Outlook for the Chilean Economy

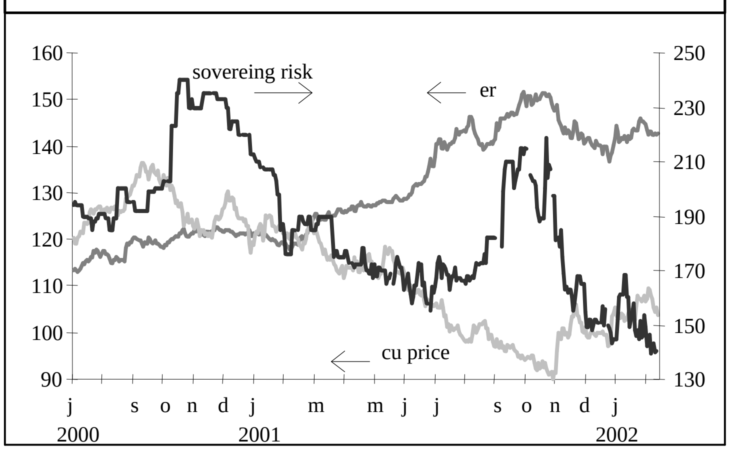
Jorge Marshall, Vice-President of the Board, Central Bank of Chile. Address to the Eight Annual Latin American Banking Conference, Salomon, Smith & Barney, New York, March 7-8, 2002.

I am honored to participate in the 8th Latin American Banking Conference, which gives me the opportunity to share with you some views on recent economic developments and the outlook for the Chilean economy. The key elements in the current scenario are the more positive signs of the international economy and the low expected inflation. These developments have allowed for a more expansionary monetary stance, which in turn should contribute to expanding internal activity through the next quarters. In this presentation I will briefly review each one of these points.

Several events in the second half of 2001 changed the external scenario of the Chilean economy, increasing uncertainty in financial markets and reducing global growth. Economic activity in the US and Japan did not come up to expectations, raising doubts as to the growth recovery expected for the end of 2001. The September 11 attacks reinforced this gloomy global outlook for the world economy, although they were followed by a strong policy response on the part of major central banks. The increased uncertainty of the world economy was amplified in Chile by the rapid deterioration of neighboring economies, which caused substantial contagion in financial markets until October 2001.

External Shocks 2001

(% and index)



More recently, financial markets are responding to a better outlook for the world economy, contagion from Argentina has moderated and global activity is starting to show some signs of recovery. In these conditions, the uncertainty that affected the domestic economy during the early second half of 2001 is gradually dissipating and the external scenario should return to its average trend in 2003.

During 2001 the effects of this international scenario were lower export demand, terms of trade deterioration, a higher sovereign premium and a drop in foreign investment. Only the drop of around 7% in terms of trade has had a significant effect on real income, equivalent to a loss in the order of 3%.

The fact the exports continue to register growth in spite of weak external demand is because of the real depreciation of the Chilean peso. A partial recovery of export prices and terms of trade can now be foreseen with copper prices expected to average $0.72 per pound this year and $0.80 in 2003.

As a result, deterioration of global economic conditions slowed domestic activity. Annual growth of GDP declined from 3.6% in the first half to 2.3% in the second half of 2001. An important part of this deceleration is attributable to such components of internal demand, as machinery investment and inventories. As the external scenario improves and aided by lower interest rates, the trend of these components of domestic demand should be reverted in the next quarters.

Outlook for 2001 - 2003
(% annual change)

	2001[e]	2002[f]	2003[f]
GDP	2.9	3.3	5.3
Internal demand	-0.5	4.1	5.6
CPI	2.6	3.0	3.0
CPIX	3.2	3.5	2.6
Current Account (% GDP)	-1.6	-1.0	-1.0

e: estimated ; f: forecast

More stable portions of domestic demand, such as non-durable consumption, show a sustained, although modest, growth through 2001. The expansion of household consumption, similar to GDP, concentrated mainly in non-durable and domestic goods. Behind these trends is a slight increase in employment towards the middle of the year, as well as a real wage increase and consumer loans stability, which interrupted continuous decline since early 2000. Future scenarios consider a slight growth of private consumption in 2002 and a stronger increase in 2003.

Regarding external demand, non-traditional exports have been quite dynamic and contributed to GDP growth. Real exchange rate depreciation increased external competitiveness of the trade sector. In addition, the current account deficit of the balance of payments reached 1.6% of GDP in 2001 and is expected to drop to around 1% of GDP in 2002 and 2003.

Fiscal policy is committed to a structural “surplus” of 1% of GDP, as part of a strategy to apply a rule-based counter-cyclical policy and this was achieved in 2001. The actual deficit was 0.3% of GDP, which differs from the “structural” surplus as the economy performed below its potential and copper prices were also below their medium-term trend. For 2002 fiscal policy will remain moderately expansionary, as the budget considers a real expenditure growth of 4.9%, essentially led by public investment, growing at 11% in real terms.

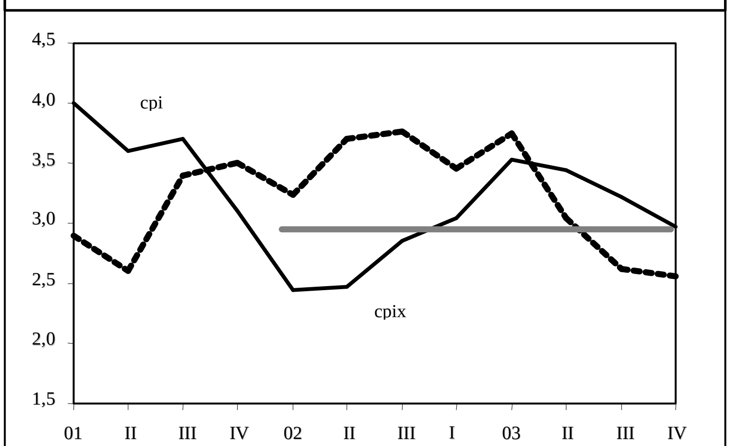
Financial sector performance significantly improved in 2001 as banking (after tax) profits increased from 12.7% in 2000 to 17.7%. Lending growth continued on a moderate pace, around 4.5%. As in previous years, lending has been primarily focused on firms, with an almost unchanged level of consumer credit. Regarding solvency indicators of financial institutions, the risk-adjusted capital-asset ratio has remained around 13%, which is well above the 8% minimum. Non-performing loans (as a percentage of total loans) declined to 1.6%, similar to early 1999 and should continue to decline. These figures confirm a sound and well-capitalized financial sector, amply able 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.

Financial Performance

	1997	1998	1999	2000	2001
Loan growth	13.2	4.8	2.7	4.3	4.6
Expenses (% op. margin)	63.2	59.4	58.9	58.3	54.8
Capital (% risk adj. asset)	n.a.	12.5	13.5	13.3	12.7
N P L (% of loans)	1.0	1.5	1.7	1.7	1.6
R O E	14.8	12.4	9.8	12.7	17.7

In short, economic activity is likely to increase its expansion in the next quarters due to strengthening domestic demand. Growth forecasts stand at 3.3% for 2002 and at 5.3% for 2003. Domestic demand is expected to increase above these rates, driven by improved terms of trade, lower sovereign premium and a clearer global outlook.

Inflation Outlook
(% annual change)

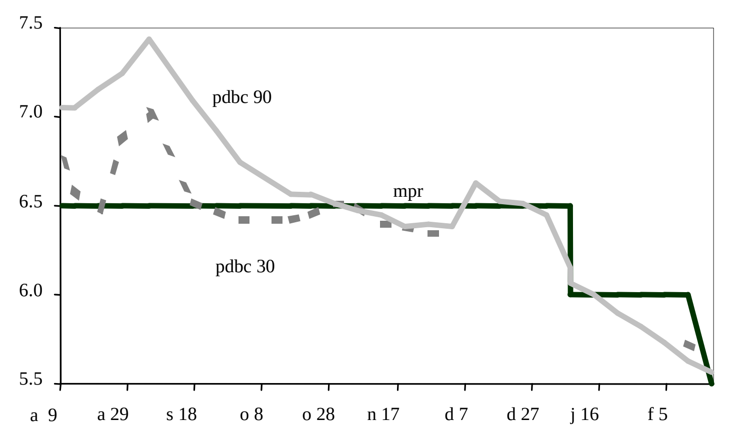


This growth outlook, in addition to the recent stability of the foreign exchange market, anticipates smaller inflationary pressures in a 12 to 24 month horizon. In this way, headline and core inflation are estimated to fluctuate around 3%, well anchored within the 2% to 4% target range that currently rules monetary policy.

Inflation in 2001 benefited from a reduction of margins, due to the unexpected part of the exchange rate depreciation. This effect may tend to disappear through 2002, depending on how costs evolve and market conditions develop. Current level of demand makes any margin increase difficult.

Following this logic, market inflation expectations have significantly decreased in recent months and this has had a bearing on recent monetary policy adjustments. In fact, as inflationary pressures are well situated within the Central Bank target, the policy rate has been reduced from 6.5% to 5.5% since January 2002.

Monetary Policy
(weekly average, aug. 2001-feb. 2002, %)



Changes in the policy rate have moved parallel to financial markets interest rate, which has declined for short and long-term instruments. This is consistent with expectations of inflation stability and also with the real depreciation of 14% during 2001.

Thus, the Central Bank's projections essentially consider an improving international economy, inflation comfortably within the 2% to 4% target range and domestic growth gradually increasing, slowly in 2002 and more strongly in 2003. The Central Bank will continue applying its policy instrument according to the inflation-targeting framework, which allows for flexibility of the policy rate as inflation forecast is secure within the target range.

Finally, in this analysis it is important to highlight that current economic fundamentals are strong. This is particularly the case of the current account and fiscal deficits. Moreover, macroeconomic policy has functioned in the last two years under a rule-based framework. Fiscal policy is committed to a "structural" surplus of 1% of GDP while monetary policy follows an inflation-targeting scheme. The flexible exchange rate regime is functioning as expected. Financial system soundness rests on well-capitalized banks, firm management and supervision. There are no restraints on capital account transactions other than prudent regulations for banks and institutional investors.