



The Chilean Economy

José De Gregorio
Governor
Central Bank of Chile



Introduction

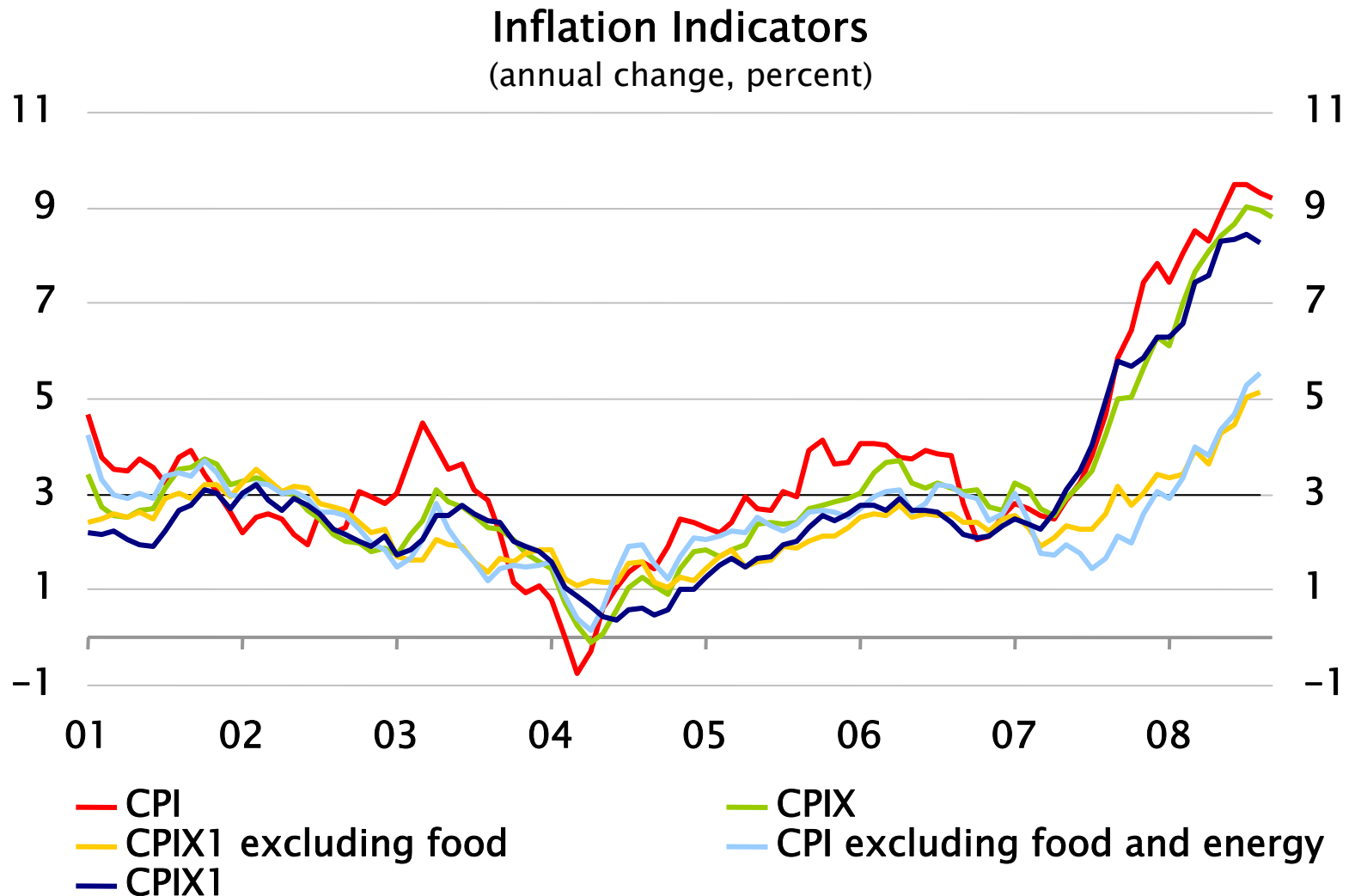
- The magnitude and depth of the current financial crisis is impressive.
- Recent developments are increasingly shocking and significant, but it is too soon to know the impact it will have on the world economy and in Chile in particular.
- Up to now, Chile has remained fairly “unharméd”; however, this does not guarantee a “bump-free” ride as the crisis unfolds.
- Sound macro framework and policies are key in making the process as painless as possible.
- Inflation is still high and risks of alternative scenarios have risen. Under extreme uncertainty, prudence is highly valuable.



Current Outlook



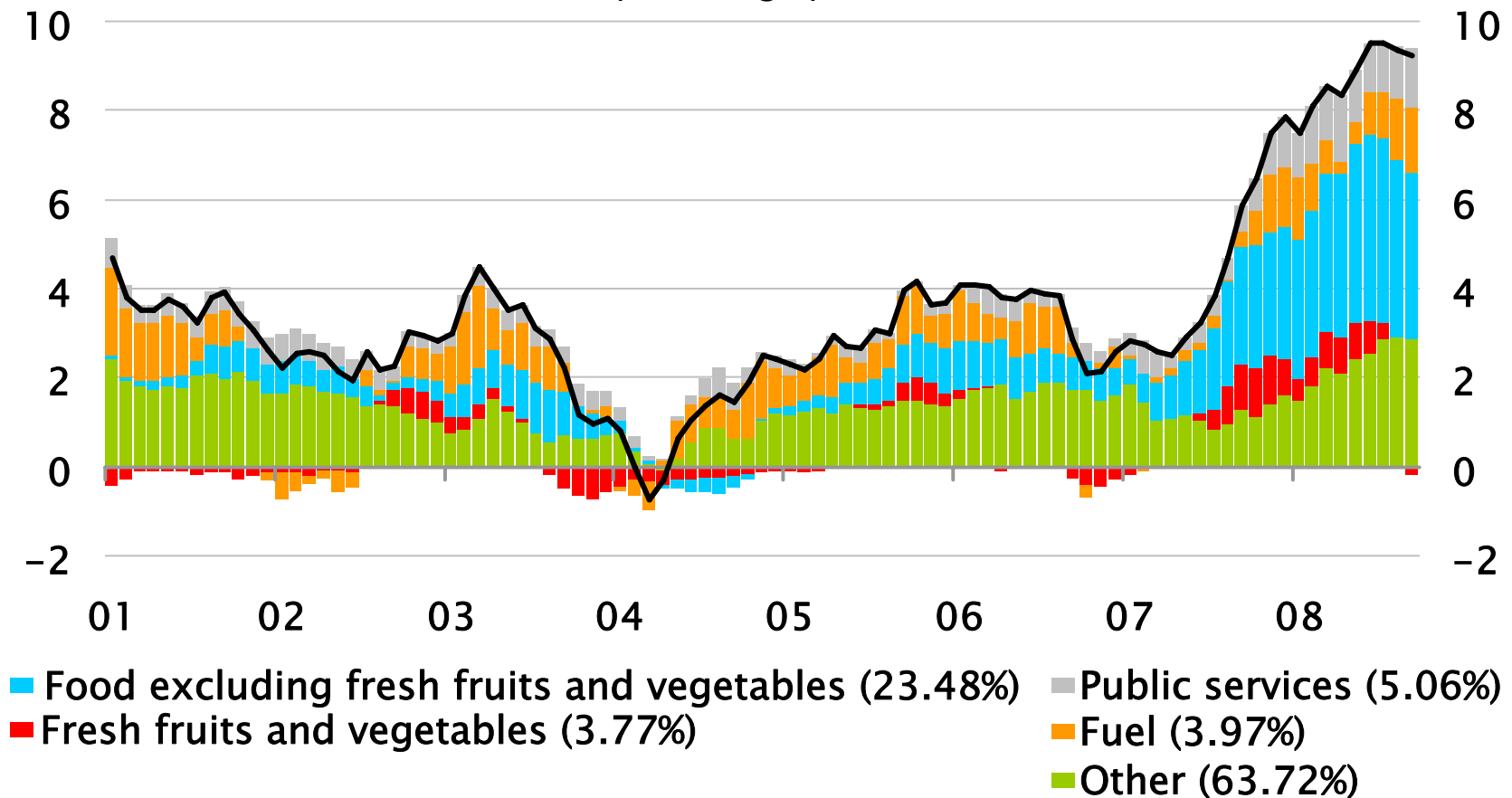
Annual CPI inflation reached 9.2% in September, largely diverging from the 3% medium-term target.





High inflation responds to international food and energy price hikes, although recently we have seen the harmful effects of propagation.

Annual CPI Decomposition (*)
(percentage points)



(*) CPI weight in parentheses.

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

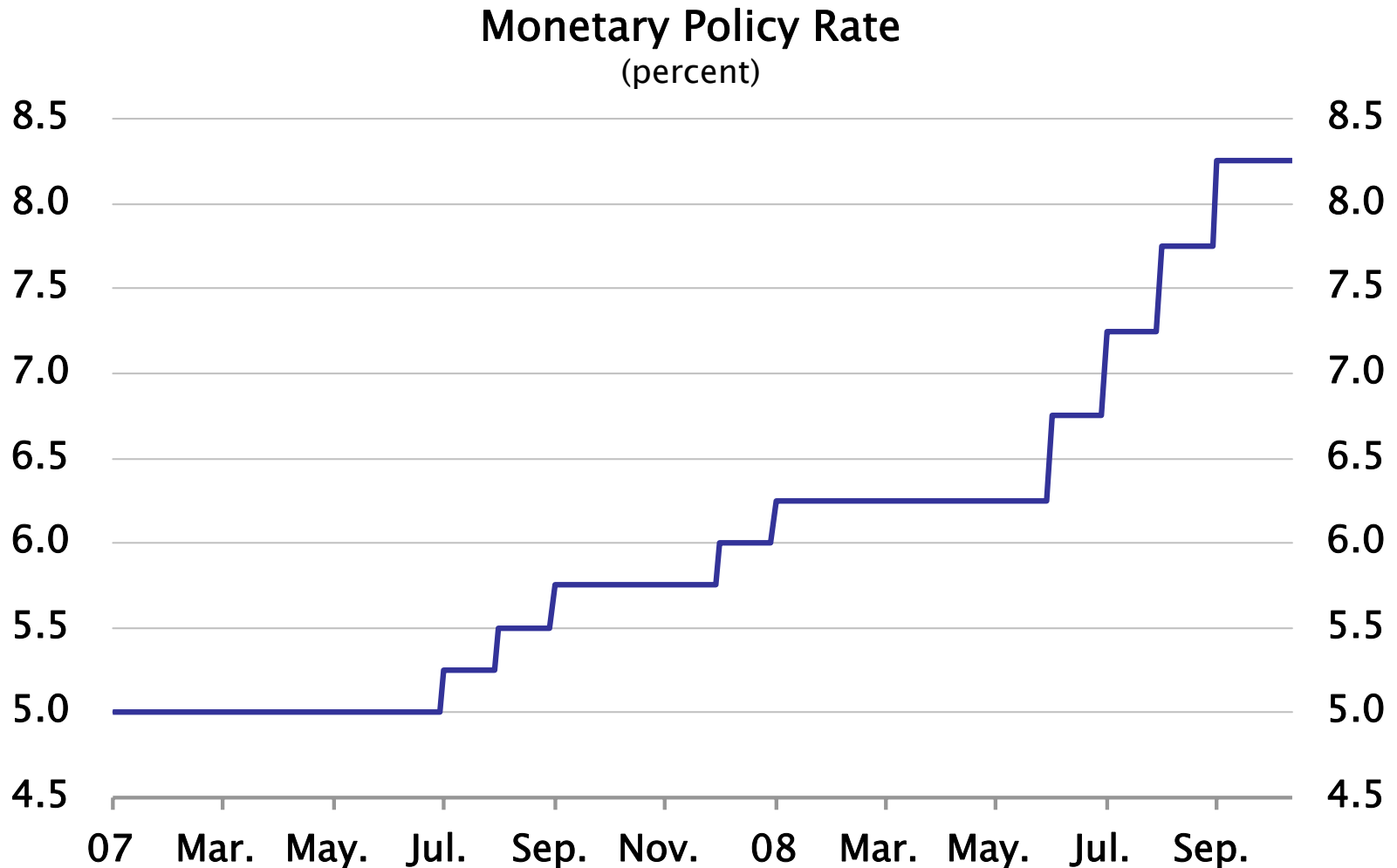


High propagation could be due to:

- Increased indexation practices for price and salaries in response to high inflation. Some casuistic evidence supports this claim.
- Higher inflation expectations, especially on short-term horizons.
- Significant exchange rate depreciation.
- Less spare capacity than previously estimated.
- Higher energy costs.
- Dynamic domestic demand, that facilitates the trespassing of higher cost to prices.



Monetary Policy has reacted decisively to the increased inflation.

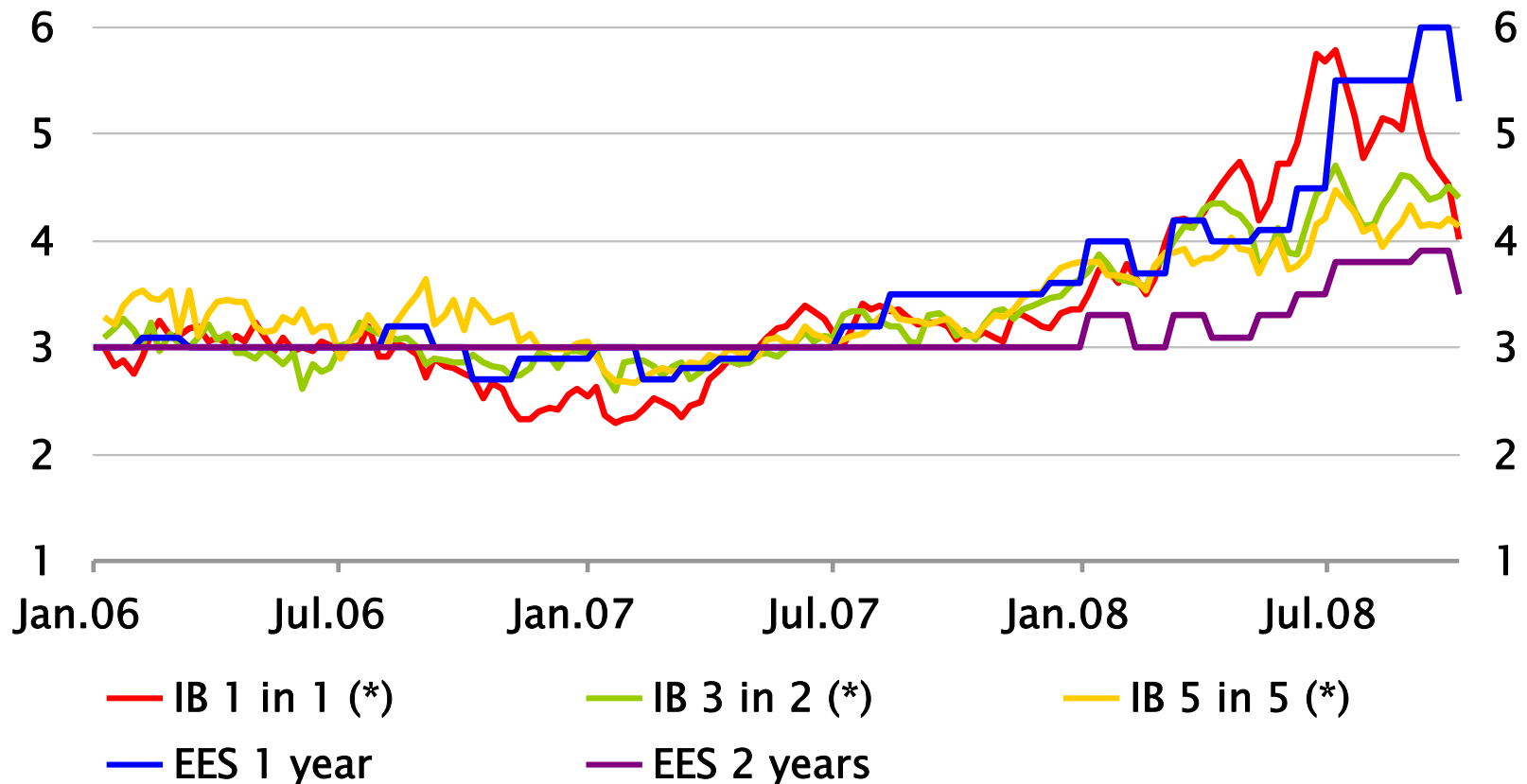


Source: Central Bank of Chile.



Inflation expectations are lower, but still above the medium-term target.

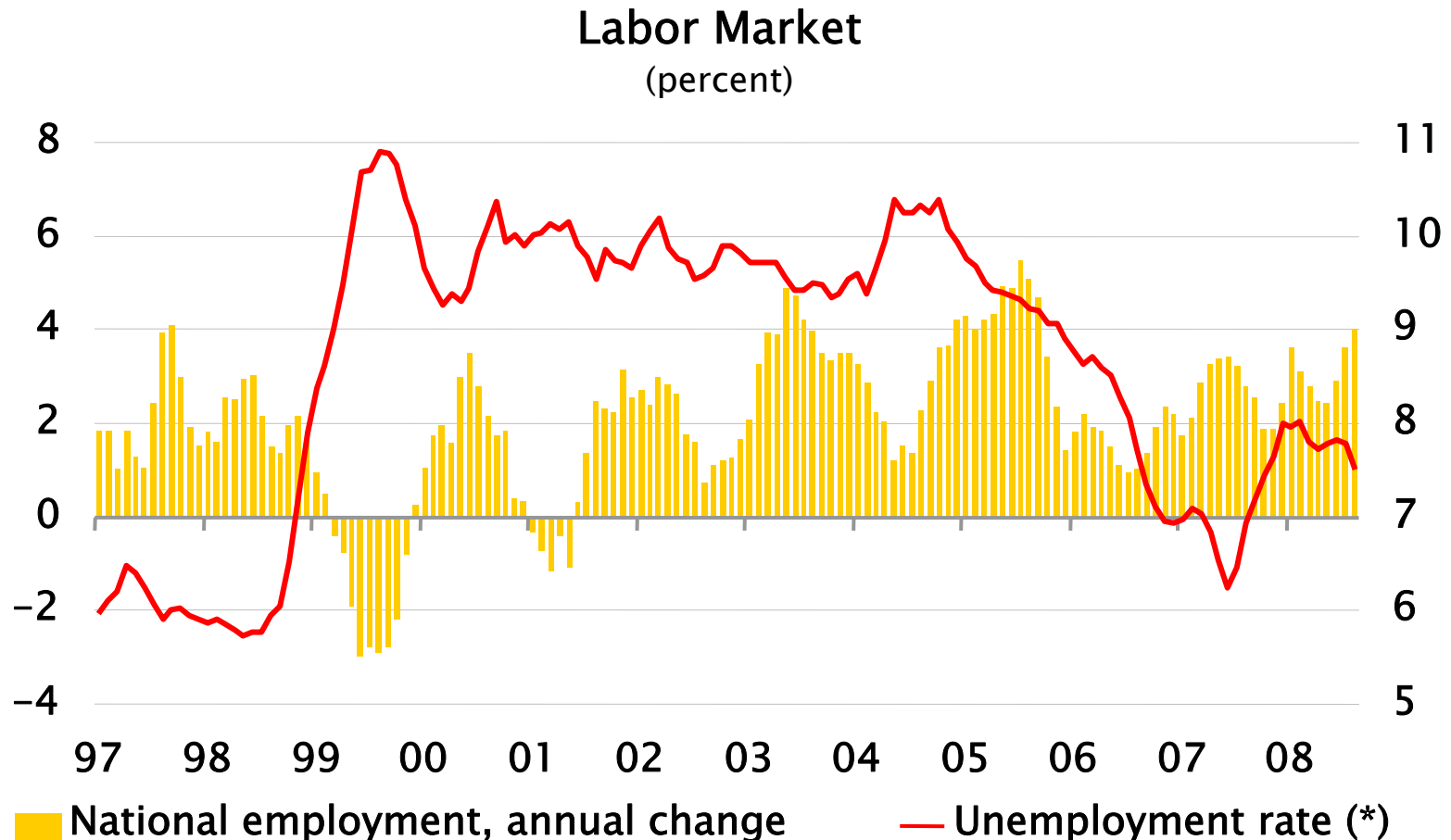
Inflation Expectations
(percent, weekly moving average)



(*) Inflation breakevens based on forward instruments.
Source: Central Bank of Chile.



Labor market shows good figures: employment is growing 4% yoy and the unemployment rate has remained at 7.5 – 8% for several months.



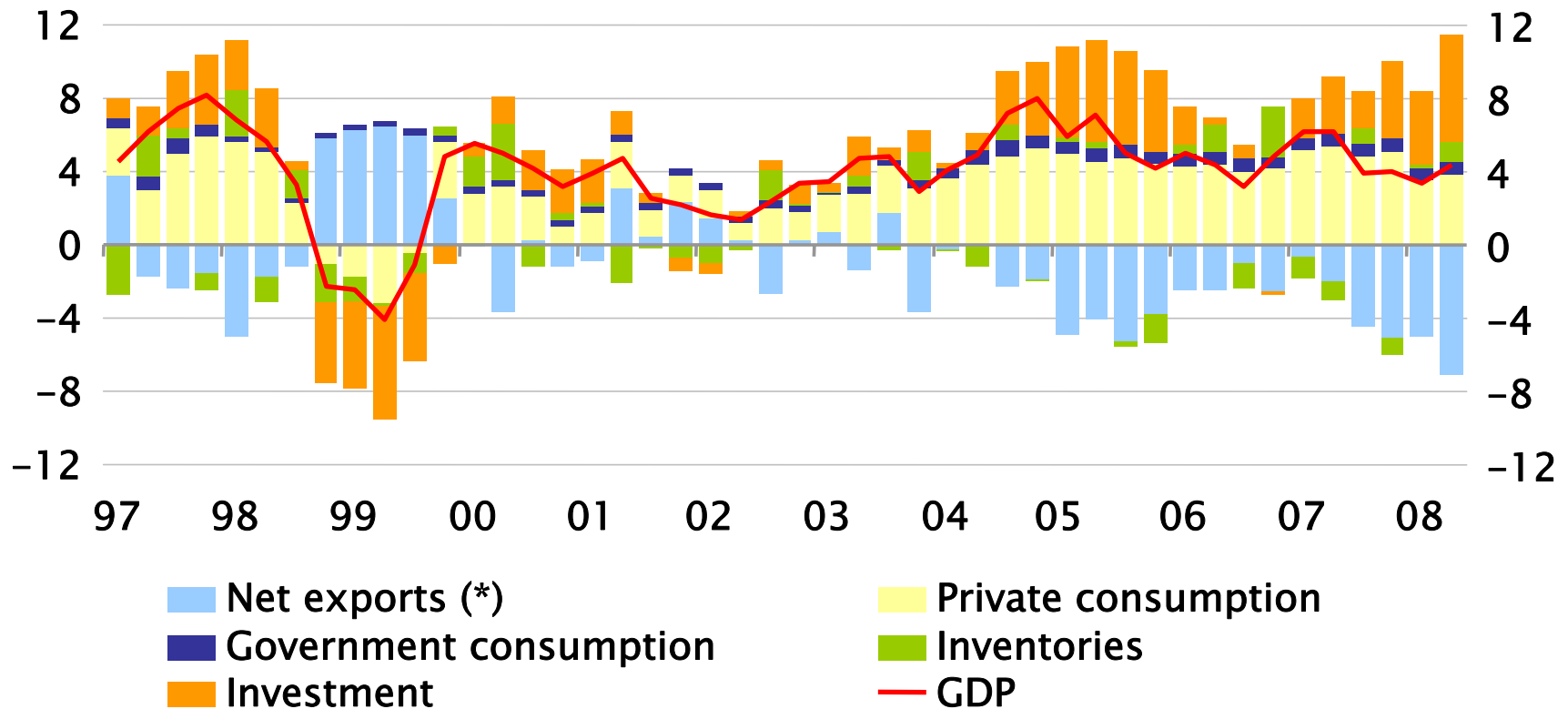
(*) Seasonally-adjusted.

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



In the first-half of 2008, GDP grew 3.8% while domestic demand grew substantially more: 9.6%.

GDP and Domestic Demand
(annual change; percentage points)

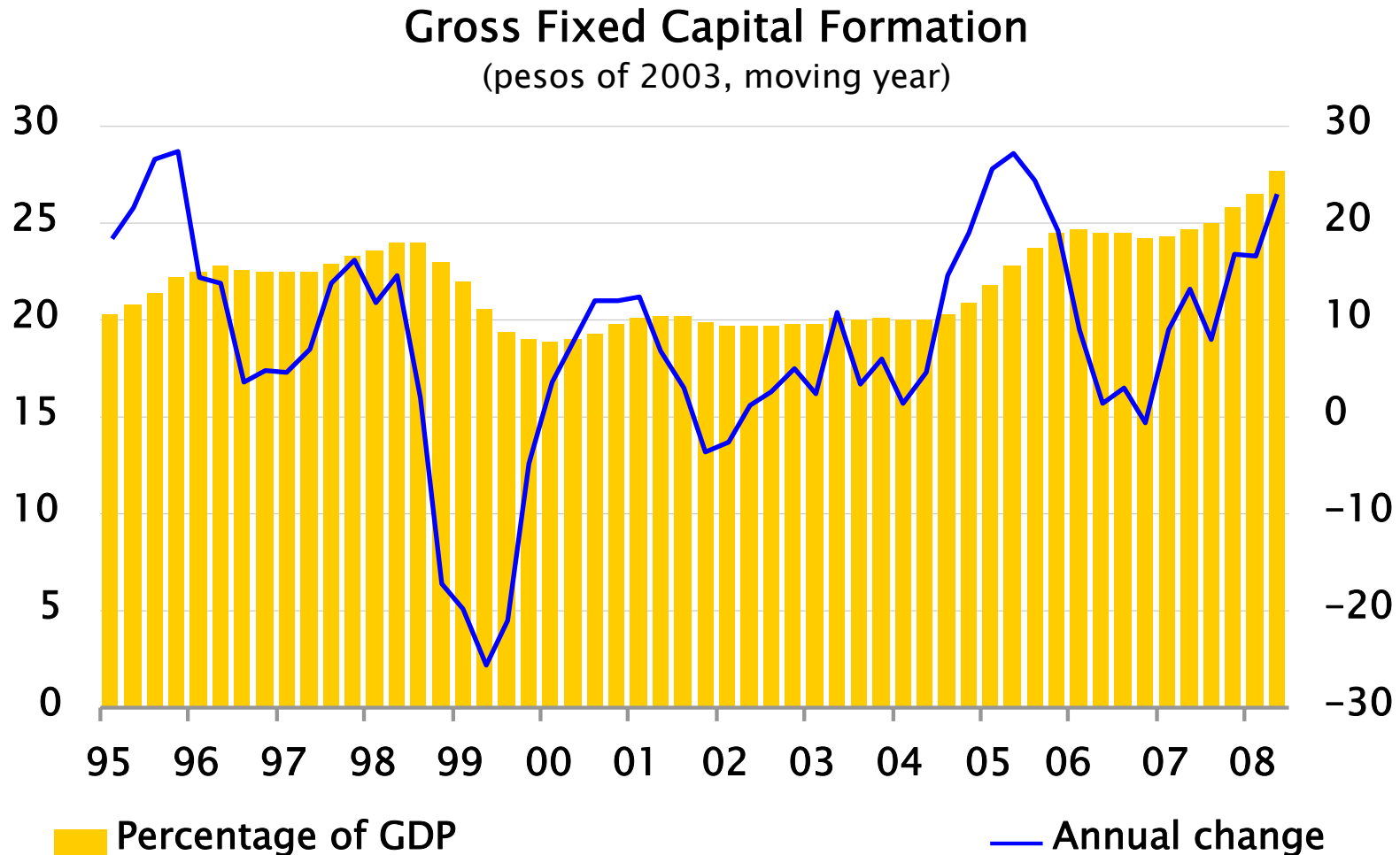


(*) Goods and services exports minus goods and services imports.

Source: Central Bank of Chile.



A significant part of domestic demand growth corresponds to dynamic investment.

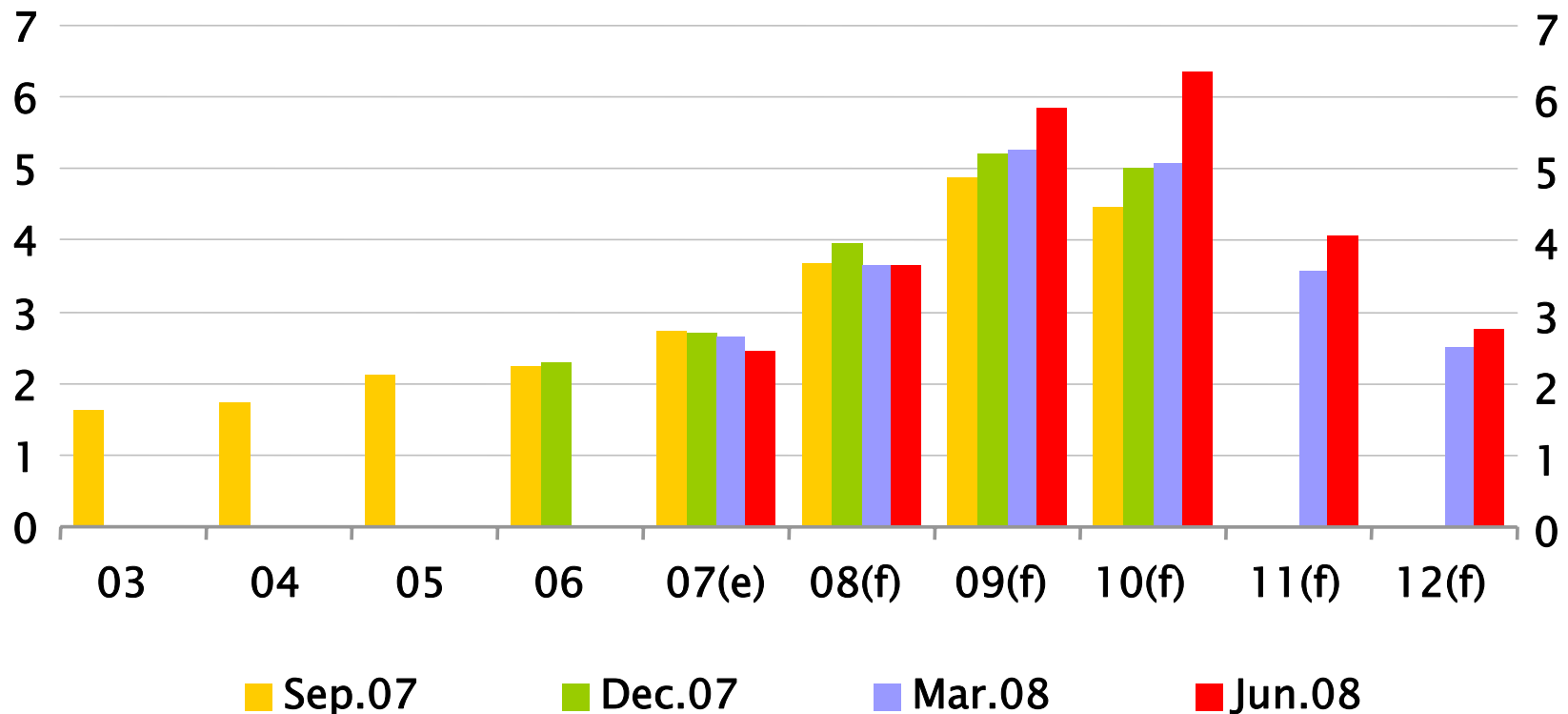


Source: Central Bank of Chile.



Prospects for 2009–2010 show that this dynamic pattern will persist.

Investment Survey (*)
(USD billion)



(*) Excludes real-estate, telecommunication and manufacturing.

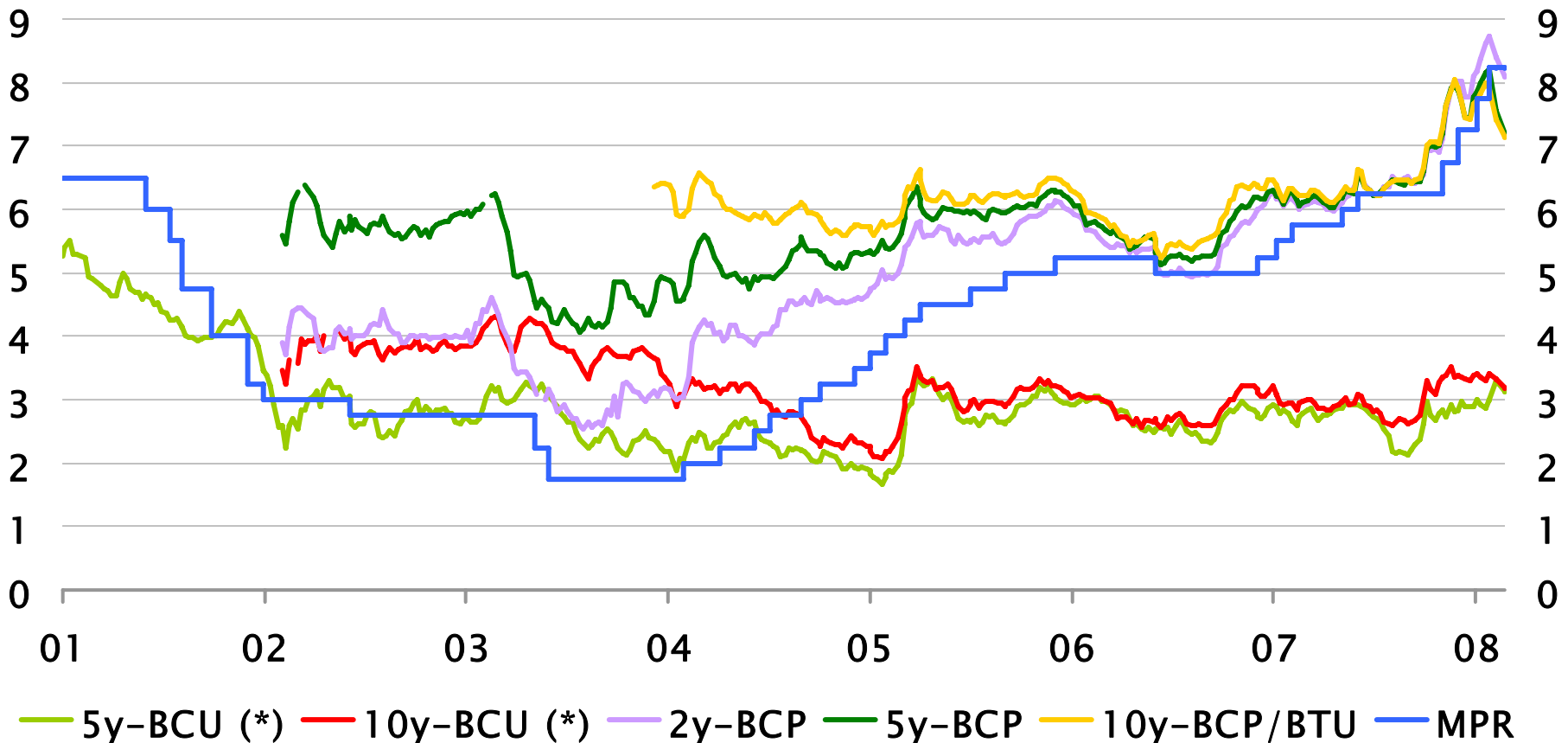
(e) Estimate. (f) Forecast.

Source: Corporación de Desarrollo Tecnológico de Bienes de Capital.



Long-term interest rates have remained at record lows.

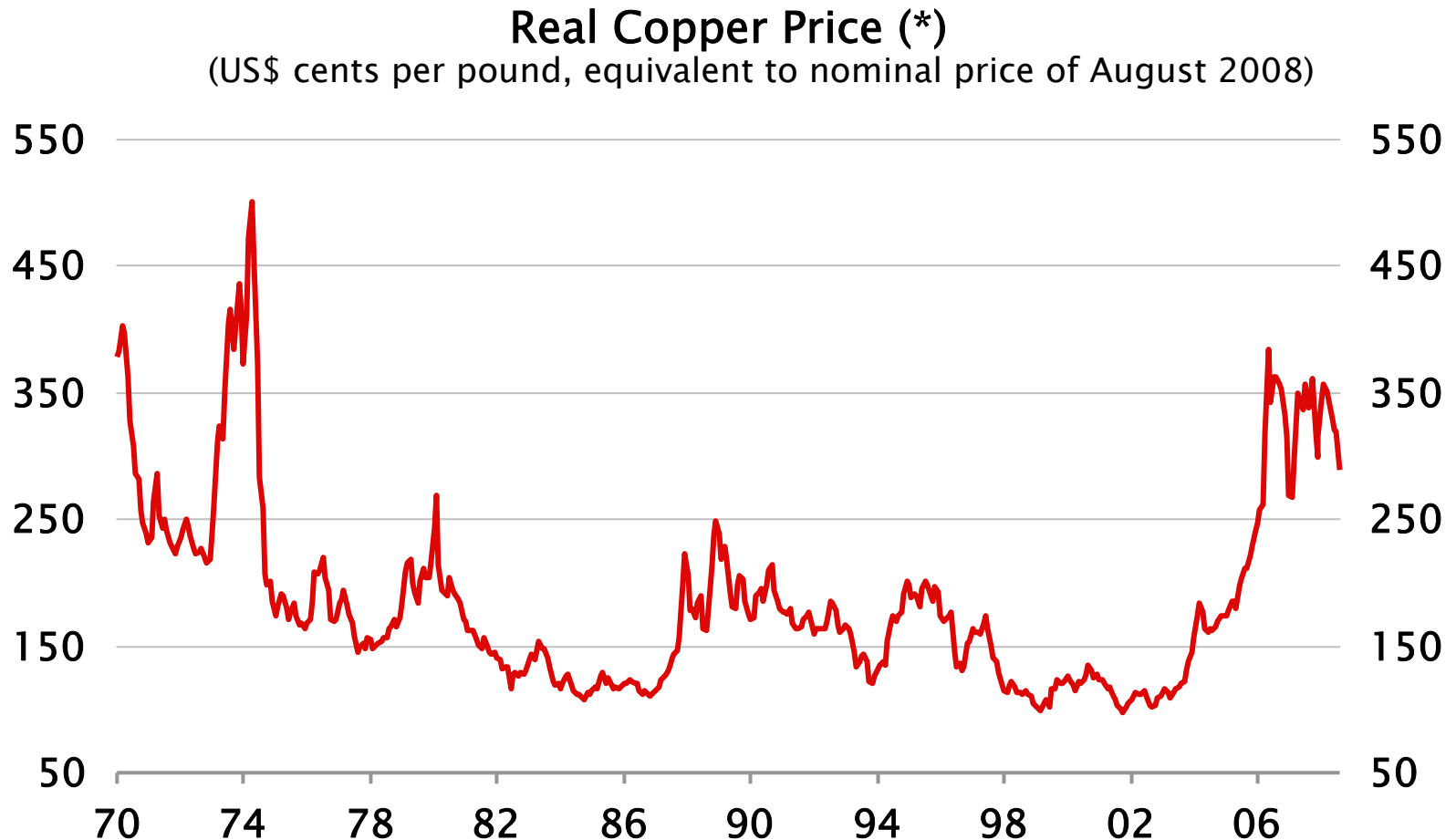
Long term Real Interest Rates
(Central Bank instruments, percent)



(*) BCU is a bond issued in UF, a CPI-indexed unit of account, with similar features to BCP.
Source: Central Bank of Chile.



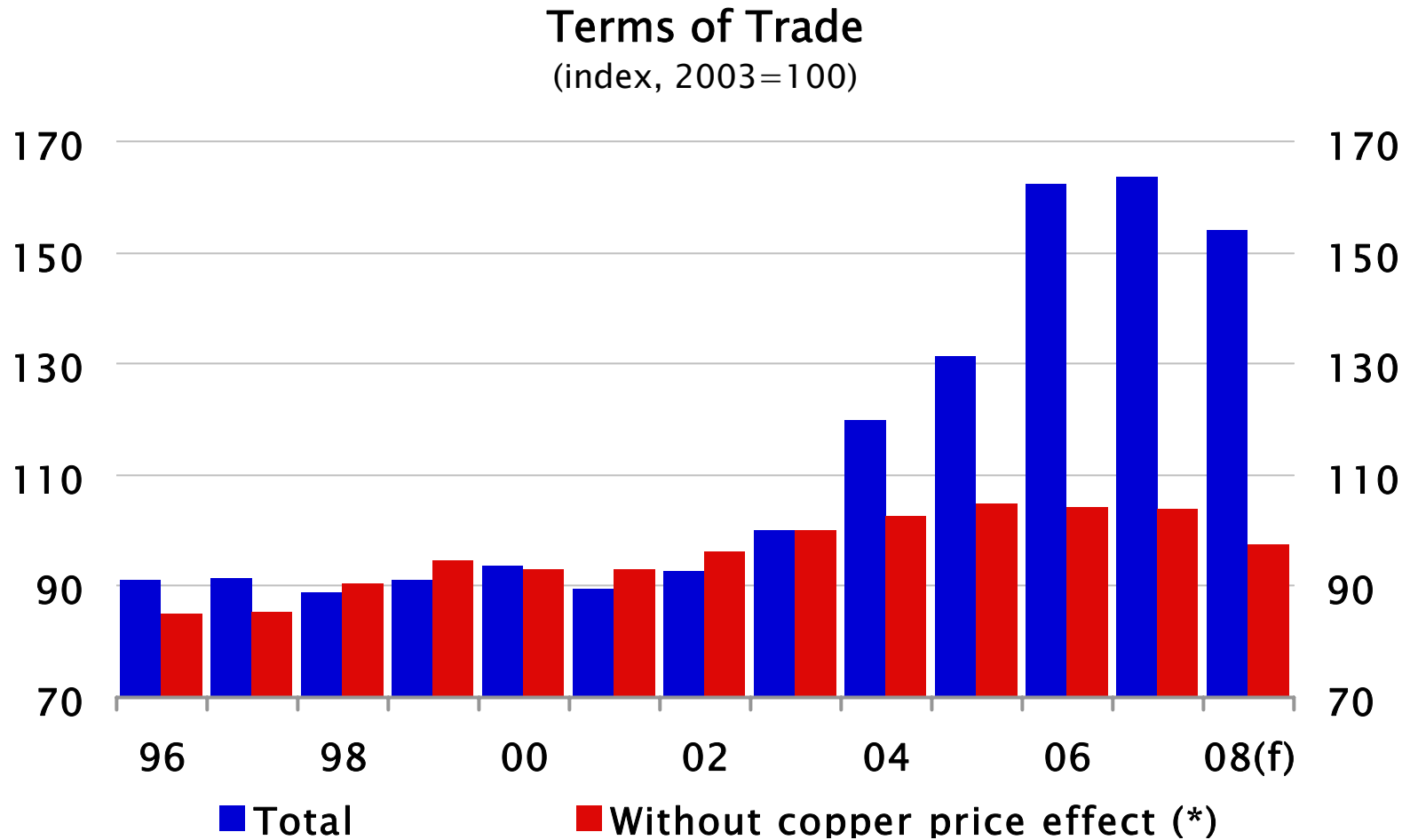
Copper prices have reached levels not seen since the early 1970s.



(*) London Metal Exchange price deflated by US Metal PPI.
Sources: Bloomberg and Cochilco.



With substantial terms of trade gains.

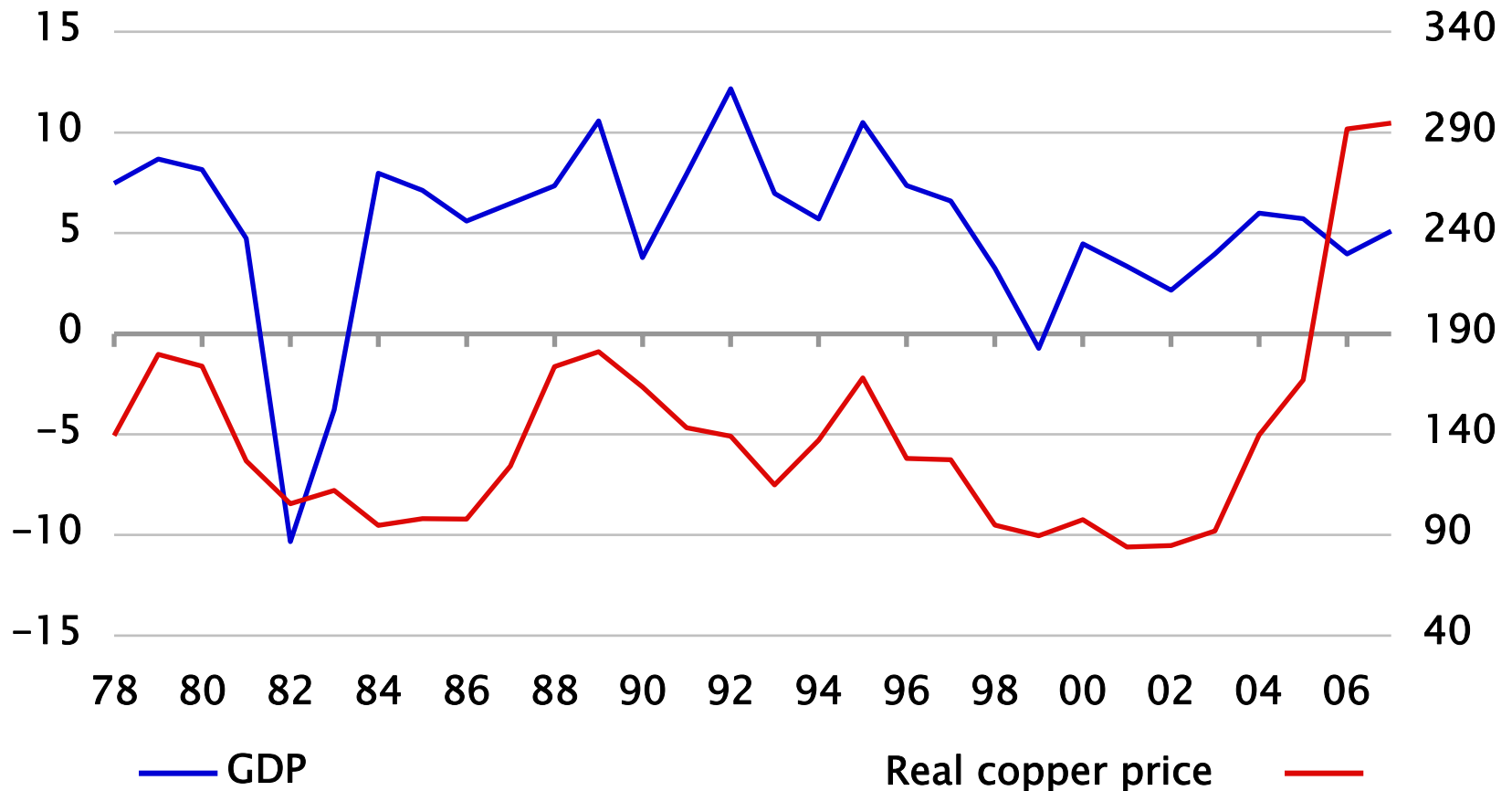


(*) Terms of trade without copper price effect are estimated using the London Metal Exchange copper price of 2003 as reference. (e) Estimate. (f) Forecast. Monetary Policy Report, September 2008.
Source: Central Bank of Chile.



However, Chile has become increasingly insensitive to the copper price.

GDP Growth and Real Copper Price (*)
(annual change, percent; US\$ cents per pound)



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



Prospects



The baseline scenario of the September Monetary Policy Report considers that annual CPI inflation will reach the 3% target during 2010.

Inflation Forecast: September 2008 MPR (annual change, percent)

	2006	2007	2008 (f)	2009 (f)	2010 (f)
Average CPI inflation	3.4	4.4	8.8	6.9	3.4
December CPI inflation	2.6	7.8	8.5	4.9	
CPI inflation around 2 years (*)					3.0
Average CPIX inflation	3.2	4.0	8.2	6.5	3.6
December CPIX inflation	2.7	6.3	8.4	4.8	
CPIX inflation around 2 years (*)					3.3
Average CPIX1 inflation	2.5	4.1	7.9	6.7	3.6
December CPIX1 inflation	2.4	6.3	8.5	4.8	
CPIX1 inflation around 2 years (*)					3.4

(f) Forecast.

(*) Projected inflation at 2010.QIII.

Source: Central Bank of Chile.



Convergence of inflation to the target is grounded on output growing around 1 pp below its trend due to restrictive monetary policy.

GDP forecast (annual change, percent)

	2006	2007	2008 (f)	2009 (f)
GDP	4.3	5.1	4.5–5.0	3.5– 4.5
National income	6.7	7.8	5.2	3.5
Domestic demand	6.4	7.8	9.1	3.9
Gross fixed capital formation	2.9	11.9	19.3	2.9
Total consumption	6.4	7.4	5.6	4.3
Exports of goods and services	5.5	7.8	2.1	3.8
Imports of goods and services	10.5	14.3	12.6	4.1
Current account (% of GDP)	4.7	4.4	–1.1	–2.7

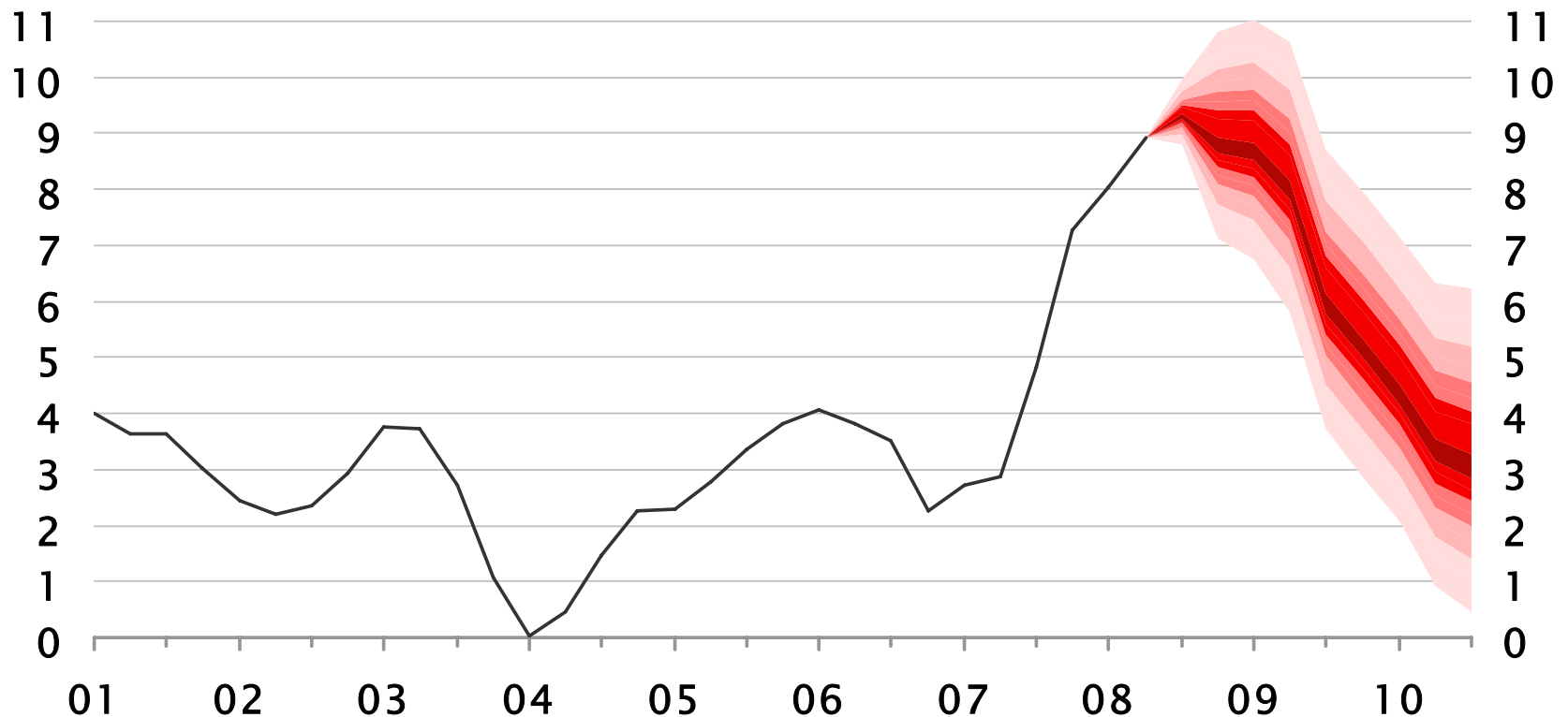
(f) Forecast.

Source: Central Bank of Chile.



Convergence of inflation to the target will be gradual.

Inflation Forecast MPR September 2008
(annual change, percent)



Source: Central Bank of Chile.



Inflation convergence.

- In the MPR's baseline scenario, the restrictive monetary policy will slow down output, to grow around 1 pp below the trend over the policy horizon.
- The baseline scenario also considers:
 - Public spending growing at a slower pace than this year, in line with announcements by the Ministry of Finance when this MPR was published and the limits imposed by the structural surplus rule.
 - Inflation expectations and the future wage dynamics consistent with compliance with the target.
 - No further output gap widening due to the external scenario.
 - Prices of both oil and foodstuffs remaining high over the next two years.



According to the consensus scenario available today, world growth will be lower than that included in September MPR, specially in developed economies.

World growth: October 2008 (*)
(annual change, percent)

	Avg. 90-99	Avg. 00-05	2006	2007 (e)	2008 (f)		2009 (f)		2010 (f)
					MPR Sep.08	MPM Oct.08	MPR May.08	MPM Oct.08	MPR Sep.08
World	2.9	3.8	5.1	5.0	4.0	▼ 3.8	3.7	▼ 3.0	4.4
World at market parity	2.4	2.9	3.9	3.8	2.8	▼ 2.6	2.5	▼ 1.7	3.4
United States	3.1	2.5	2.9	2.0	1.6	▼ 1.4	1.0	▼ 0.0	2.8
Euro area	2.2	1.9	2.8	2.6	1.2	▼ 1.1	0.4	▼ -0.1	1.9
Japan	1.5	1.6	2.4	2.1	0.8	▼ 0.4	0.8	▼ 0.4	2.0
China	10.0	9.4	11.6	11.9	9.9	▼ 9.8	9.0	▼ 8.6	8.9
Rest of Asia	5.5	4.8	5.5	5.8	4.6	= 4.6	5.0	▼ 3.4	5.2
Latin America	2.7	2.9	5.4	5.6	4.3	▲ 4.5	3.8	▼ 3.0	4.2
Commodity exporters	2.7	3.1	2.7	3.3	1.6	▼ 1.3	2.2	▼ 2.0	2.9
Trading partners	3.0	3.1	4.6	4.8	3.5	▼ 3.4	3.1	▼ 2.4	3.8

(*) 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.



This new world growth forecast is consistent with a somewhat weaker scenario of commodity prices.

World growth: October 2008 (*) (annual change, percent)

	Avg. 90-99	Avg. 00-05	2006	2007 (e)	2008 (f)		2009 (f)		2010 (f)
					MPR Sep.08	MPM Oct.08	MPR May.08	MPM Oct.08	
World	2.9	3.8	5.1	5.0	4.0	▼ 3.8	3.7	▼ 3.0	4.4
World at market parity	2.4	2.9	3.9	3.8	2.8	▼ 2.6	2.5	▼ 1.7	3.4
United States	3.1	2.5	2.9	2.0	1.6	▼ 1.4	1.0	▼ 0.0	2.8
Euro area	2.2	1.9	2.8	2.6	1.2	▼ 1.1	0.4	▼ -0.1	1.9
Japan	1.5	1.6	2.4	2.1	0.8	▼ 0.4	0.8	▼ 0.4	2.0
China	10.0	9.4	11.6	11.9	9.9	▼ 9.8	9.0	▼ 8.6	8.9
Rest of Asia	5.5	4.8	5.5	5.8	4.6	= 4.6	5.0	▼ 3.4	5.2
Latin America	2.7	2.9	5.4	5.6	4.3	▲ 4.5	3.8	▼ 3.0	4.2
Commodity exporters	2.7	3.1	2.7	3.3	1.6	▼ 1.3	2.2	▼ 2.0	2.9
Trading partners	3.0	3.1	4.6	4.8	3.5	▼ 3.4	3.1	▼ 2.4	3.8

(*) 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.



Nonetheless, this scenario still considers that emerging economies will be less vulnerable to the financial crisis than developed economies.

World growth: October 2008 (*)
(annual change, percent)

	Avg. 90-99	Avg. 00-05	2006	2007 (e)	2008 (f)		2009 (f)		2010 (f)
					MPR Sep.08	MPM Oct.08	MPR May.08	MPM Oct.08	
World	2.9	3.8	5.1	5.0	4.0	▼ 3.8	3.7	▼ 3.0	4.4
World at market parity	2.4	2.9	3.9	3.8	2.8	▼ 2.6	2.5	▼ 1.7	3.4
United States	3.1	2.5	2.9	2.0	1.6	▼ 1.4	1.0	▼ 0.0	2.8
Euro area	2.2	1.9	2.8	2.6	1.2	▼ 1.1	0.4	▼ -0.1	1.9
Japan	1.5	1.6	2.4	2.1	0.8	▼ 0.4	0.8	▼ 0.4	2.0
China	10.0	9.4	11.6	11.9	9.9	▼ 9.8	9.0	▼ 8.6	8.9
Rest of Asia	5.5	4.8	5.5	5.8	4.6	= 4.6	5.0	▼ 3.4	5.2
Latin America	2.7	2.9	5.4	5.6	4.3	▲ 4.5	3.8	▼ 3.0	4.2
Commodity exporters	2.7	3.1	2.7	3.3	1.6	▼ 1.3	2.2	▼ 2.0	2.9
Trading partners	3.0	3.1	4.6	4.8	3.5	▼ 3.4	3.1	▼ 2.4	3.8

(*) 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.



Recent developments of world economy and its impact on Chile

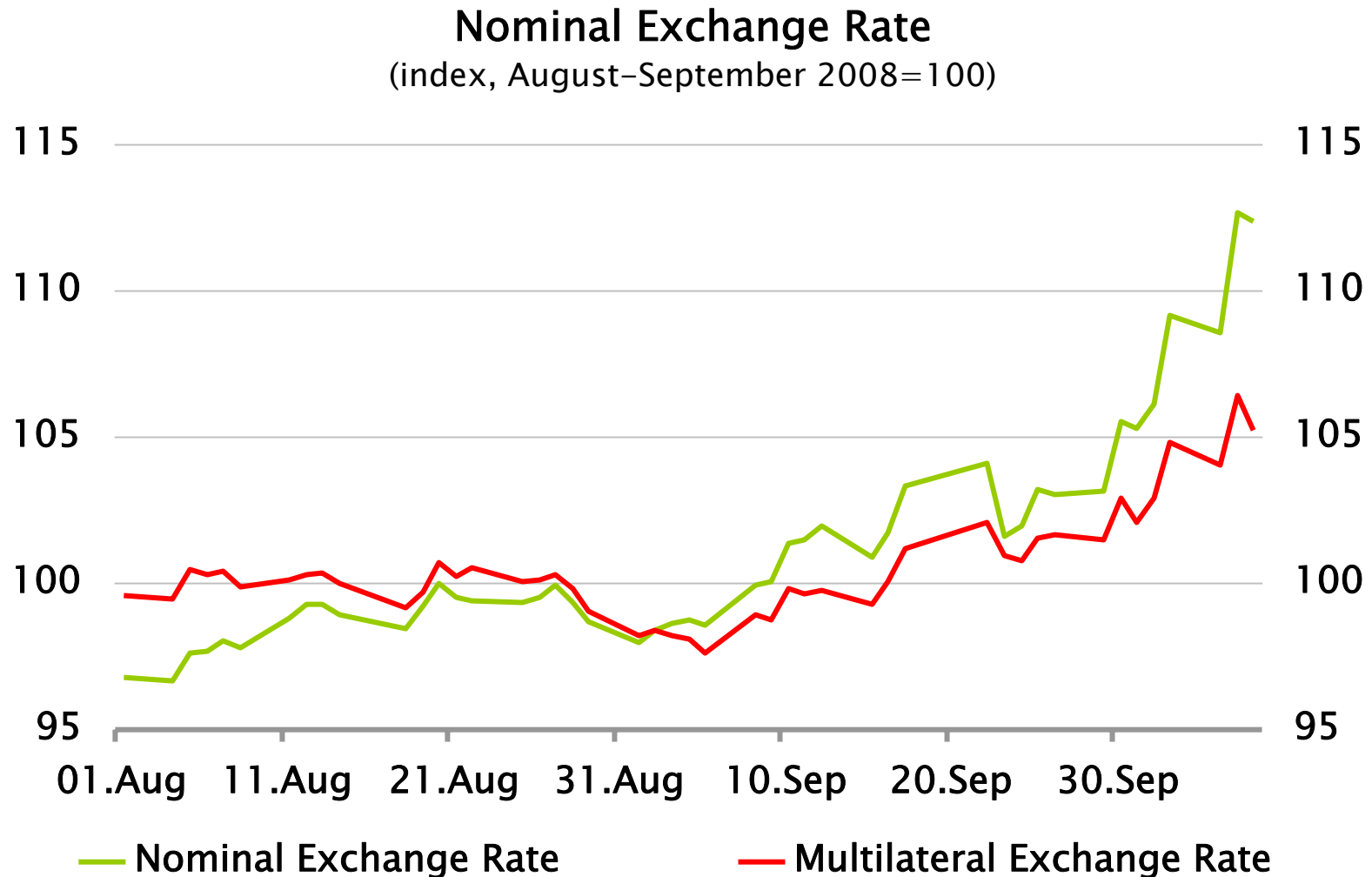


It is premature to determine the consequences of the financial crisis on world markets and the Chilean economy.

- Undoubtedly, the developments of the last few weeks are striking, but it is still too early to draw definitive conclusions regarding changes in the external and domestic economic outlook and how they will affect the convergence of inflation to the target.
- Uncertainty has increased dramatically around the world.
- Up to now, Chile has remained fairly “unharmmed”, however this does not guarantee a “bump-free” ride as the crisis unwinds.
- Sound macro framework and policies are key in making the process as painless as possible.
- Inflation is still high and risks of alternative scenarios have risen. Under extreme uncertainty, prudence is highly valuable.



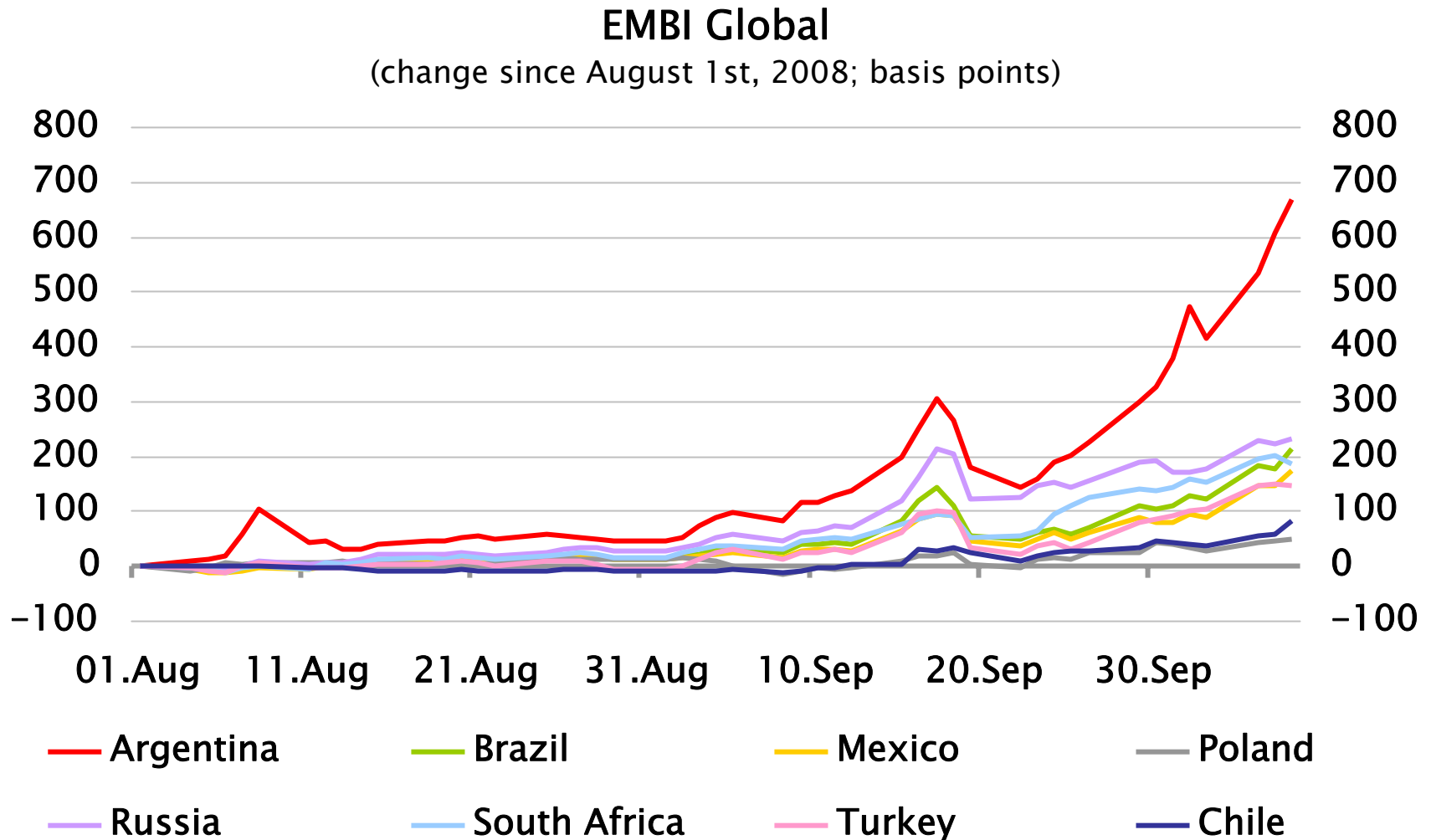
The most recent impact has been felt in the exchange rate.



Source: Central Bank of Chile.



Sovereign spreads have increased, but relatively less in Chile.

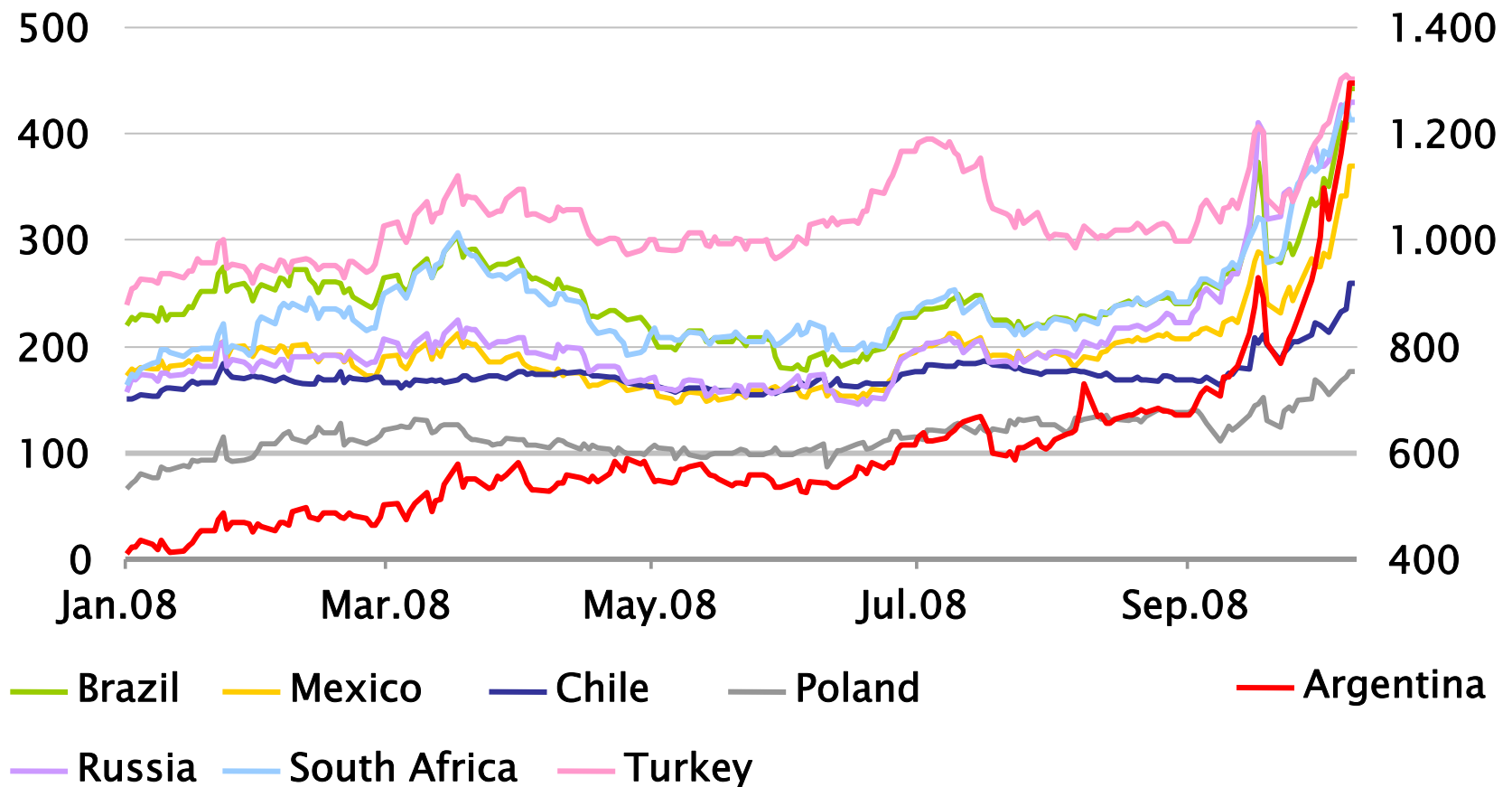


Sources: Bloomberg and JP Morgan Chase.



And are still below most emerging economies' sovereign risk.

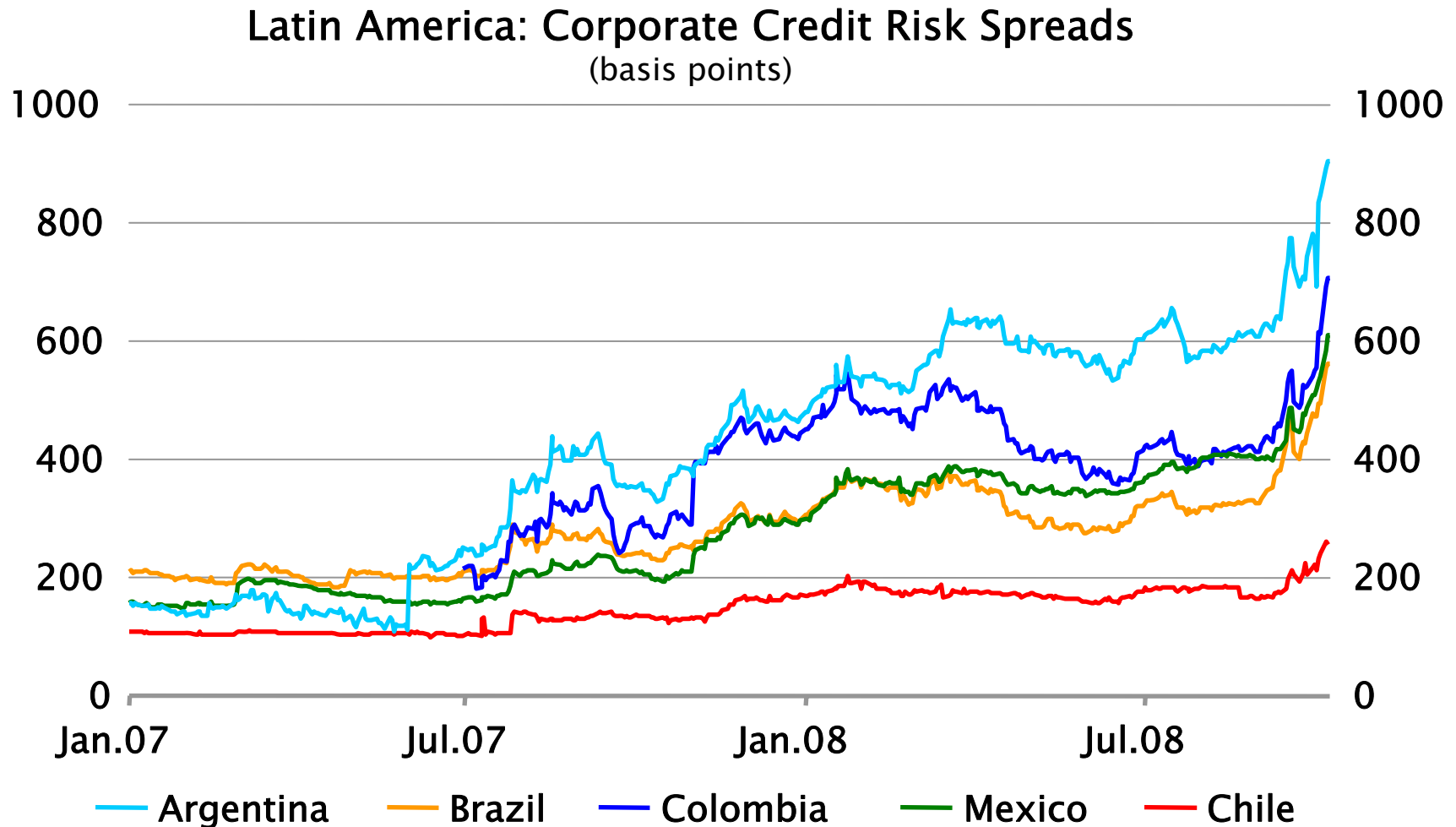
EMBI Global
(basis points)



Sources: Bloomberg and JP Morgan Chase.

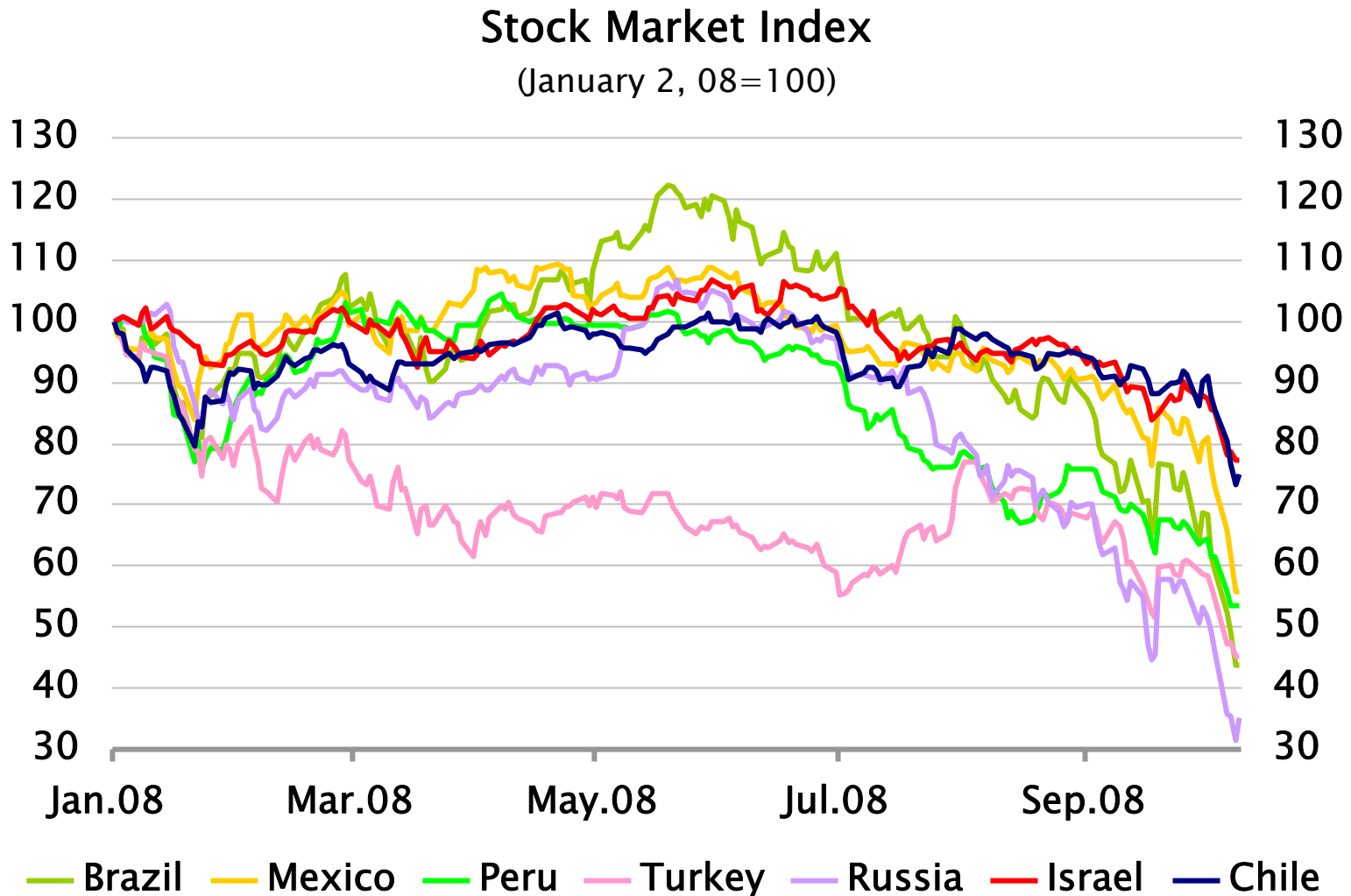


Corporate external financing costs have also increased in LATAM; although to lesser extent in Chile.





The Chilean stock market's fall is lower compared to that suffered in other emerging markets.



Source: Bloomberg.



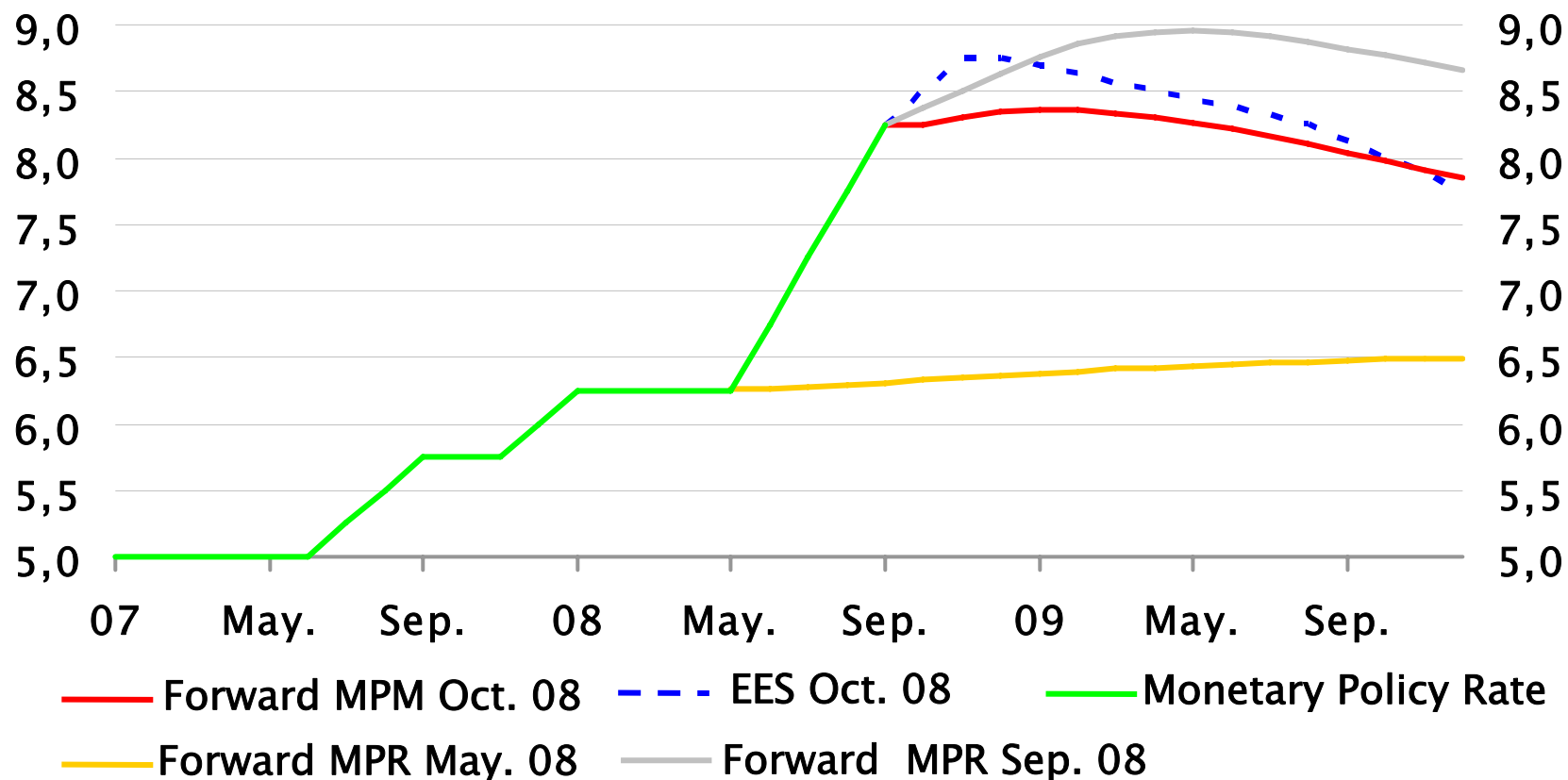
Financial markets are working appropriately, but some tensions have recently emerged. Measures have been taken to alleviate liquidity tensions.

- Chile has been able to obtain external funding and will probably continue to do so. However, if access were to come to a standstill, the CBC is well prepared and equipped to take decisively action.
- Our external liquidity position, improved by the recent foreign exchange intervention program (April 10 – Sept. 29), is sufficient to secure the normal functioning of the financial system. Particularly, in reference to external funding needs.
- To alleviate the exchange market liquidity tensions, the Bank has auctioned US\$1000 millions 28 day US dollar swap operations, and has two more operations for a total of \$1000 millions programmed.
- Sterilization of the operation is done with REPO window operations at monetary policy rate at 28 days.



In our MPM (October 9th), we maintained de MPR at 8,25.

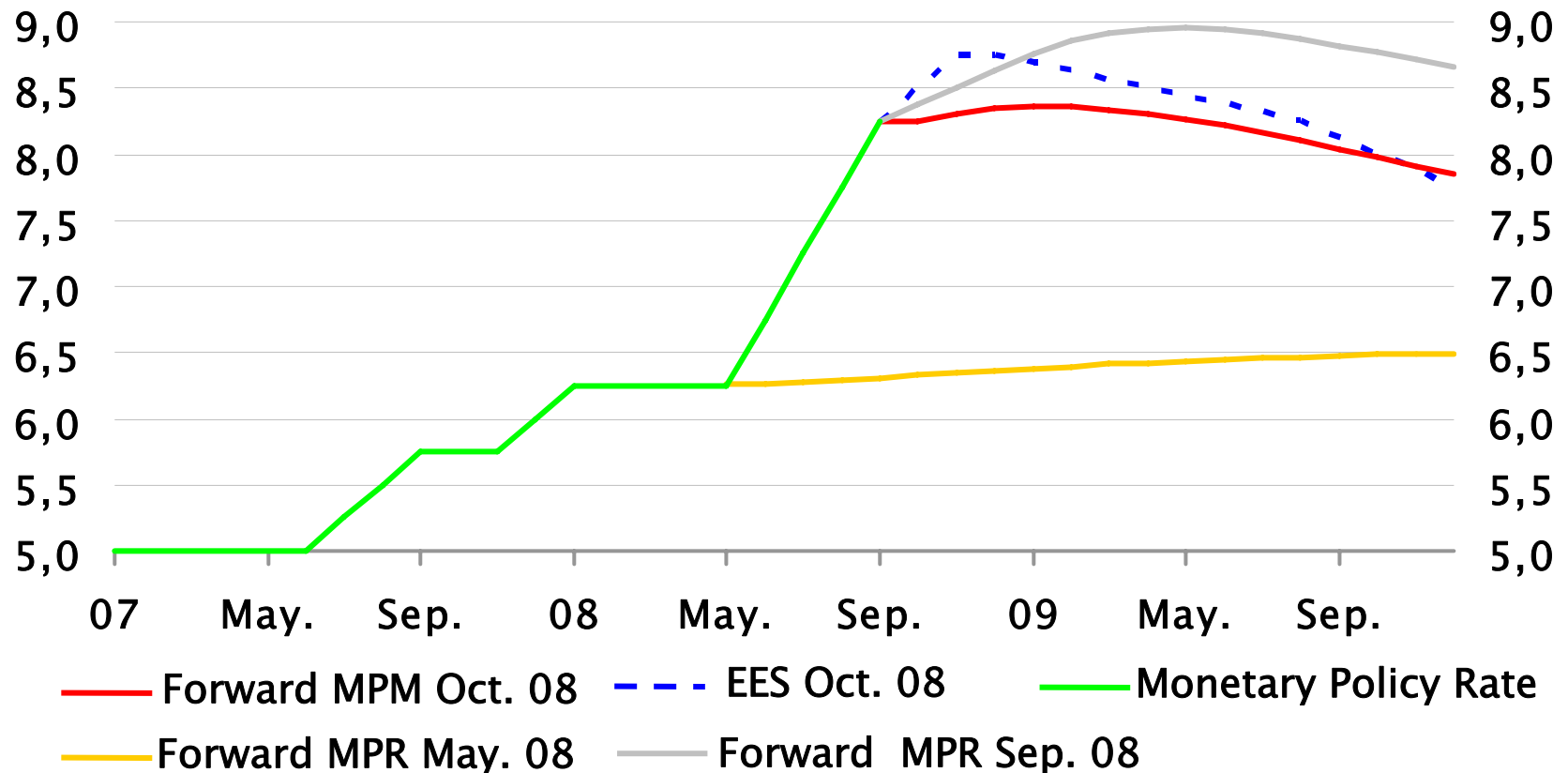
Monetary Policy Rate and *forward* curve
(percent)





Inflation is still high and risks of alternative scenarios have risen. Under extreme uncertainty, prudence is highly valuable.

Monetary Policy Rate and *forward* curve
(percent)





Macro framework and policies



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

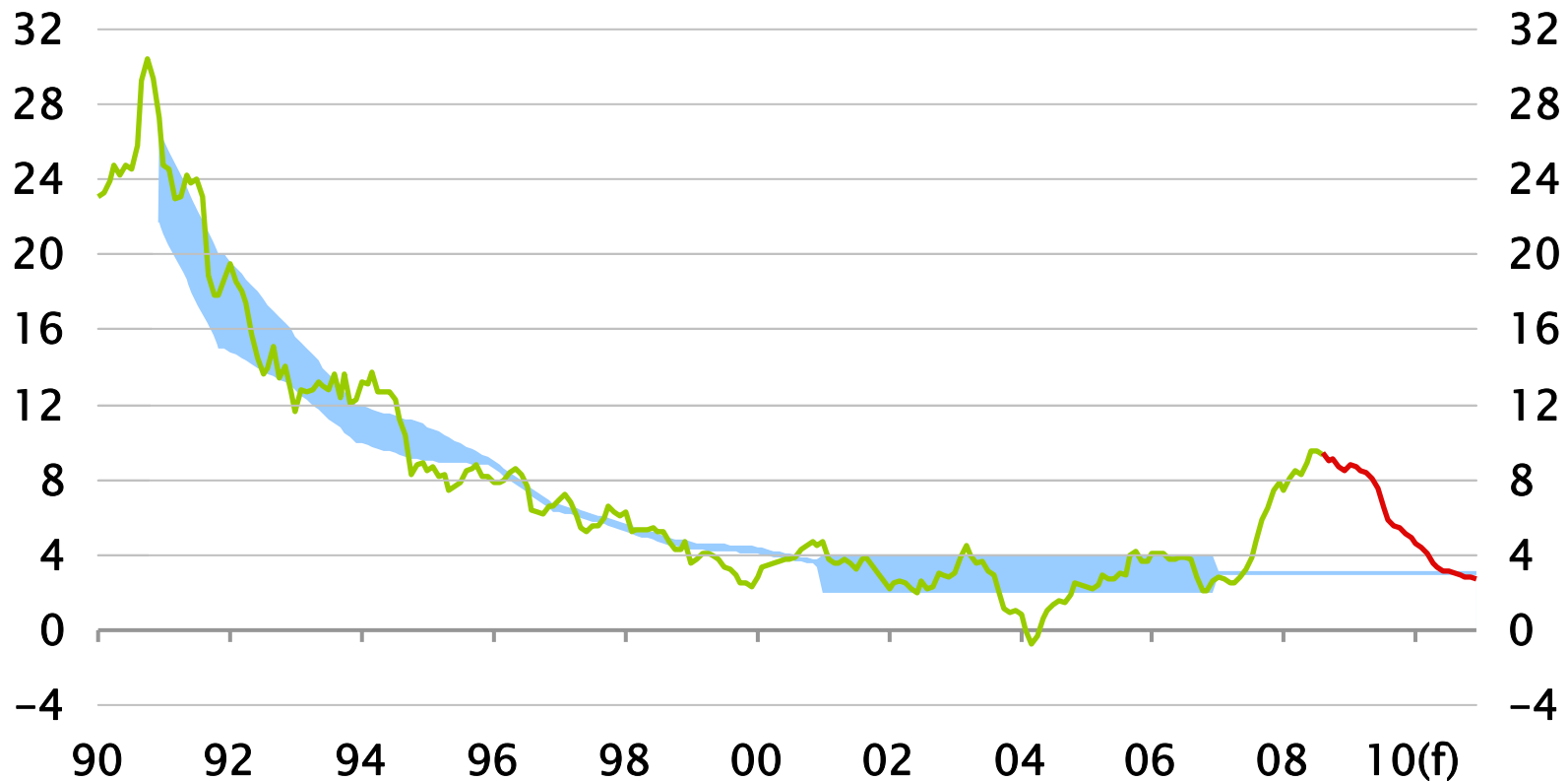
- World financial turmoil is worrisome for all, including Chile.
- However, the macroeconomic framework in place since the late 1990s has been increasingly effective at managing external shocks.
- The main contributing elements are:
 - A responsible and predictable fiscal policy which guarantees public sector solvency;
 - Inflation targeting cum floating exchange rate regime;
 - Increasing trade openness that allows for diversification of import and export markets;
 - 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.

Actual and Target Inflation (*)

(annual change, percent)

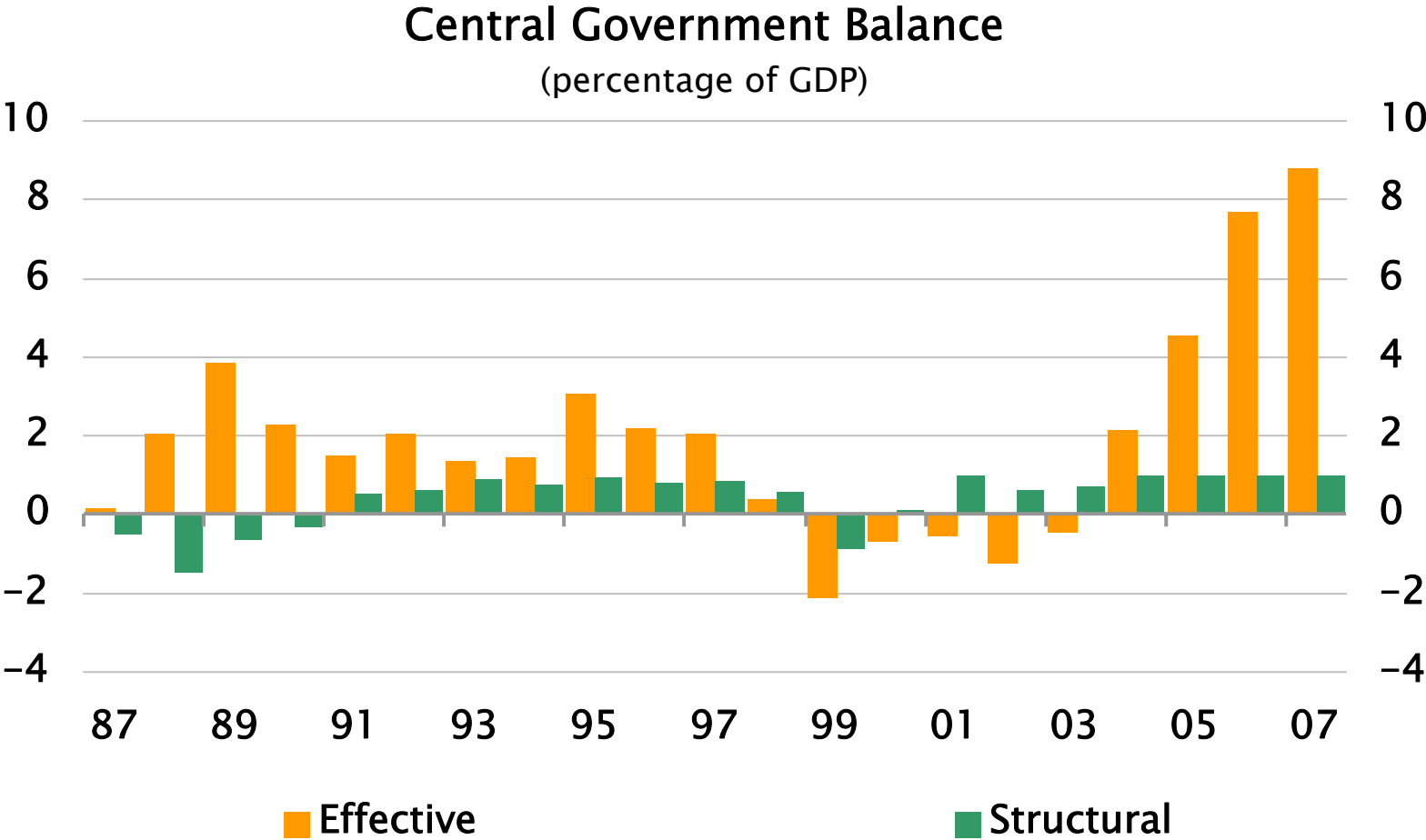


(*) Monetary Policy Report, September 2008. The forecast considers a monthly frequency based on a quarterly forecast.

Source: Central Bank of Chile.



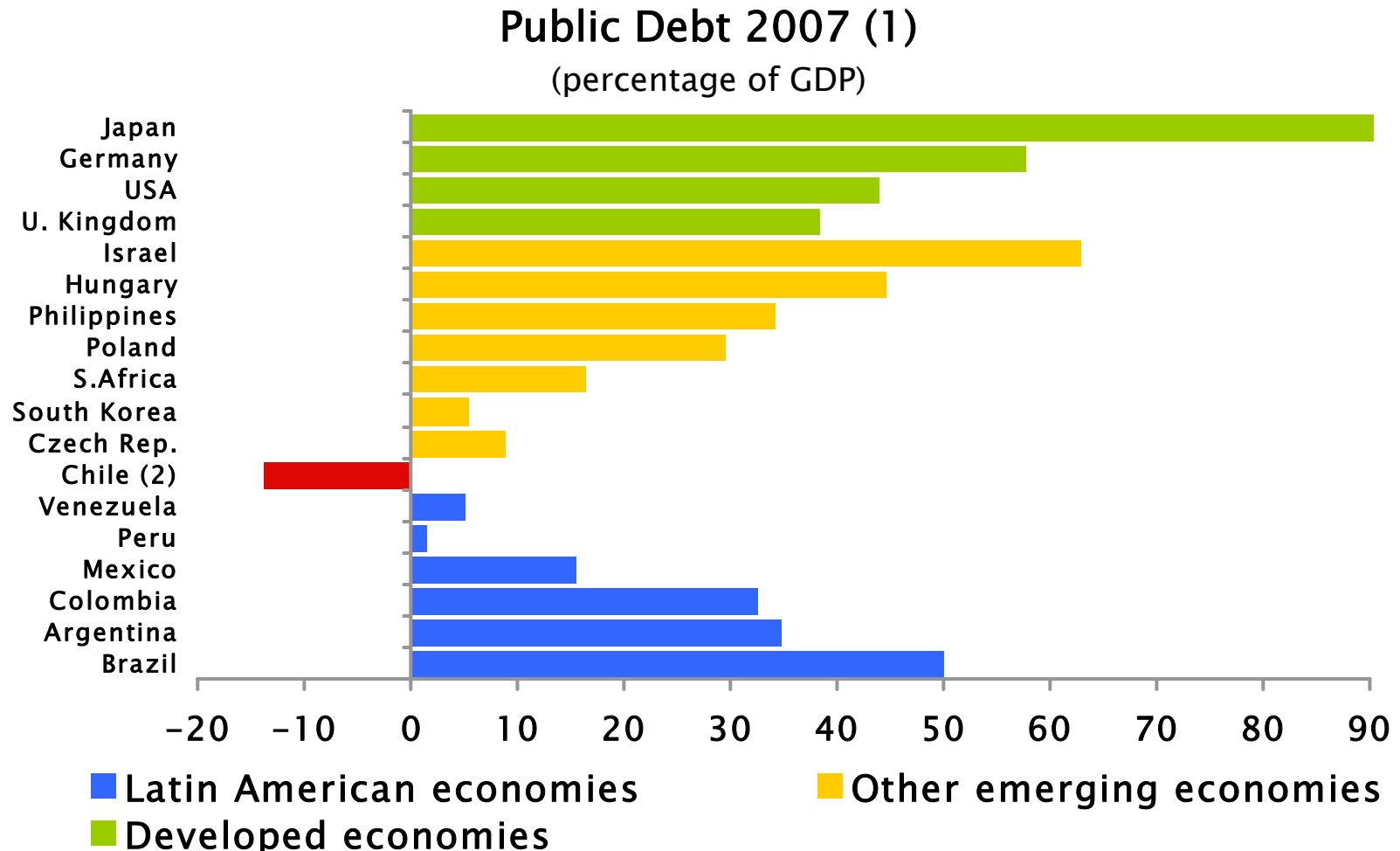
Fiscal surplus has been high due to favorable terms of trade and copper price.



Source: Chile's Ministry of Finance.



Government has taken advantage of favorable times to reduce its debt.



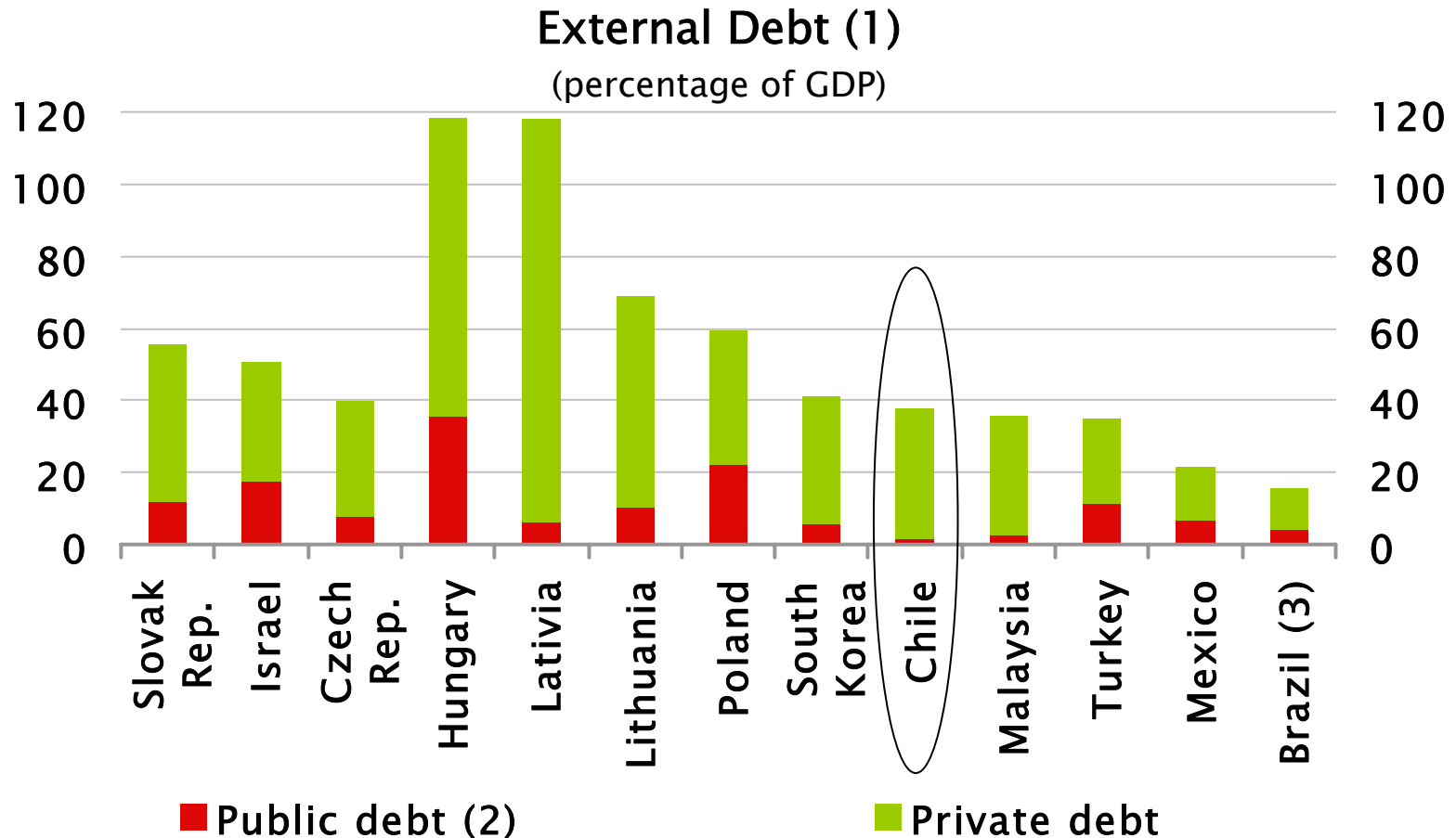
(1) General Government Net Debt (excluding Reserves, Central Bank Debt and Social Security.

(2) As of March 2008.

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



And total external debt (mainly private) is low compared to other emerging economies.



(1) In this context, Public Debt is the Consolidated Government Debt.

(2) External debt at March 2008, except Chile (2Q08), Mexico (4Q07) and Hungary (4Q07). Estimated GDP 2008.

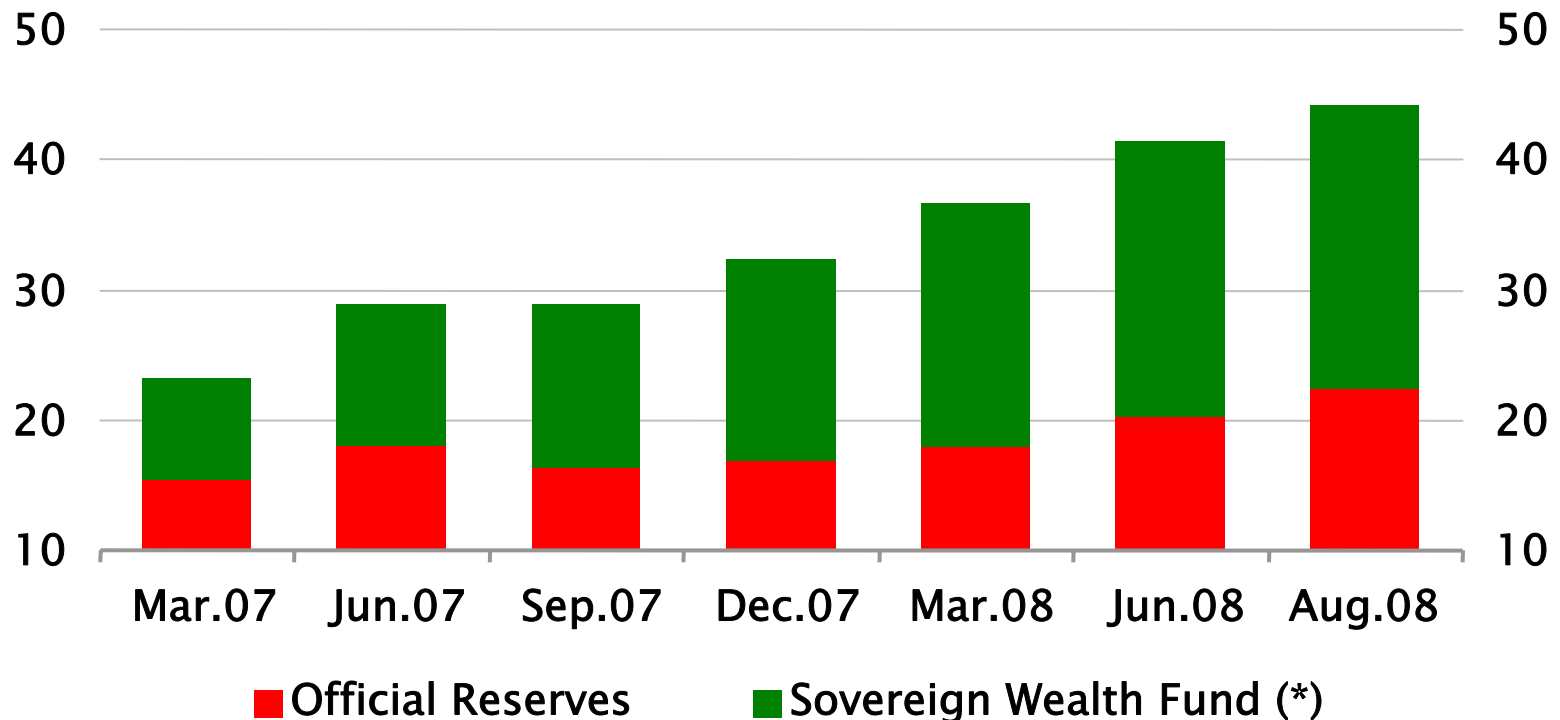
(3) Brazil began a program of announced prepayments of its debt since 2005.

Sources: Central Bank of Chile, IMF, Moody's and World Bank.



Foreign assets of the CBC and the Treasury have increased 53% yoy, totalizing 44 USD billion.

Net International Reserves and Sovereign Wealth Fund
(USD billions)

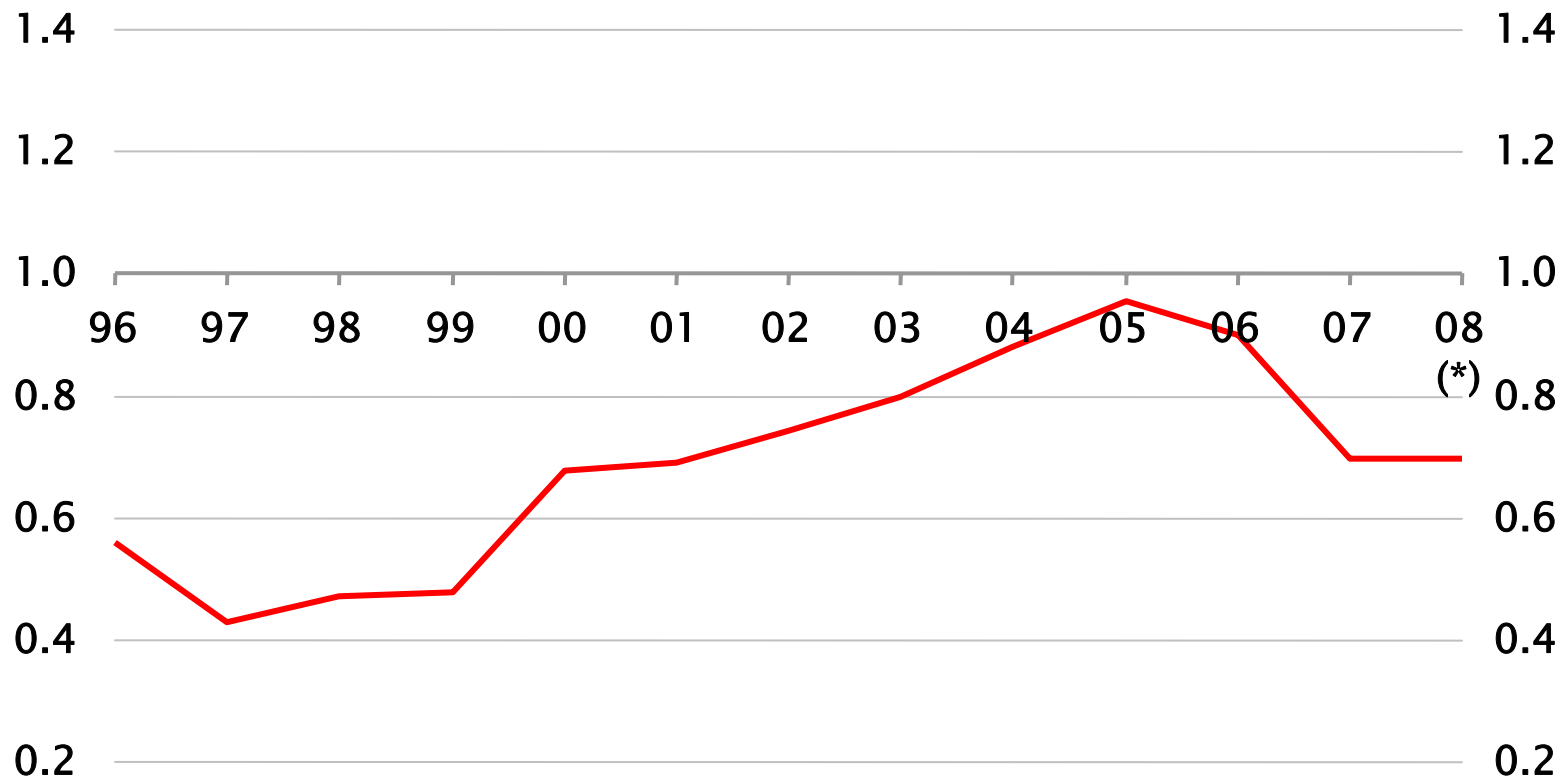


(*) Includes the Pension Reserve Fund (PRF) and the Economic and Social Stabilization Fund (ESSF)
Source: Central Bank of Chile and Finance Ministry.



Also, short term foreign debt is less than foreign assets of the CBC and the Treasury .

Short-term residual external gross / foreign assets
(ratio)

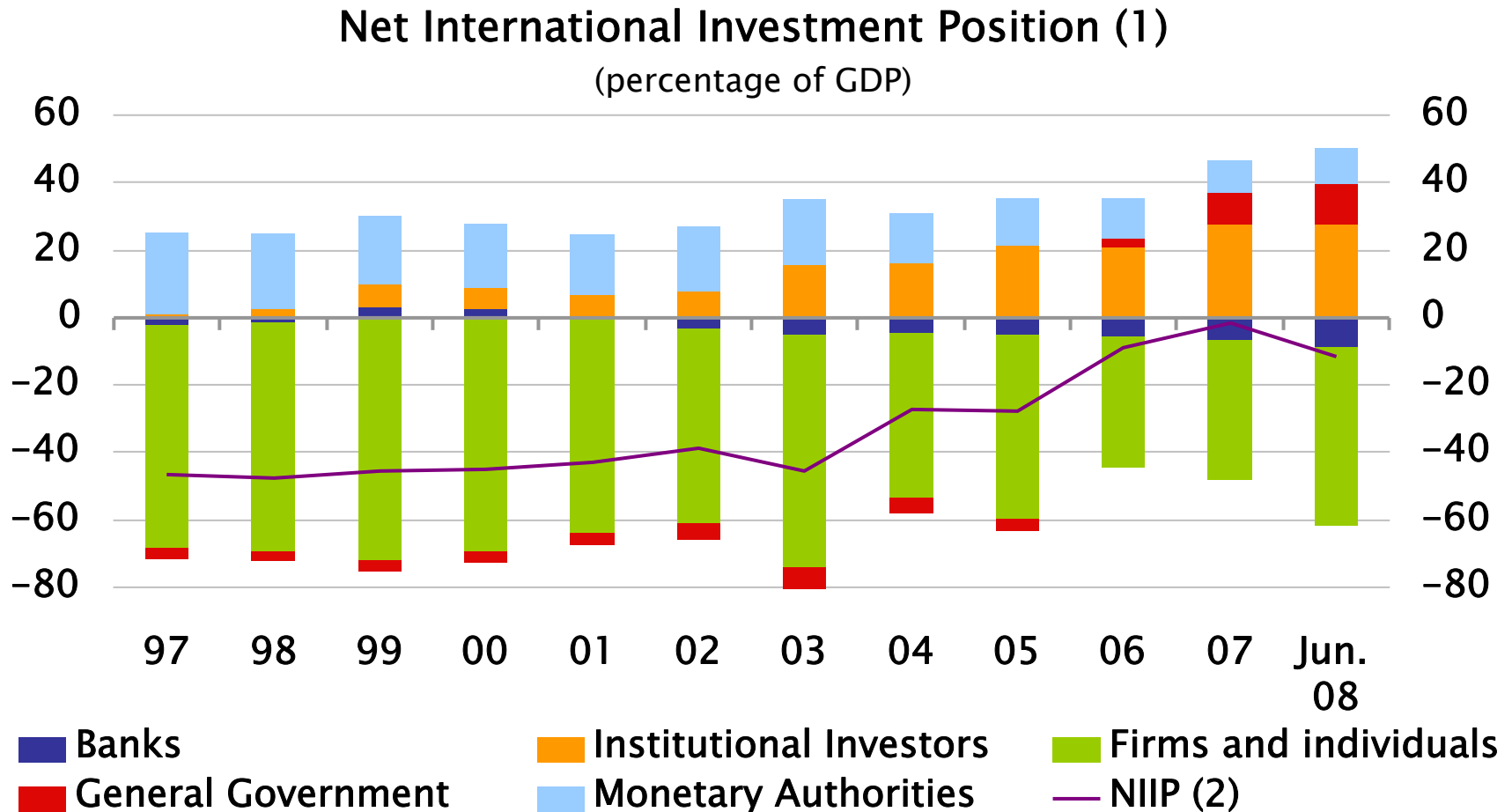


(*) At August 2008.

Source: Central Bank of Chile and Finance Ministry.



Net International Investment Position was negative in June 2008, but this has reversed thanks to asset accumulation by the CBC and the Treasury.

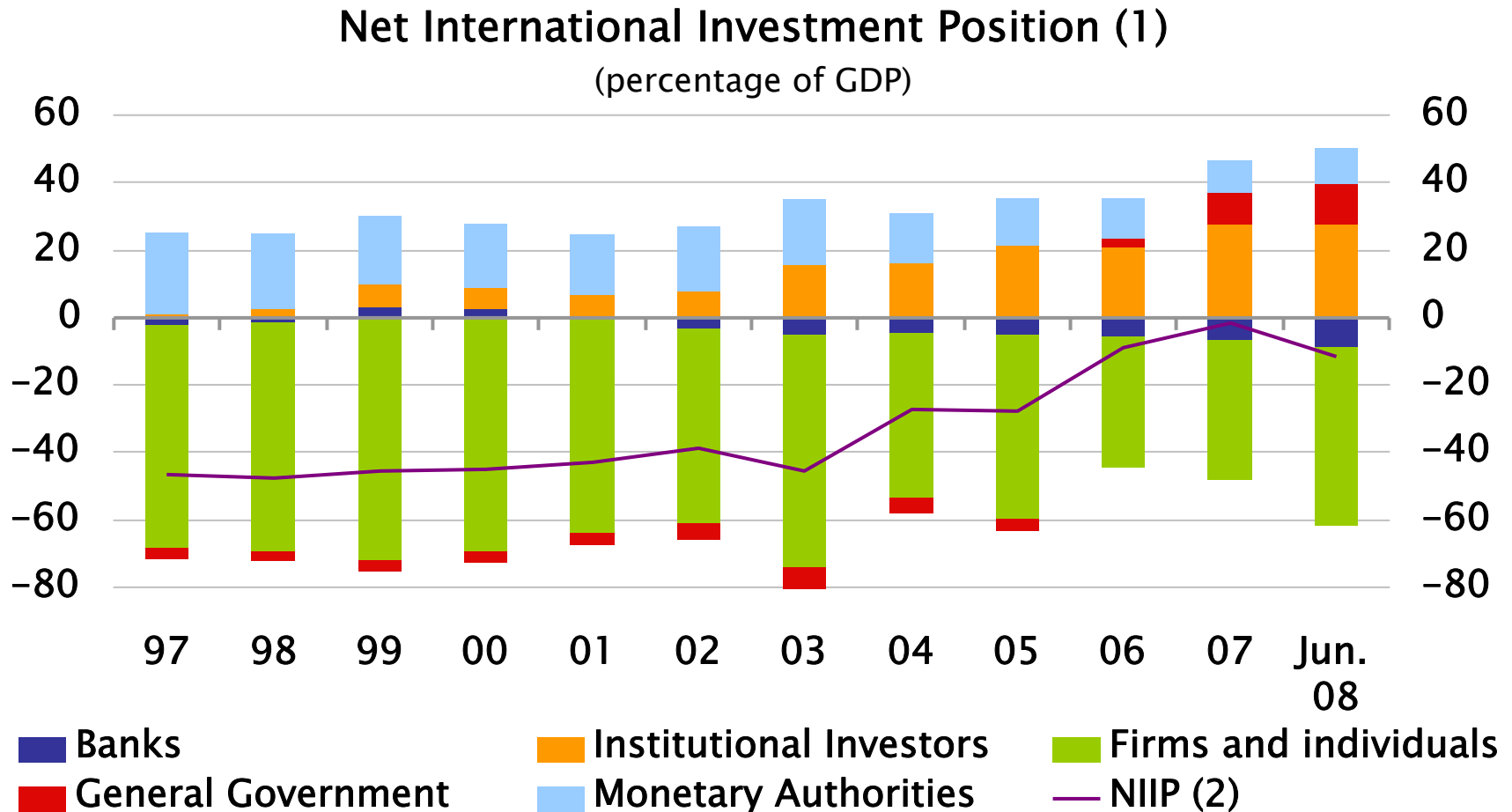


(1) GDP at constant real exchange rate (base rate December 2005=100).

(2) Net International Investment Position,
Source: Central Bank of Chile.



From a historical perspective, specially comparing to the 1990s, our IIP is visibly better.



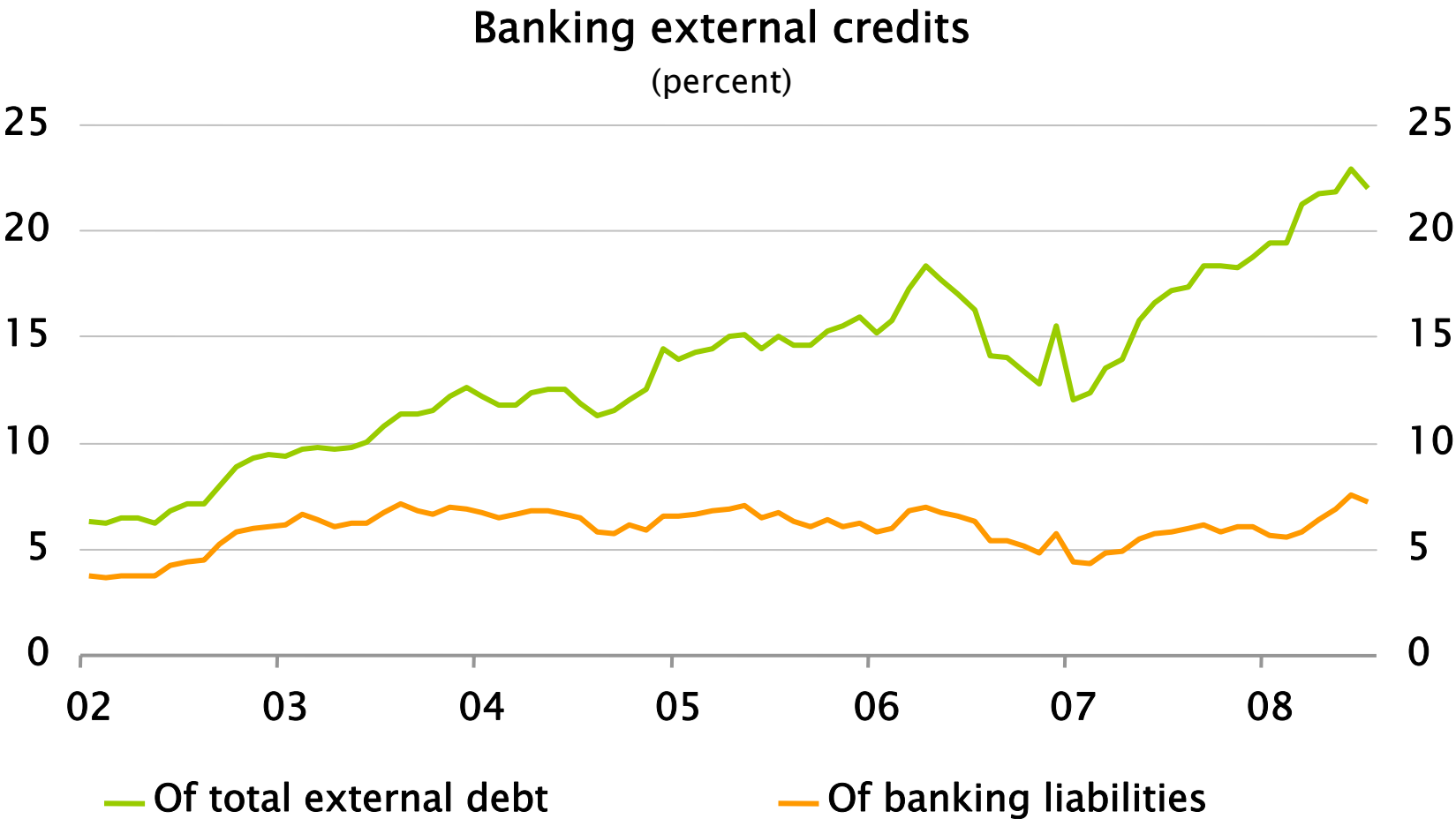
(1) GDP at constant real exchange rate (base rate December 2005=100).

(2) Net International Investment Position,

Source: Central Bank of Chile.



The banking sector dependence on external financing is relatively low.

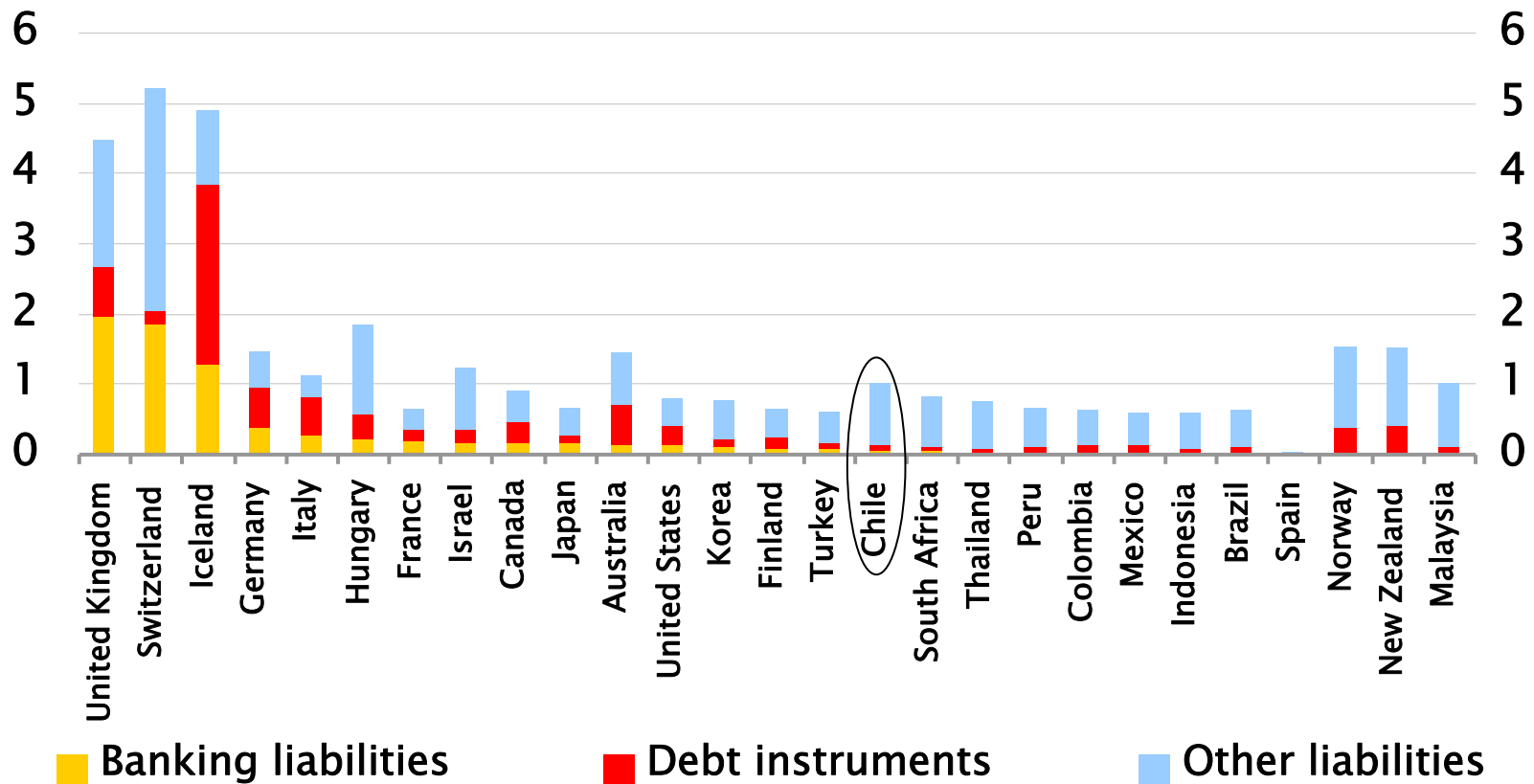


Source: Central Bank of Chile.



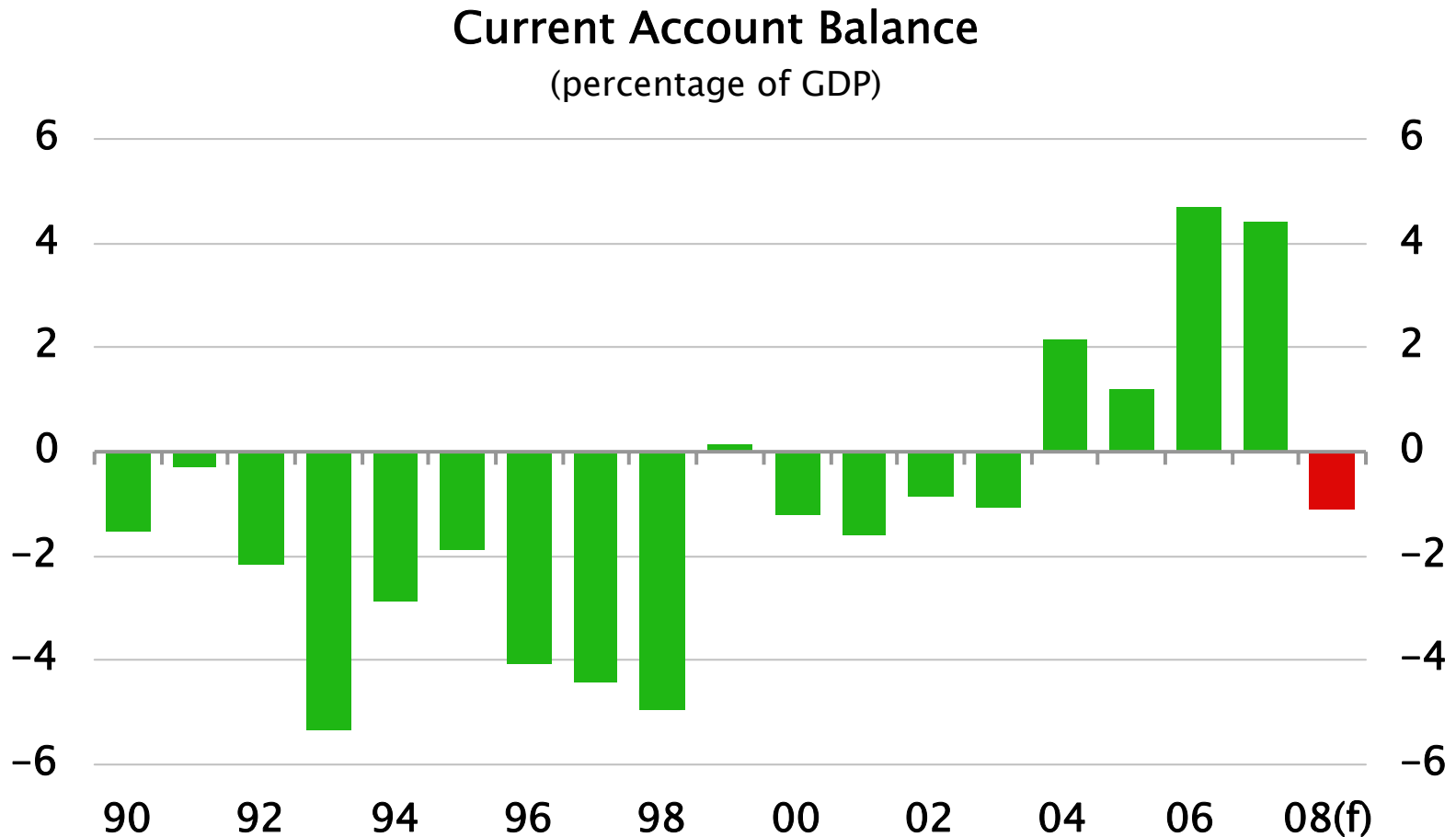
And compared to other countries too.

External liabilities (percentage of GDP)





Our current account balance, mainly due to our solid public policies, also shows better figures than during the 1990s.

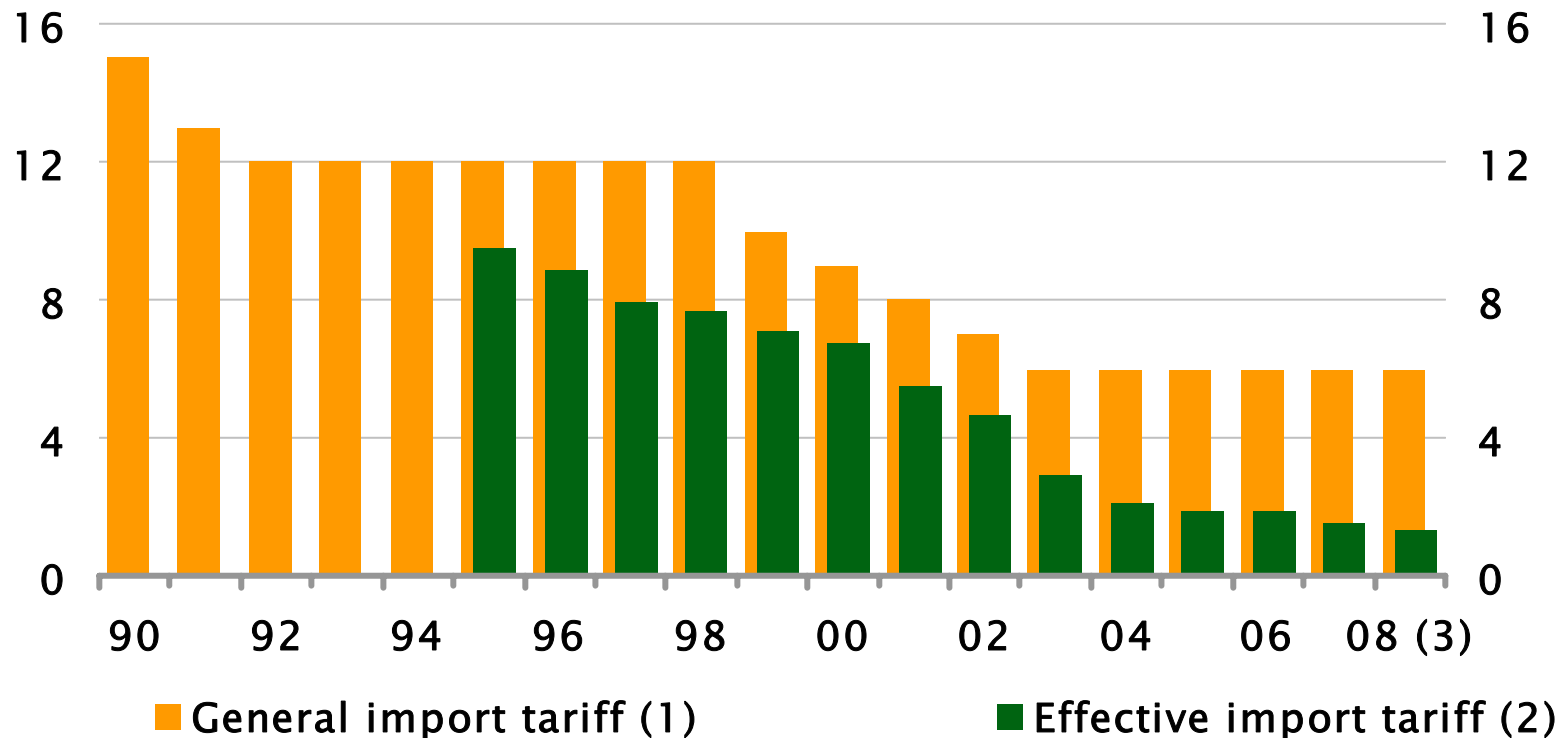


(f) Monetary Policy Report, September 2008.
Source: Central Bank of Chile.



Chile has increased integration and trade openness in the last decade, gaining access to a greater number of markets.

Trade Integration
(general import tariff, percentage)



(1) Includes every product of general agreement and excludes those of free trade agreements.

(2) Becerra, G. (2005), Statistical Economic Studies 50. Later data is estimated as the ratio of foreign trade tariffs to imports until March 2008.

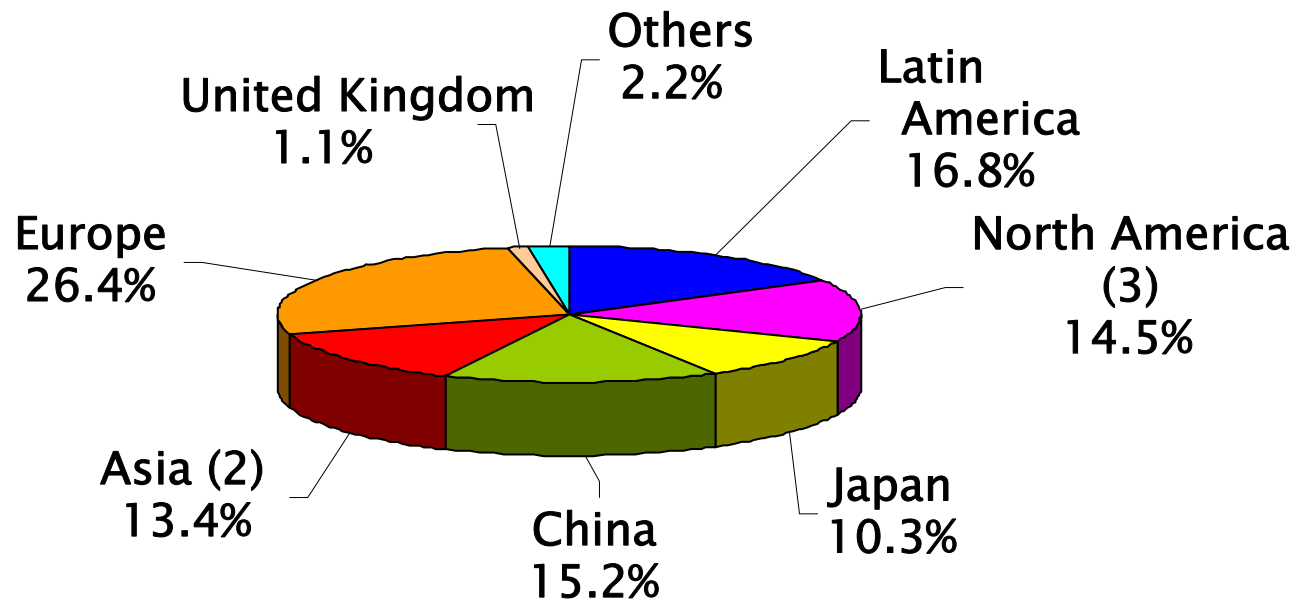
(3) As of June 2008.

Source: Central Bank of Chile.



The export markets are greatly diversified.

Export destinations 2008 (1)
(share of total exports)

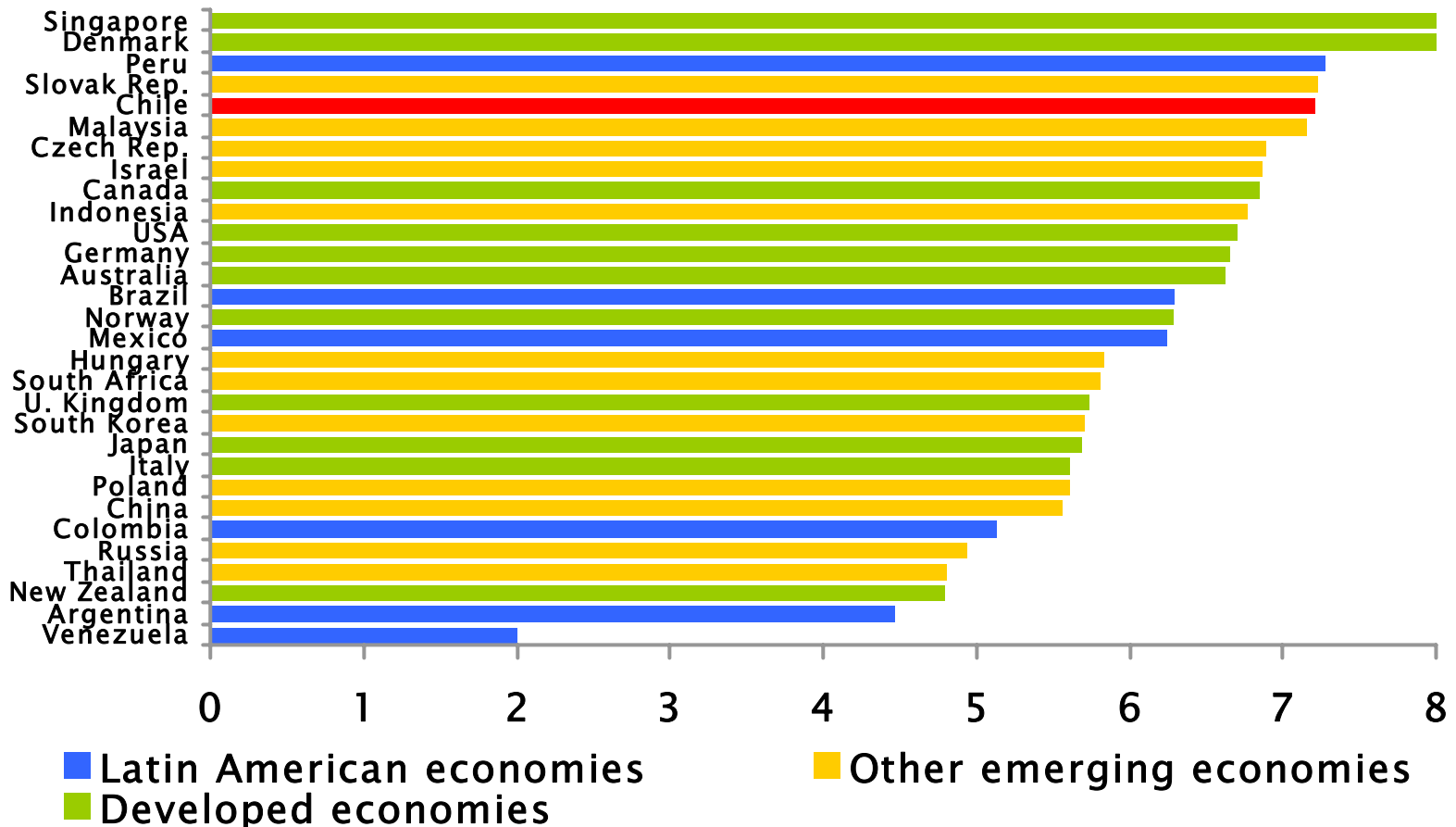


(1) Accumulated to the first half of 2008. Excluding free zone. (2) Excludes China and Japan. (3) Includes United States and Canada.
Source: Central Bank of Chile.



Macroeconomic policy framework is recognized in international rankings.

Contribution of monetary policy to macroeconomic performance (index, 2008)

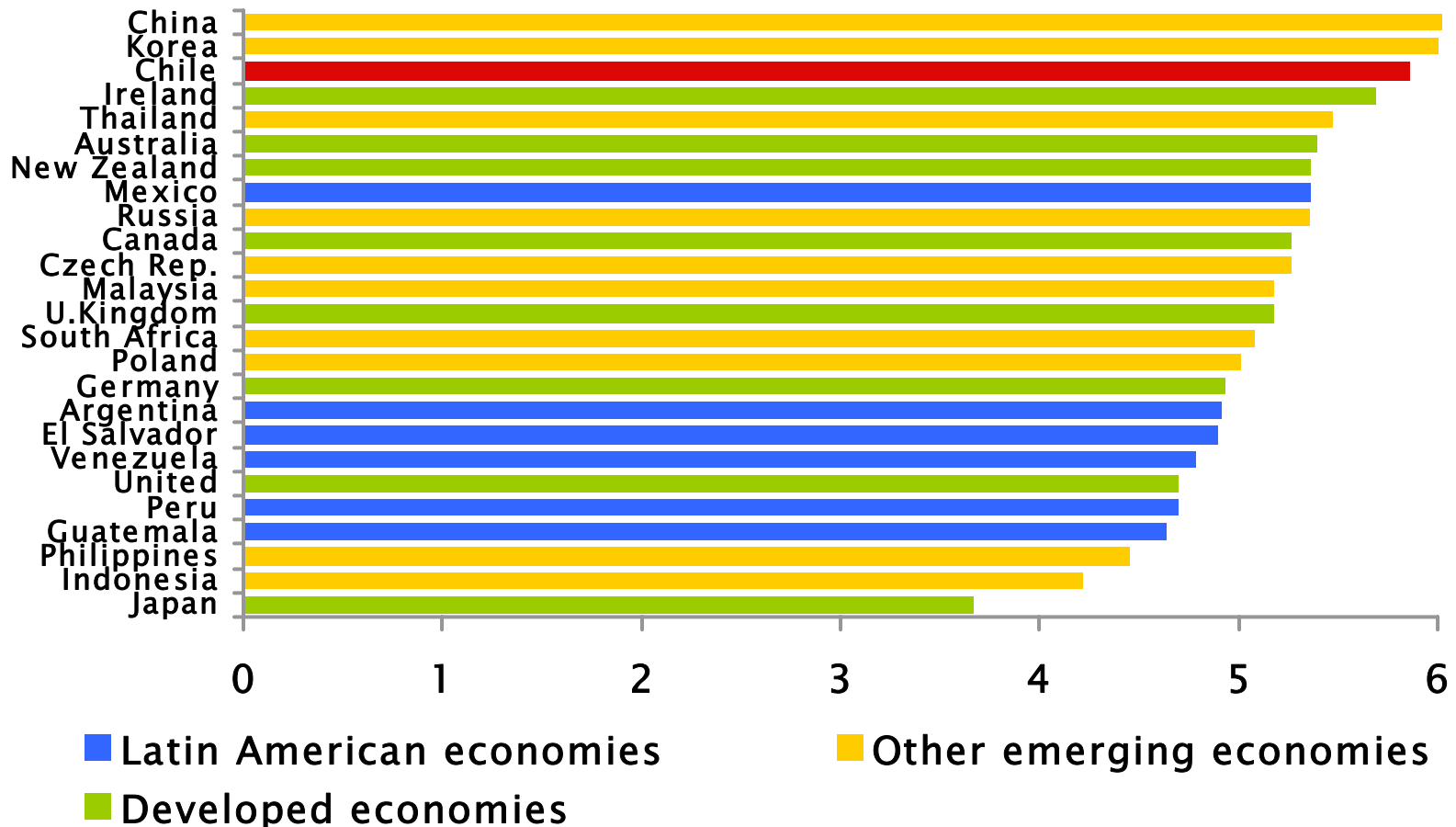


Source: IMD World Competitiveness Yearbook, Institute for Management Development (May 2008).



Macroeconomic management also ranks high.

Macroeconomic management (index, 2007)

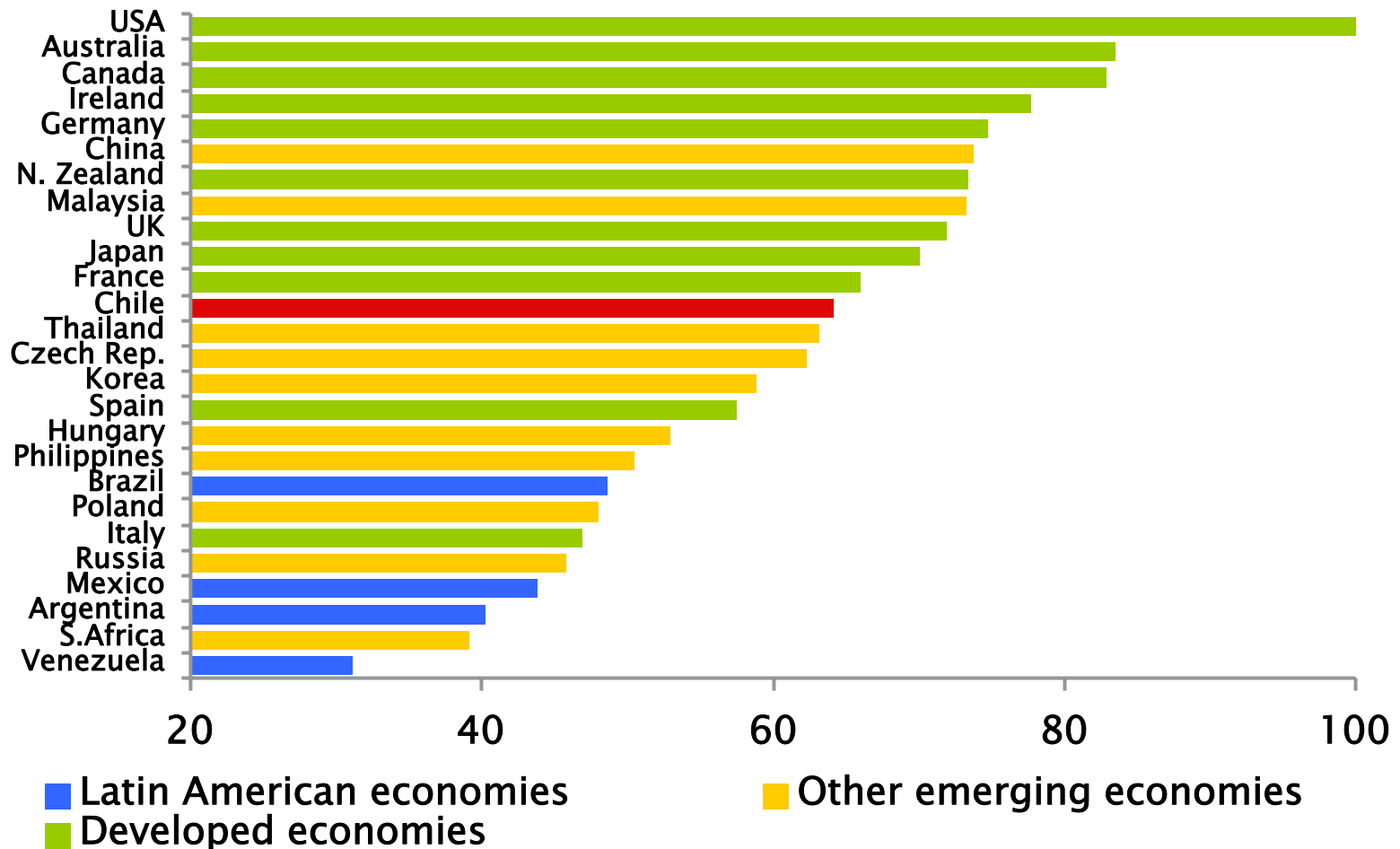


Source: Global Competitiveness Report 2007–2008, World Economic Forum (September 2007).



And has the best relative position in Latin America regarding economic competitiveness.

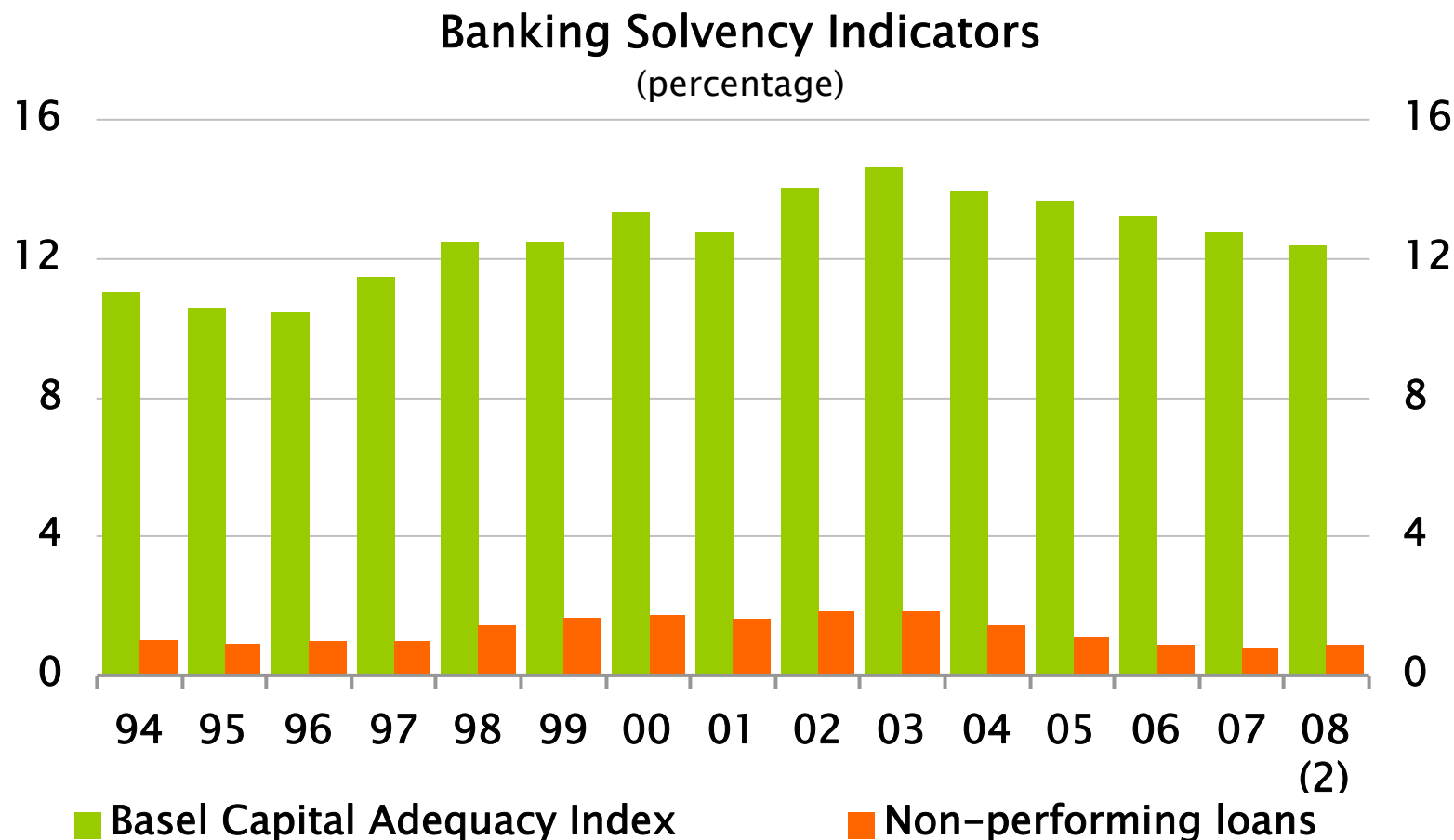
Competitiveness Ranking 2008



Source: Competitiveness Ranking, International Institute for Management Development.



Our banking system is strictly supervised, with solvency indicators above standard norms.



(1) As of January 2008 data of past-due loans are not strictly comparable with earlier data, since as part of the convergence plan to International Financial Reporting Standards (IFRS), banks changed the format of their financial statements.

(2) June figures for past-due loans and July ones for the Basle indicator.

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



Concluding remarks



The ongoing financial crisis puts significant uncertainty in the world and local outlook. The CBC closely monitors the implications for Chile.

- Undoubtedly, the developments of the last few weeks are striking, but it is still premature to draw definitive conclusions regarding their impact on the external and internal economic outlook and how they will affect the convergence of inflation to the target.
- The Board reiterates that, whatever changes might occur, monetary policy will be conducted so as to ensure convergence of inflation to the target.
- The Chilean monetary policy framework has the virtue to allow relatively rapid adjustments according to changes in conditions that determine inflation.



Flexibility is essential in times of great uncertainty.

- Should the Board evaluate that the events of the last weeks events draw a different scenario than the one considered most likely a month ago, it will adopt decisions consistent with the new evaluation.
- This does not differ from what the Board did only a few weeks after having published May's Monetary Policy Report, when it changed the monetary policy path, increasing the MPR strongly as higher propagation of inflation was evidenced.
- Or, last Thursday when the MPR was maintained in recognition of the value of waiting for further clues on how the international scenario will evolve and its impact on the Chilean economy.



The Board reaffirms that it will take all necessary actions to ensure convergence of inflation to the target in two years.

- Just as it has done in the past, the Board will remain vigilant to the events of the external and domestic economic scenarios, and will take all necessary actions to maintain the normal functioning of markets.
- Also, the Board closely monitors developments of the financial crisis and its implications on inflationary pressures and the convergence of inflation to the target. It cannot be ruled out that pressures that reduce inflation can be generated in the world economy, and that must be considered in future decisions.
- In the name of the Board, we reaffirm that we will adopt all necessary actions to ensure the convergence of inflation to its 3% target in the medium run.



The Chilean Economy

José De Gregorio
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	4.5–5.0	3.5–4.5
Consumer prices (annual % change Dec/Dec)	3.7	2.6	7.8	8.5	4.9
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	74,700	72,500
Imports of goods FOB (millions of USD)	30,492	35,899	43,991	58,400	62,400
Current account balance (% of GDP)	1.2	4.7	4.4	–1.1	–2.7
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	–	–