Monetary Policy Report
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Goldman Sachs
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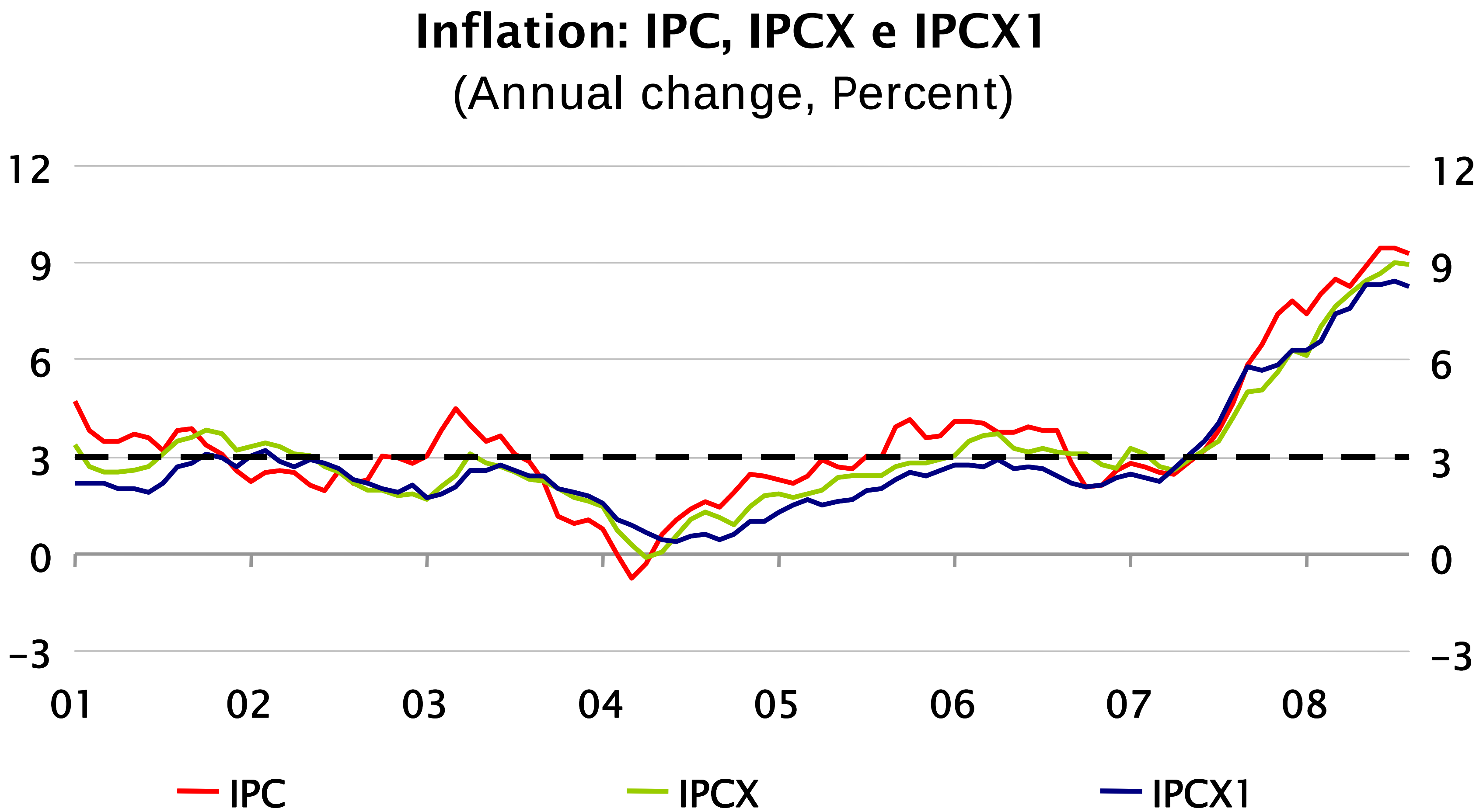
Issues

- I. Recent Trend in Inflation
- II. Current Stance of Monetary Policy
- III. Baseline Scenario
- IV. Some Conclusions

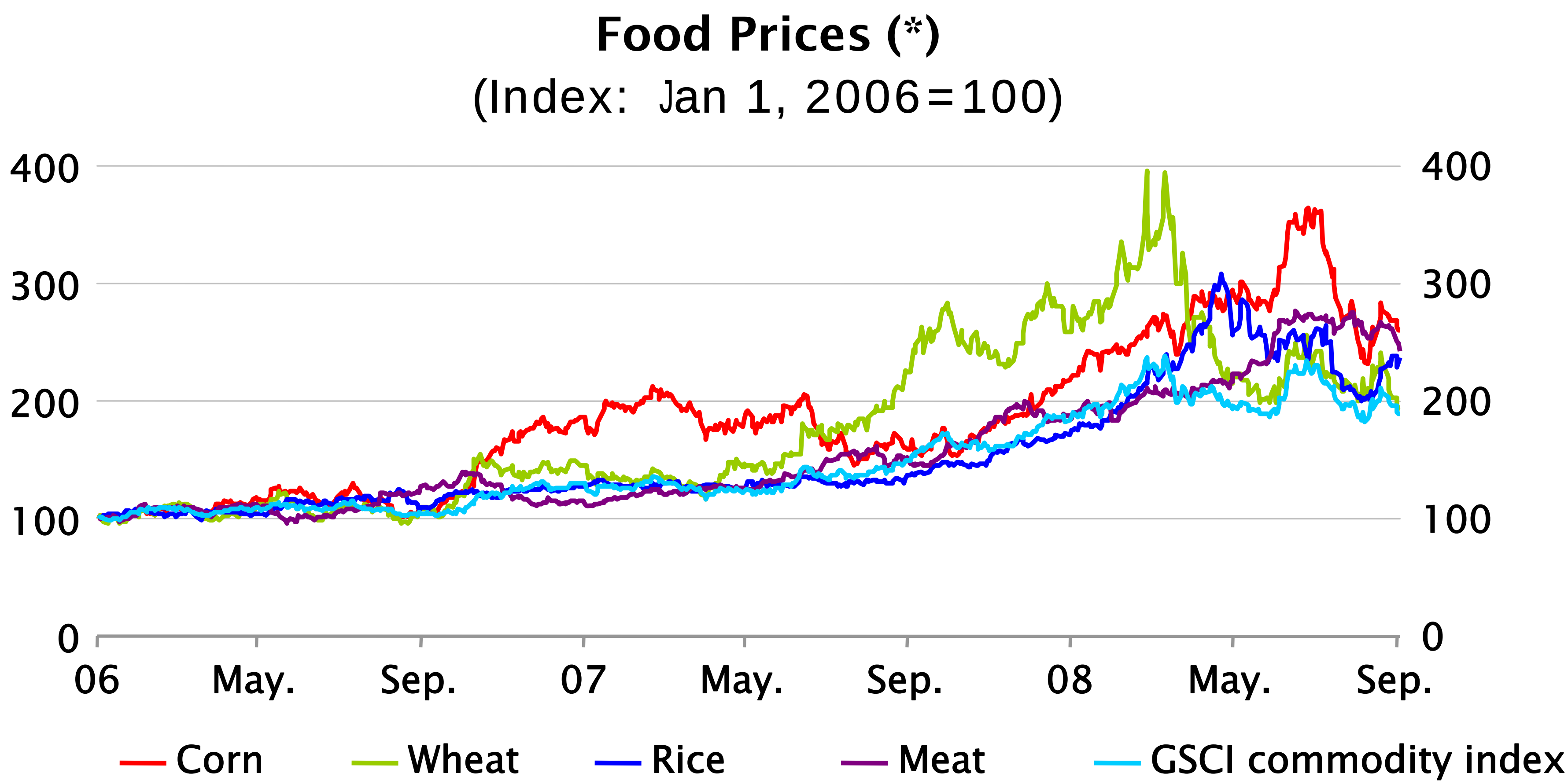
I. Recent Trend in Inflation

CPI inflation is around 9%, more than three times the BCCh target



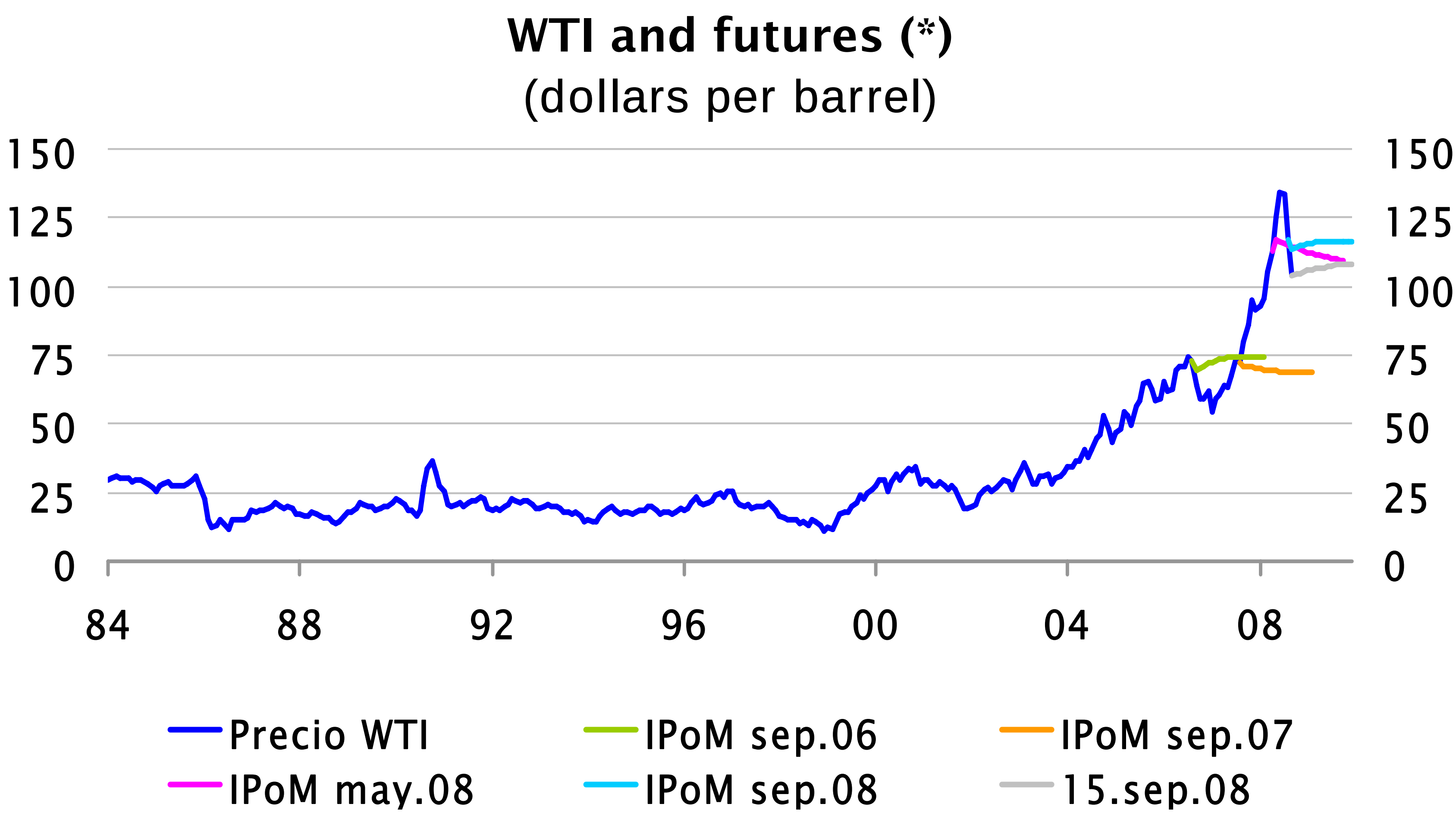
Sources: Banco Central de Chile and Instituto Nacional de Estadísticas.

This trend has been strongly influenced by large and persistent increases in world food prices …



(*) Precio del maíz corresponde al contrato N° 2 de maíz amarillo spot. Precio del trigo corresponde Red Soft Winter N° 2 spot. Precio del arroz corresponde a grano largo bruto N° 2. Precio de la carne corresponde a contratos futuros de novillos, Brasil. Índice GSCI agrícolas calculado por Goldman Sachs. Source: Bloomberg.

… and oil prices.



(*) Futures consider the average of last 10 previous to each Monetary Policy Report.
Source: Bloomberg.

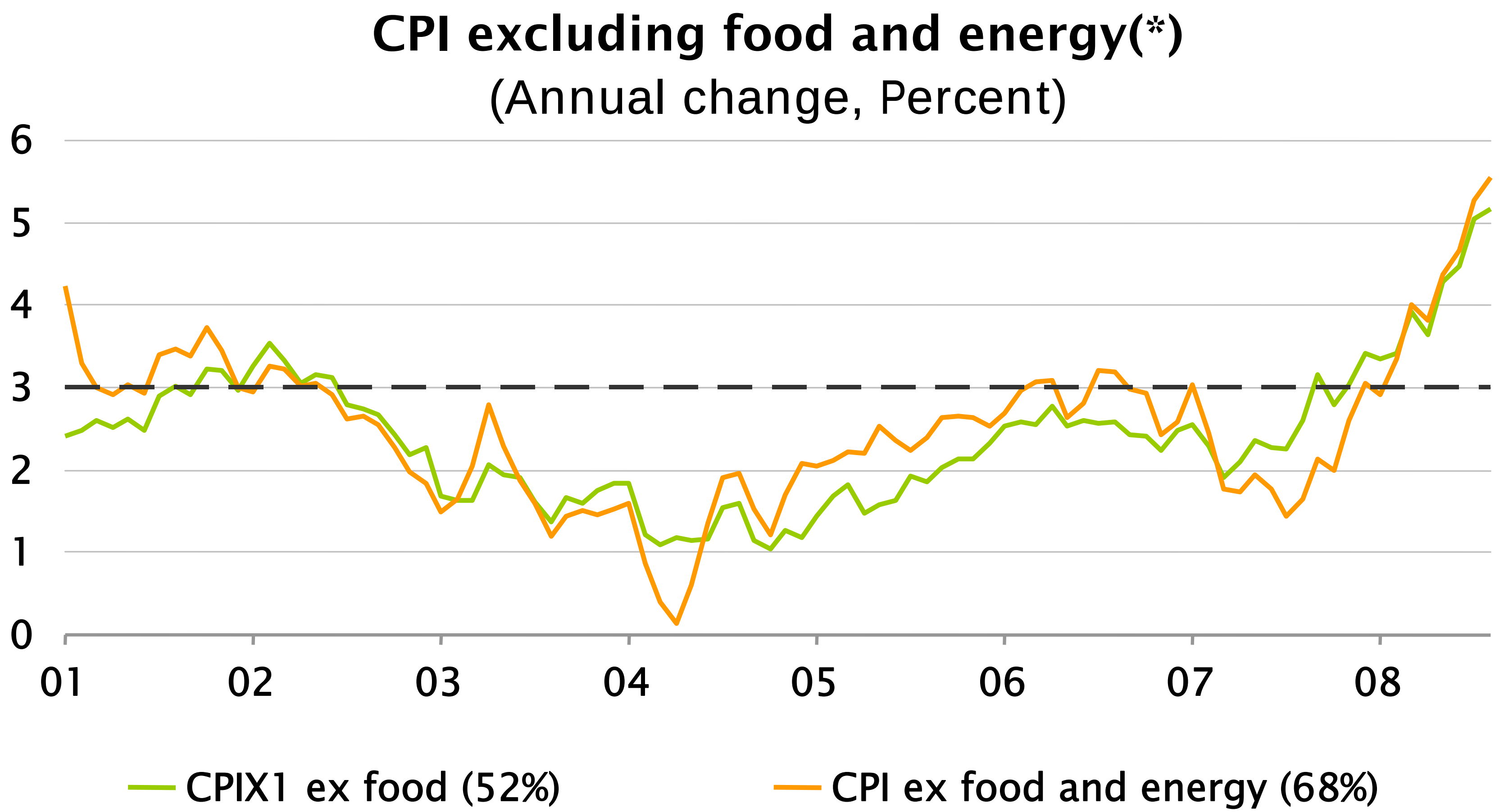
A significant share of inflation is explained by an increase in domestic prices of gasoline, energy and food products.

Incidence of food and energy on CPI

	Share on CPI (Percent)	August 2008	
		Annual change (percent)	Incidence on CPI (percentage points)
1. Fuel (1)	4.01	17.6	1.4
2. Electricity	1.64	27.7	0.6
3. Food	23.48	17.1	4.0

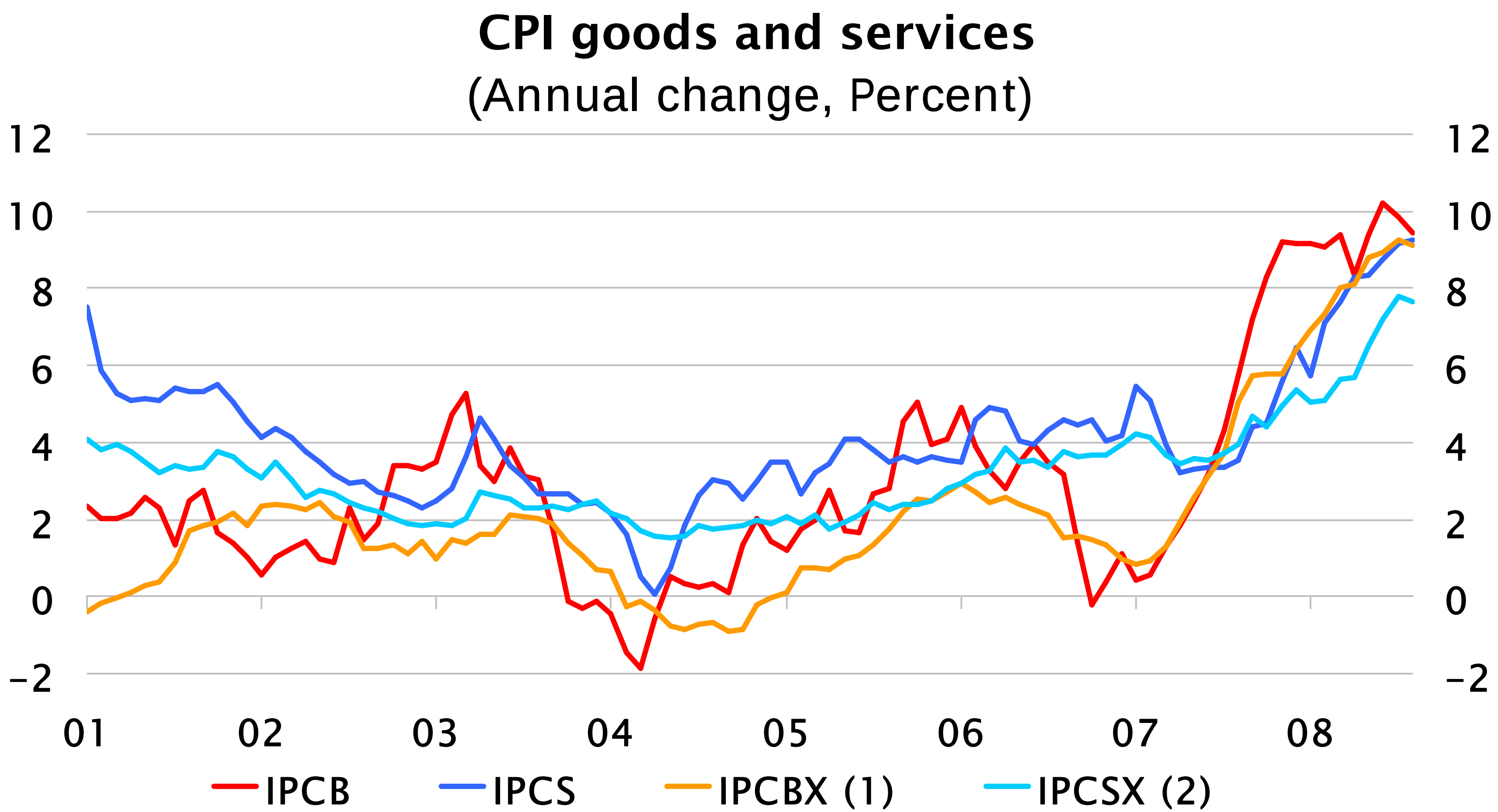
(1) Natural gas/liquefied gas/gasoline.
Sources: Instituto Nacional de Estadísticas and Banco Central de Chile.

Also, we have seen a significant increase in prices not directly linked with food or energy



(*) In parenthesis their shares in CPI basket.
Sources: Banco Central de Chile and Instituto Nacional de Estadísticas.

This is also evident in the inflation dynamics of services



(1) Excludes Gasoline and fresh fruits and vegetables
(2) Excludes basic services and metro/bus tariffs
Sources: Banco Central de Chile and Instituto Nacional de Estadísticas.

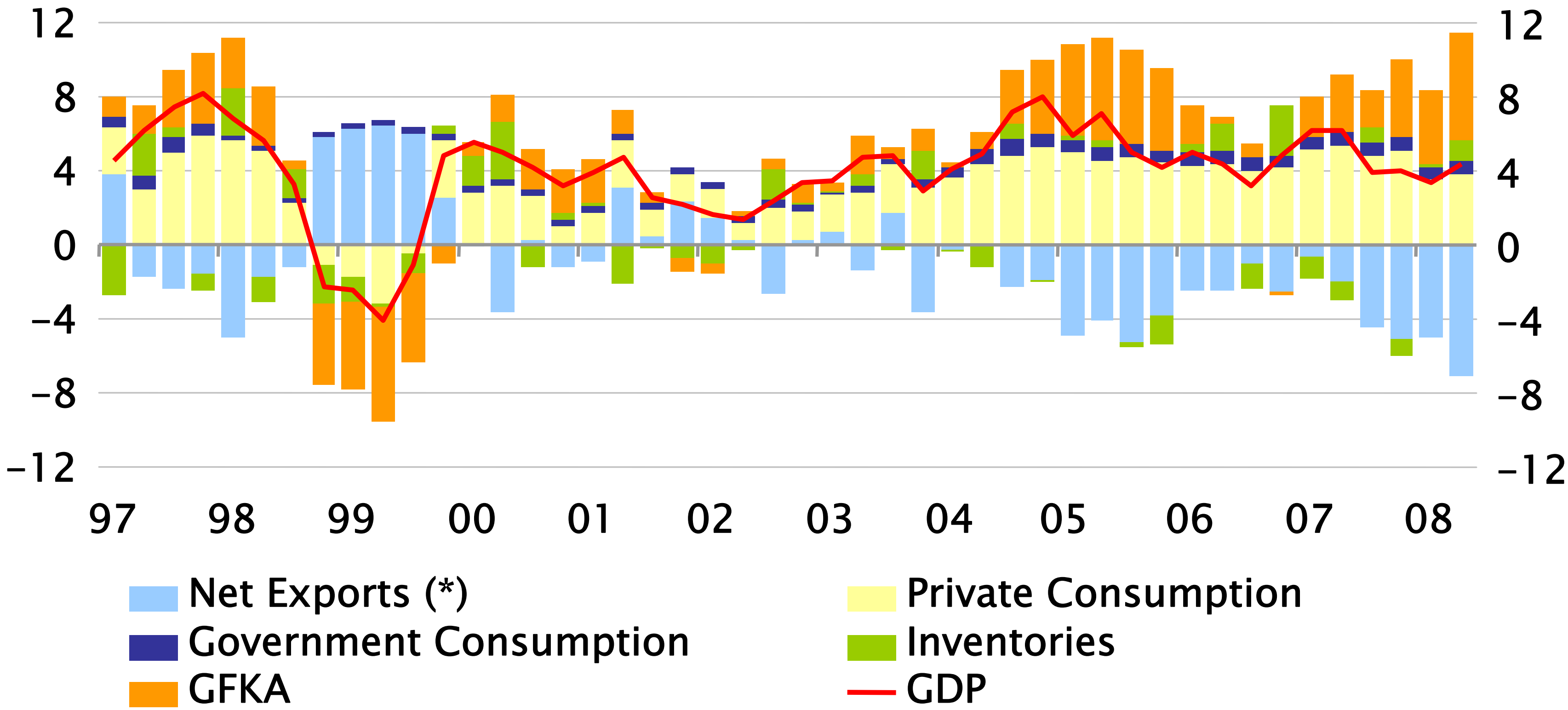
The increase in ex-food ex-energy prices might reflect

- Significant increase in production costs
- High growth in domestic demand
- A high degree of price/wage indexation
- An increase in inflation expectations
- Exchange rate dynamics

Domestic demand have grown at rates twice as large as the growth rate of output

GDP and domestic demand

(Real annual change; percentage points)

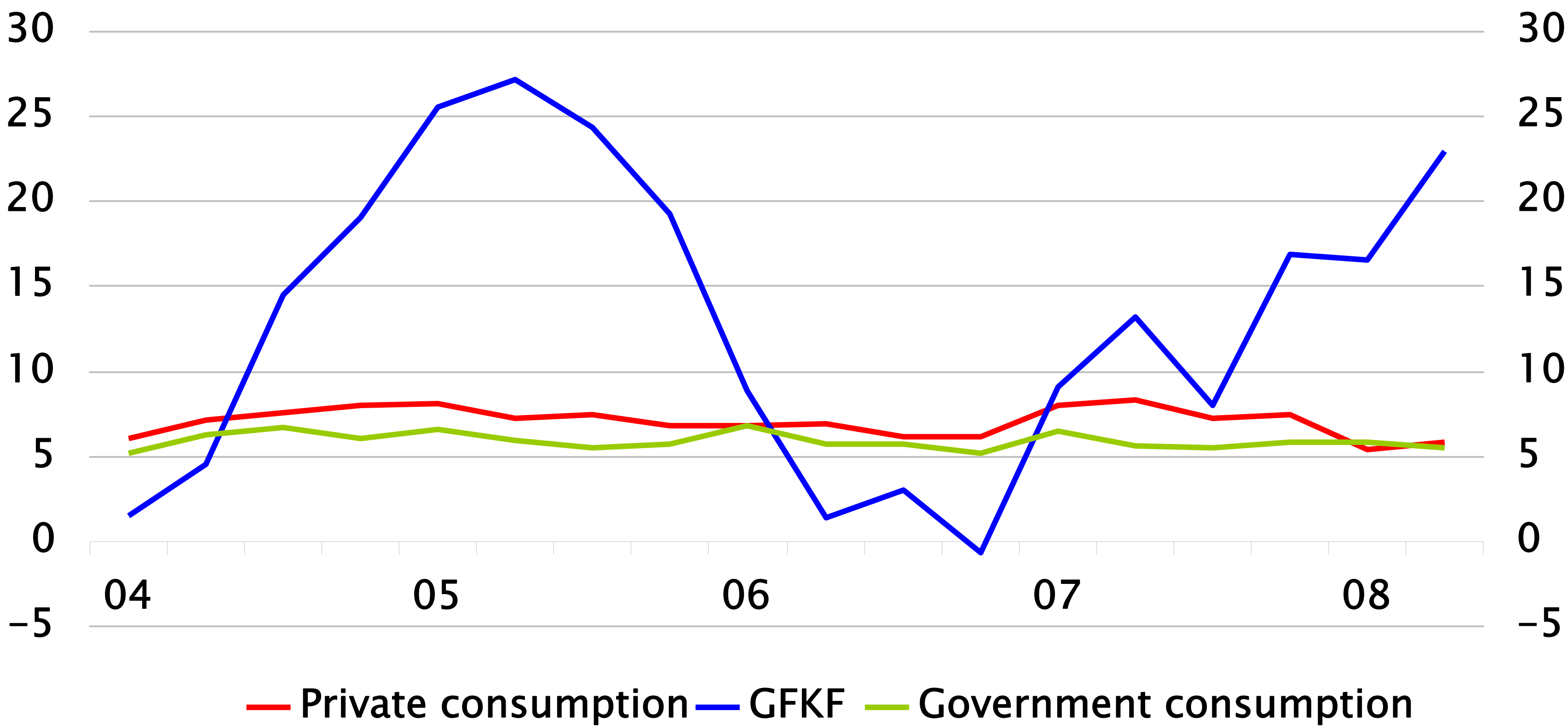


Source: Banco Central de Chile.

Investment is the most dynamic component

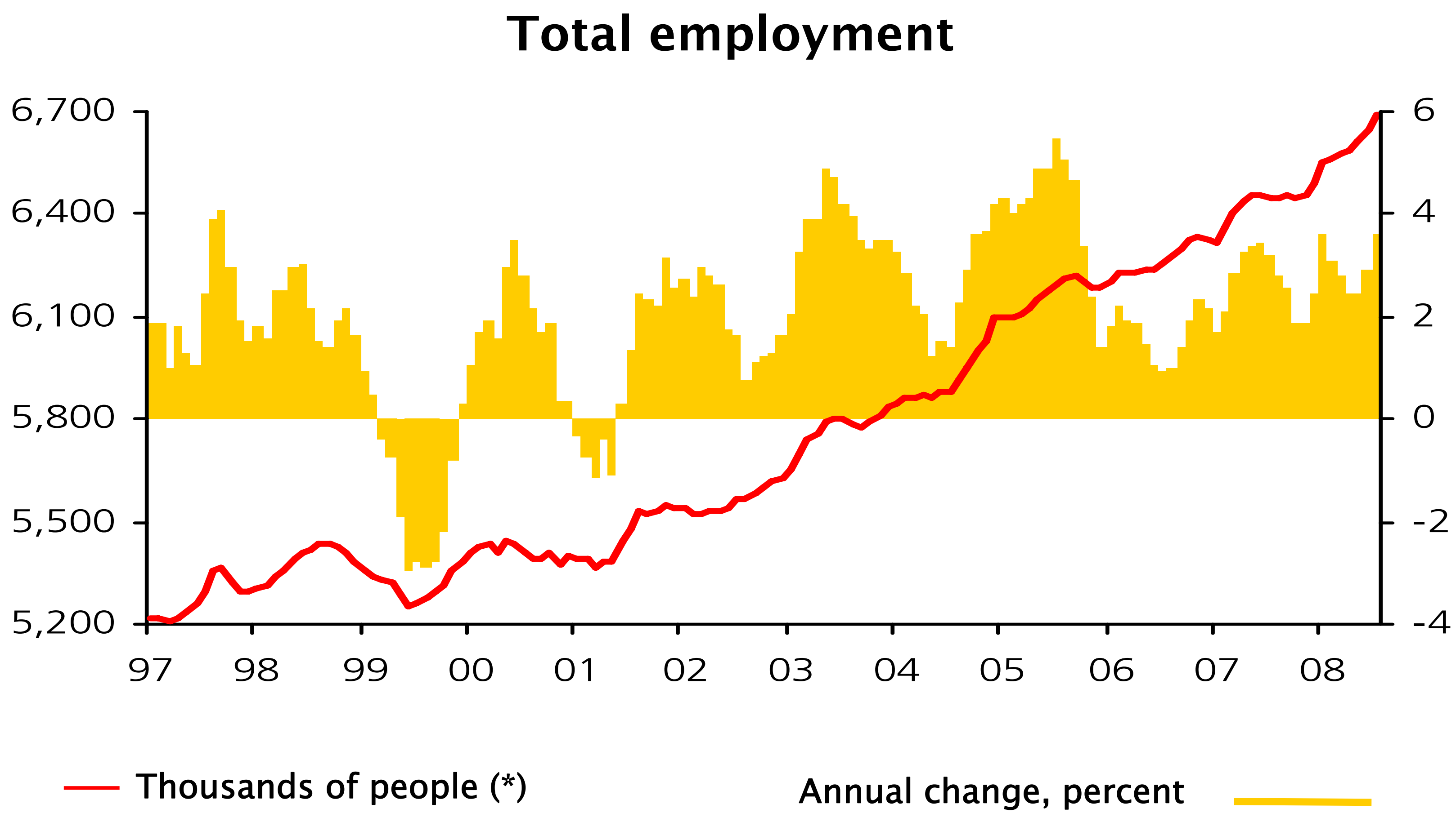
Components of domestic demand

(Real annual change; percentage points)



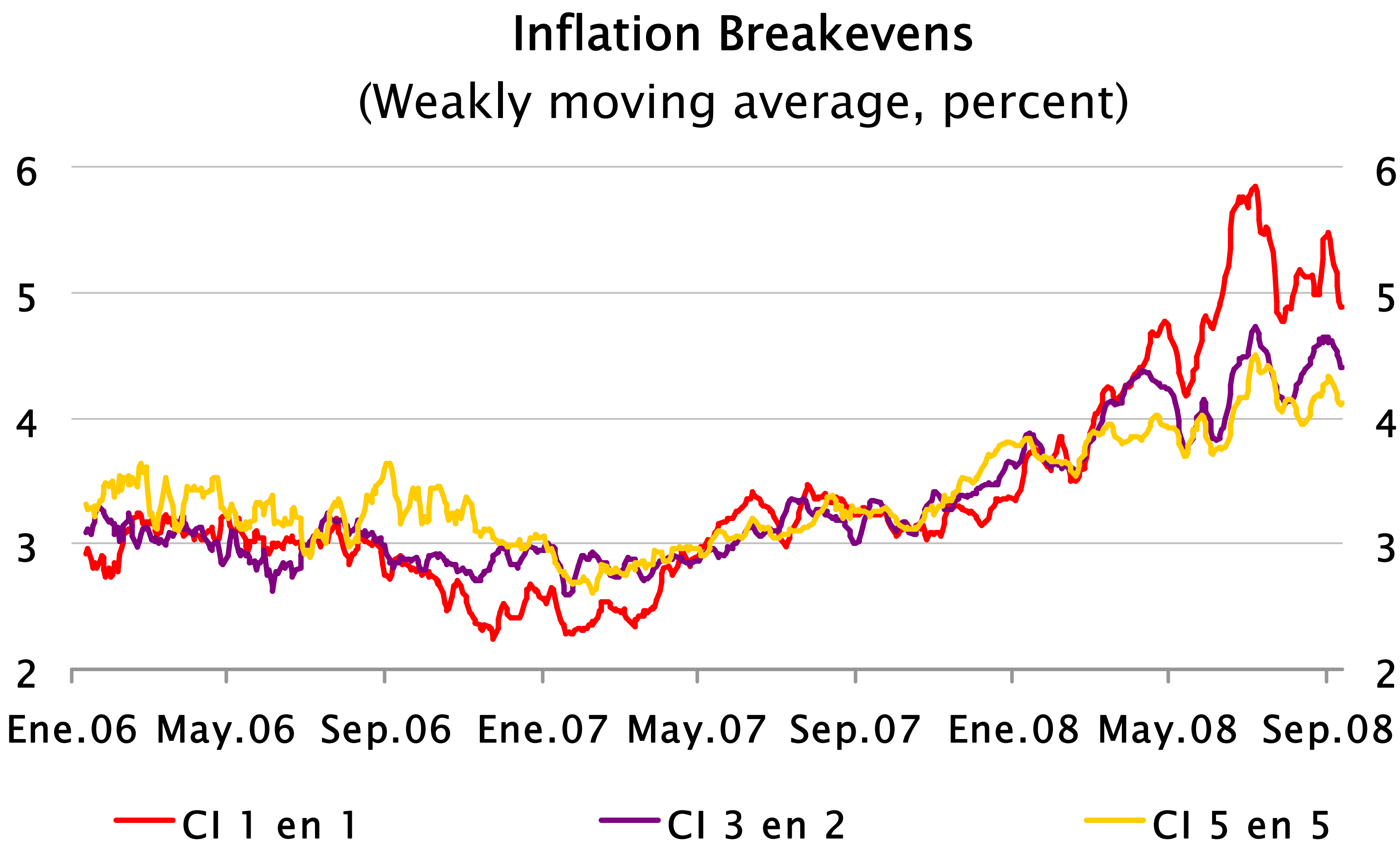
Source: Banco Central de Chile.

These phenomena occur in a context of a dynamic labor market



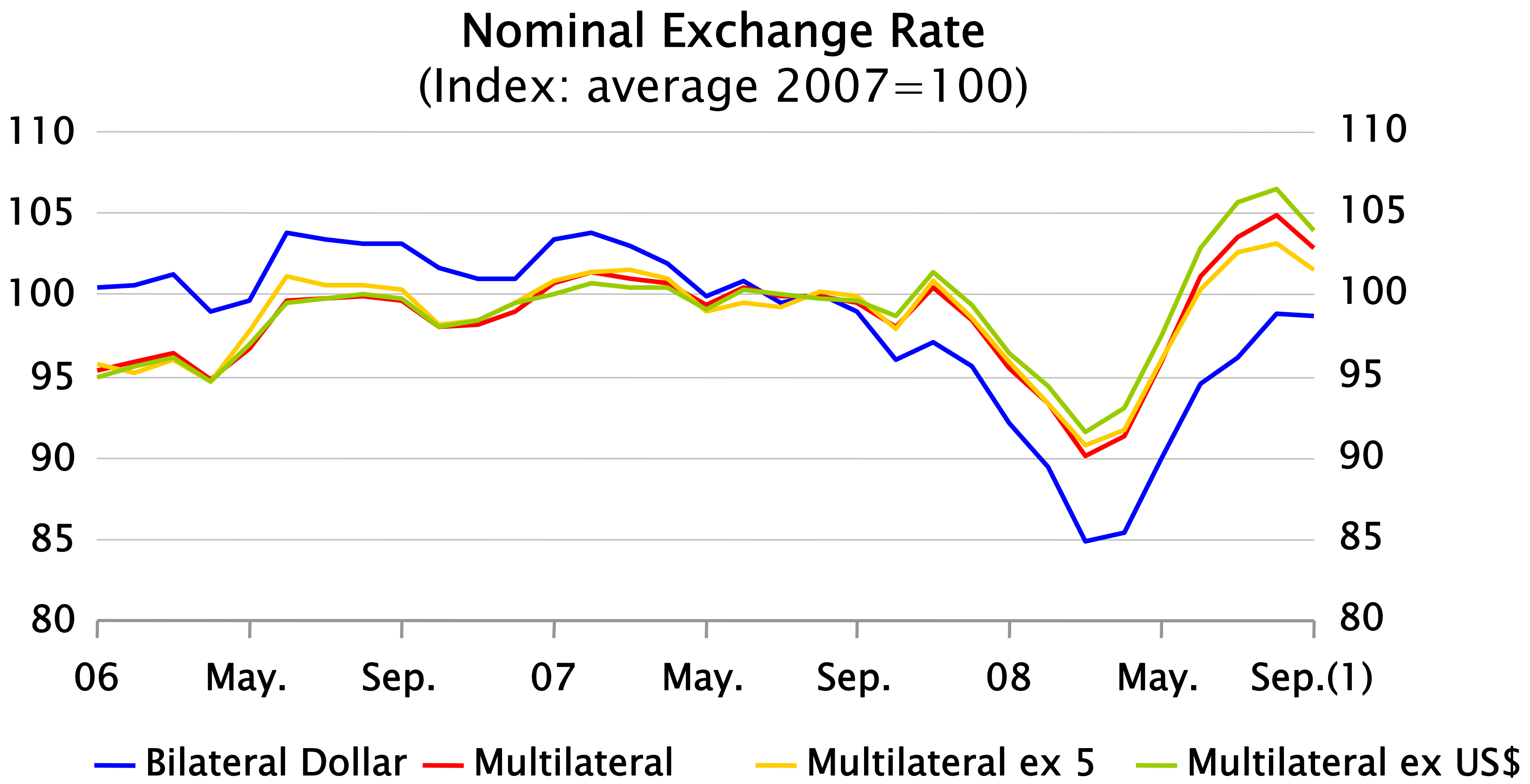
(*) Seasonally-adjusted series.
Source: Banco Central de Chile and Instituto Nacional de Estadísticas.

We have observed an increase in inflation expectations



Source: Banco Central de Chile and Bloomberg.

Neither we can rule out the impact of exchange rate movements, but on an annual basis they seem to be of second order

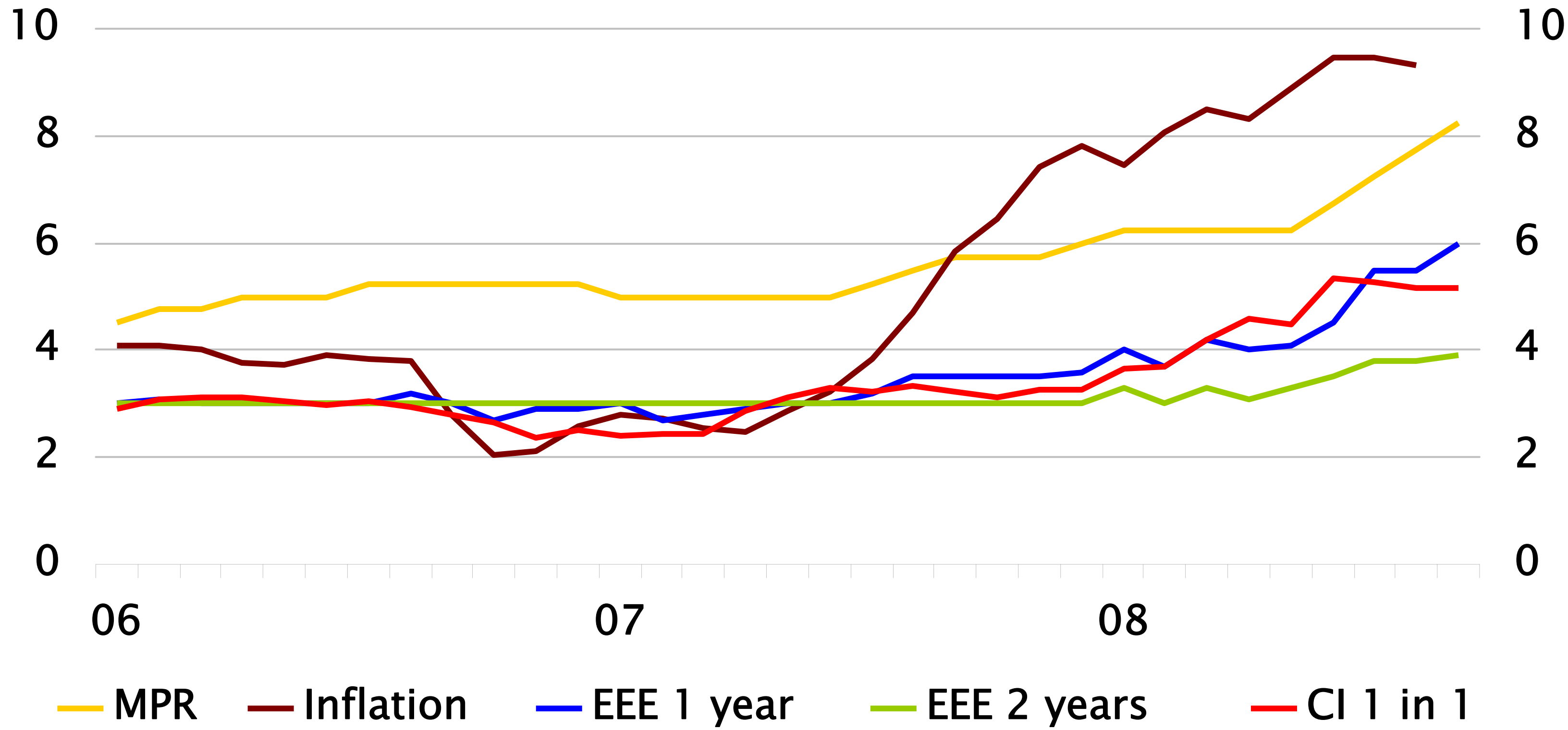


(1) Average up to September 5, 2008.
Source: Banco Central de Chile.

II. Current Stance of Monetary Policy

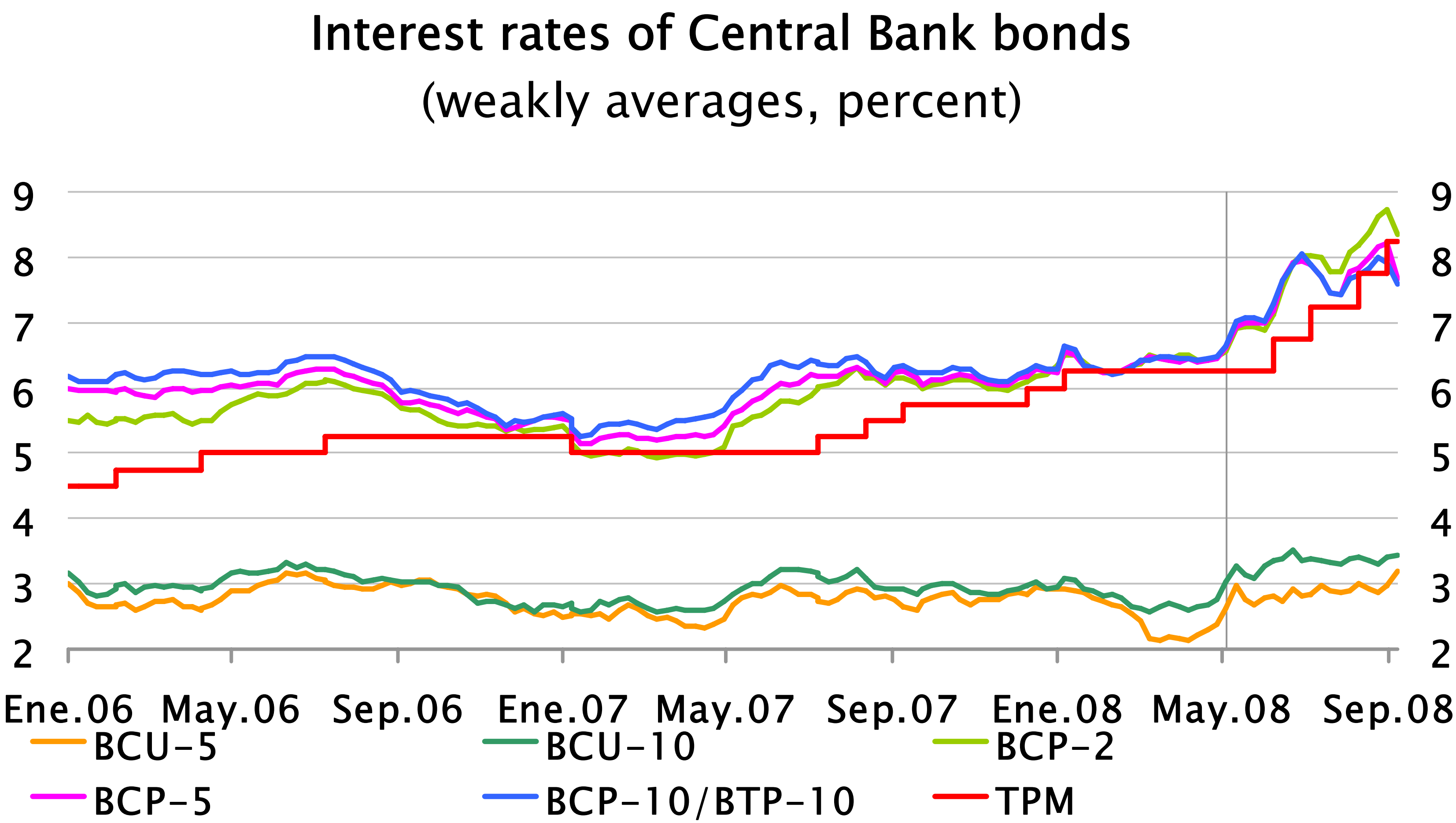
The Central Bank has increased the MPR substantially in the last months

MPR, inflation and inflation expectations
(percent)



(1) Monthly average.
Sources: Banco Central de Chile, Bloomberg and Instituto Nacional de Estadísticas.

Real rates of Central Bank bonds remain at historical levels

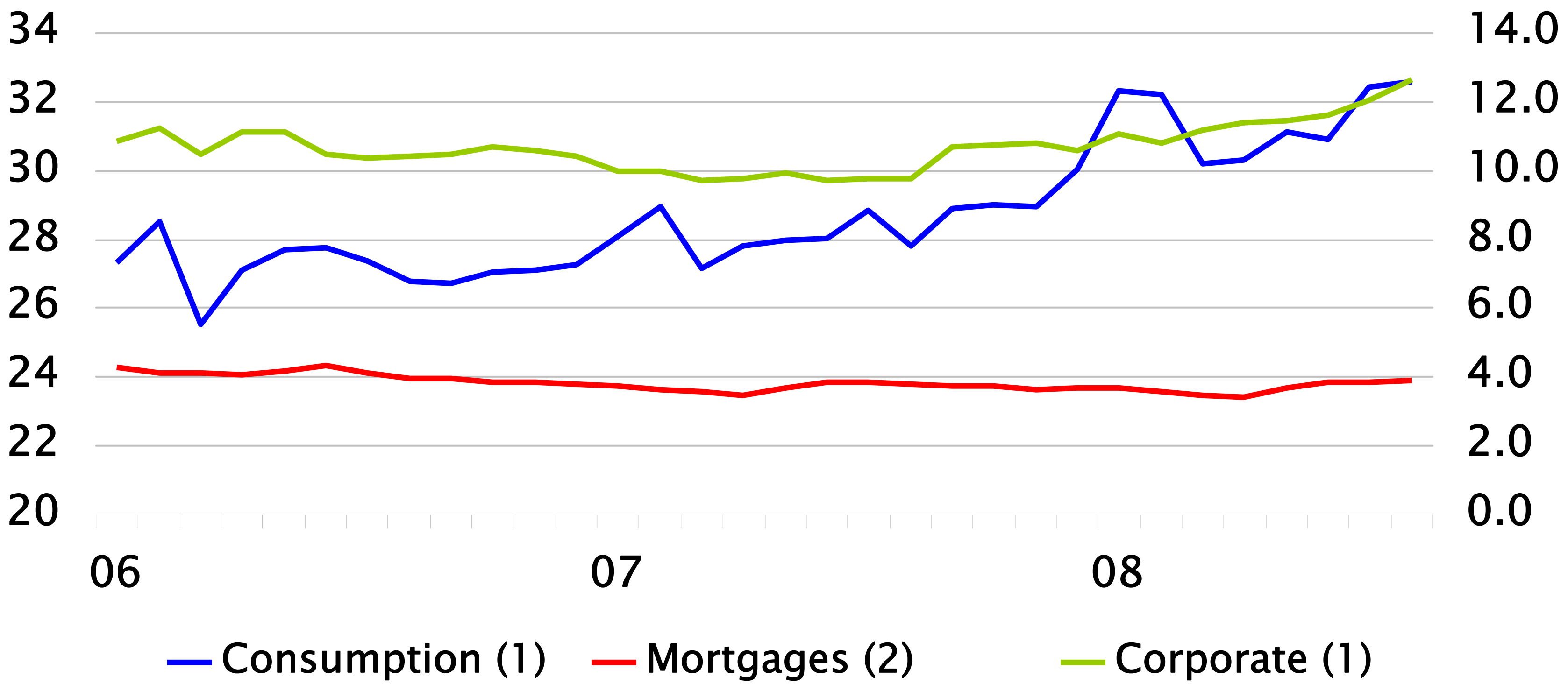


Sources: Banco Central de Chile

Neither we have observed significant increases in lending rates. At this stage, monetary policy is in a neutral phase.

Lending Rates

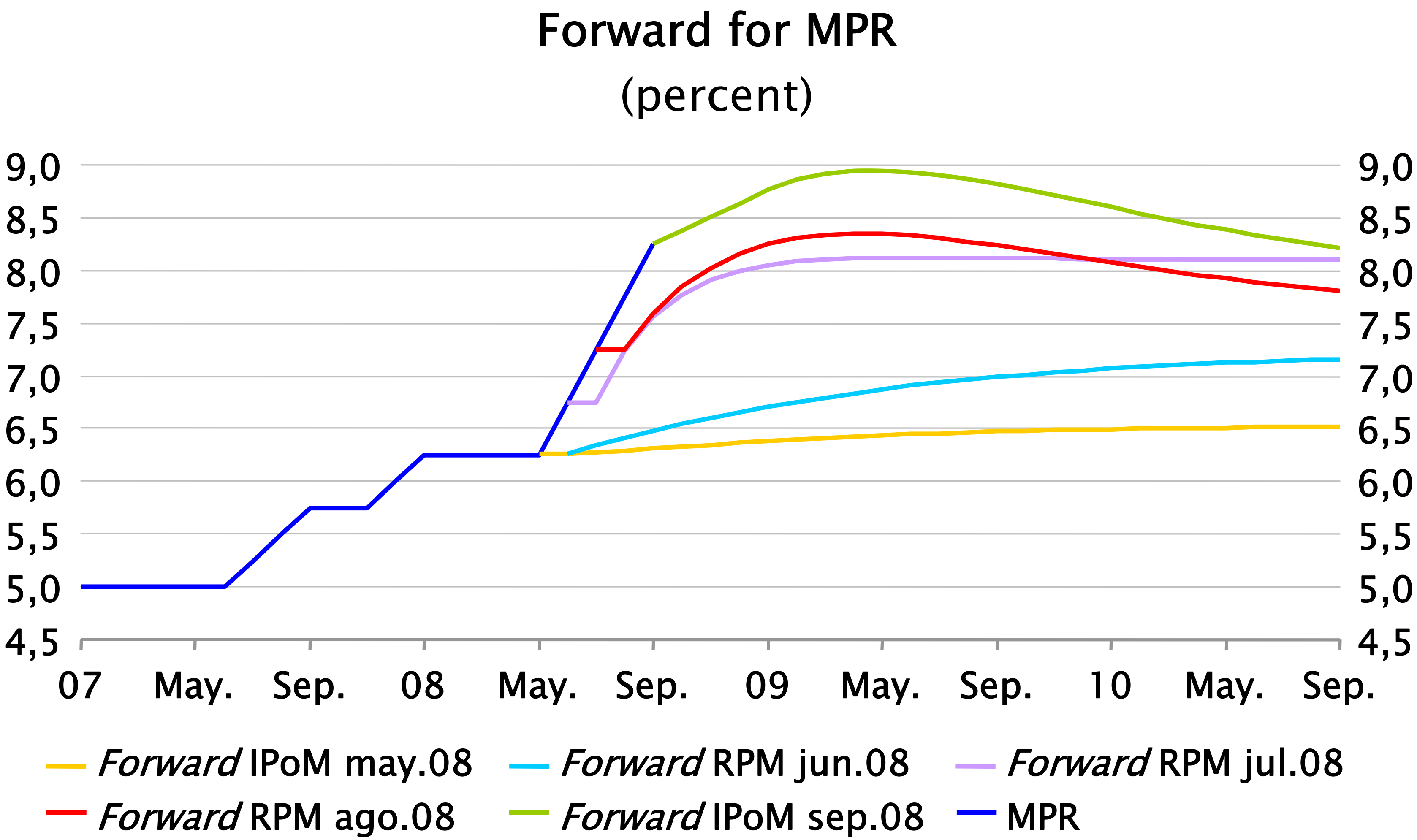
(base 360 days, percent)



(1) Weighted average nominal rates.
(2) Rate 4-5% and Duration: 5-6.

Sources: Banco Central de Chile

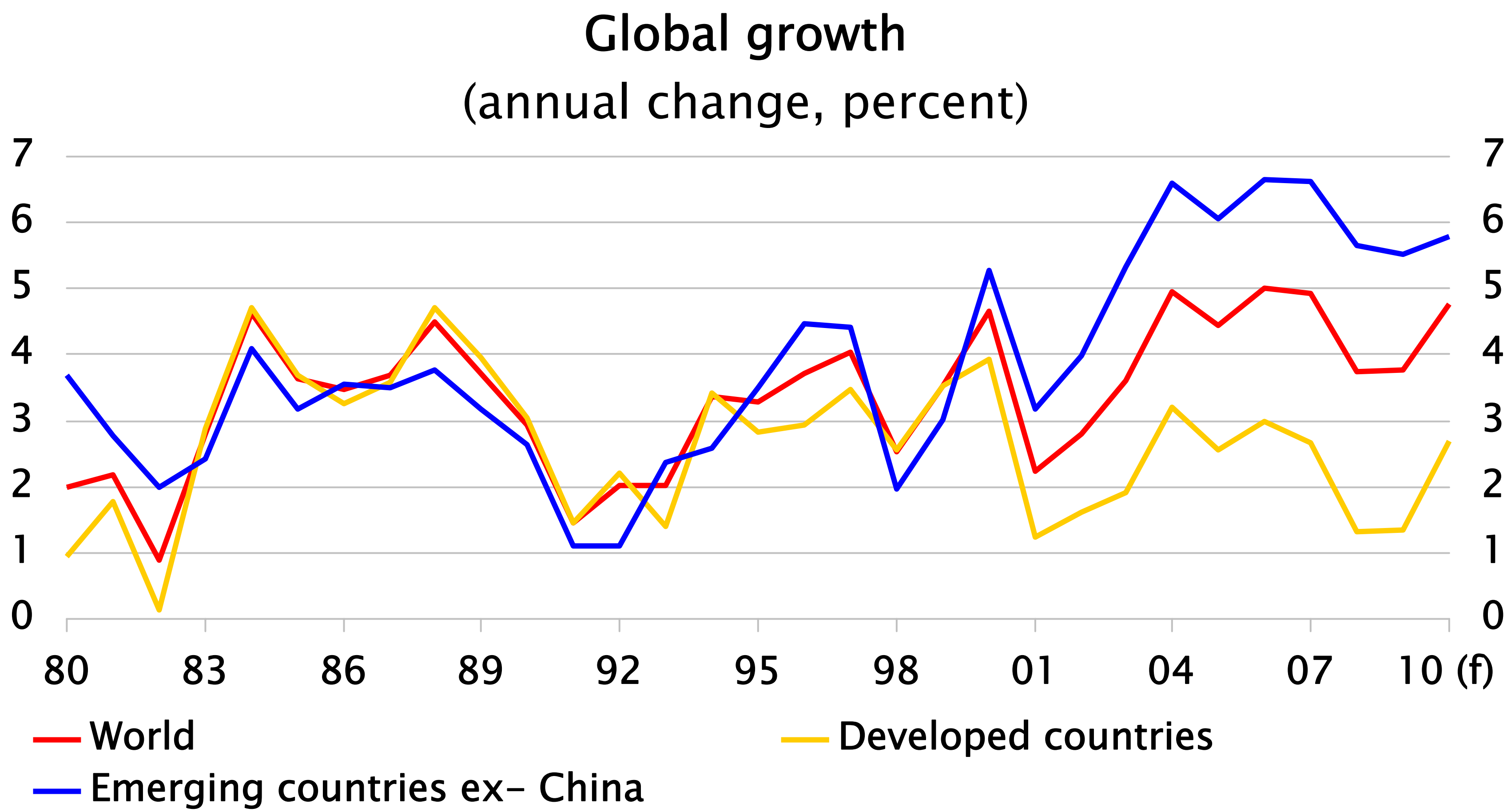
Asset prices discount further increases in monetary policy rate



Source: Banco Central de Chile

III. Baseline Scenario

Emerging markets' growth continues *surprisingly* very resilient to lower dynamism in developed countries



(f) Forecast.
(*) According to IMF.
Source: IMF.

We expect commodity prices to stay at levels similar to those currently observed

Assumptions for international scenario
(annual average)

	2007	2008 (f)		2009 (f)		2010 (f)
		IPoM May.08	IPoM Sep.08	IPoM May.08	IPoM Sep.08	IPoM Sep.08
Terms of Trade (*)	0,8	-7,2	-5,9	-8,9	-7,2	-4,3
Foreign Inflation, in US$ (*)	8,5	12,5	14,1	2,2	3,3	2,8
Copper price BML (US$cent/pound)	323	350	350	300	310	300
WTI Oil price (US$/barrel)	72	110	115	109	116	115

(f) Forecast.
(*) Annual rate of change.
Source: Banco Central de Chile.

In the domestic front, we expect a lower dynamism in activity

Forecast for GDP
(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
Total Exports	5.5	7.8	2.1	3.8
Total Imports	10.5	14.3	12.6	4.1
Current Account (% of GDP)	4.7	4.4	–1.1	–2.7

(f) Forecast.
Source: Banco Central de Chile.

In the baseline scenario, annual inflation will stay around the current level until 2009.I, reaching 3% by 2010.III.

Inflation Forecast
(annual change, percent)

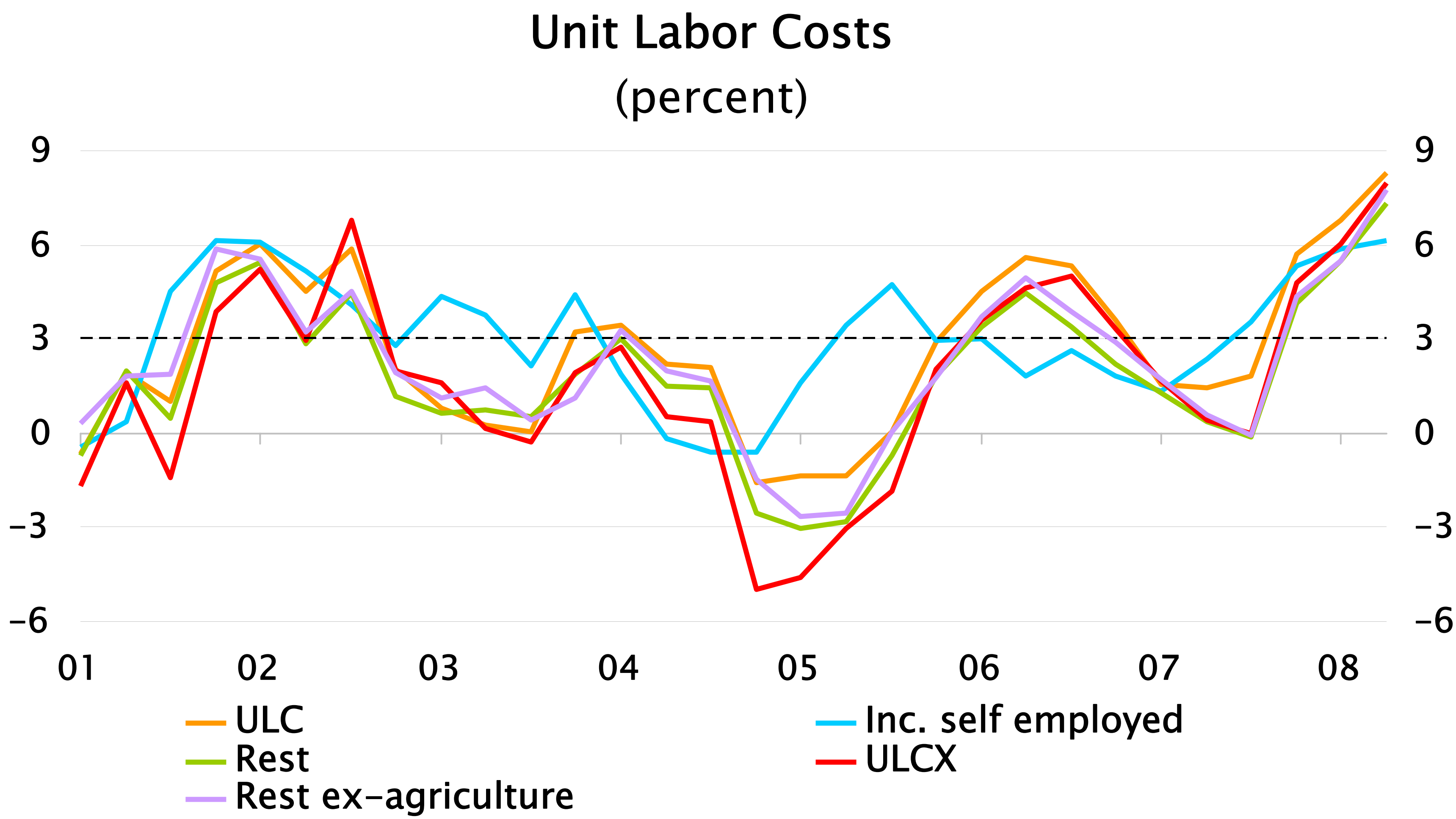
	2007	2008 (f)	2009 (f)	2010 (f)
CPI Inflation (average)	4,4	8,8	6,9	3,4
CPI Inflation (dec)	7,8	8,5	4,9	
CPI Inflation (in two years) (*)				3,0
CPIX Inflation (average)	4,0	8,2	6,5	3,6
CPIX Inflation (dec)	6,3	8,4	4,8	
CPIX Inflation (in two years) (*)				3,3
CPIX1 Inflation (average)	4,1	7,9	6,7	3,6
CPIX1 Inflation (dec)	6,3	8,5	4,8	
CPIX1 Inflation (in two years) (*)				3,4

Source: Banco Central de Chile.

This outlook for inflation is based upon a downward adjustment in the growth rate for domestic demand due to:

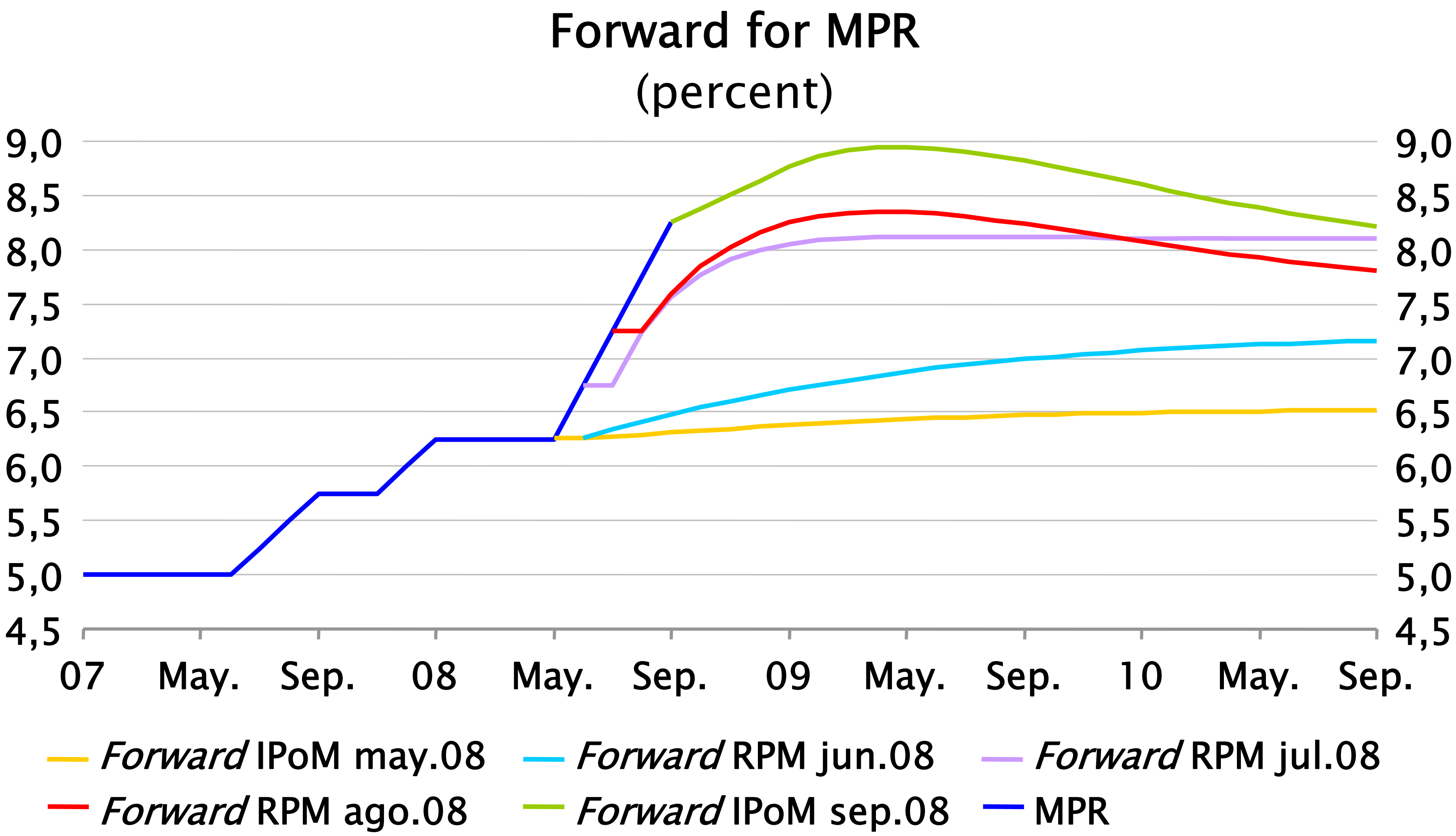
- The effects of a restrictive monetary policy.
- The normalization of the spending cycle in durable goods and some components of capital formation.
- A lower growth rate of government expenditure.
- It does not rely on a drop in energy/food prices.

We also expect inflation expectations and wage adjustments to evolve coherently with inflation convergence



Source: Banco Central de Chile and Instituto Nacional de Estadísticas.

This scenario considers a trajectory for the MPR that, in the short run, is higher than that implicit in assets prices



Source: Banco Central de Chile.

IV. Some Conclusions

- Current inflation dynamics require decisive actions from the Central Bank.

- Inflation convergence requires a lower growth rate of domestic demand.

- The BCCh will continue its process of monetary restrictiveness until the convergence process to 3% in 2 years is safeguarded.

- The baseline scenario is subject to significant uncertainty, specially on the external front.

- The balance of risks to global growth is tilted to the downside. Also, Chile has strong fundamentals, but there is a risk of further restrictions to access global financial markets. The optimal monetary policy response to these alternatives is not obvious. The bank will evaluate them and act accordingly.

- However, either scenario provides the adequate framework for inflation convergence.