



The Chilean Economy in the Current Global Financial Crisis

José De Gregorio
Governor
Central Bank of Chile

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Introduction

- The magnitude and depth of the current financial crisis is impressive.
- Recent developments have changed the macroeconomic outlook for the global economy, in particular regarding growth in developed economies.
- As all emerging markets, Chile has been affected by the recent crisis. Terms of trade and external demand for our exports have declined, although the decline in oil price provides some inflation and costs relief. Some tensions surfaced in local money markets.
- The Chilean economy is well prepared to weather the storm. Sound macroeconomic policies and a strong financial system are key in making the process as painless as possible.
- Inflation is still high, but lower growth perspectives will help to reduce inflation.
- Uncertainty is unusually high.



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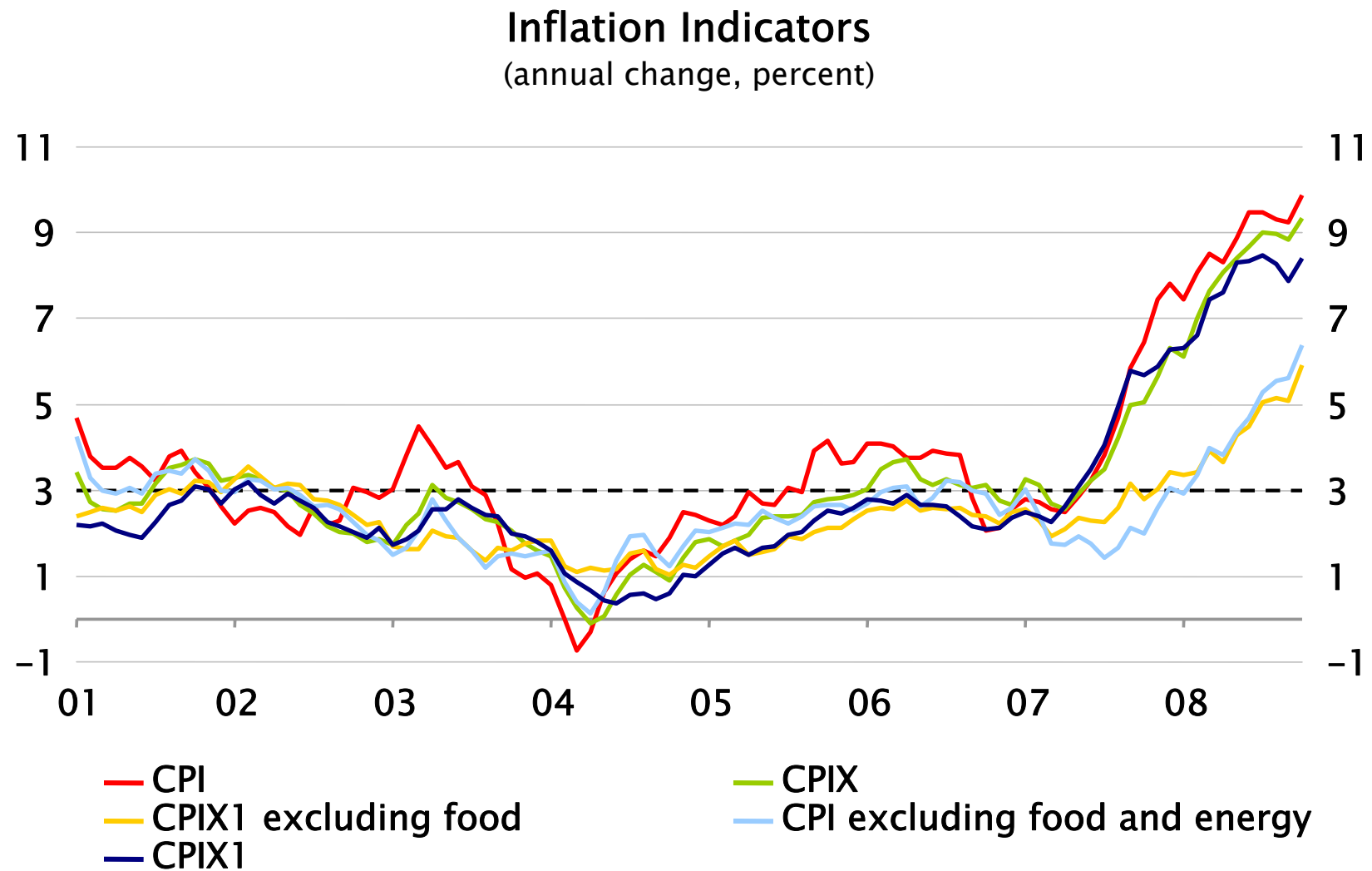
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Current Inflation and Growth



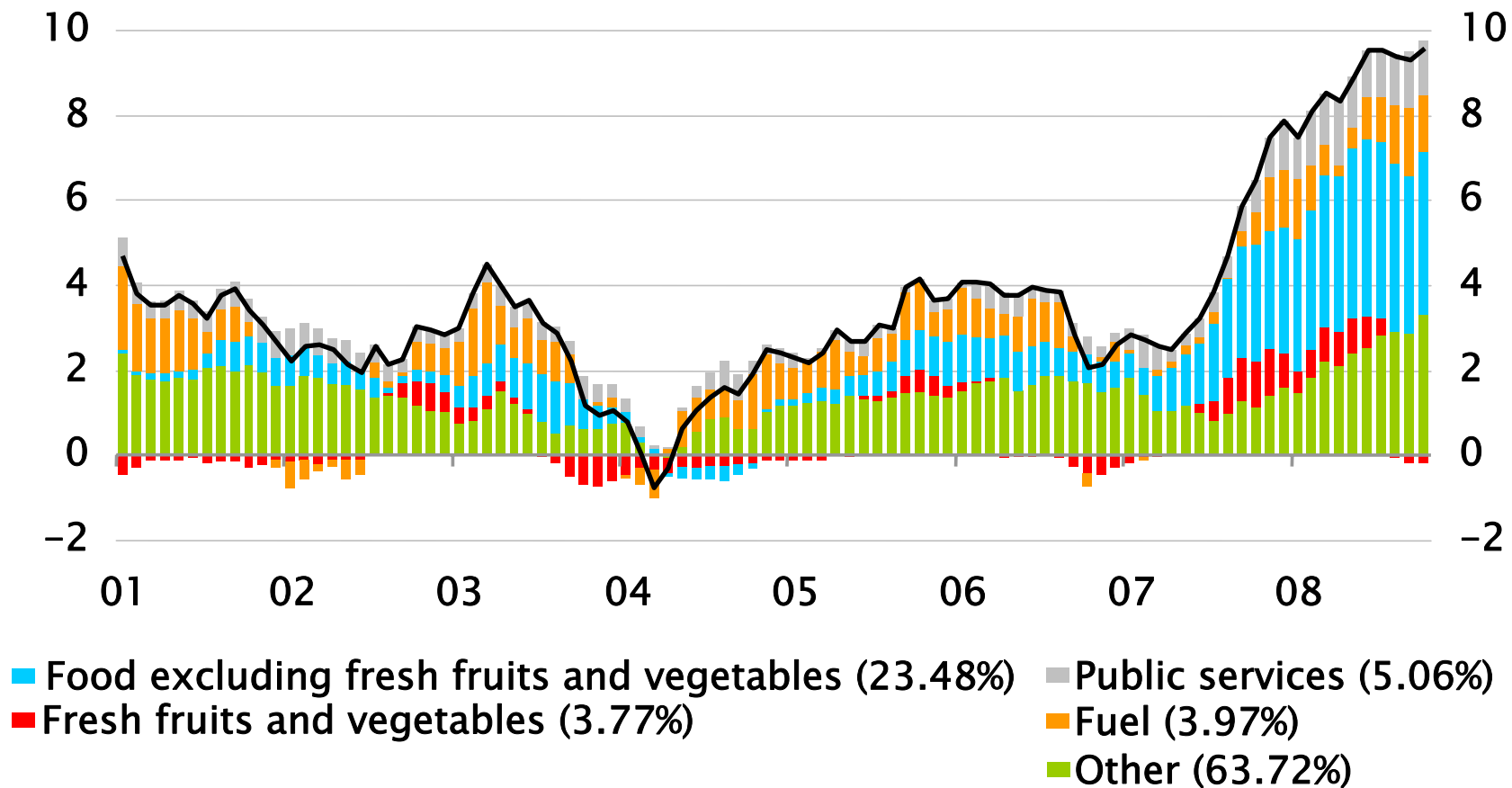
Inflation has been the most important problem since mid 2007. Annual CPI inflation reached 9.9% in October, largely diverging from the 3% target.





In Chile, an economy with few domestic distortions, higher international energy and food prices triggered the initial inflation surge. More recently, propagation has been larger and more widespread than expected.

Annual CPI Decomposition (*)
(percentage points)



(*) CPI weight in parentheses.

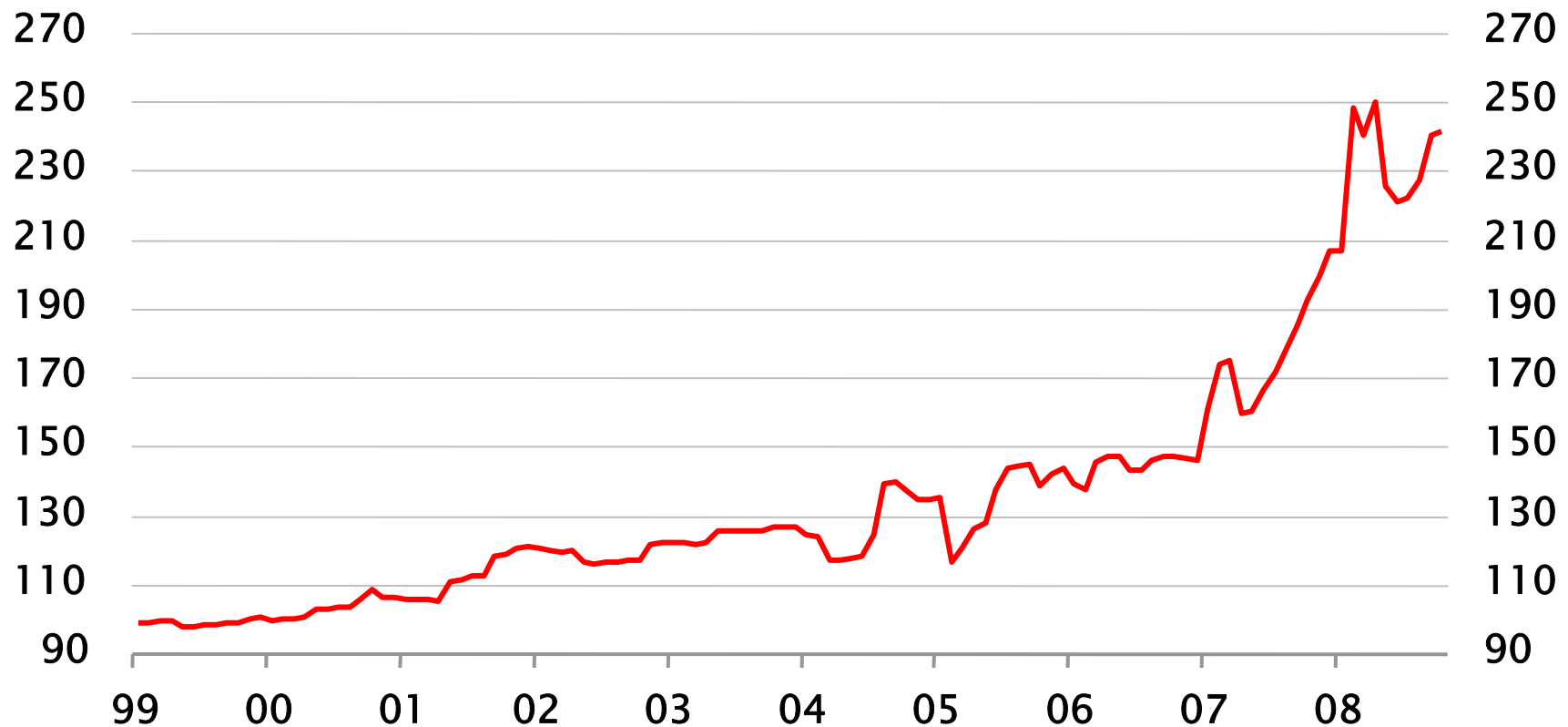
Sources: Central Bank of Chile and National Bureau of Statistics.



Energy costs, at the household and firm level, have risen significantly since 2007, increasing cost pressures but giving the correct incentives for large capacity increases in energy generation.

Electricity Price Included in CPI

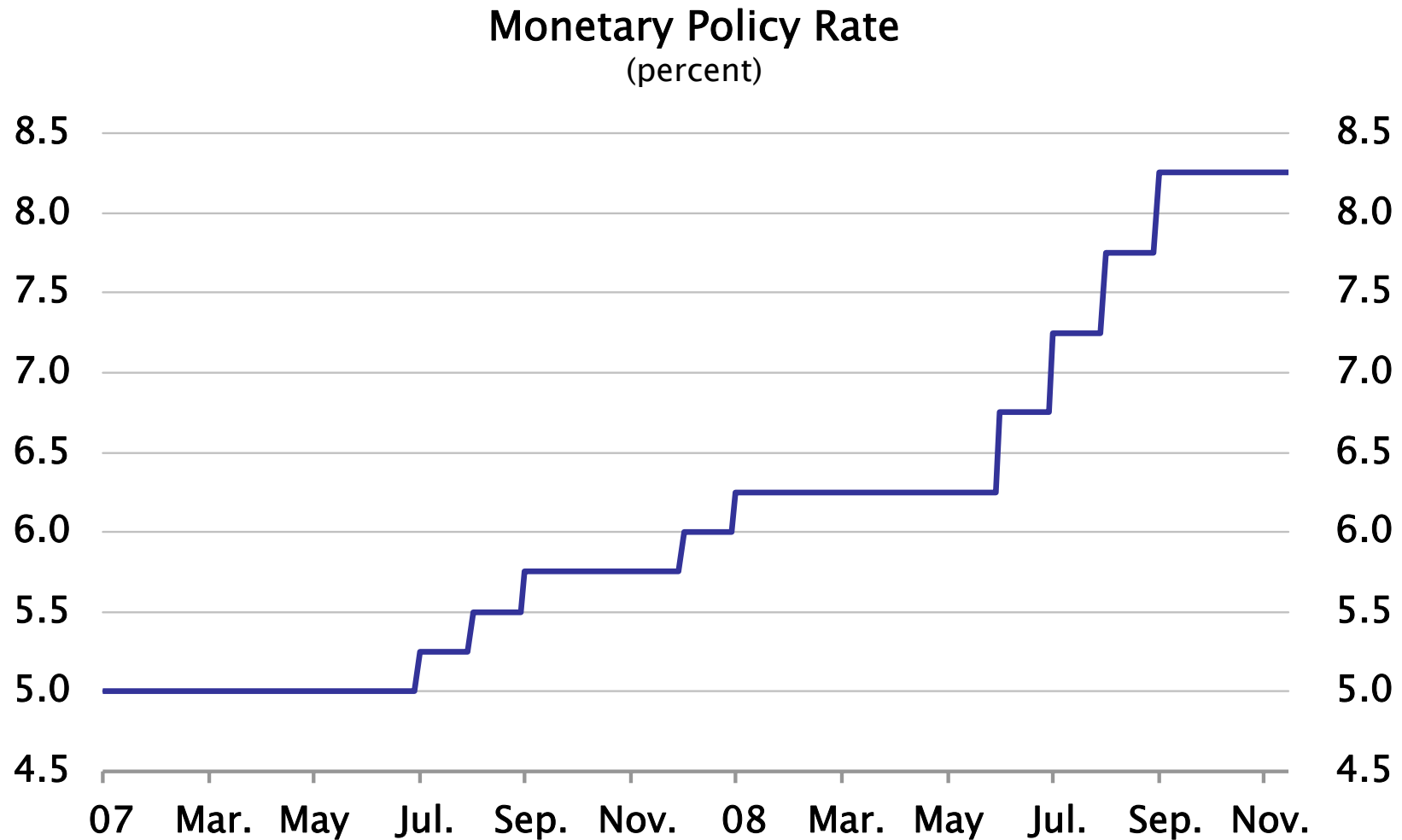
(index, December 1998 = 100)



Source: National Bureau of Statistics.



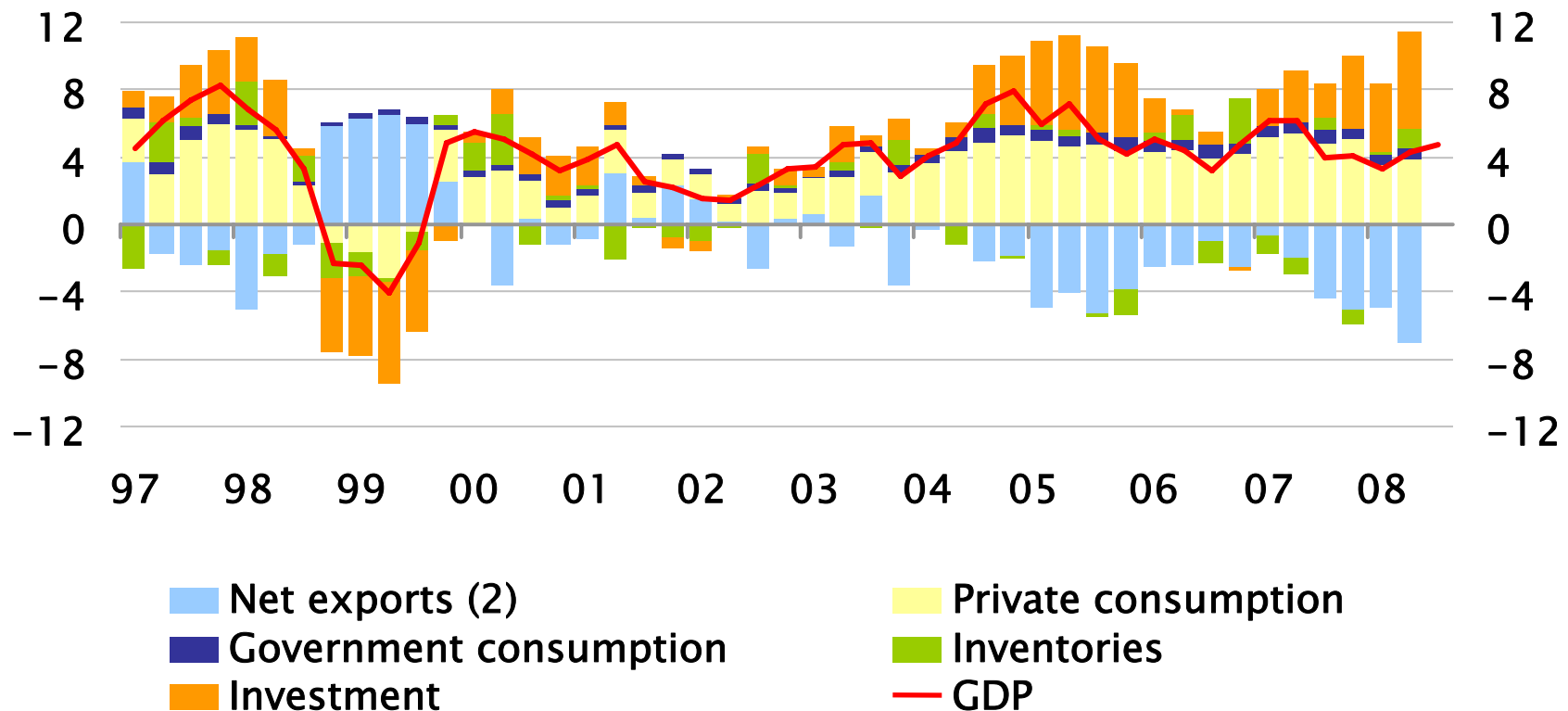
Monetary Policy reacted forcefully from mid-2007 to September 2008 to increased inflation, particularly after higher propagation became evident by mid-2008.





In the run-up to the turmoil in September, GDP growth hovered around 4%, but domestic demand expanded at a brisk pace, close to 10% thanks mostly to rapid investment.

GDP and Domestic Demand (1)
(annual change; percentage points)



(1) GDP for 3Q08, corresponds to IMACEC average of the quarter.

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

Source: Central Bank of Chile.

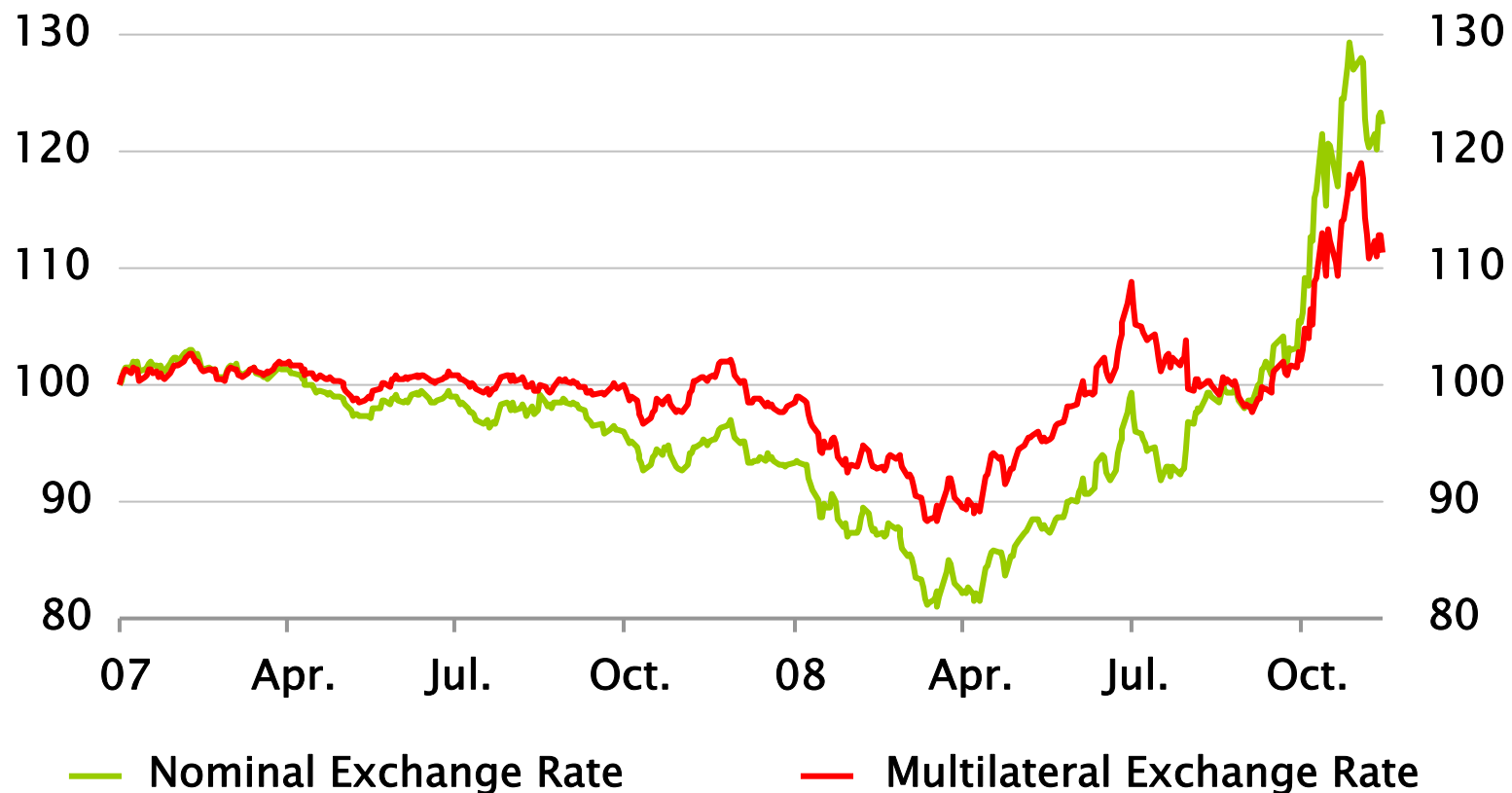


The Recent Financial Turmoil and its Impact on Chile



The nominal exchange rate has bore the brunt of the recent financial turbulence, depreciating more than 25% since early September.

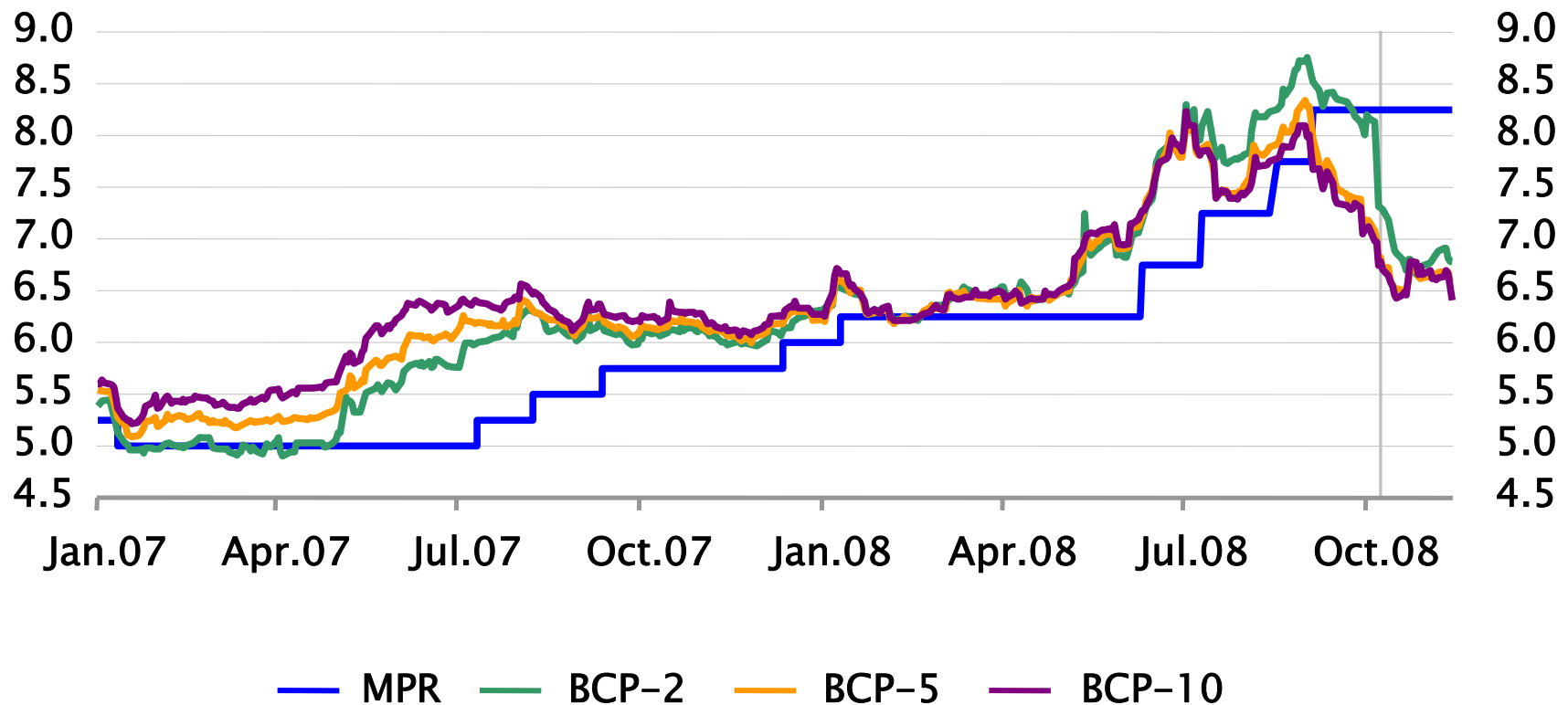
Nominal Exchange Rate
(index, January 2, 2007=100)





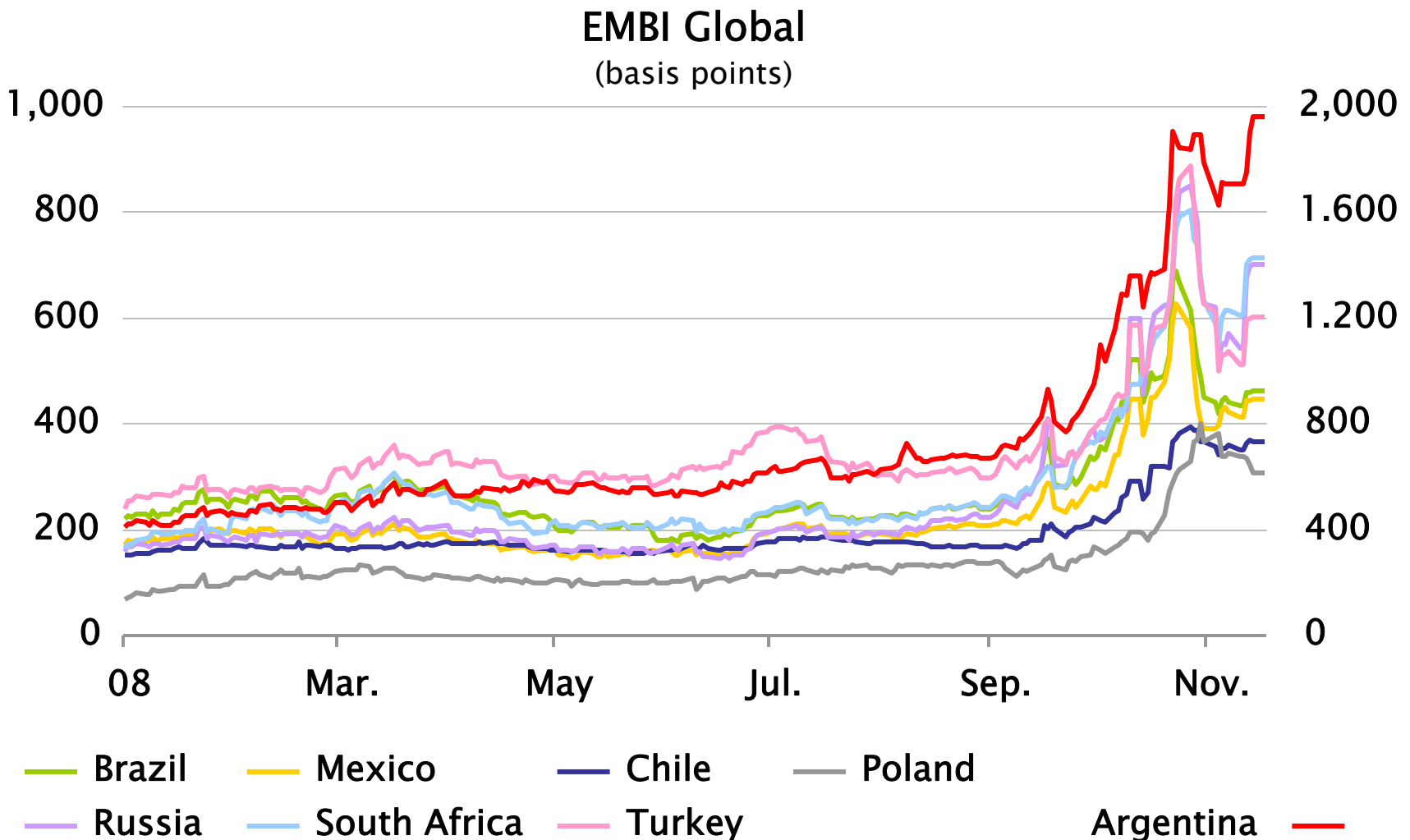
But local fixed income markets have reacted sensibly.
Yields on nominal Central Bank bonds have plummeted
by close to 200bp since early September.

Nominal Interest Rates
(percent)





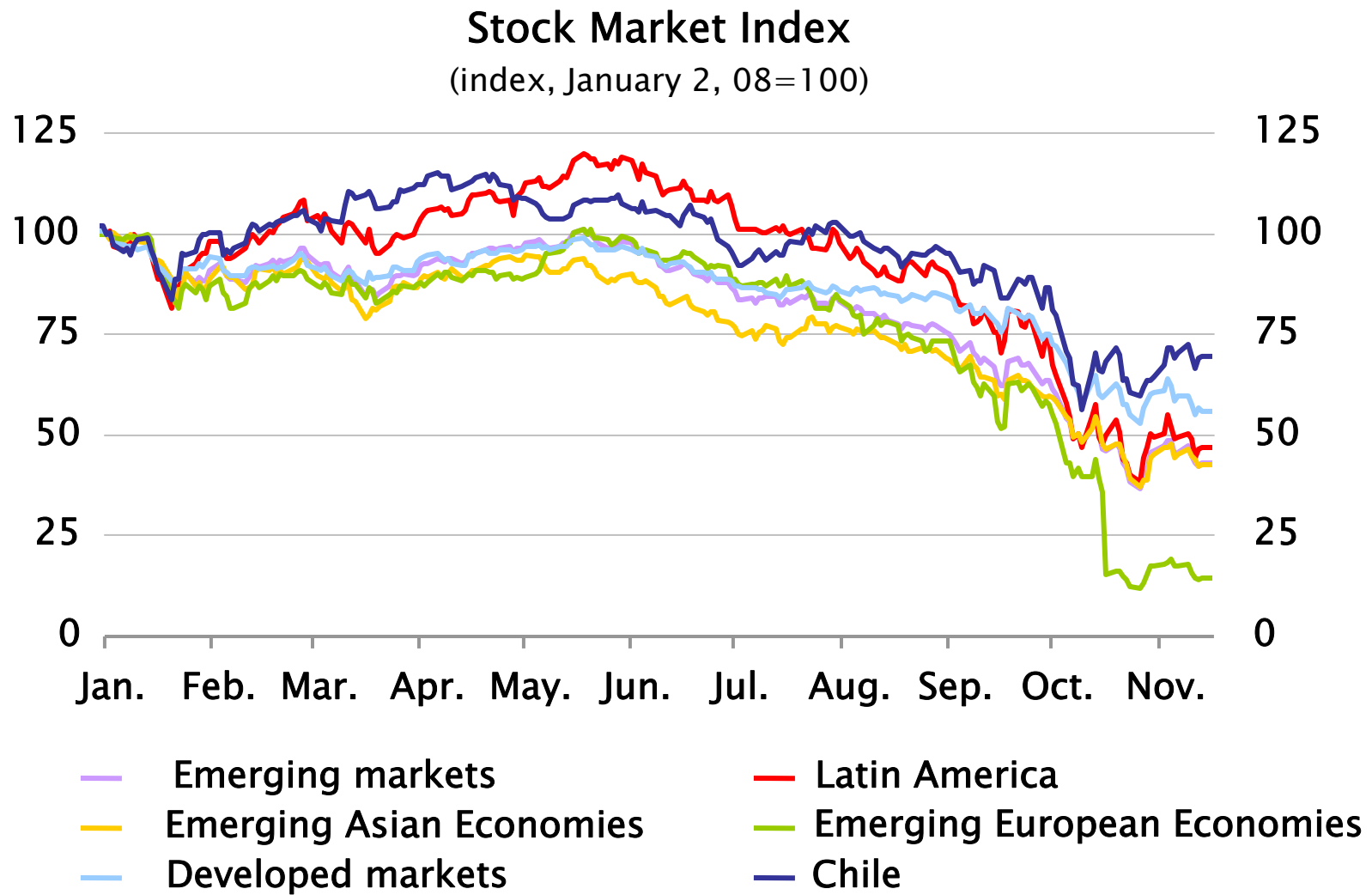
Chile's sovereign spread reaction has been limited.



Sources: Bloomberg and JP Morgan Chase.



The response of the local stock market has been more limited than in other economies.



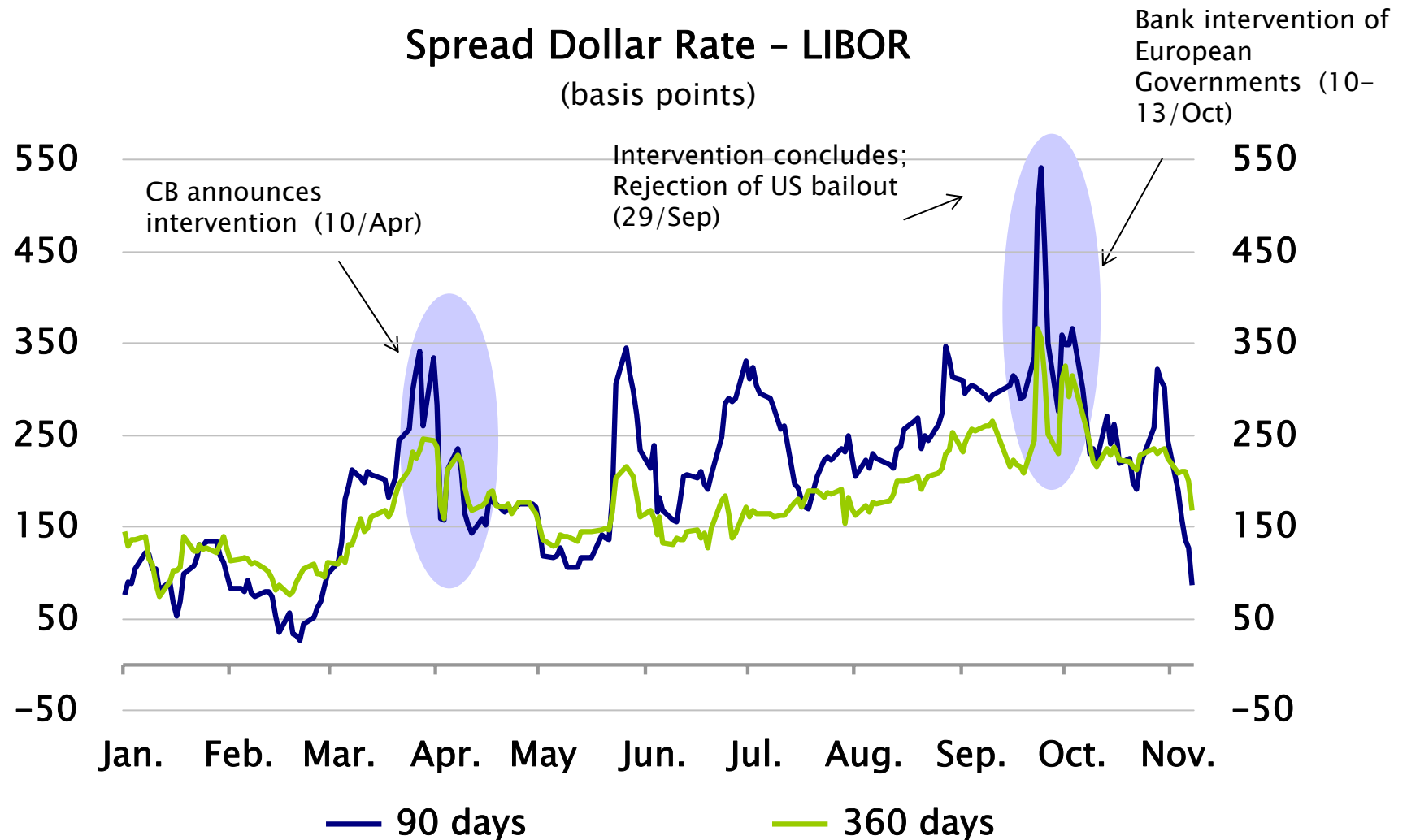


Notwithstanding an overall healthy adjustment to recent turbulences, local markets have not remained totally unscathed.

- USD local liquidity became under tension during the fourth quarter of 2007. Onshore dollar rates displayed an increasing spread over LIBOR, peaking at 400–500bp at the height of the turmoil (late September, early October).
- Local peso money markets also became stressed during the recent conjuncture. Short term deposit rates peaked at close to 200bp over MPR, and term deposits traded at heavy discounts in the local exchange.
- The Board's assessment is that rather than a concrete cut in access to foreign lending, the local financial tensions were motivated by a fear of sudden stop in external funding in the banking system and potentially the corporate sector, leading to liquidity hoarding by banks and corporates.
- This process was compounded by an increased assessment of credit risk going forward due to the implications of the severe global downturn.

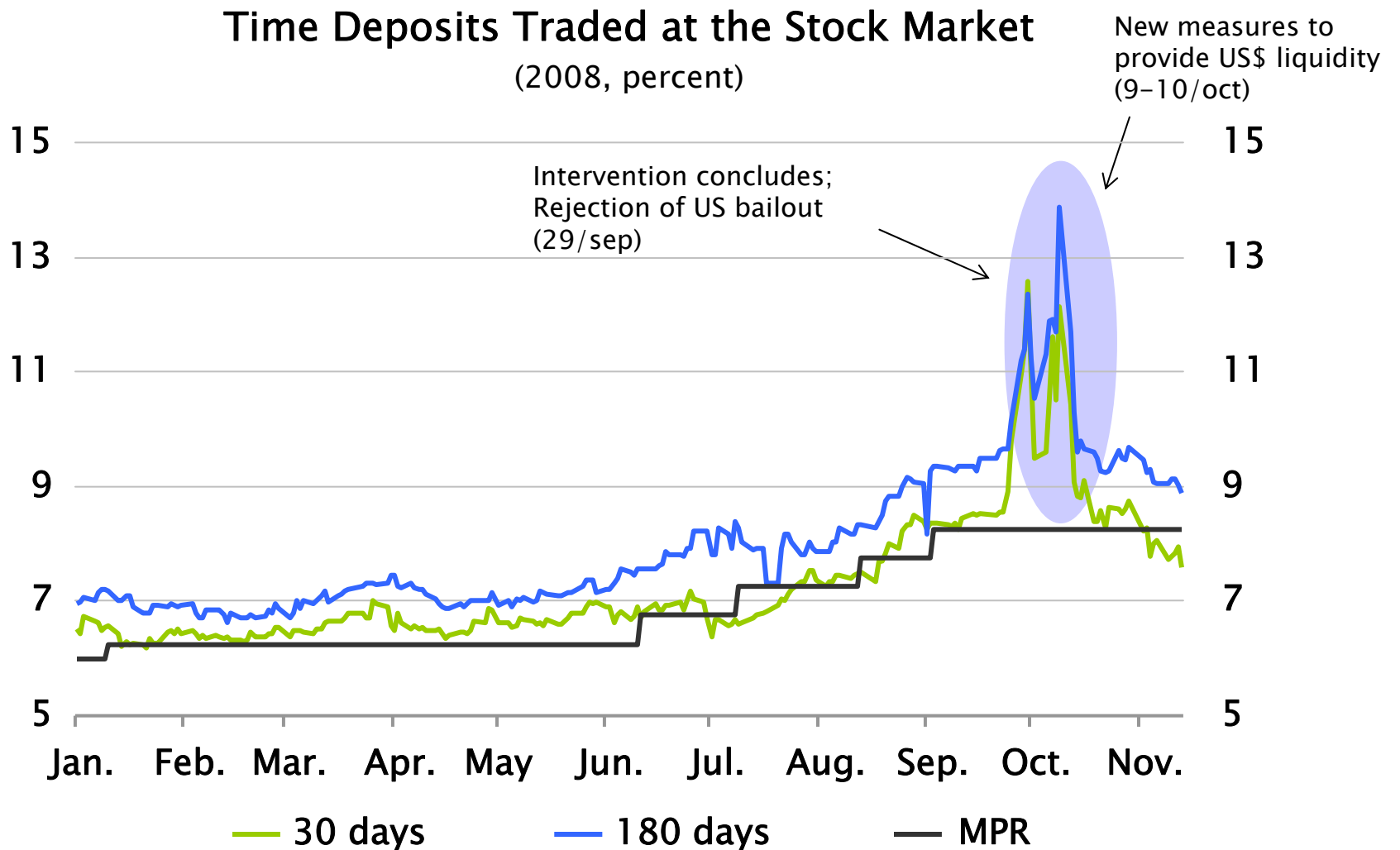


Policy actions over October calmed down liquidity tensions in USD local markets...





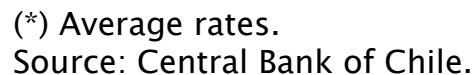
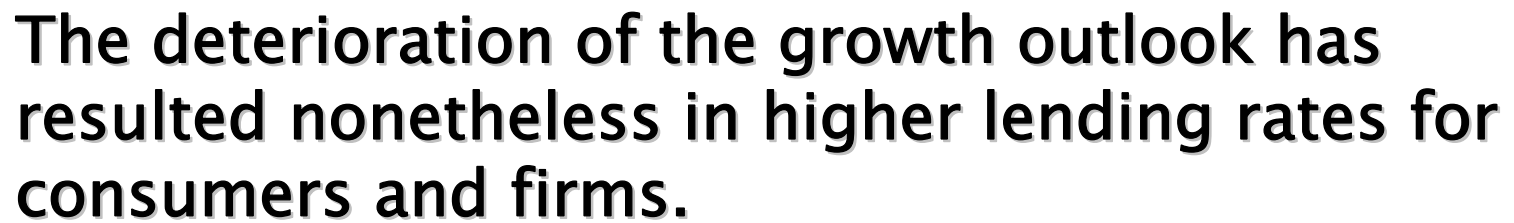
...dampening also the stress in local money markets.





October measures.

- Basis of the program: setting out of a pre-announced set of policies over a sufficiently long period of time, aiming at ensuring that the Central Bank would stand ready to provide foreign and peso liquidity for the normal functioning of the financial system.
- Main measures:
 1. A swap program (peso-USD repo), with weekly auctions of US\$500 million for 60 and 90 days (alternating per week). The program will run for 6 months, and has the potential of “swaping” a maximum of US\$5 billion.
 2. The range of collaterals for the provision of peso liquidity was broadened by 50% and REPO operations were extended.
 3. The public sector announced a one-off increase in USD deposits in the banking system for US\$700 million, allocated through competitive auctions performed by the Central Bank as the fiscal agent.
- Not all dollar liquidity has been demanded, which confirms that Chile is still having normal access to foreign financing. Financial tensions have diminished significantly.





Medium-Term Prospects



Last week the Central Bank provided an update of the macroeconomic outlook. World growth prospects have declined sharply, specially in developed economies.

World Growth: Update November 2008 (*)
(annual change, percent)

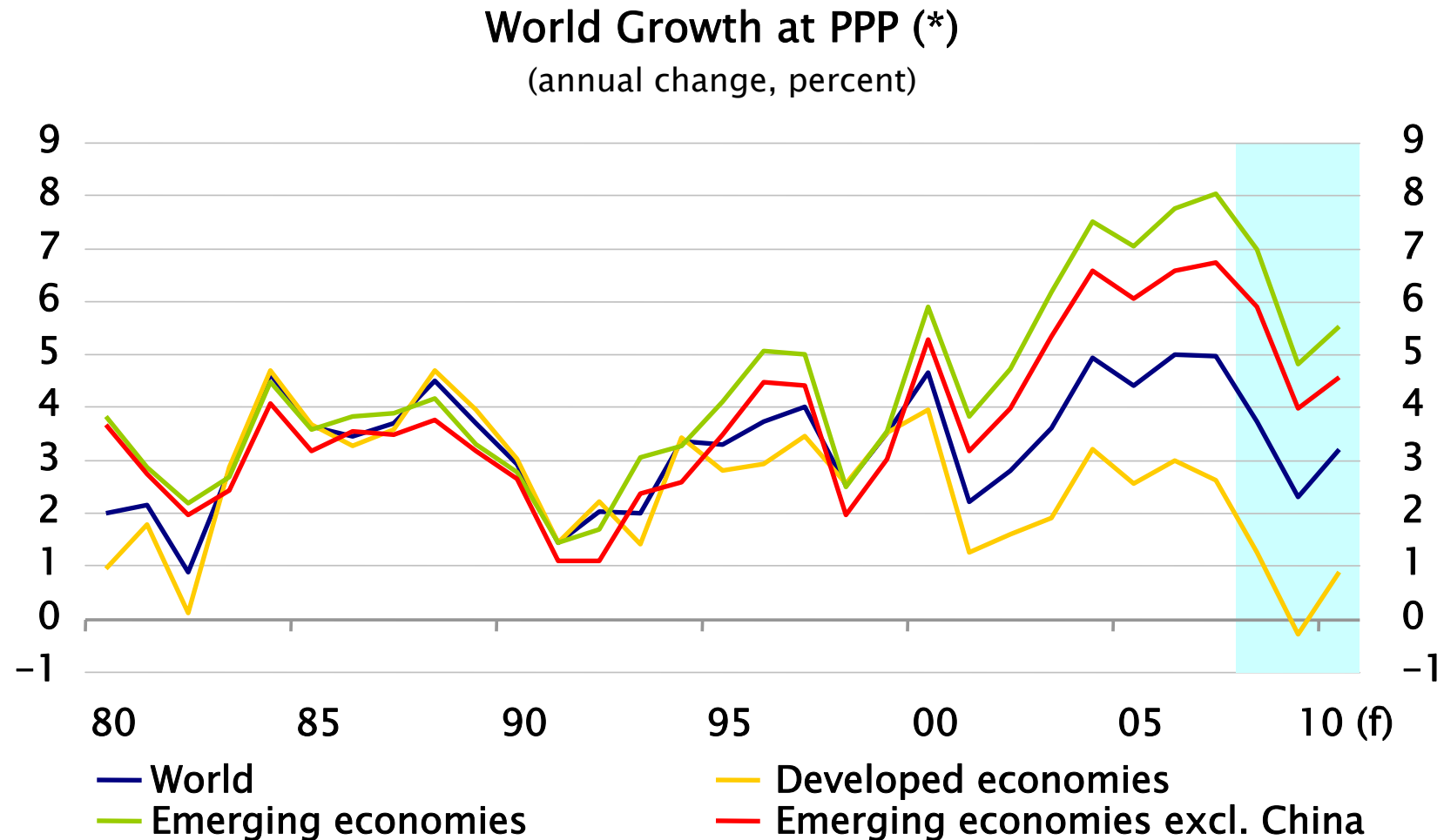
	2007 (e)	2008 (f)		2009 (f)		2010 (f)	
		MPR Sep.08	Update Nov.08	MPR Sep.08	Update Nov.08	MPR Sep.08	Update Nov.08
World	5.0	4.0 ▼	3.7	3.7 ▼	2.3	4.4 ▼	3.2
World at market parity	3.7	2.8 ▼	2.6	2.5 ▼	1.1	3.4 ▼	2.1
United States	2.0	1.6 ▼	1.3	1.0 ▼	-0.7	2.8 ▼	1.0
Euro area	2.6	1.2 ▼	1.0	0.4 ▼	-0.7	1.9 ▼	0.5
Japan	2.1	0.8 ▼	0.4	0.8 ▼	-0.1	2.0 ▼	0.6
China	11.9	9.9 ▼	9.6	9.0 ▼	8.5	8.9 ▼	8.5
Rest of Asia	5.8	4.6 ▼	4.5	5.0 ▼	2.4	5.2 ▼	3.2
Latin America	5.6	4.3 ▲	4.5	3.8 ▼	2.4	4.2 ▼	2.9
Commodity exporters	3.3	1.6 ▼	1.2	2.2 ▼	0.9	2.9 ▼	1.9
Trading partners	4.8	3.5 ▼	3.4	3.1 ▼	1.9	3.8 ▼	2.6

(*) Regional growth according to PPP weights published by the IMF in World Economic Outlook, April 2008.
(e) Estimate; (f) Forecast.

Source: Central Bank of Chile based on information from investment banks, Consensus Forecast and IMF.



Important uncertainties remain on the length and deepness of the recession in industrial countries, which will be key for emerging markets prospects.



(*) Regional classification and PPP weights according to IMF definition. (f) Forecast.

Source: Central Bank of Chile based on information from investment banks, Consensus Forecast and IMF.



Lower commodity prices should, on the whole, provide some inflation relief already over the coming months.

International Baseline Scenario Assumptions
(annual average)

	2007	2008 (e)		2009 (f)		2010 (f)	
		MPR Sep.08	Update Nov.08	MPR Sep.08	Update Nov.08	MPR Sep.08	Update Nov.08
Terms of trade (*)	0.8	-5.9	-10.5	-7.2	-18.2	-4.3	-2.5
External prices (US\$) (*)	8.5	14.1	12.2	3.3	0.5	2.8	4.8
LME copper price (US\$ cents/lb)	323	350	320	310	165	300	190
WTI oil price (US\$/barrel)	72	115	105	116	70	115	80

(e) Estimate; (f) Forecast.

(*) Annual change, percent.

Source: Central Bank of Chile.



The current tightening of credit conditions, along with sharply lower global growth going forward, should provoke a significant deceleration of GDP and domestic demand growth.

Economic Growth and Current Account: November 2008 Update

	2006	2007	2008 (f)	2009 (f)
GDP (annual percentage change)	4.3	5.1	4.0–4.5	2.0–3.0
Domestic demand (annual percentage change)	6.4	7.8	9.2	0.6
Current account (% of GDP)	4.7	4.4	–2.7	–4.5

(f) Forecast.

Source: Central Bank of Chile.



The economy should be able to finance the widening of the current account deficit without tensions thanks to the fiscal rule, the level of international reserves and continued access to financial markets.

Economic Growth and Current Account: November 2008 Update

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Current account (% of GDP)	4.7	4.4	–2.7	–4.5

(f) Forecast.

Source: Central Bank of Chile.



The growth slowdown will generate enough slack to bring about a quicker convergence of annual CPI inflation to the 3% target.

Inflation Forecast: November 2008 update
(annual change, percent)

	2006	2007	2008 (f)	2009 (f)	2010 (f)
Average CPI inflation	3.4	4.4	8.9	6.2	3.0
December CPI inflation	2.6	7.8	8.5	4.0	
CPI inflation around 2 years (*)					2.8
Average CPIX inflation	3.2	4.0	8.5	6.6	2.8
December CPIX inflation	2.7	6.3	9.4	4.2	
CPIX inflation around 2 years (*)					2.7
Average CPIX1 inflation	2.5	4.1	7.8	6.1	2.7
December CPIX1 inflation	2.4	6.3	8.2	4.3	
CPIX1 inflation around 2 years (*)					2.5

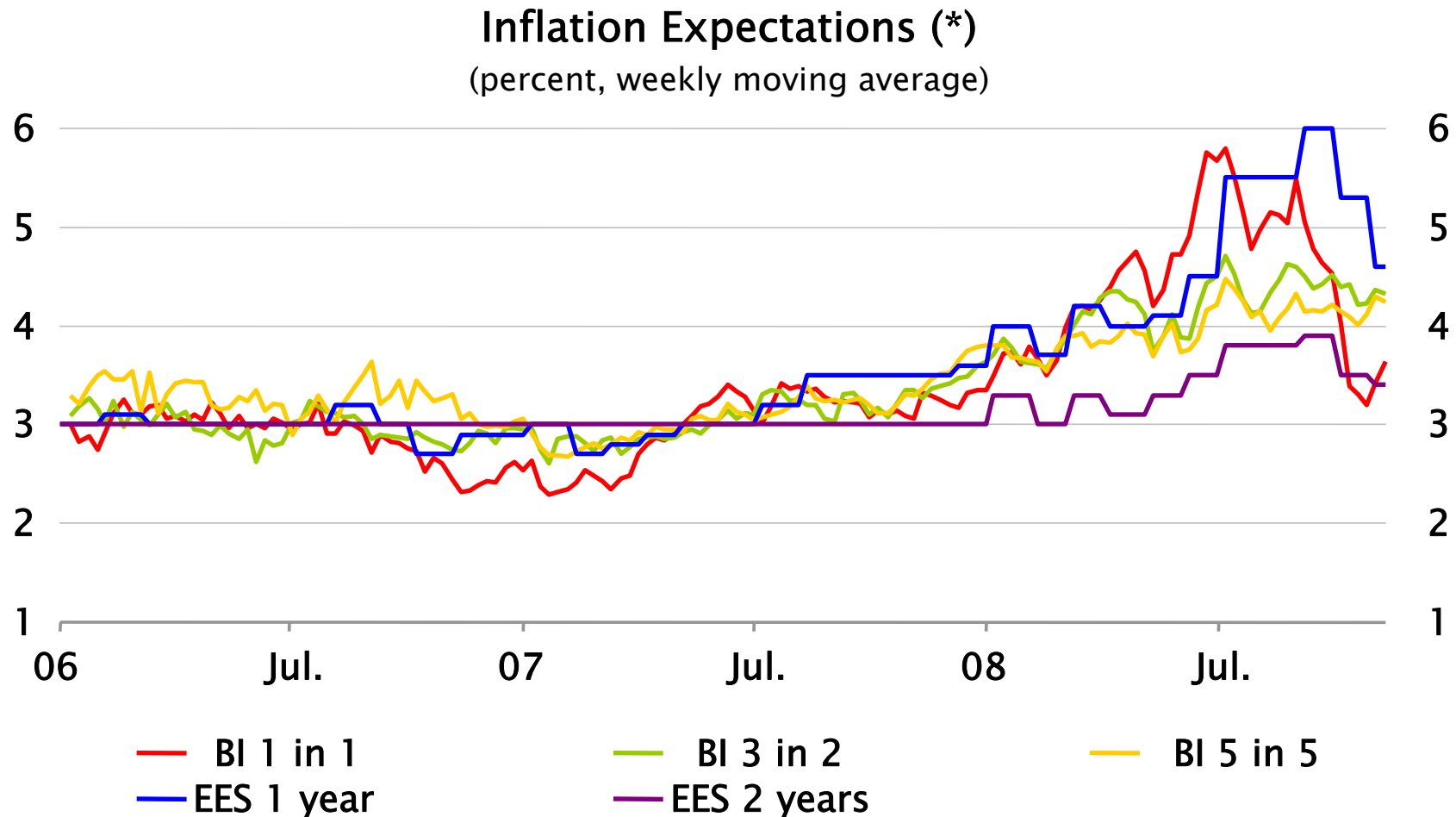
(f) Forecast.

(*) Projected inflation at 2010.QIV.

Source: Central Bank of Chile.



Current inflation expectations are broadly in line with this scenario, seeing the unfolding global environment as basically disinflationary.



(*) Considering inflation breakevens (BI) based on forward instruments and the Economic Expectations Survey (EES).

Source: Central Bank of Chile.



Chile's Resilience to the Global Financial Crisis



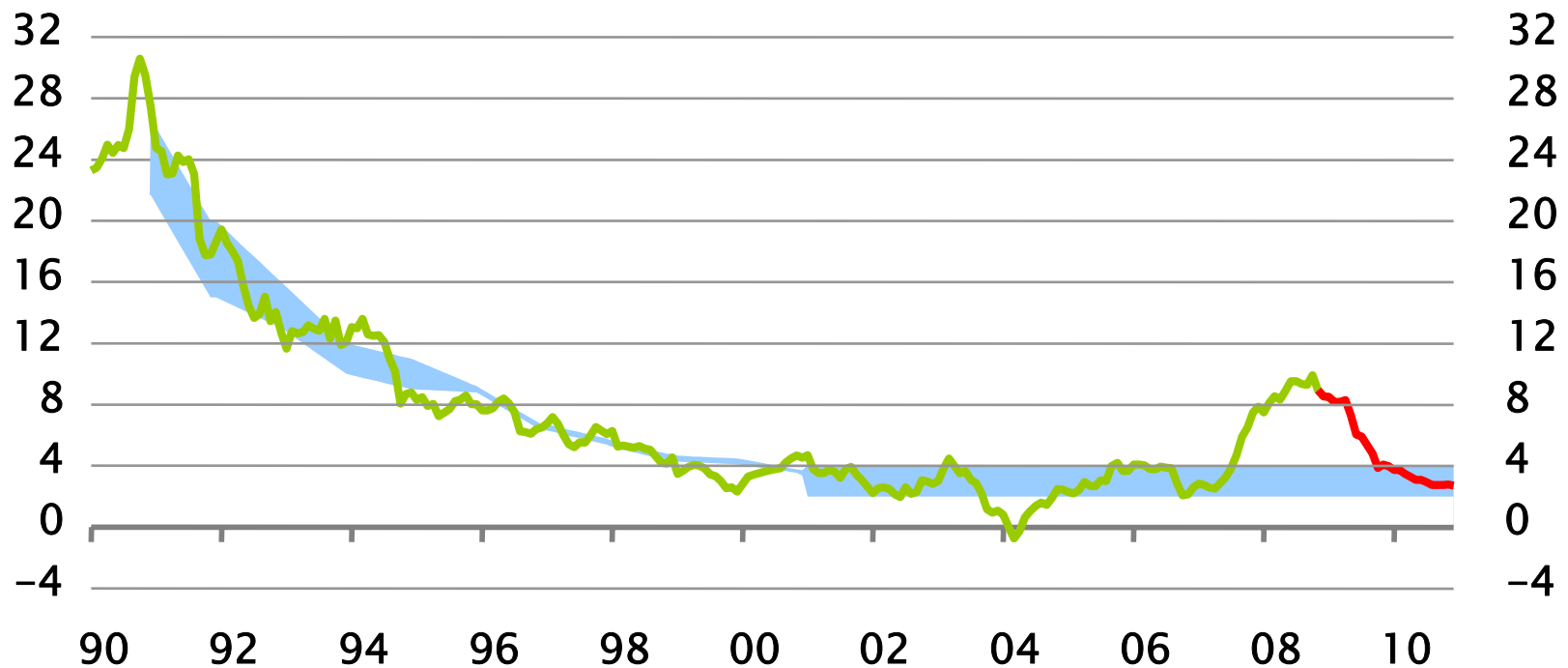
The Chilean economy is well prepared to deal with the world financial turmoil.

- The world financial crisis and the global slowdown is unusually large.
- However, the macroeconomic framework that has been built since the mid 1980s and consolidated in the late 1990s has been increasingly effective at managing external shocks and providing macroeconomic stability.
- The main elements are:
 1. A responsible and predictable fiscal policy which guarantees public sector solvency and smoothes the spending out of copper income. A policy that was sometimes questioned for being too strict is revealing its merits;
 2. Monetary policy is conducted by an independent central bank which uses an inflation targeting regime supported by a floating exchange rate;
 3. Increasing trade openness allowing for the diversification of import and export markets;
 4. A solid financial system, with competitive and well-capitalized banks, appropriately regulated and supervised.



Despite the current deviation, our IT regime has been very effective in curbing inflation. The challenge after large external shocks is to bring inflation back to target in a two-year policy horizon.

Actual and Target Inflation (*)
(annual change, percent)

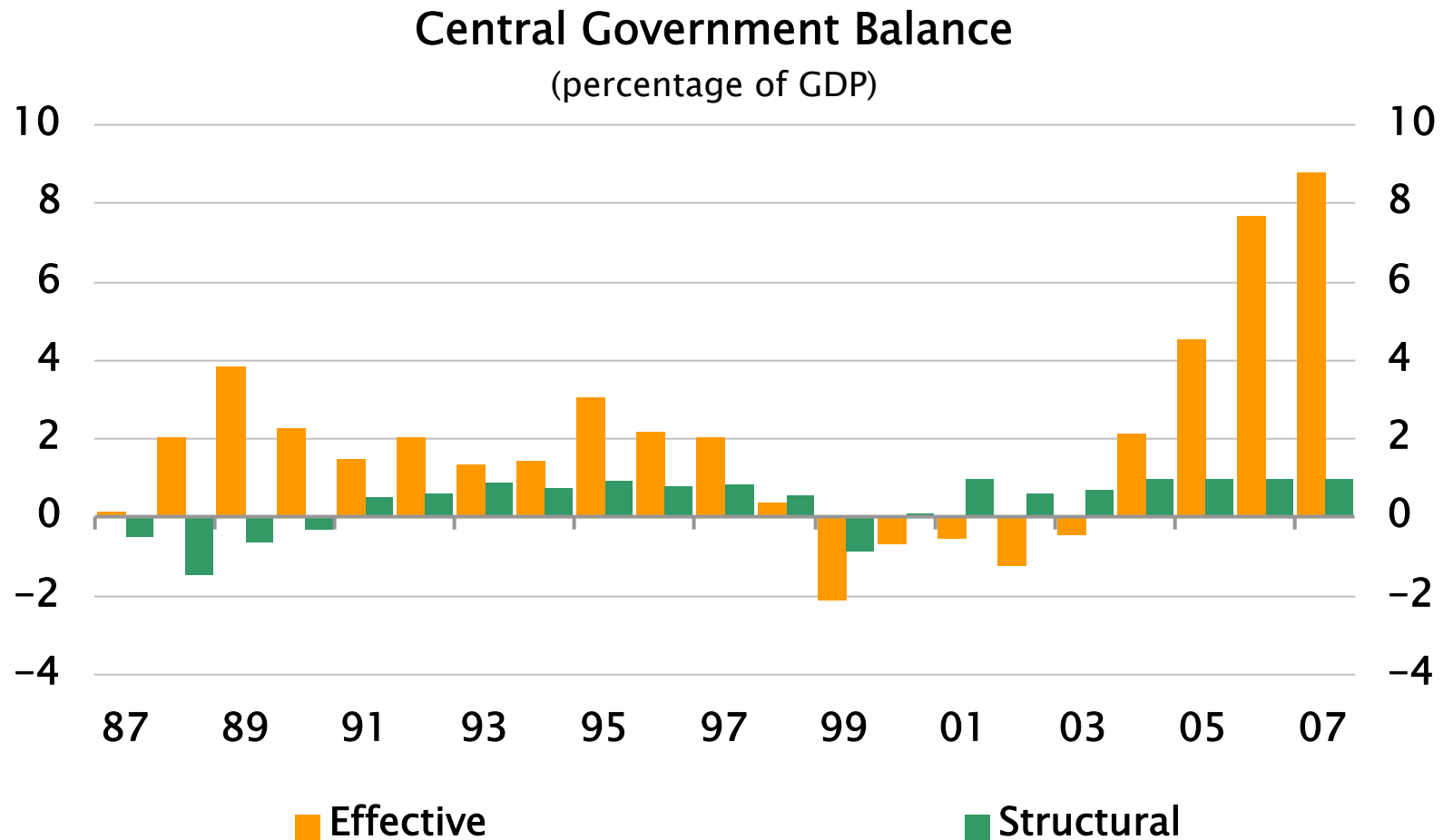


(*) Updated baseline scenario, November 2008. The forecast considers a monthly frequency based on a quarterly forecast.

Source: Central Bank of Chile.



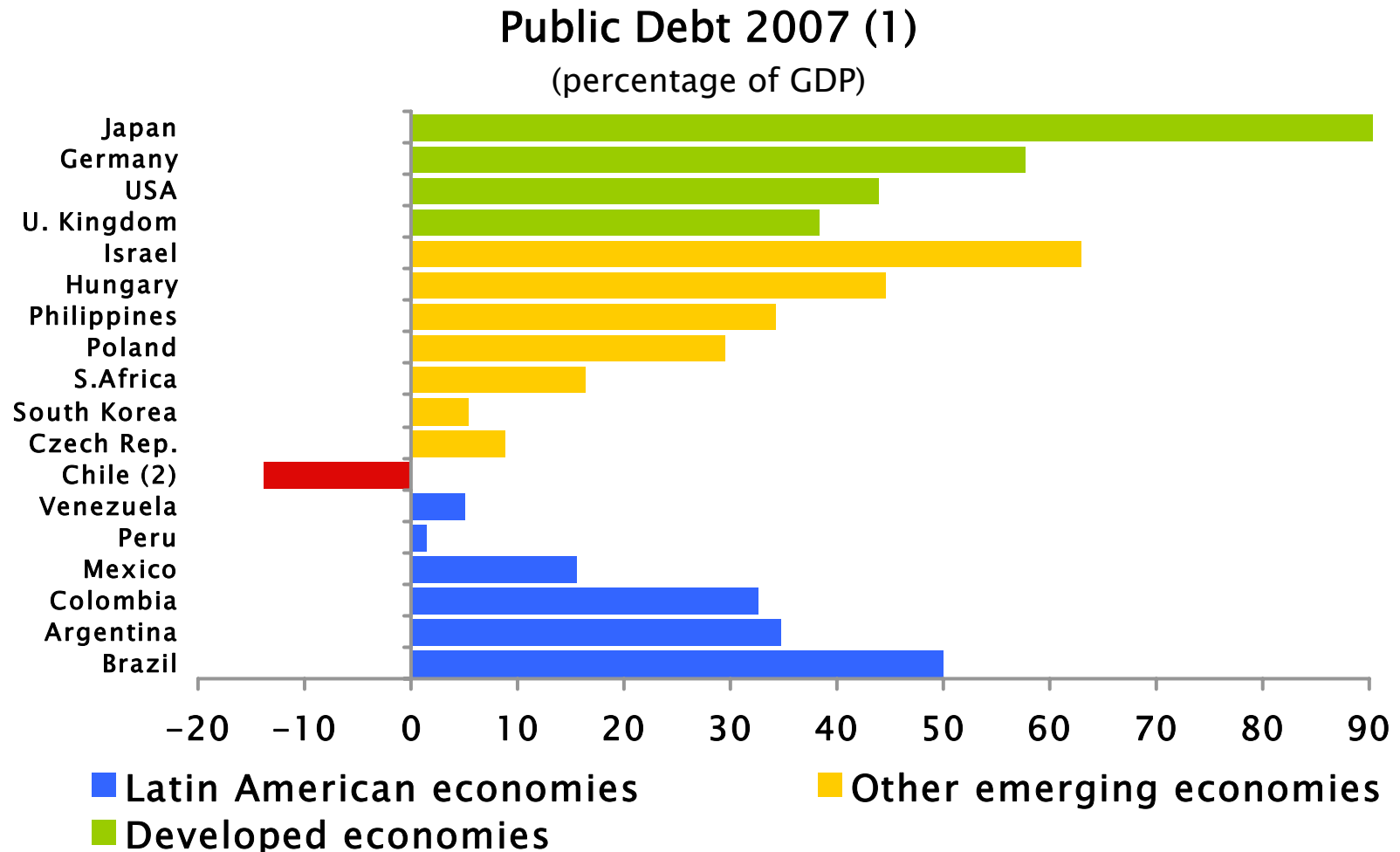
Fiscal policy is implemented through a rule based on a target for the structural surplus of 0.5% of GDP. Thus, fiscal surpluses have been high due to high copper income.



Source: Chile's Ministry of Finance.



The government has taken advantage of favorable times to reduce its debt, becoming a net creditor.



(1) General Government Net Debt (excluding Reserves and Central Bank Debt).

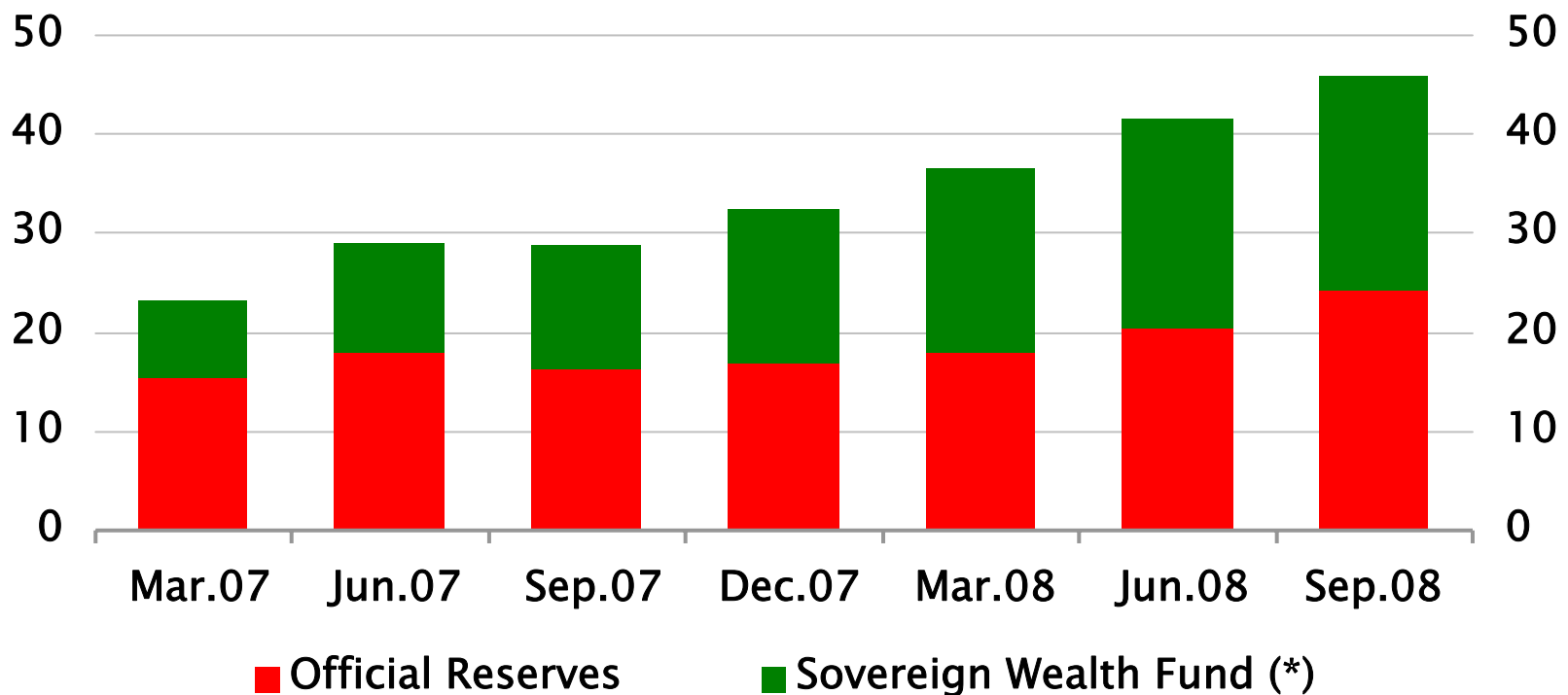
(2) As of March 2008.

Sources: Central Bank of Chile, IMF, JPMorgan, Ministry of Finance.



Foreign assets of the CBC and the Treasury have increased 59% yoy, totalizing US\$46 billion.

Net International Reserves and Sovereign Wealth Fund
(USD billions)

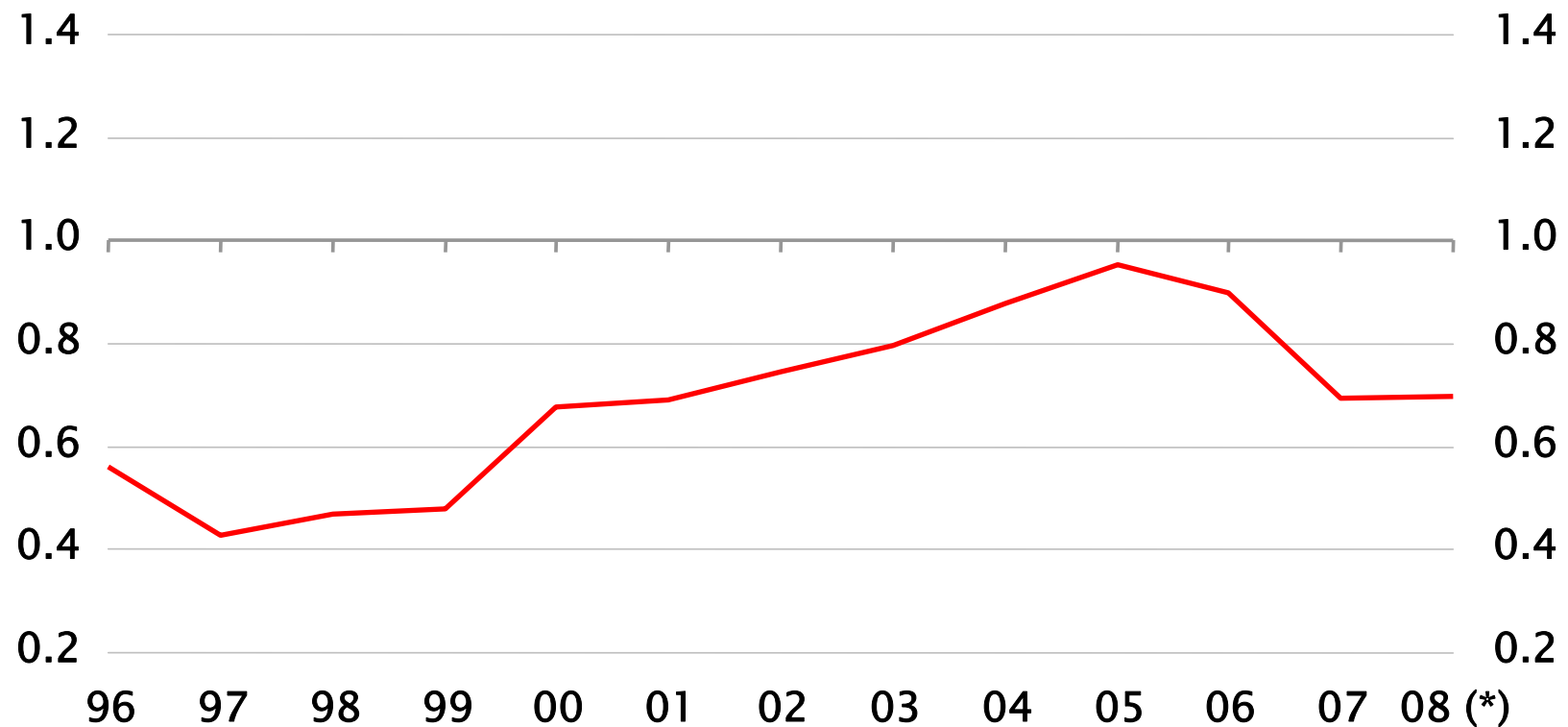


(*) Includes the Pension Reserve Fund (PRF) and the Economic and Social Stabilization Fund (ESSF)
Source: Central Bank of Chile and Finance Ministry.



Short-term foreign debt and long term debt maturing within a year is less than available international reserves and resources at the sovereign wealth funds.

Short-Term Residual External Gross Debt/Reserves and SWF
(ratio)



(*) At August 2008.

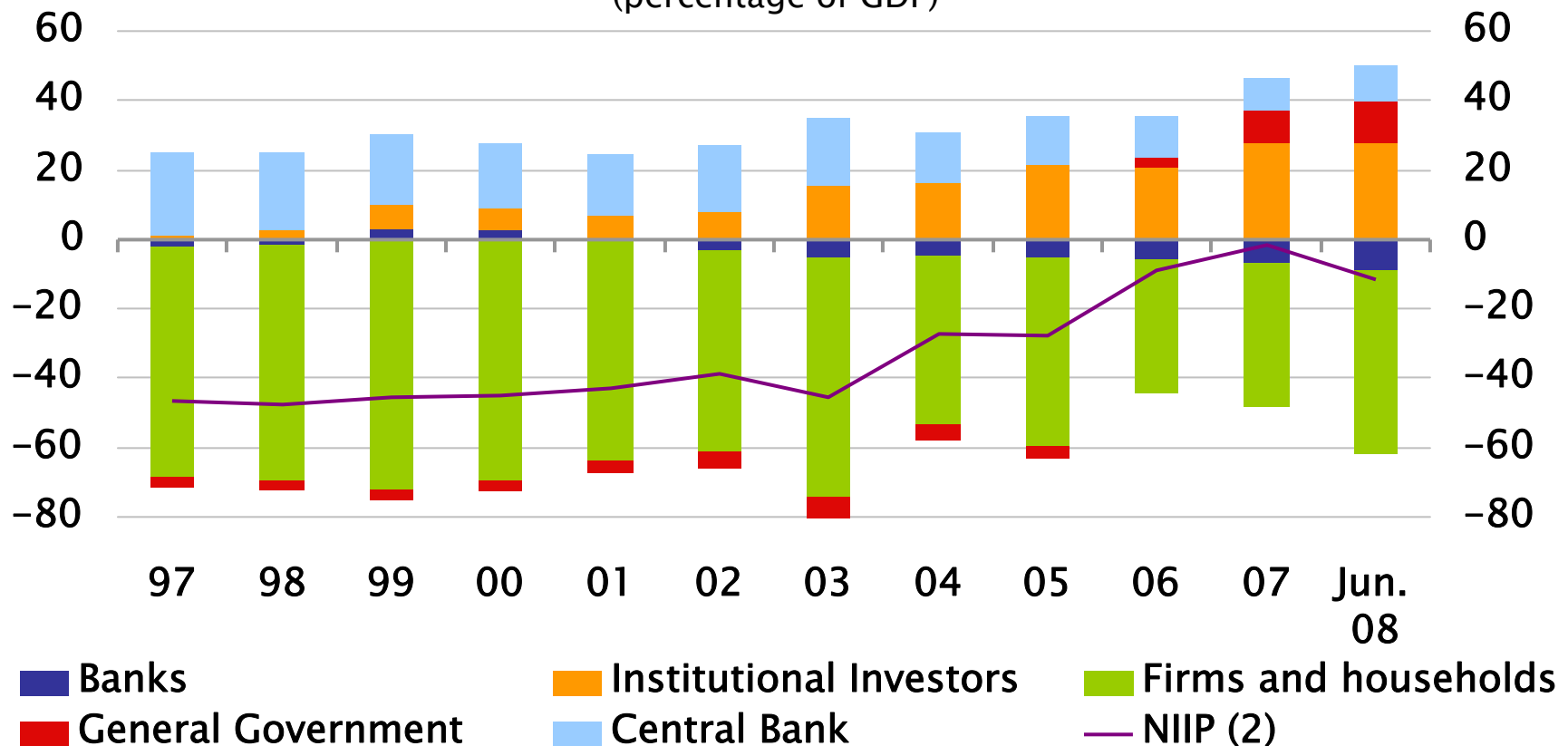
Source: Central Bank of Chile and Finance Ministry.



From an international and historical point of view the International Investment Position of the economy is visibly strong, thanks to the accumulation of reserves, public savings and increased diversification of pension funds abroad.

Net International Investment Position (1)

(percentage of GDP)



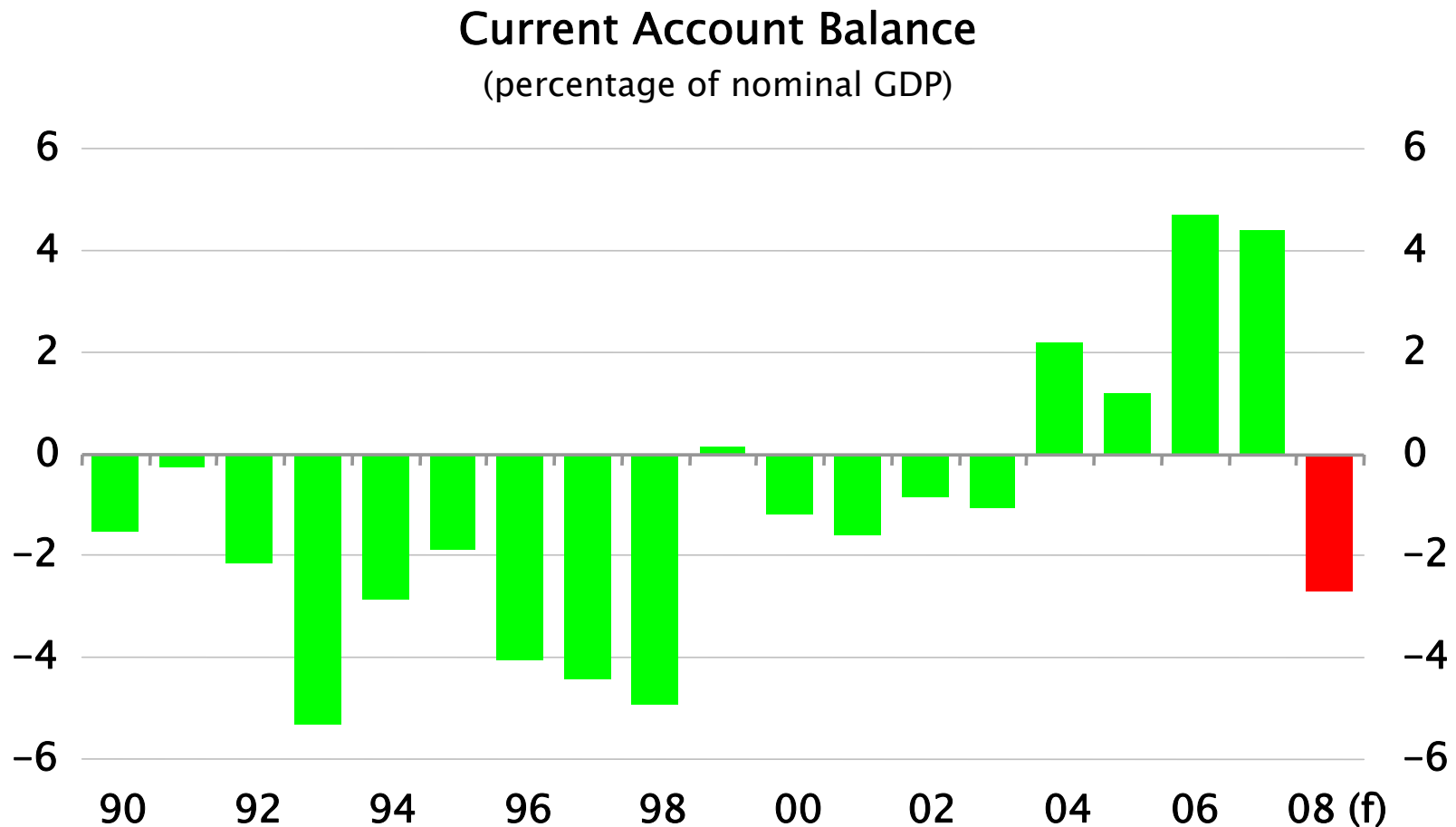
(1) GDP at constant real exchange rate (base rate December 2005=100).

(2) Net International Investment Position.

Source: Central Bank of Chile.



Given the decline in ToT, a deficit in the current account is expected for 2008–09, which have no problem to be financed. However, for other emerging markets this turnaround may pose some problems, in particular due to the closing of the US current account imbalance.

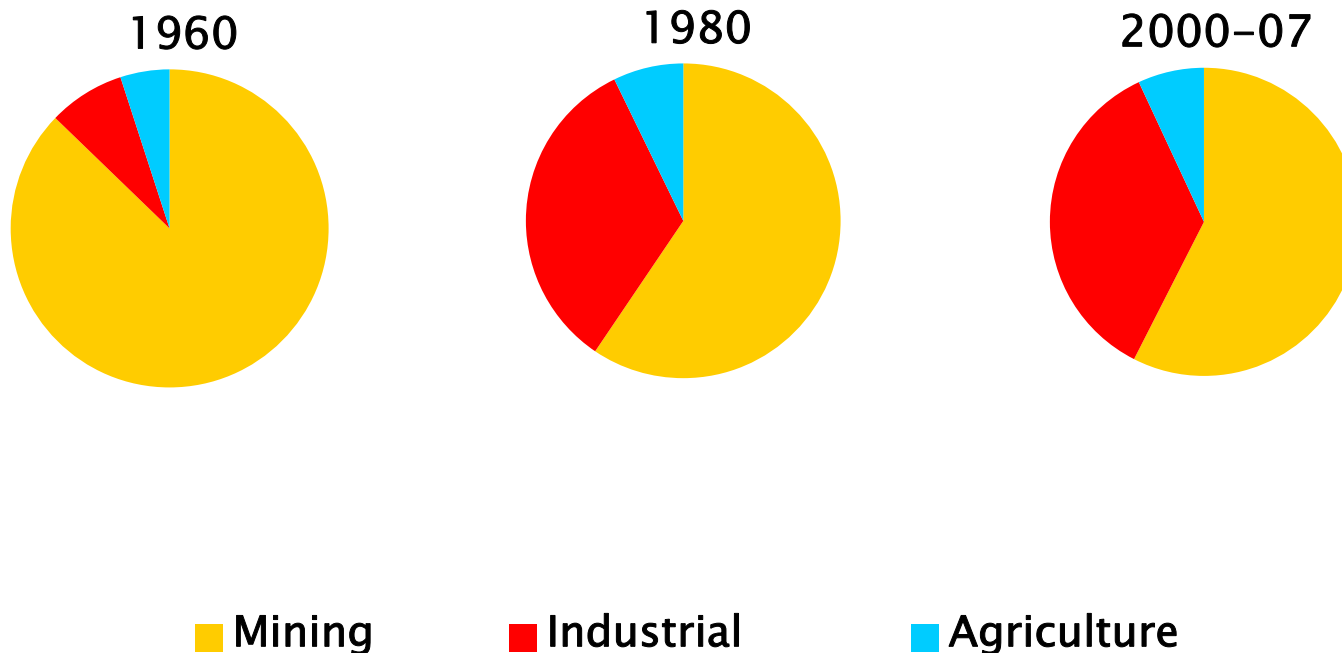


(f) Forecast, November 2008 update.
Source: Central Bank of Chile.



Copper is still important in the Chilean exports structure, but the decline in copper price should not create a serious problem as it was often the case in the past.

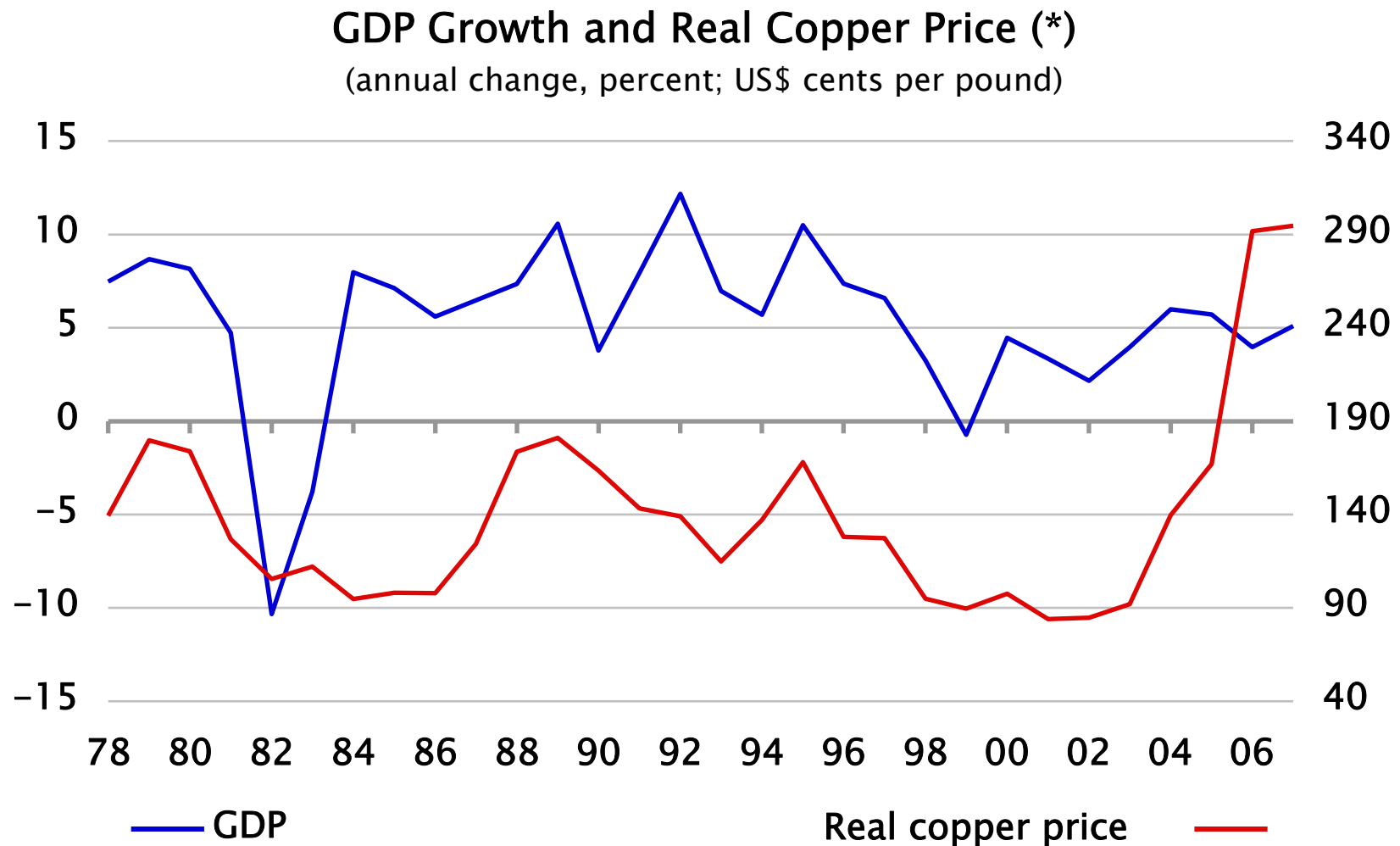
Chilean Exports by Economic Sector (% share of total exports)



Source: Central Bank of Chile.



Chilean GDP has become increasingly insensitive to copper price. During copper price booms Chile's GDP tended to grow too fast and during bust growth declined sharply. This is not the case during the current decade.

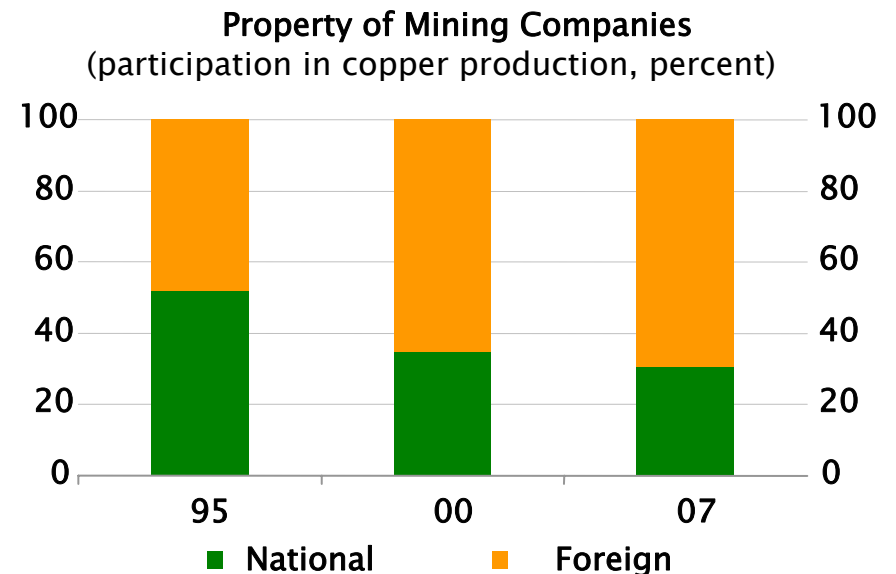
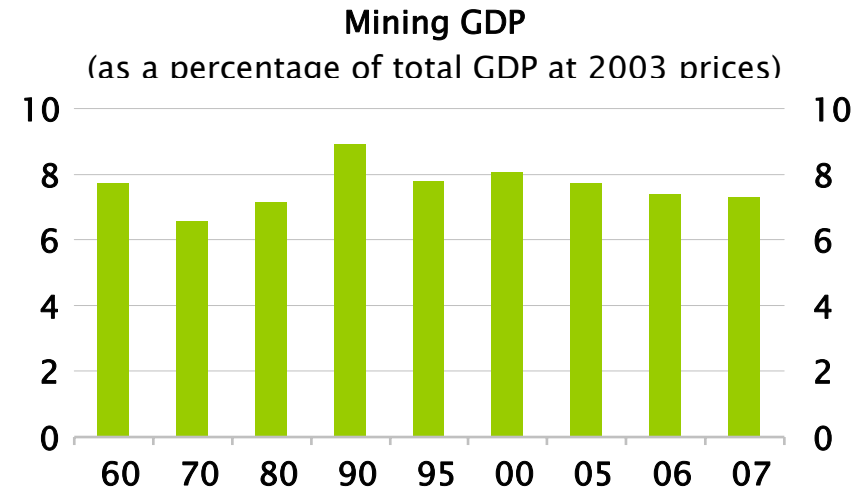
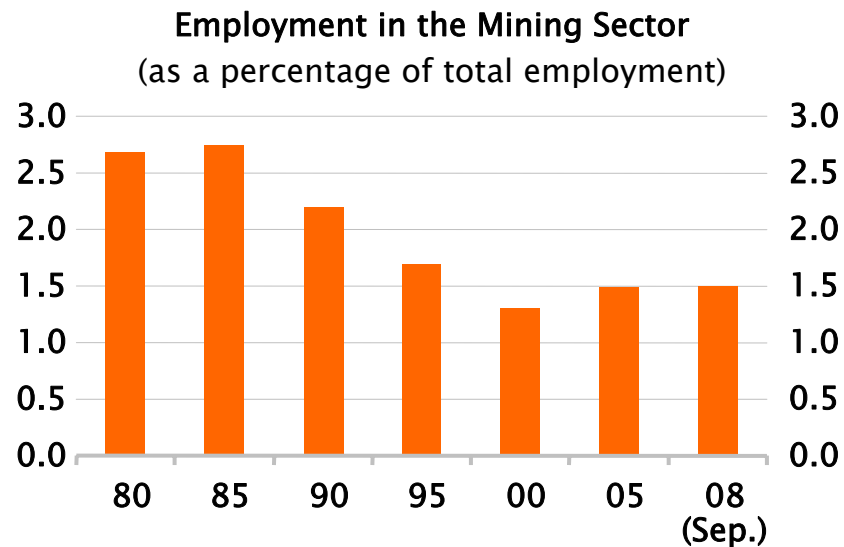


(*) Copper price deflated by U.S. Commodity PPI (2005=100).
Sources: Cochilco and Central Bank of Chile.



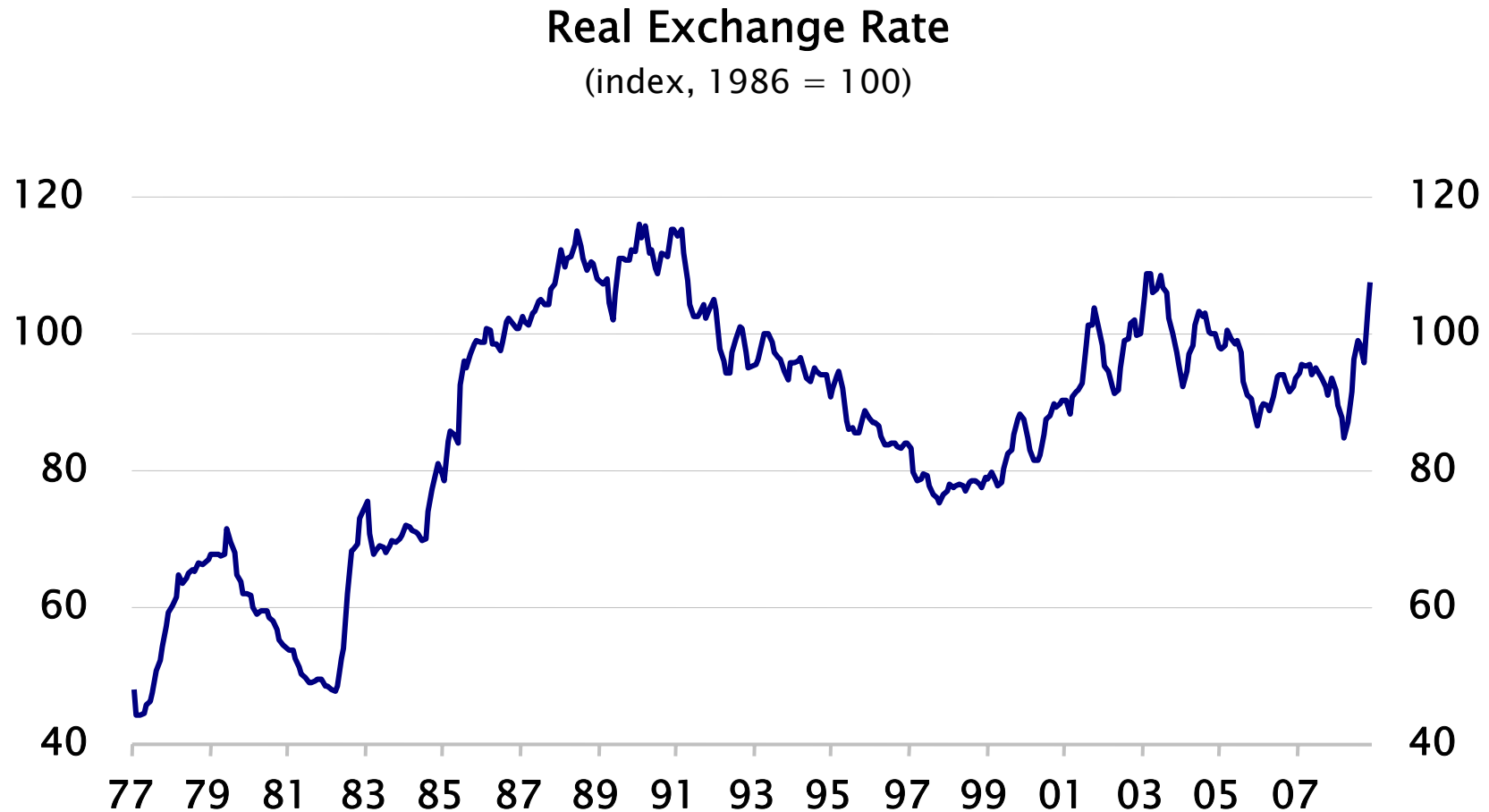
Mining represents a small part of the Chilean Economy.

Mining represents less than 10% of the Chilean GDP and less than 2% of total employment. A large fraction of mining is foreign-owned and the copper price mostly affect fiscal revenues, through state-owned copper enterprise and taxes.





On the contrary of what happened in previous episodes, the exchange rate has done a great deal of the adjustment.



Source: Central Bank of Chile.

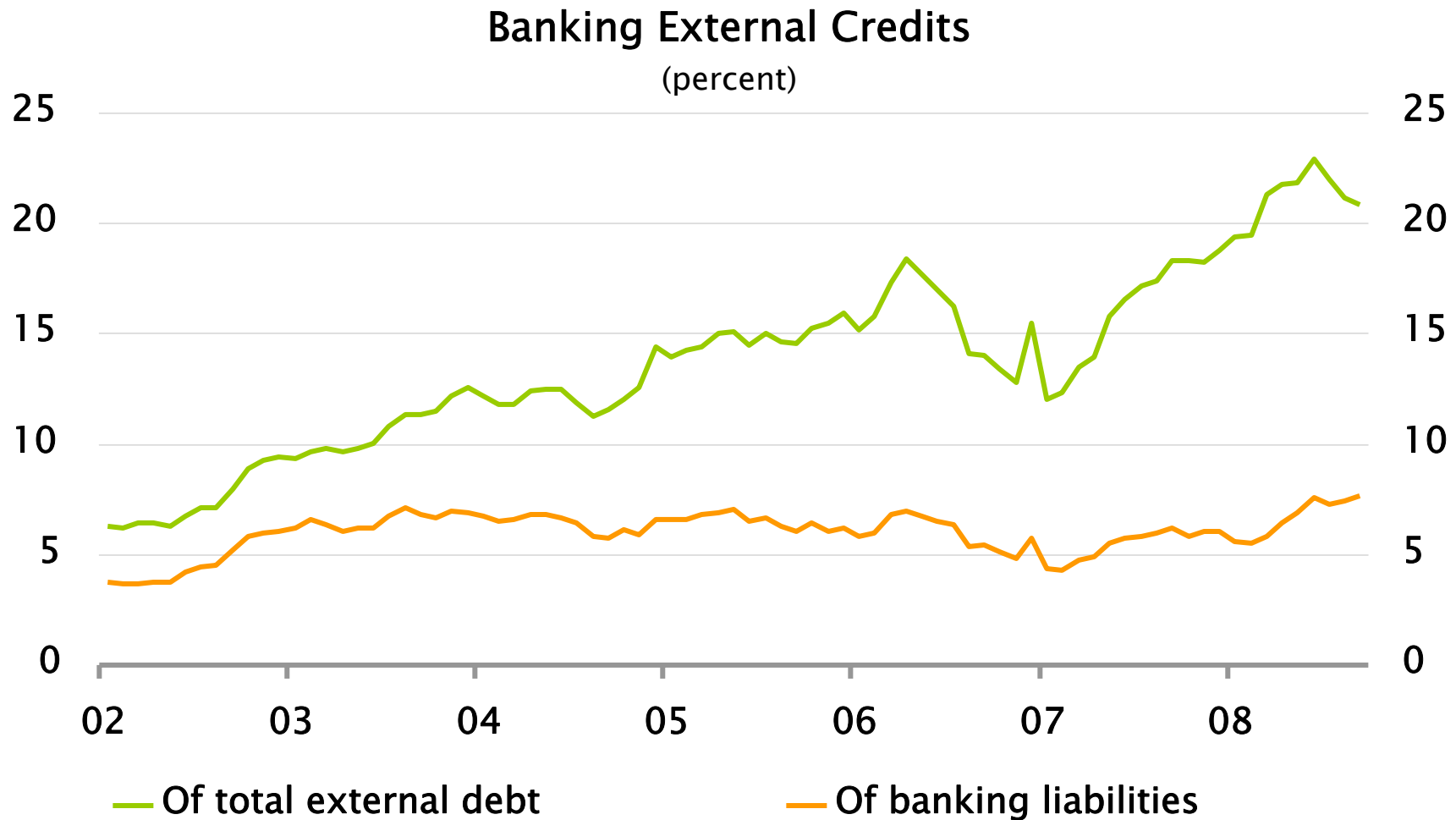


Chile has learned the lesson's from the past, and has built a resilient financial system. Its corporate sector is also well protected to exchange rate fluctuations.

- Following Chile's 1982 economic and banking collapse, a new General Banking Act was enacted in 1986. Although over time several changes have been implemented, some basic features remain which ensure the development of a dynamic and sound banking system in the context of adequate prudential regulation.
 - Mortgage origination in Chile is adequately regulated. Debtor's liability is not limited to the value of the collateral.
 - Financial investments by banks is limited to traditional products (eg, not equity).
 - Securitization of credit risk is restricted. Credit risk is kept within the balance sheet. The Central Bank regulates covered bonds for mortgages (cap on loan-to-value at 75%).
 - Banks can hold positions only on specified derivative contracts. Credit derivatives are not allowed, while in order to enter into foreign exchange or interest rate derivative contracts institutions require an exhaustive process of authorization by the Superintendence of Banks and Financial Institutions.
 - The capital cost of an un-hedged forex position is high, and banks are required to assess the forex exposures of their corporate clients.



Banking sector dependence on external financing is relatively low. Most external debt is long-term and held by non-financial companies.

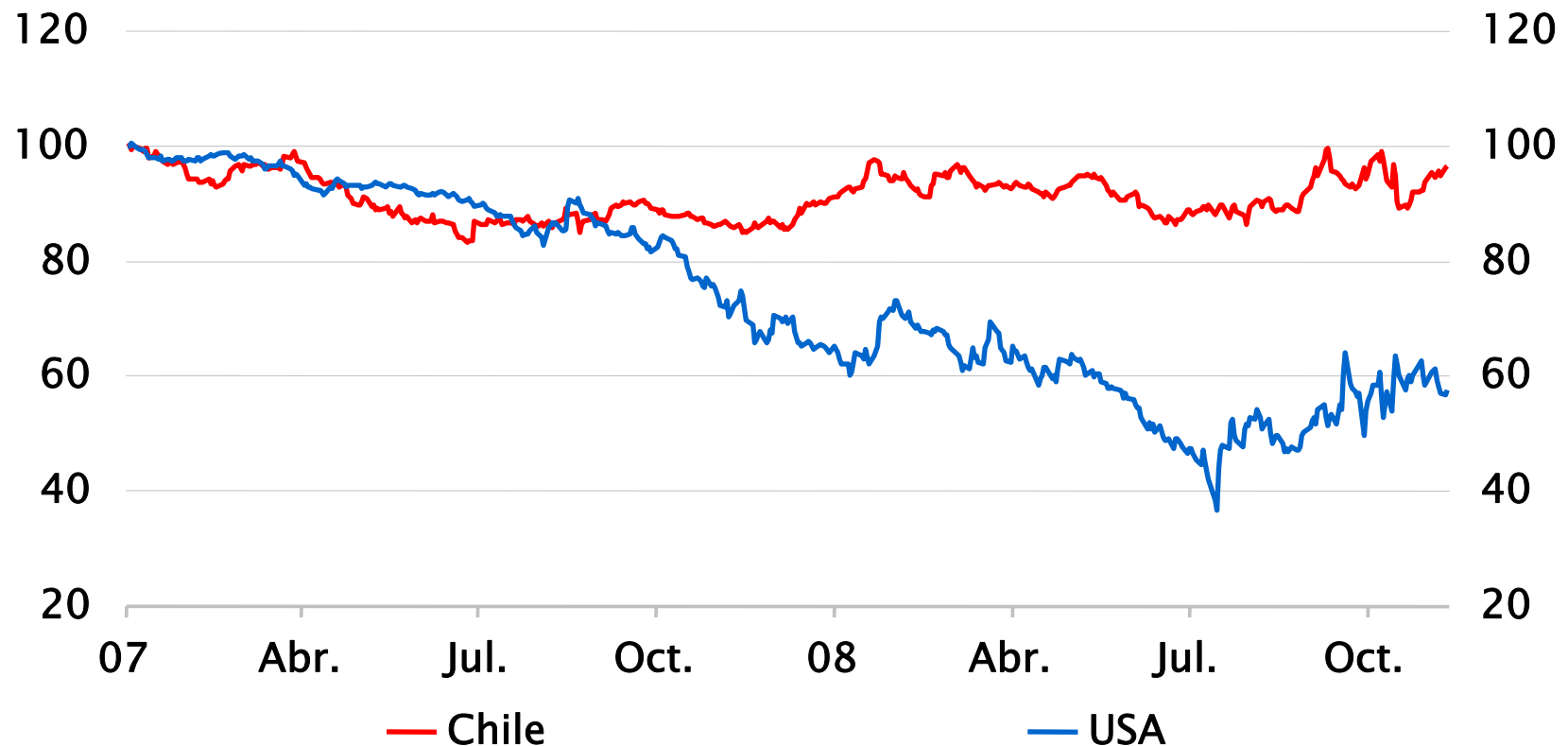


Source: Central Bank of Chile.



Relative to the market, local banks have not suffered as much as in the developed economies.

Ratio of Bank Index and Aggregate Stock Index (*)
(index, January 1, 2007=100)



(*) Corresponds to the ratio of banking stock index/ total stock index: S&P 500 for the USA and IPSA for Chile.

Sources: Bloomberg and Central Bank of Chile.



The Chilean Economy in the Current Global Financial Crisis

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Governor
Central Bank of Chile



Snapshot

	2005	2006	2007	2008 (f)	2009 (f)
Gross Domestic Product (billions of USD)	118.6	146.4	164.1 (e)	–	–
Real GDP growth (%)	5.6	4.3	5.1	4.0–4.5	2.0–3.0
Consumer prices (annual % change Dec/Dec)	3.7	2.6	7.8	8.5	4.0
Population (millions of inhabitants)	16.3	16.4	16.6	16.8	16.9
Exports of goods FOB (millions of USD)	41,267	58,485	67,644	n.a.	n.a.
Imports of goods FOB (millions of USD)	30,492	35,899	43,991	n.a.	n.a.
Current account balance (% of GDP)	1.2	4.7	4.4	–2.7	–4.5
Foreign exchange reserves excl. gold (millions of USD, as of 31 Dec. of each year)	16,960.1	19,424.6	16,904.7	–	–
Foreign debt (% of GDP)	39.1	32.6	34.1	–	–
Average exchange rate (Chilean pesos per dollar)	559.9	530.3	522.7	–	–