoral reallocation of resources. For instance, real and nominal wage stickiness due to indexation clauses, substantial minimum wage increases in the last two years, the low turnover in the stock market and some credit constraints are all elements that complicate unemployment reduction.

Also, the boom in residential investment over the course of 1995 and 1997 increased the stock of new houses and at the current speed of sales a situation of overcapacity probably remain during 2001 and 2002. Non residential investment is also affected by spare capacity, in particular the retail sector. However, other components of business capital formation grew during 2000.

Monetary Policy Rate and
Central Bank Instruments (%)



As these conditions have persisted, there has been a tendency towards longer-lasting relative price adjustments, for instance in the real exchange rate and domestic real interest rates, as well as a lower external deficit and a preponderance of tradable sectors in GDP growth.

The latter considerations became increasingly evident as domestic demand and employment decelerated between the second and third quarters of 2000. Since market expectations increasingly assumed the transient character of the inflation hike, the new evidence showing decelerating domestic demand augmented the probability that disinflation over the course of 2001 and 2002 would proceed faster than expected. Founded on these concerns, the Central Bank cut interest rate from 5.5% to 5% last August.

More recently, with firmly anchored inflation expectations and a still-lackluster job creation, the slowdown in the global economy has an additional disinflationary effect that motivated further easings of monetary policy, bringing the policy rate to 4.0%. These policy decisions had been anticipated by the markets. In the last two quarters the yield curve markedly shifted downward, responding both to a significant moderation in market expectations of future movement of the policy interest rate, due to the reduction of the sovereign spread, lower interest rates abroad, and the outlook for GDP growth.

The real exchange rate has fluctuated according to market expectations and policy decisions. During the second semester of 2000 the real exchange rate depreciated 7% with respect to 1999 average. It seems that changes in perceptions of future interest rate differentials, long-term currency value expectations and movements in risk premia are the main factors influencing exchange rate fluctuations. The economy's external financial position is very robust, with a current account deficit that is expected to remain between 1% and 2% of GDP.

Also, financial sector performance has improved after the slowdown of 1999. Aggregate lending to the private sector increased by around 5% in 2000, although it has been primarily focused on firms, with an almost unchanged level of consumer credit. Regarding solvency indicators of financial institutions, banking (after tax) profits rate increased from 9.4% in 1999 to 12.7% in 2000. On the other hand, the risk-adjusted capital-asset ratio has remained around 13.4%, which is well above the 8% minimum. Non-performing loans (as a percentage of total loans) have stayed in the 1.7% to 1.8% range since April 1999. Despite this performance, provisions for absorbing potential losses are currently 30% greater than non-performing loans. These figures confirm a sound and well-capitalized financial sector, which enables it to contribute to future economic expansion. An important element of current macroeconomic policy is aimed at strengthening the domestic financial system, by improving the regulatory framework and deepening international financial integration.

The outlook for 2001 and 2002, released in the *Monetary Policy Report* of January, considers that the stance of monetary policy, as well as the level of the exchange rate, set the conditions for forecasted GDP growth of around 5.8%, on average. The passing of the oil shock of 2000, as well as

Outlook for 2000 - 2001
(% annual change)

	2000[e]	2001[f]	2002[f]
GDP	5.4	5.6	5.9
Internal demand	7.2	7.2	6.7
CPI	4.5	3.4	2.9
CPIX	3.4	3.2	3.0
Current Account (%GDP)	-1.3	-1.7	-1.9

e: estimated ; f: forecast

the absence of demand-driven inflationary pressures, is consistent with a forecast of inflation that gradually converges to 3%, the center of the target range. These forecasts are consistent with the current consensus outlook for global growth and international financial conditions. Market expectations are broadly in line with this forecast, as indicated in the Central Bank monthly expectation survey and the path of asset prices in financial markets.

The current external scenario contains three elements of uncertainty that might affect the domestic economy. First, if global deceleration in 2001 is more intense than expected, there may be a negative effect on export growth and commodity prices. Currently, export volume is projected to grow by 5.5% in 2001, which is lower than the 6.1% observed in 2000 and is partly due to currency depreciation. Also, the copper price forecast for 2001 has been reduced to 86 cents per pound.

Second, the decrease of international interest rates has also been more pronounced than anticipated, reducing the financial cost of domestic and foreign credit. Past experience indicates that this financial channel may have a significant positive effect on domestic demand.

Third, prospects for capital flows to emerging markets are still uncertain. This was recently reflected in the persistence of sovereign risk premiums of emerging economies at levels higher than those observed in mid 2000. But there has been a decline of premia in the last two months, which may anticipate a more favorable performance of financial flows to emerging economies. The combined impact of these variables on domestic activity is hard to quantify, since the mentioned factors tend to cancel each other out. Yet, it is difficult to assert wether financial variables will fully compensate weak global activity.

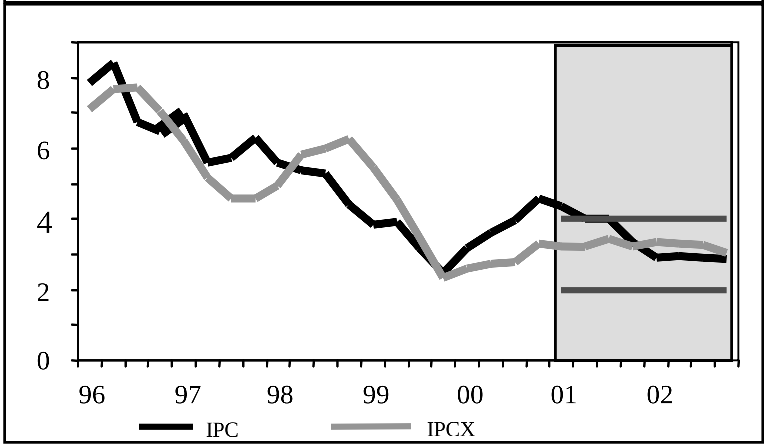
The other main determinant of the economic outlook is the expansion of internal demand, which is expected to keep its recent pace in the next two years. It is important to notice that at the end of March the Central Bank will release national accounts data based on 1996 prices, replacing the present statistics based on 1986 prices. The new series will need to be analyzed on its own basis and methodology, avoiding misleading comparisons between both series.

Regarding the components of internal demand, employment and household expectations suggest a moderate growth of consumption, while business capital formation has had a significant upturn since mid 2000 and is expected to remain on this path through the next two years.

Internal demand should also respond to the current monetary conditions, as fiscal policy aims to achieve a “structural” surplus of 1% of GDP in 2001 and 2002, which represents an increase from the “structural” surplus of 0.4% of GDP attained in 2000. The evolution of business and consumer confidence may retard or spur internal demand.

As mentioned, consistent with this forecast, inflation is expected to gradually converge towards the center of the target range of 2% to 4%. But it also is important to have in mind that the January *Monetary Policy Report* estimated that scenarios of lower inflationary pressures and lower growth have higher probability than alternative scenarios. This fact has been considered in the recent interest rate cut.

CPI and CPIX Inflation
(% annual change)



Current economic fundamentals are strong, as the imbalances that threatened sustained growth before the Asian crisis have been fully corrected. This is particularly the case of the current account and fiscal deficits. Moreover, macroeconomic policy has embraced a rules-based framework. Fiscal policy is committed to a “structural” surplus of 1% of GDP. Monetary policy has adopted a more transparent and forward-looking framework by improving the inflation-targeting scheme. The flexible exchange rate regime is functioning as expected. Financial system soundness rests on well-capitalized banks, strong management and supervision. There are no restraints on capital account transactions other than prudential regulations for banks and institutional investors.

In these circumstances, the outlook for the Chilean economy envisages a positive trend for economic activity and a declining inflation. Inflation peaked in January and now is back to the target range of 2% to 4%. By the end of 2001 it is expected to converge to around 3%. This outlook reveals the positive perception and credibility of policies that is the cornerstone for sustained growth and macroeconomic stability.