



Current Developments in the Chilean Economy

Central Bank of Chile

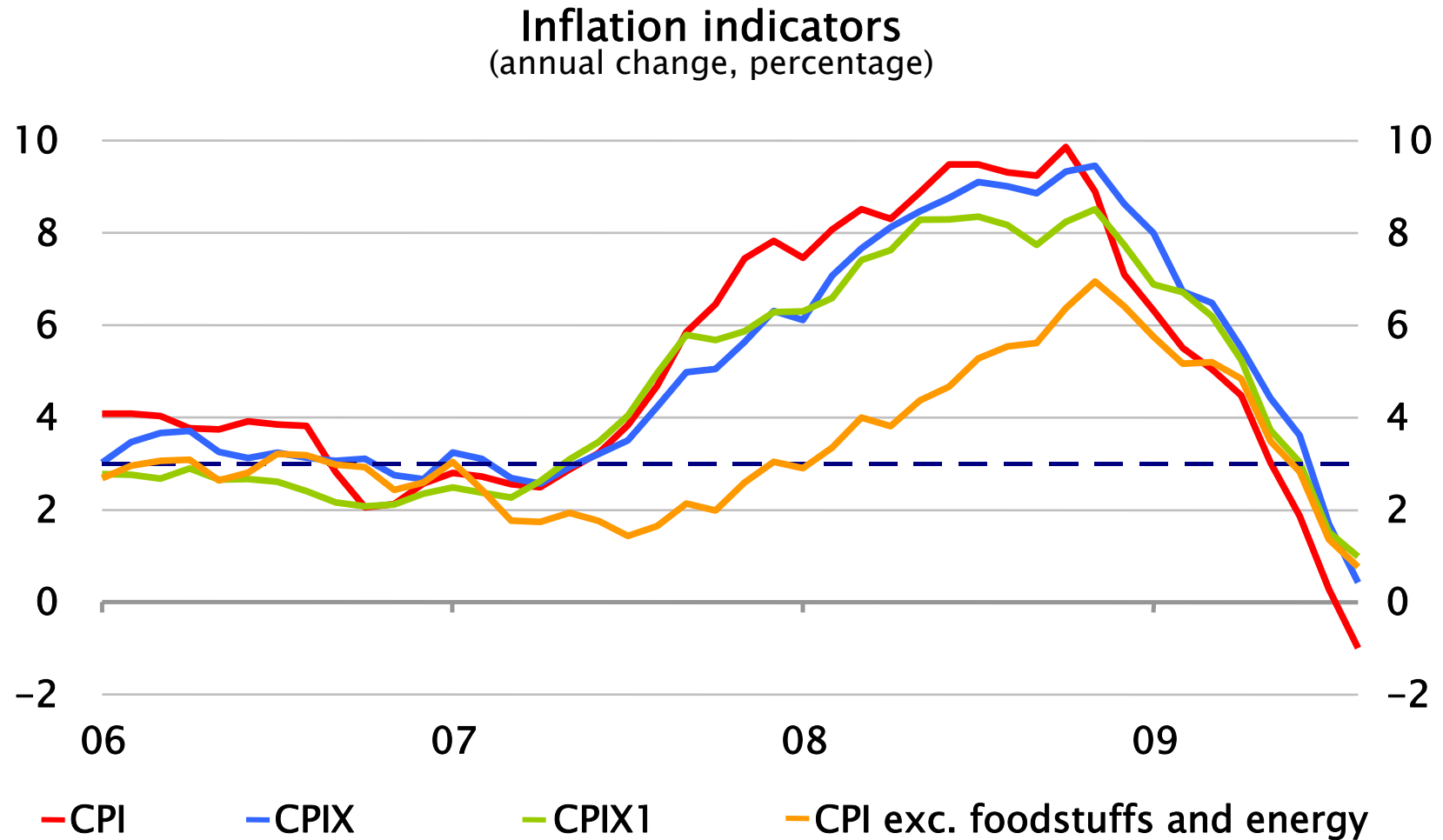


The inflationary pressures facing the Chilean economy have decreased significantly during this year.

- Second-quarter output deteriorated beyond projections and widened the output gap. However, economic activity has recently been showing signs of stabilization and even growth.
- Y-o-y inflation in Chile has declined rapidly and will be in negative territory for the rest of 2009.
- Monetary policy has reacted strongly, taking a very expansionary instance.
- The gradual recovery of confidence, the improvement of the external outlook, together with the unprecedented boost currently being provided by Chile's monetary and fiscal policies, will allow, in the most likely scenario, for a rebound of output and demand.



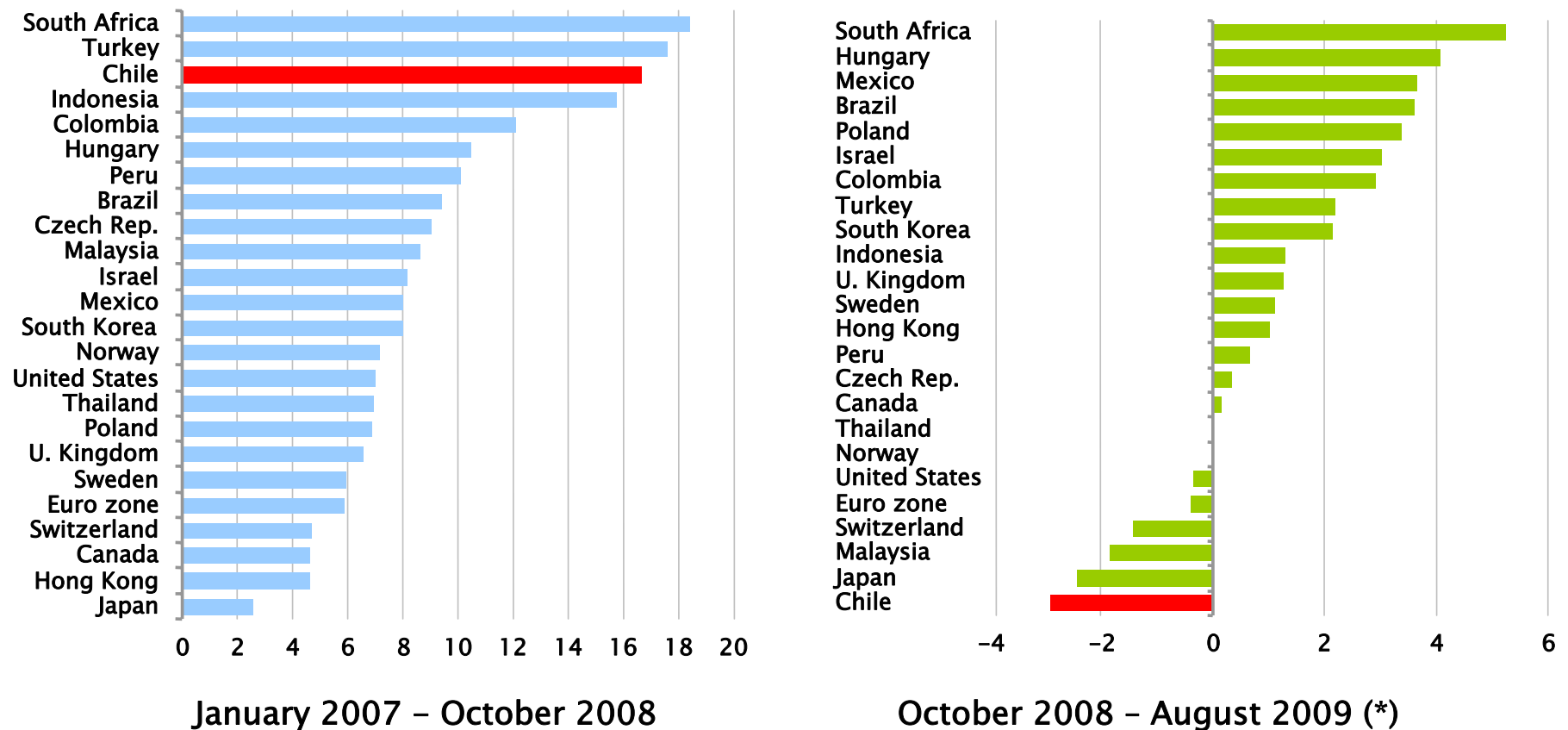
The drop in both headline and core inflation has been faster and stronger than forecast.





The fast decrease in Chile's inflation rate reflects the high degree of transmission from changes in external prices into the domestic market.

Accumulated CPI change (percentage)



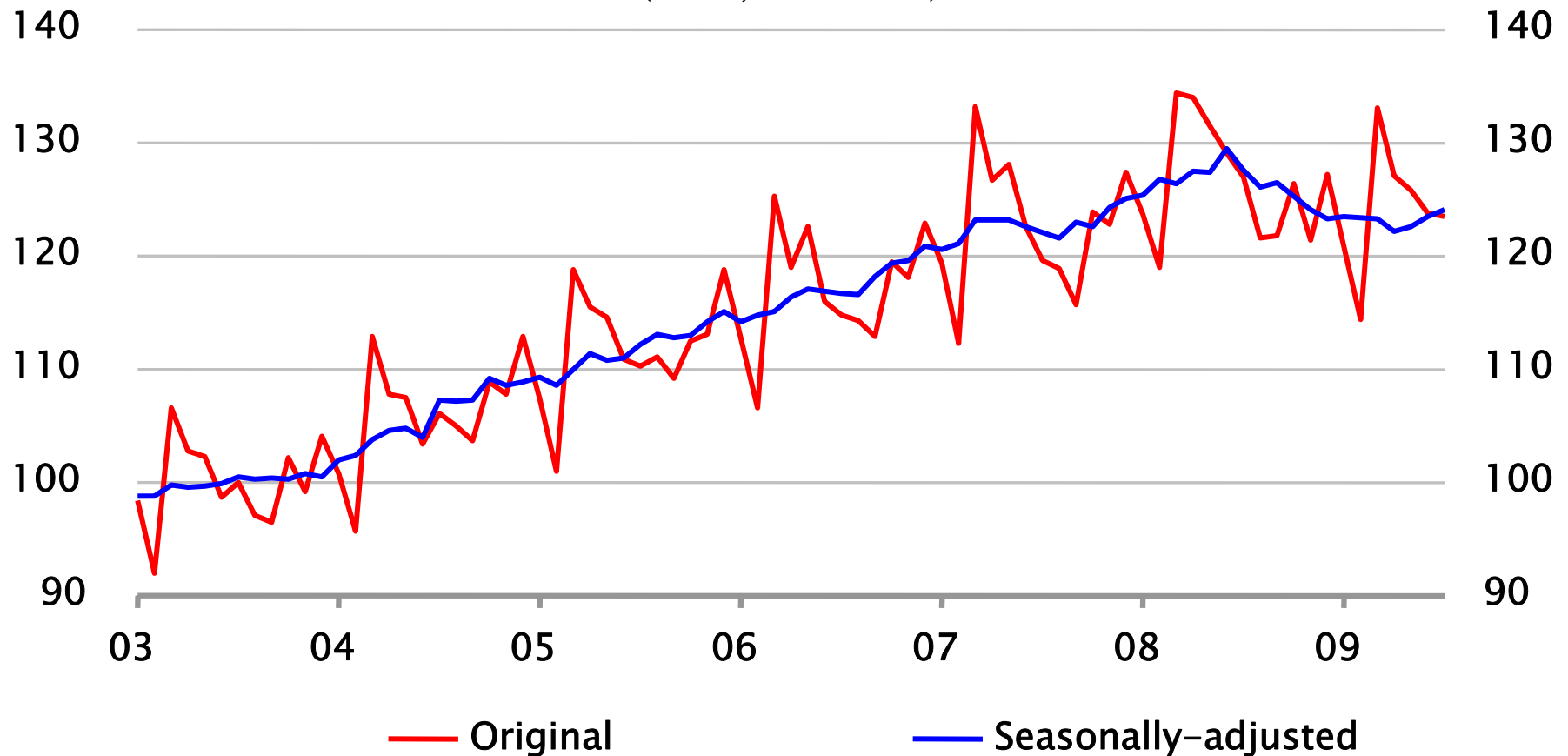
(*) July figures for Canada, Colombia, Hong Kong, Hungary, Japan and South Africa.
Sources: Statistics bureaus at each country and Bloomberg.



Chile's drop in economic activity has widened the output gap. Nonetheless, recent data is showing signs of stabilization and even growth.

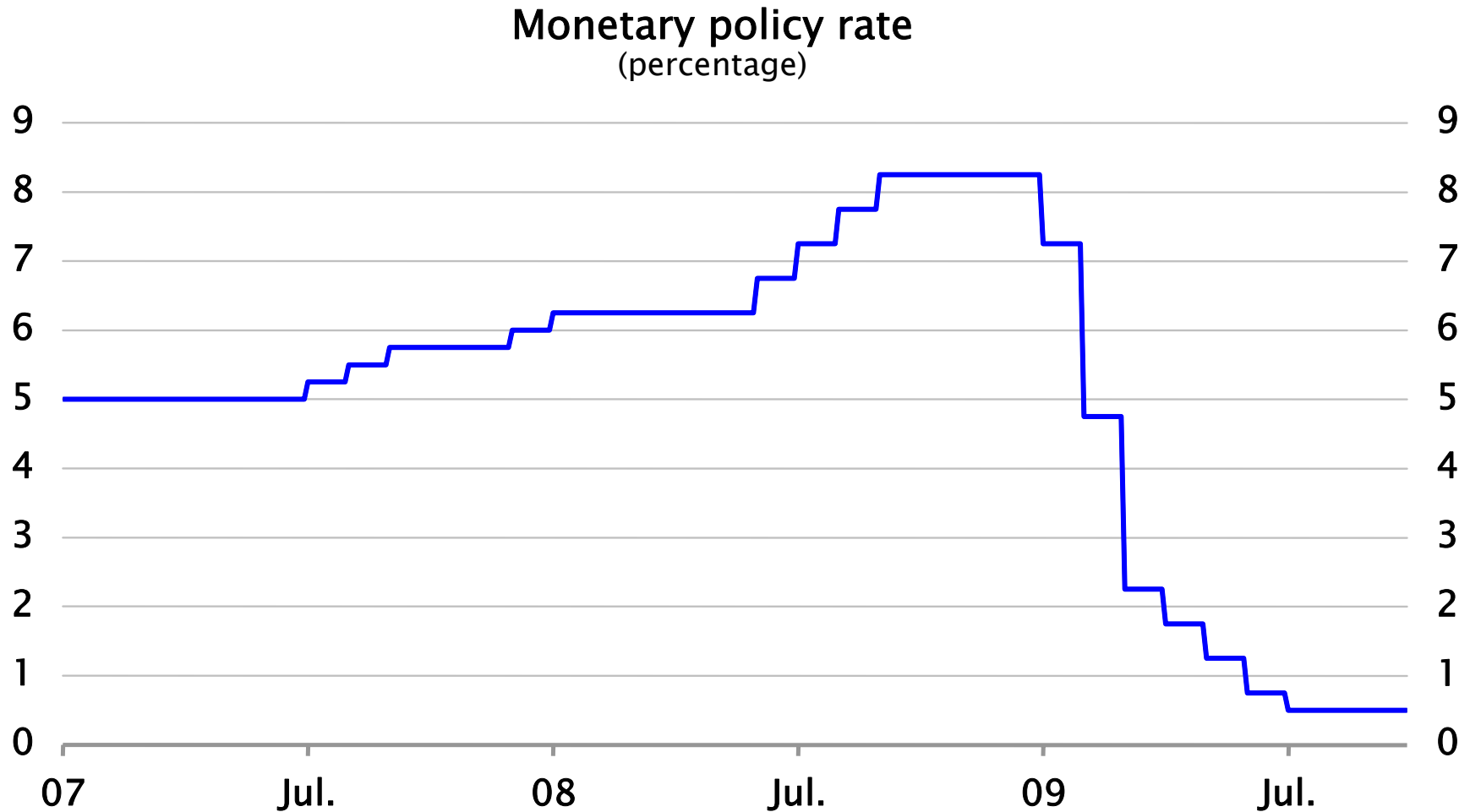
Monthly index of economic activity (Imacec)

(Index, 2003=100)





The Board increased the monetary stimulus bringing the MPR to its minimum level, 0.5%, and stated that it will keep it there for a prolonged period of time.



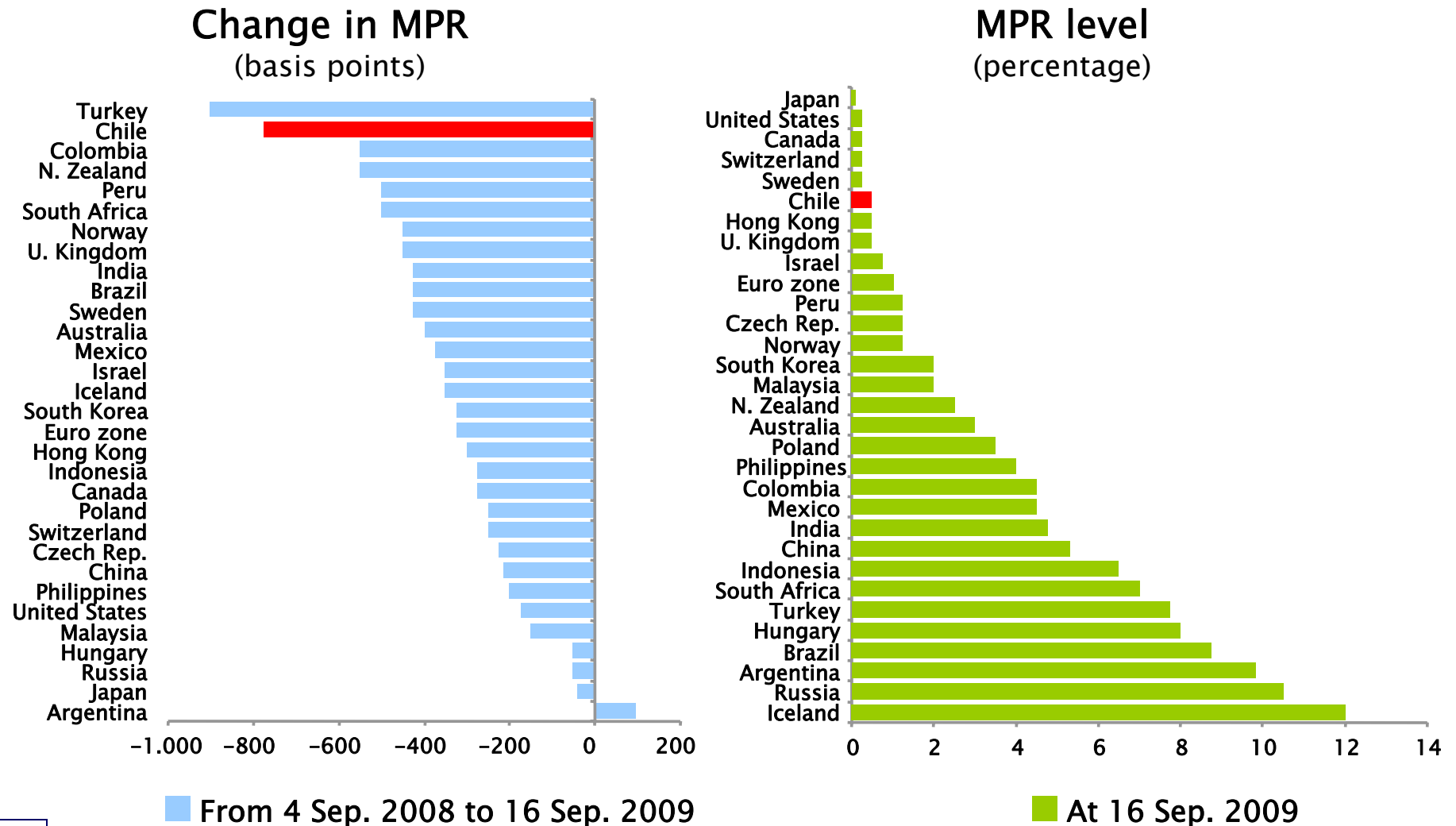


To reinforce this decision and align financial asset prices with the path of monetary policy, the Board decided to implement complementary monetary policy measures.

- To establish a term liquidity facility (Facilidad de Liquidez a Plazo, FLAP) for banking institutions, whereby it will grant 90– and 180–day liquidity at the prevailing level of the monetary policy rate.
- To adjust the program of Central Bank note issuance at maturities below one year, in consistency with the aforesaid decision.
- To suspend, for the rest of 2009, the issuance of debt instruments maturing in or after one year, corresponding to two–year Central Bank peso–denominated bonds (BCP–2) and one–year Central Bank notes (PDBC–360).



Chile's MPR is among the lowest compared to other economies.

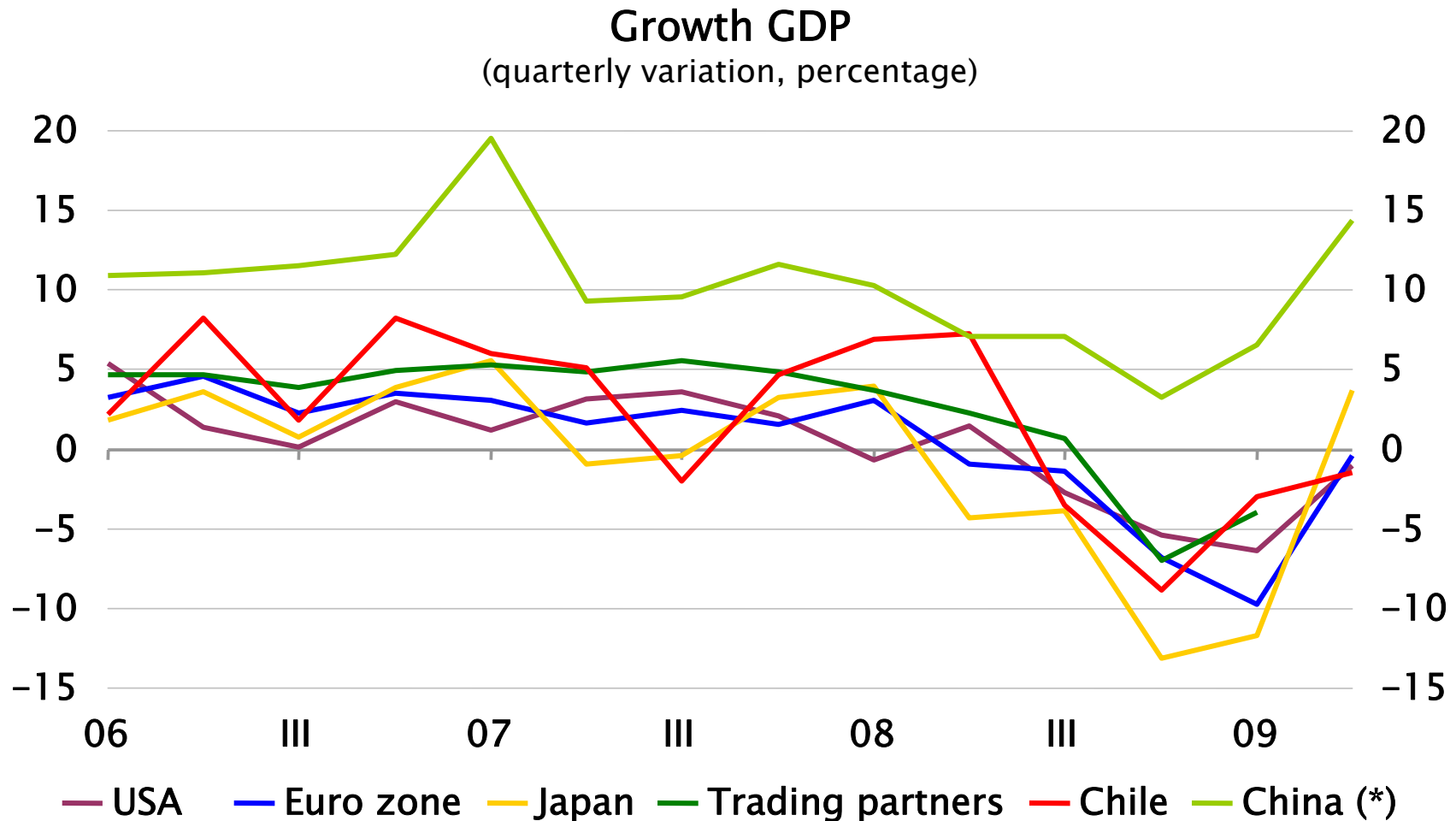




Macroeconomic Scenario



The world economic is showing signs of stabilization, after a deep contraction in the first quarter in a large numbers of countries.



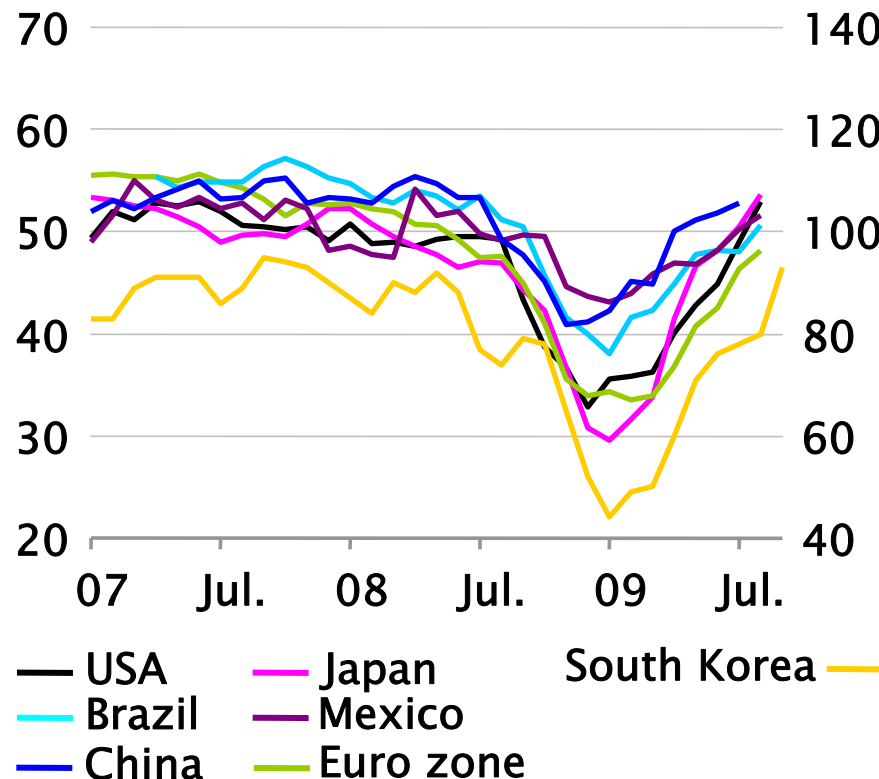
(*) Estimated using annual change.

Sources: Central Bank of Chile and Bloomberg.

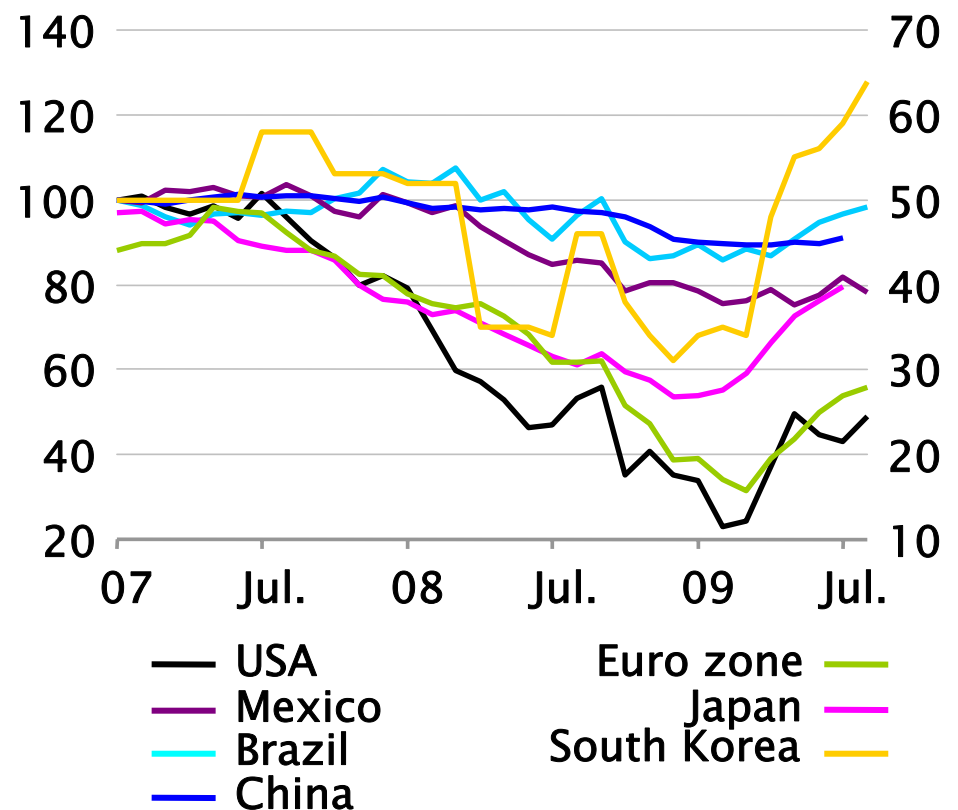


World economic outlook shows there is progressive dissipation of the sudden and deep uncertainty that affected households and firms in late 2008.

Manufacturing PMI (1)
(perception index, percentage)



Consumer confidence (2)
(perception index, percentage)



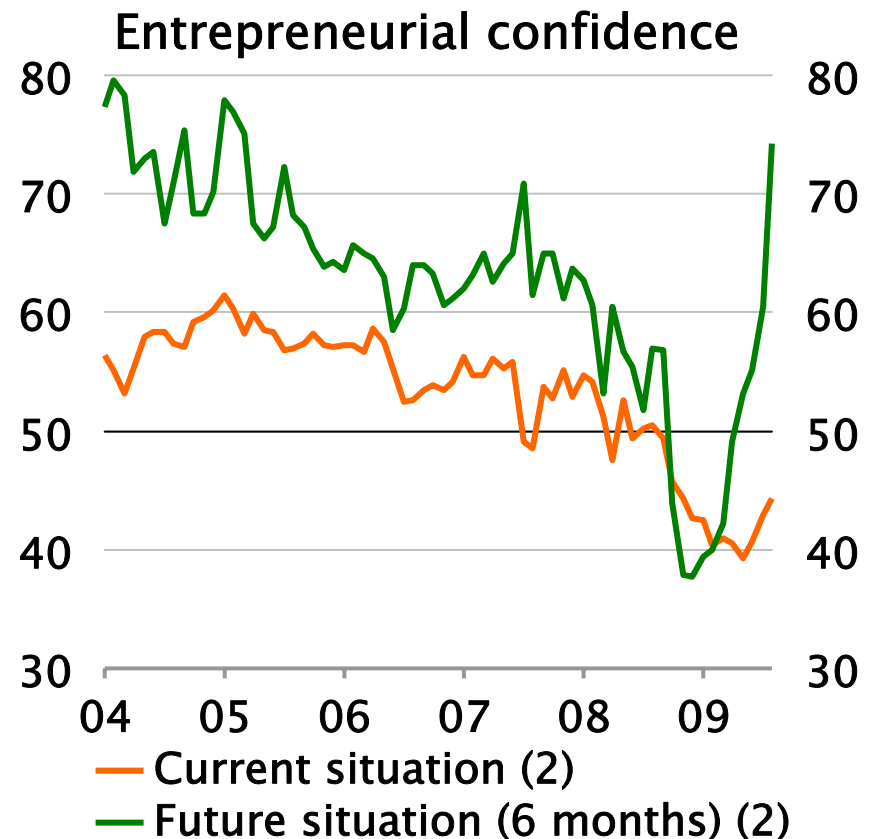
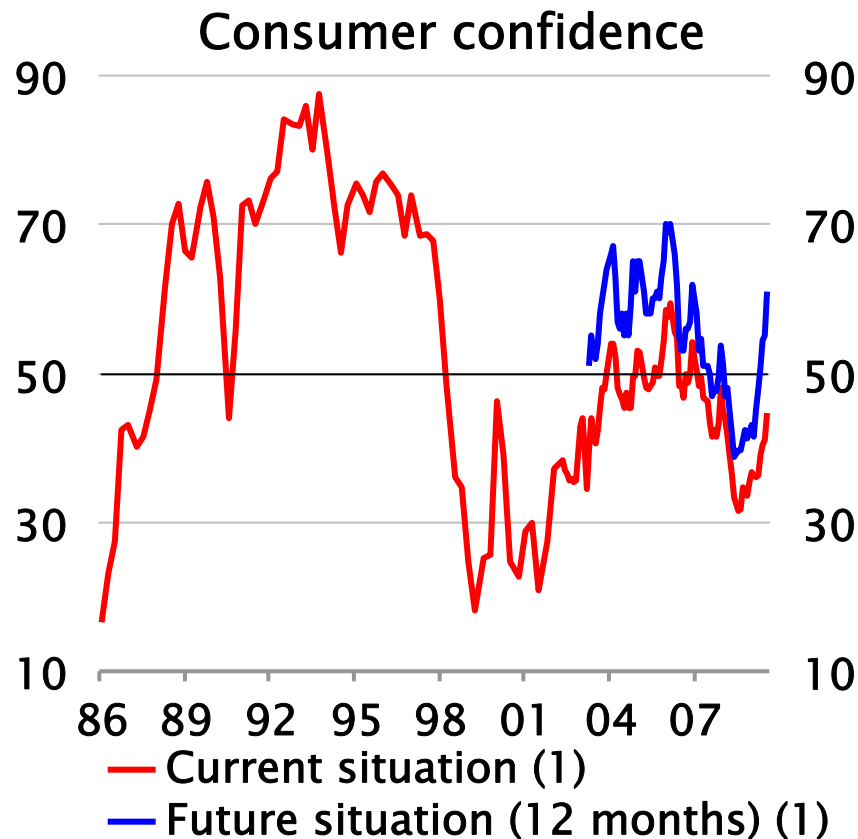
(1) South Korea is anchored at 100, the rest are at 50. (2) Series for Japan, South Korea and the Euro zone are anchored at 50. The rest of the series are indexed based on January 2007=100.

Source: Bloomberg.



In Chile, expectations of both individuals and businesses have improved, particularly the perception of future activity.

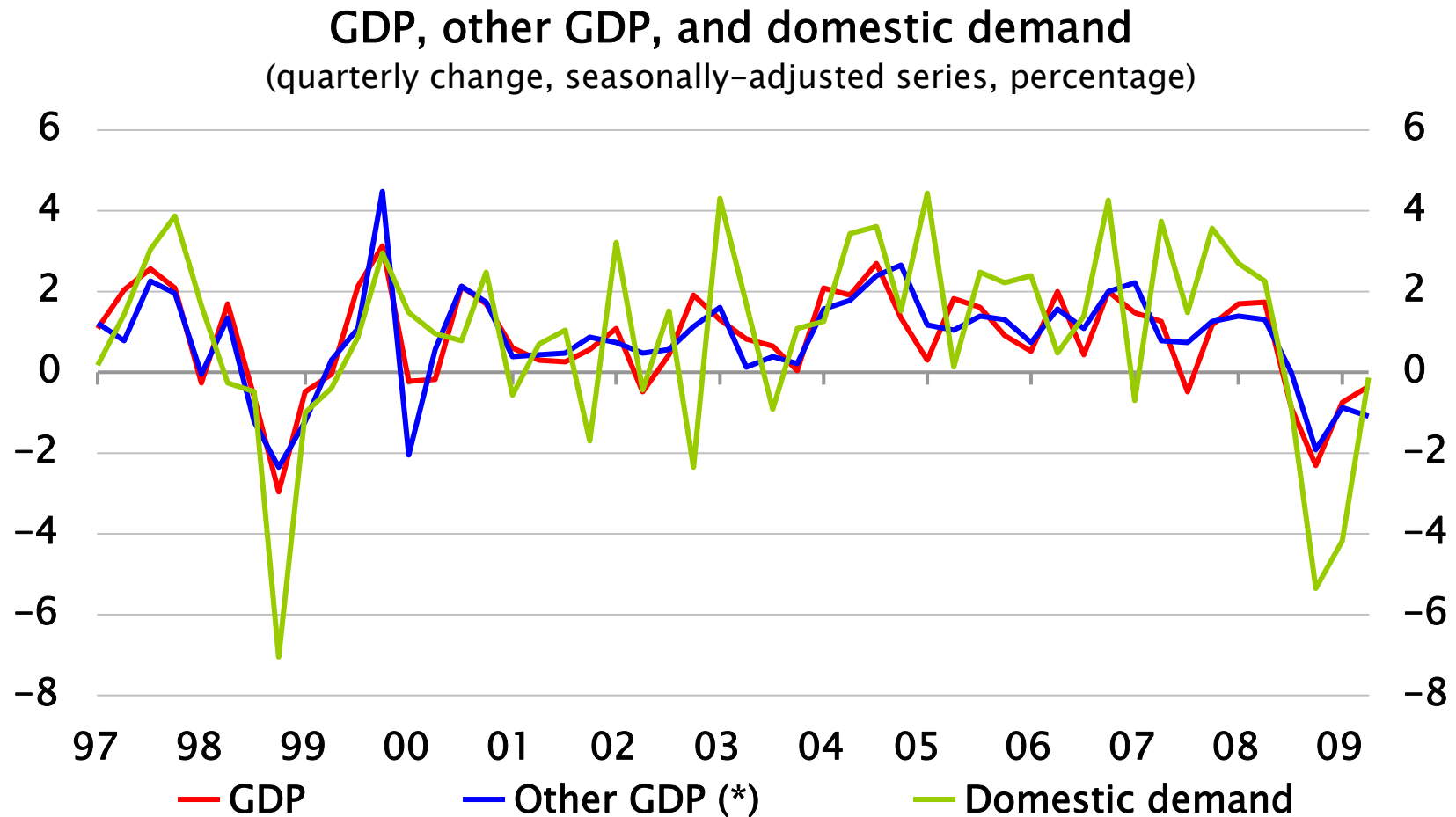
Perception index



(1) A value above (below) 50 points indicates optimism (pessimism). Prior to January 2003, the index was quarterly; since that date, it is published monthly. (2) A value above (below) 50 points indicates positive (negative) expectations. Sources: Adimark and ICARE/Universidad Adolfo Ibáñez.



Domestically, output still fell in the second-quarter, although at decreasing rates. Domestic demand decline has stopped.

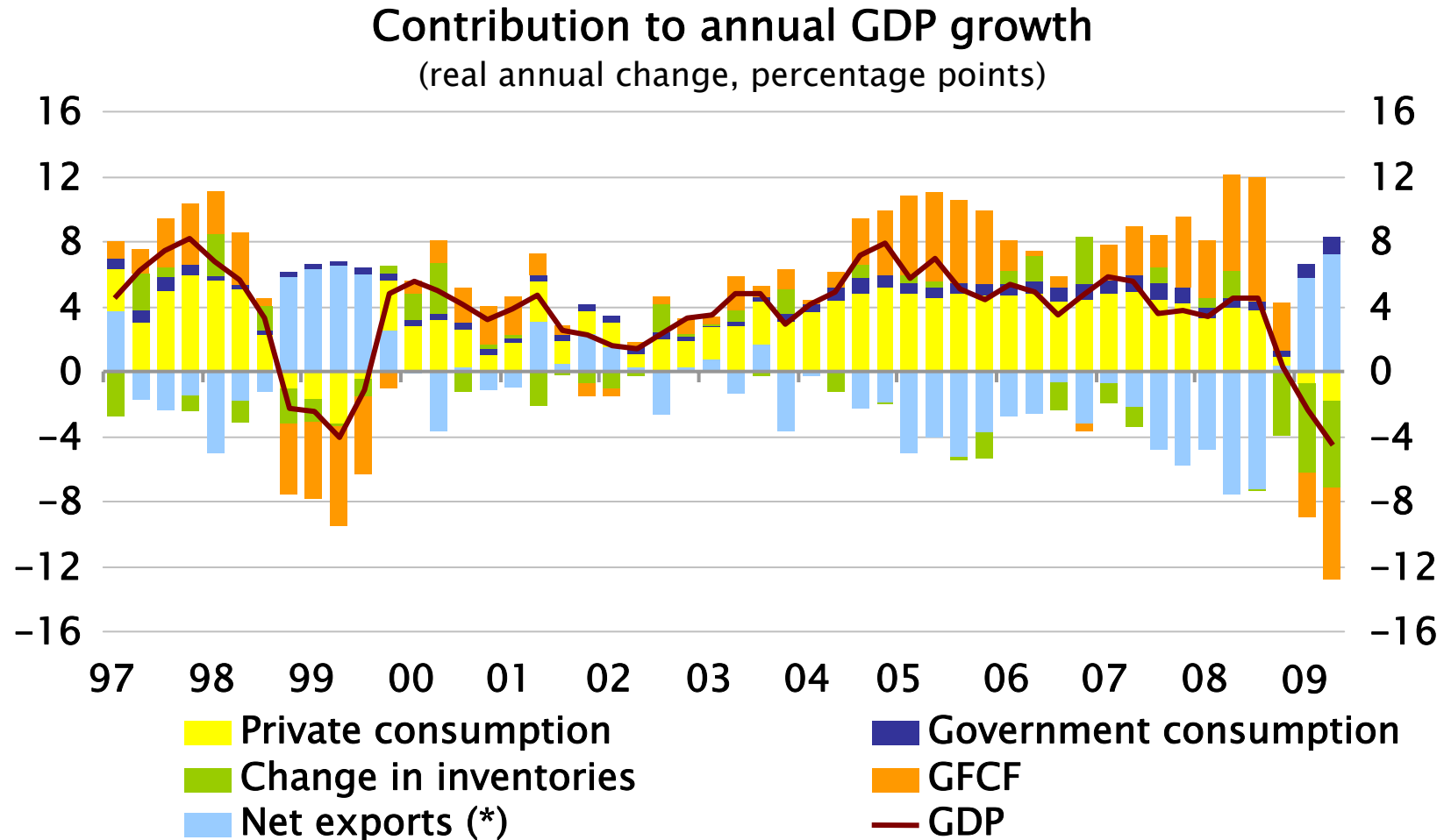


(*) Includes the following sectors: agriculture, livestock, and forestry; manufacturing; construction; retail; transport and communications; financial and business services; home ownership; personal services; and public administration.

Source: Central Bank of Chile.



The decrease in investment and a substantial inventory depletion has explained part of the contraction of demand.



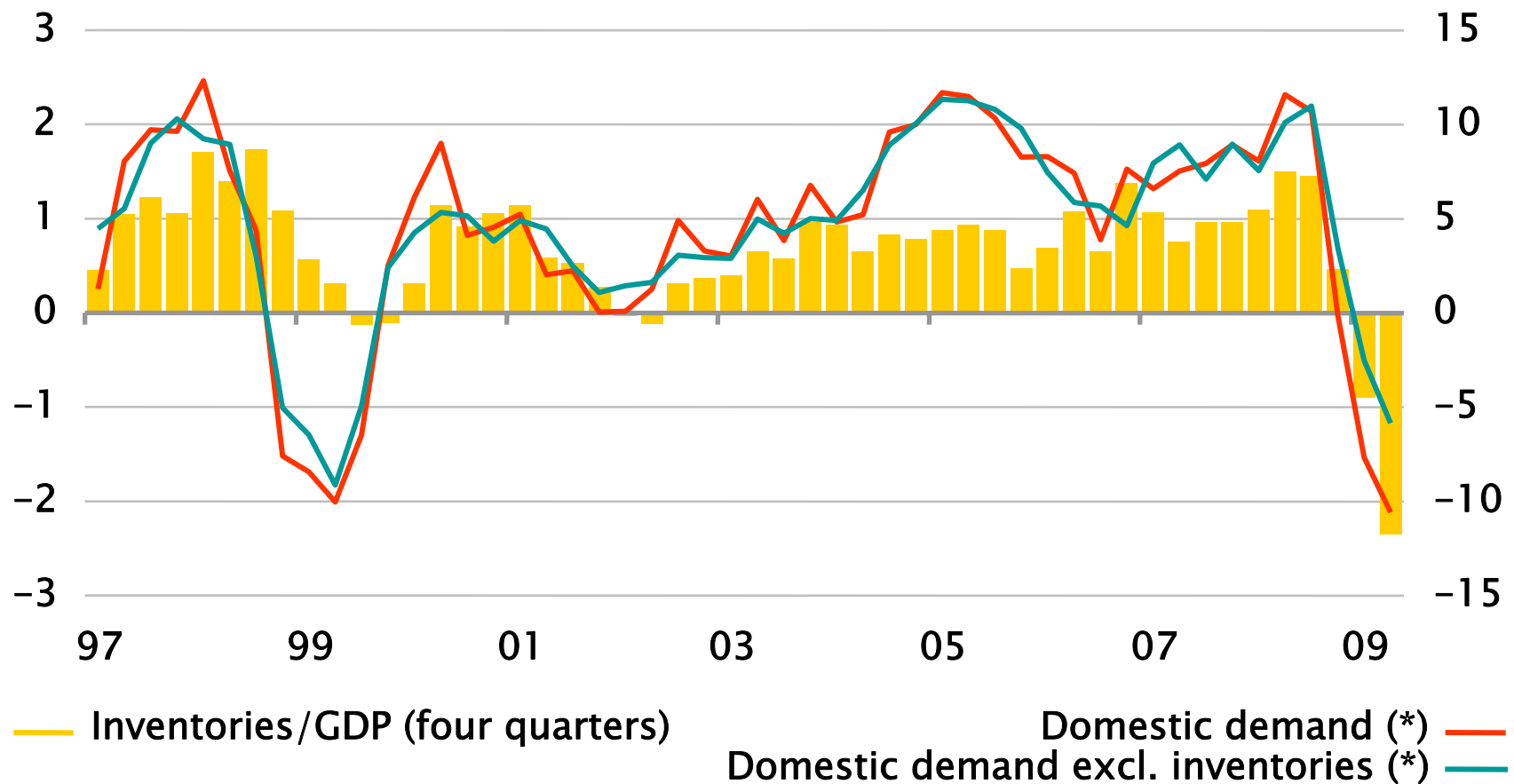
(*) Goods and services exports minus goods and services imports.

Source: Central Bank of Chile.



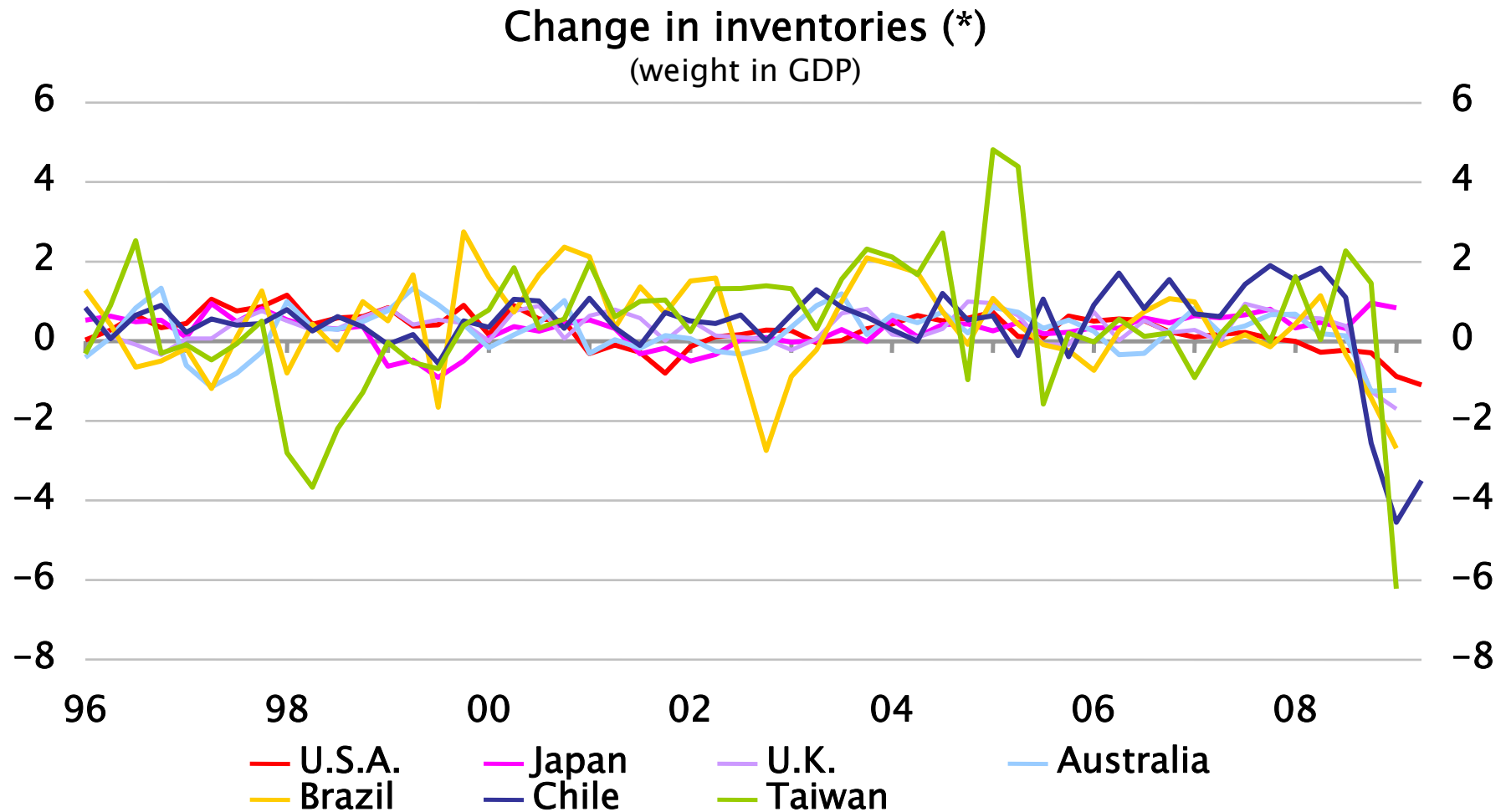
What happened to inventories is an unusual phenomenon, which can be explained by the strong uncertainty installed in late 2008.

Change in inventories over GDP and Domestic Demand
(percentage)





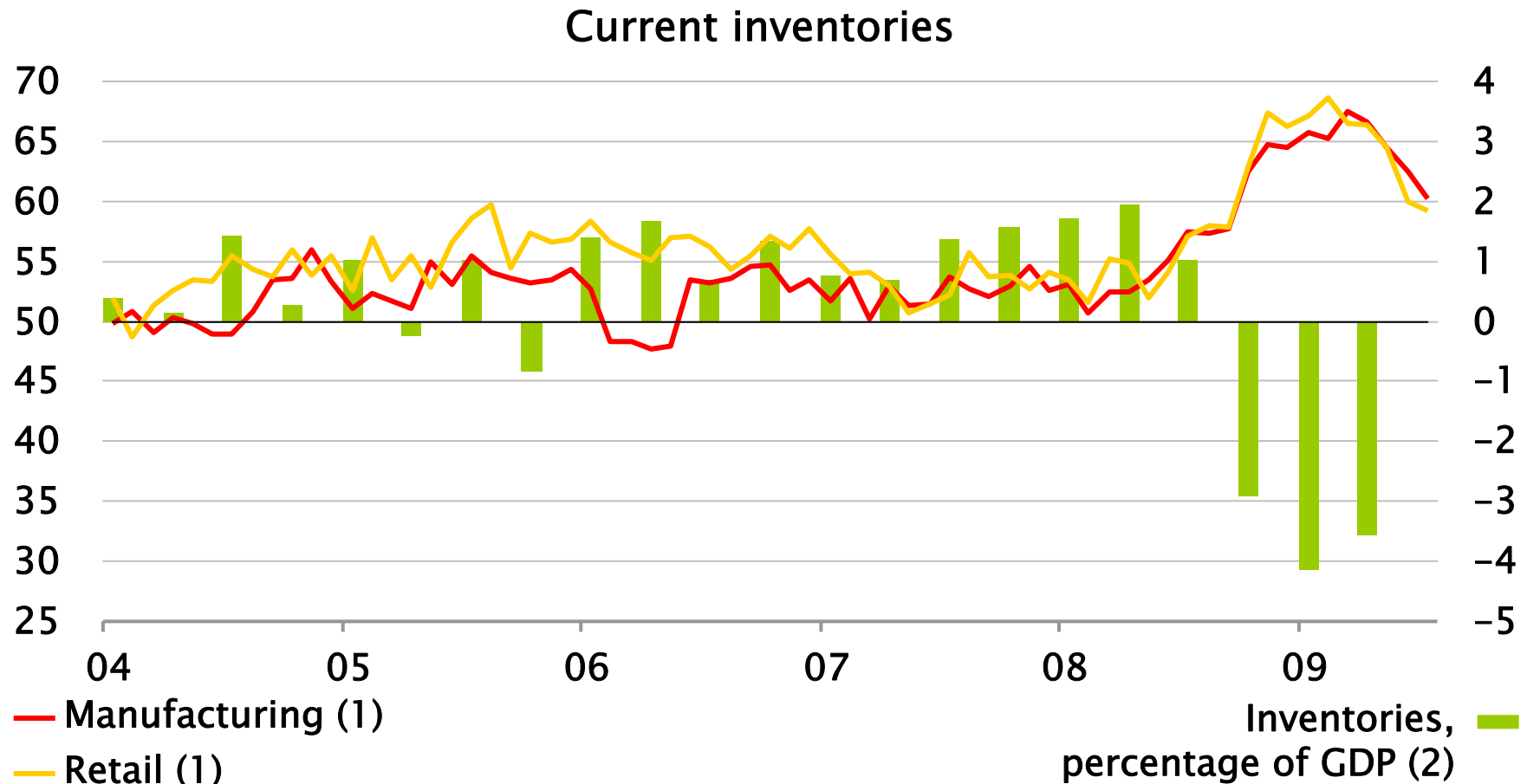
But, this has happened not only in the Chilean economy.



(*) Seasonally-adjusted series.
Source: CEIC Data.



In recent months, the perception of excessive inventories has tended to decrease gradually.

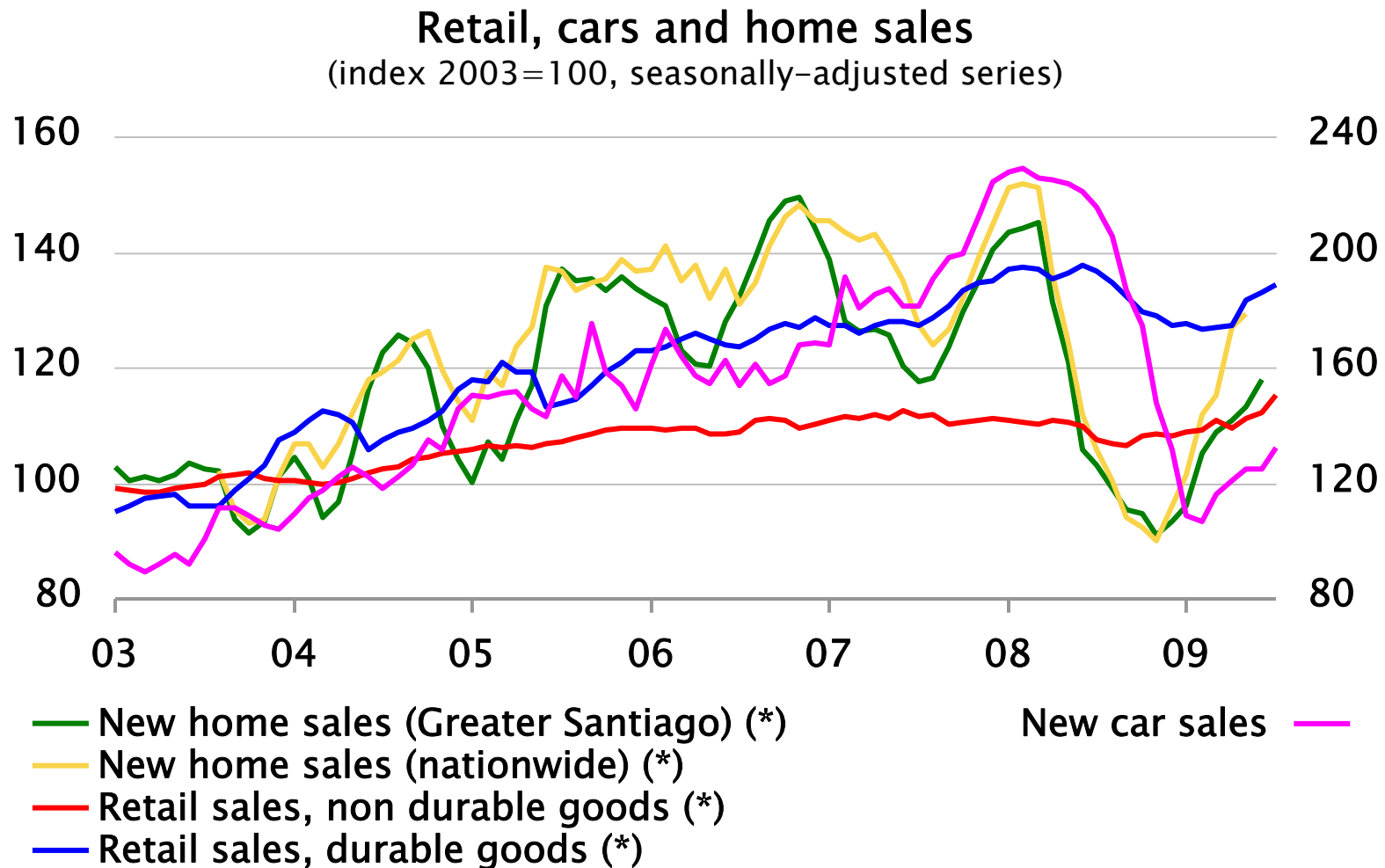


(1) A value over (under) 50 points indicates an excessive (inadequate) level. (2) Quarterly, seasonally- adjusted serie.

Sources: Central Bank of Chile and ICARE/Universidad Adolfo Ibáñez.



This is also evidenced in durable goods and new home sales, which even show slight reversals.

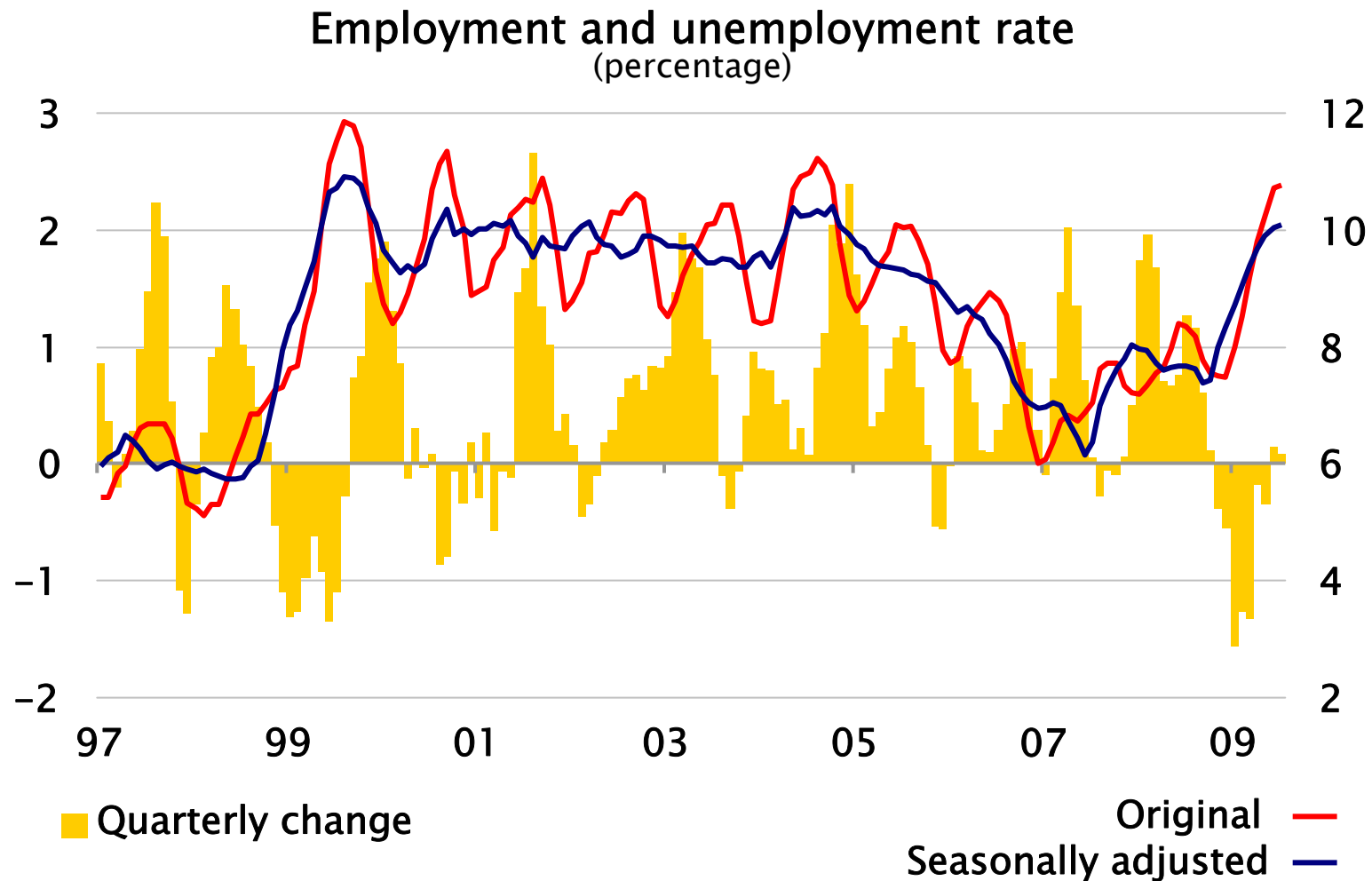


(*) Sold during the moving quarter.

Sources: National Association of Car Dealers (ANAC), Central Bank of Chile, Chilean Chamber of Builders (CChC) and National Chamber of Commerce (CNC).

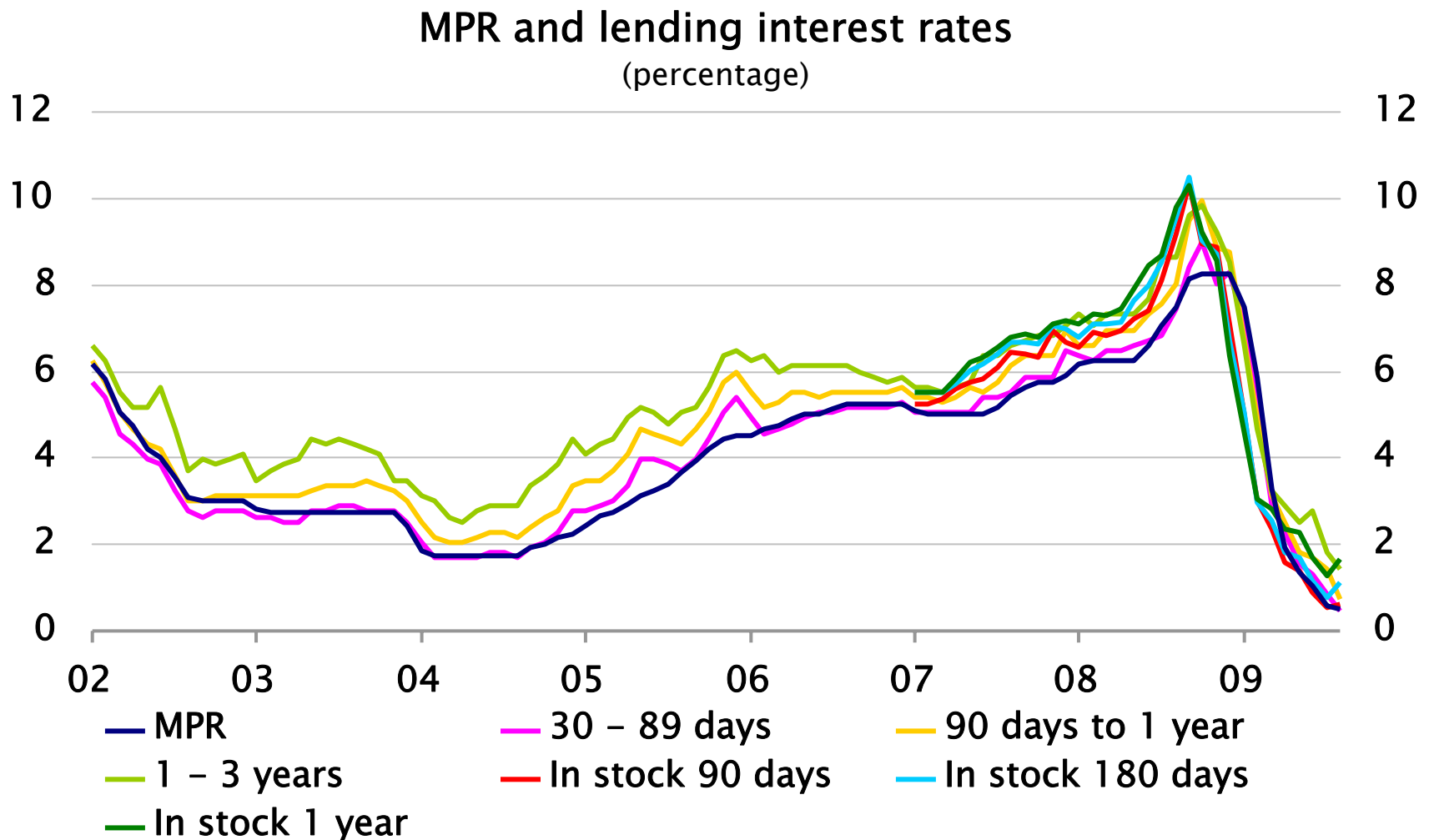


The labor market has deteriorated over the year, although recent figures show that employment has stopped falling and rising unemployment eased.





The cost of funding of Chilean banks has dropped significantly because of the powerful monetary stimulus and lower risk premiums in the world.





Lending rates have also fallen from their highs in late 2008 and early 2009.

Movements in interest rates since July 2008

(percentage; basis points)

	Jul.2008 (a)	Average Oct– Dec.2008 (b)	Current (c) (1)	Gap (c) – (a) (basis points)	Gap (c) – (b) (basis points)
MPR	7.25	8.25	0.50	–675	–775
Lending rates (2)					
Consumer	31.2	36.2	24.6	–667	–1166
Commercial	11.4	15.1	6.0	–544	–907
Loan rates					
30–89 days	6.8	8.4	0.5	–636	–796
90 days to 1 year	7.6	9.2	0.7	–684	–848
1 – 3 years	8.6	9.2	1.4	–720	–776
Lending rates (3)					
Consumer from 181 days to 1 year	37.7	40.4	35.3	–246	–510
Consumer over 3 years	30.0	35.9	21.5	–845	–1437
Commercial less than 30 days	9.7	13.5	4.9	–480	–865
Commercial from 181 days to 1 year	13.0	14.5	7.8	–514	–667
Mortgage	4.9	5.6	4.6	–31	–104

(1) August 2009. (2) Weighted averages. (3) Consumer and commercial interest rates are nominal. The housing credits are in UF.

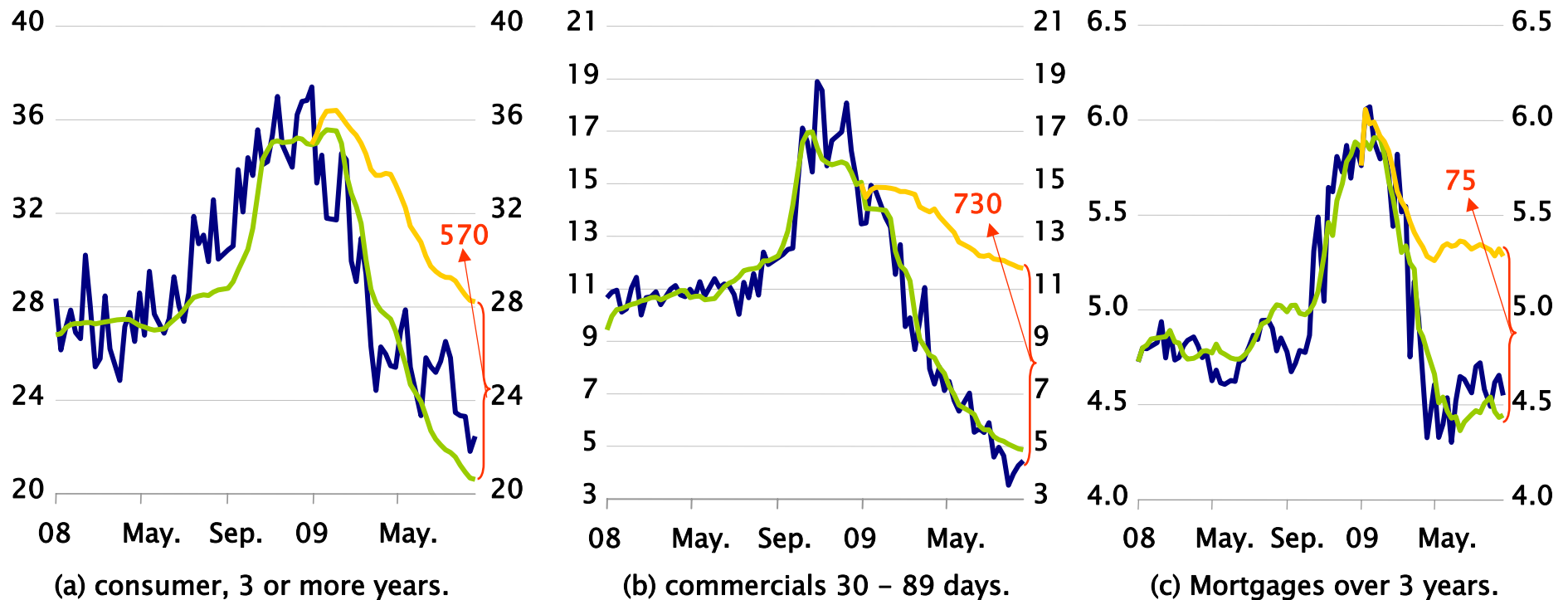
Source: Central Bank of Chile.



The action of monetary policy has been decisive in lowering interest rates.

Interest rates

(weekly data, percentage)



— Cash value

— Estimated value (1)

— MPR (January) (2)

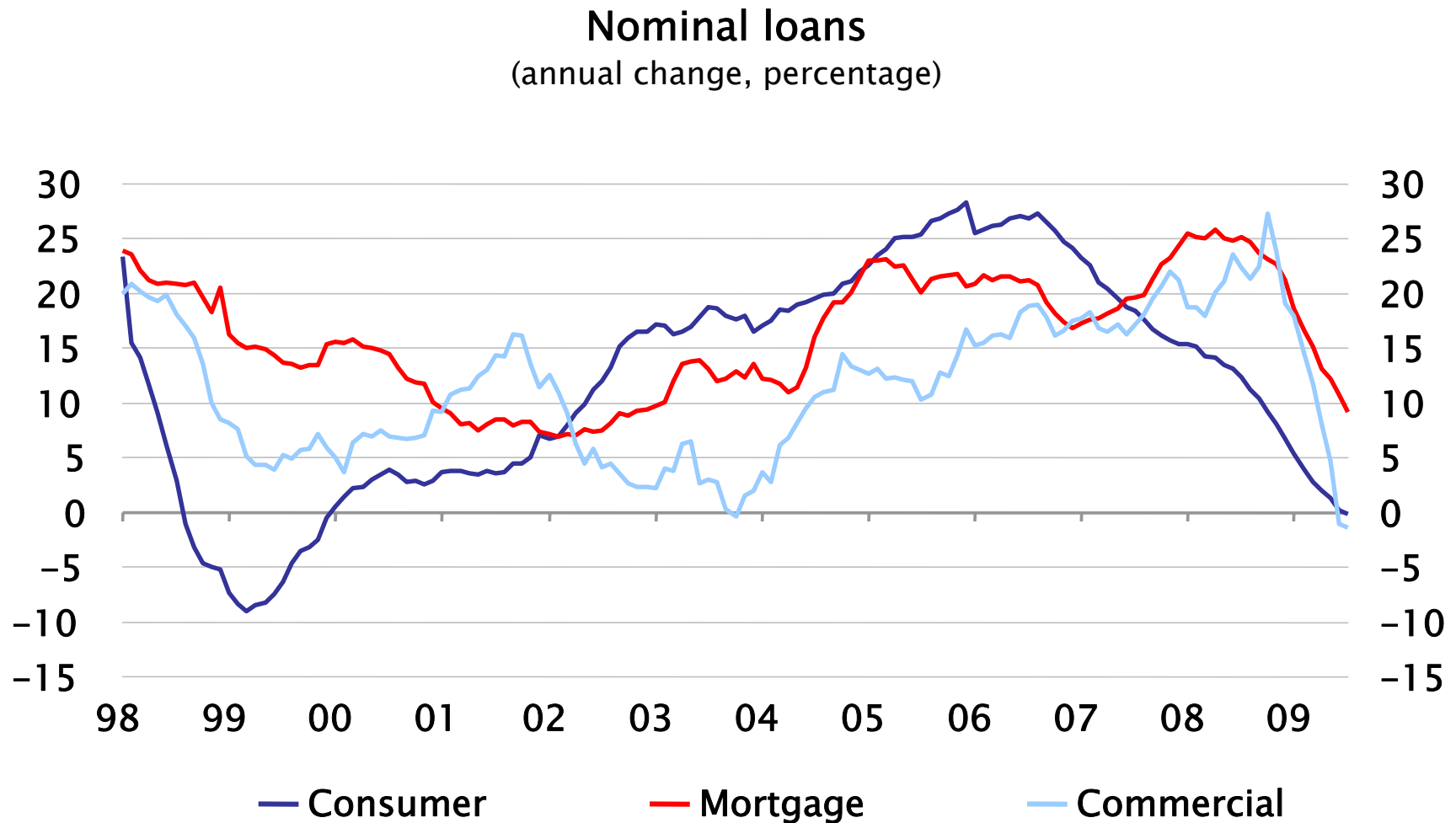
(1) Correspond to the levels of lending rates according to the Becerra *et al.* model.

(2) Estimated level at which the lending rates would be, if the TPM had been kept at 8.25%

Sources: Central Bank of Chile and Becerra *et al.* (2009).



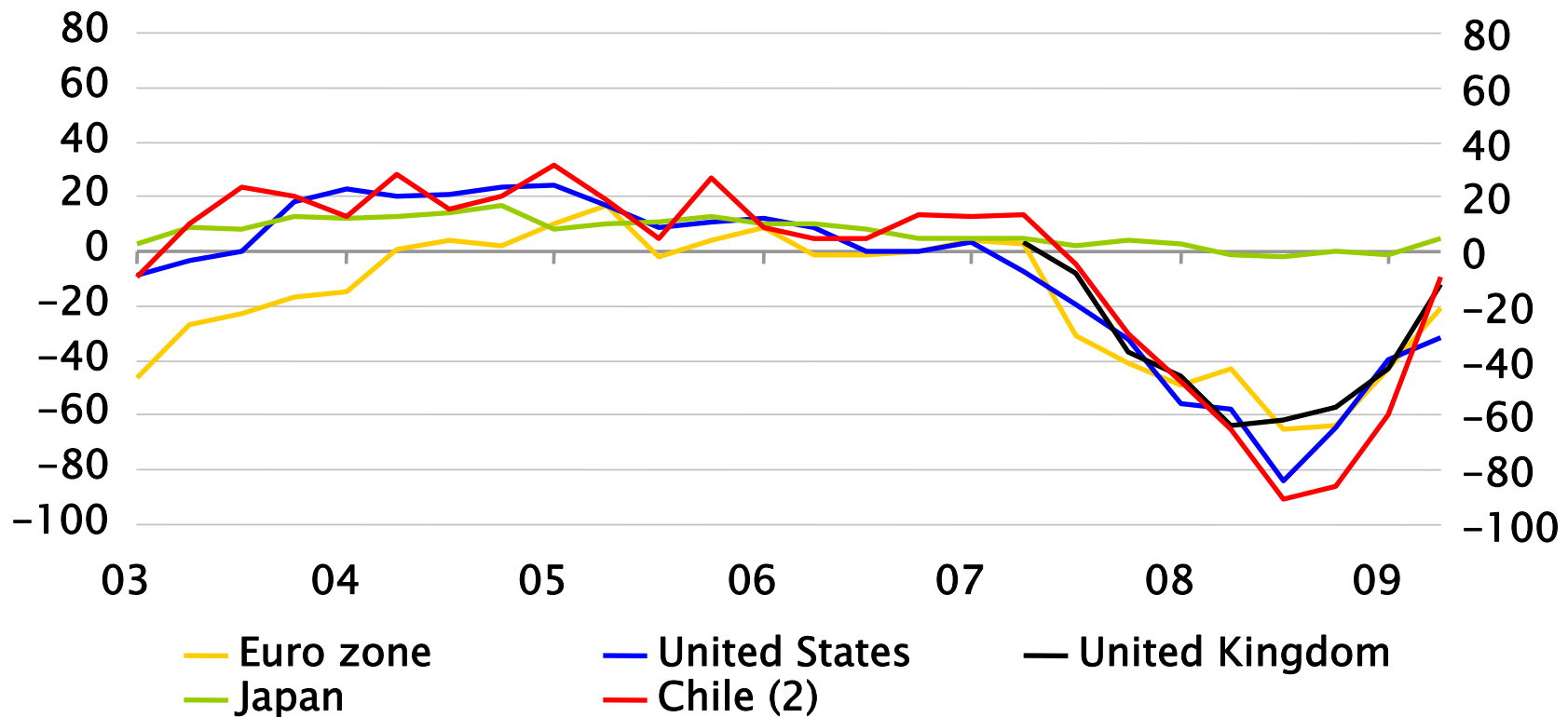
However, internal lending standards remain tight and the credit volume fell in the first half of the year.





Restrictive credit standards are a global phenomenon.

Credit conditions for businesses (1)
(balance of responses)



(1) Negative figures denote tighter credit conditions.

(2) Large companies.

Sources: Central Bank of Chile, Bank of England, European Central Bank, Bank of Japan, and U.S. Federal Reserve.



Prospects



The baseline scenario assumes that the economy will grow between 4.5 and 5.5% annually in 2010, with an unbiased risk balance.

Economic growth and current account
(annual change, percentage)

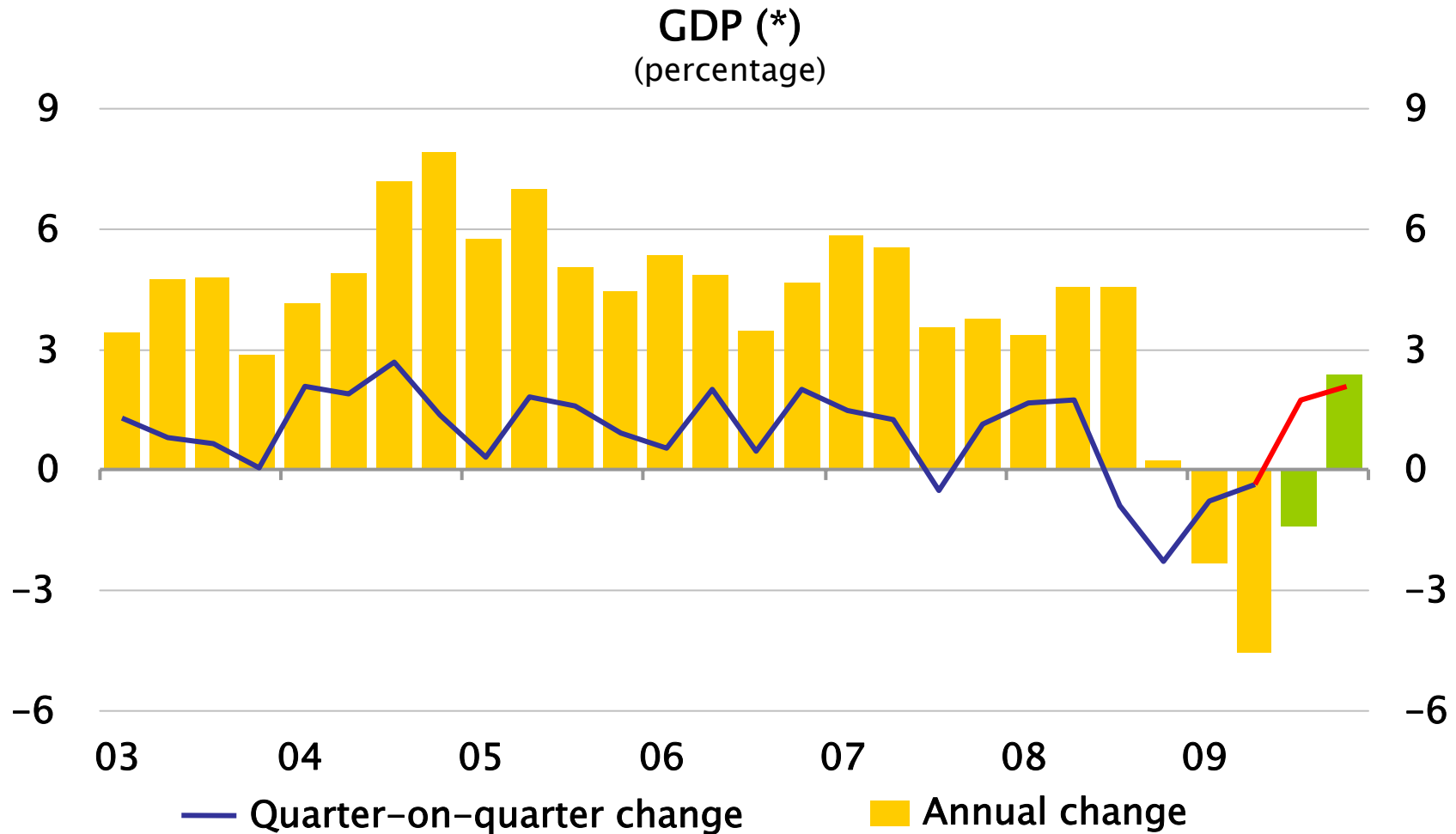
	2007	2008	2009 (f)	2010 (f)
GDP	4.7	3.2	-2.0 a -1.5	4.5 a 5.5
National income	7.1	3.8	-1.5	6.2
Domestic demand	7.8	7.4	-6.2	6.7
Domestic demand (w/o change in inventories)	8.2	7.9	-3.5	3.7
Gross fixed capital formation	12.0	19.5	-12.9	7.4
Total consumption	7.1	4.2	0.0	2.5
Goods and services exports	7.6	3.1	-4.7	4.9
Goods and services imports	14.9	12.9	-13.8	9.0
Current account (% of GDP)	4.4	-2.0	1.9	1.2

(f) Forecast.

Source: Central Bank of Chile.



This projection assumes that the output level will increase in the course of this half. However, for some months output will continue to show negative y-o-y figures.



(*) Considers the Economic Expectations Survey as from third quarter 2009.
Source: Central Bank of Chile.



Annual CPI inflation will remain negative for the rest of 2009, and will converge to the 3% inflation target toward 2011.

Inflation
(annual change, percentage)

	2008	2009 (f)	2010 (f)	2011 (f)
Average CPI inflation	8.7	1.7	1.5	3.0
December CPI inflation	7.1	-0.8	2.8	
CPI inflation in around 2 years (*)				
Average CPIX inflation	8.4	2.8	1.0	3.0
December CPIX inflation	8.6	-1.2	2.6	
CPIX inflation in around 2 years (*)				
Average CPIX1 inflation	7.8	2.8	1.2	3.0
December CPIX1 inflation	7.7	-0.6	2.6	
CPIX1 inflation in around 2 years (*)				

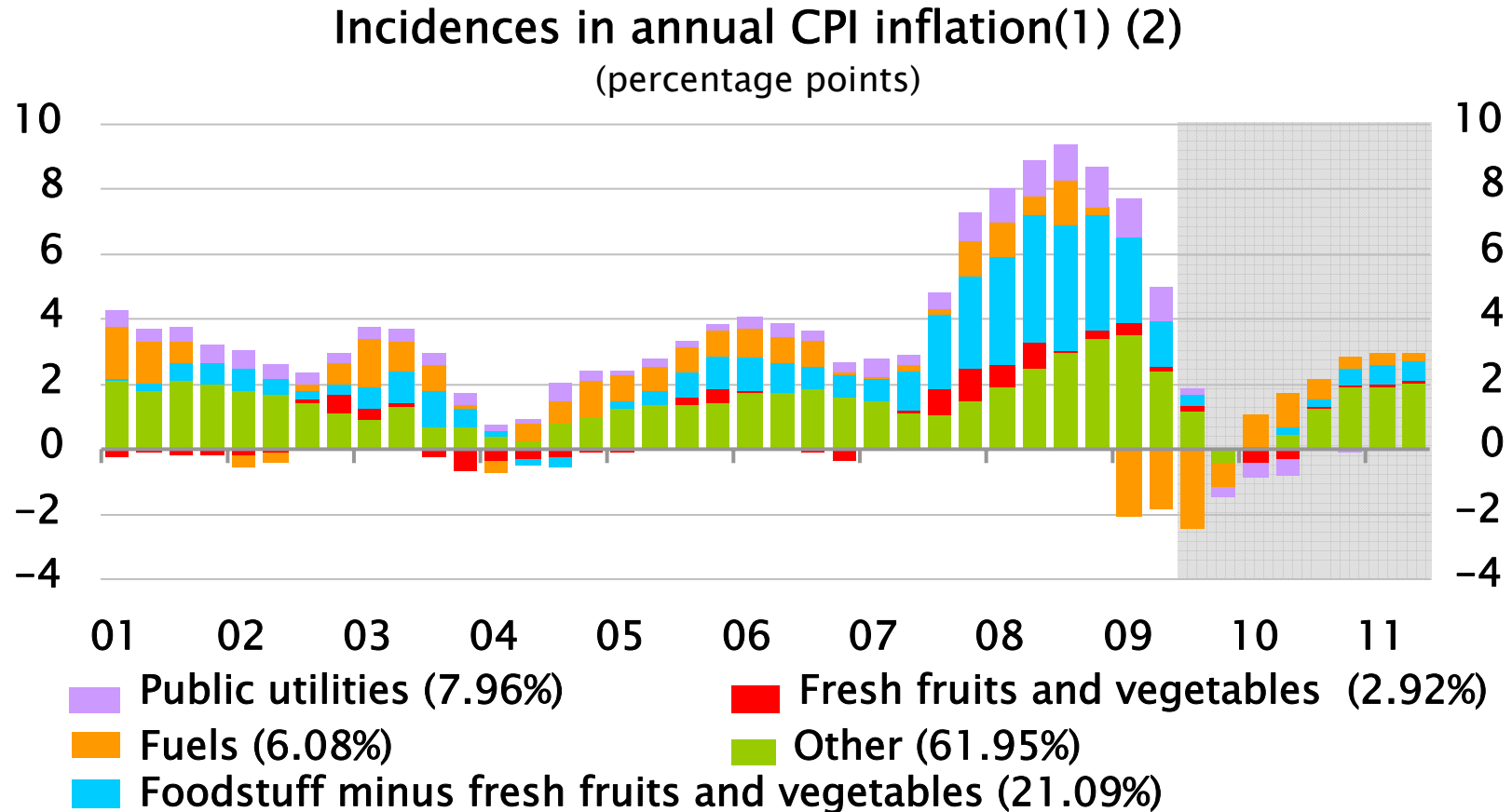
(f) Forecast.

(*) Inflation projection to the third quarter of 2011.

Source: Central Bank of Chile.



In the baseline scenario, the steady closing of output gaps and, to a lesser extent, the higher external inflation rate will push inflation up towards convergence to the inflation target.



(1) The gray area, as from third quarter 2009, depicts the breakdown of projected inflation in the baseline scenario.

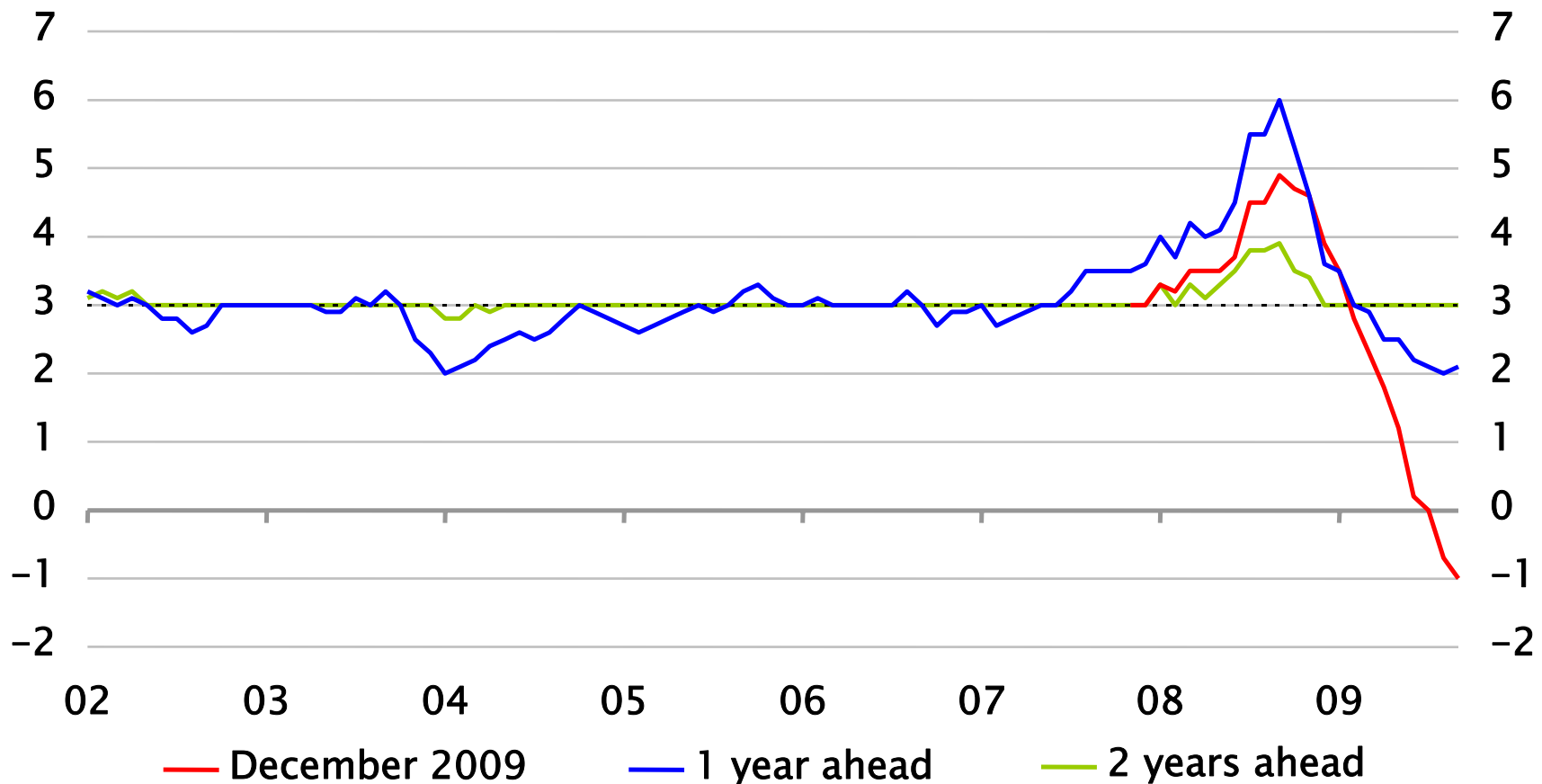
(2) In parentheses, shares in the CPI basket of December 2008. Before that, built with weights in the basket of December 1998.

Sources: Central Bank of Chile and National Statistics Bureau (INE).



Market inflationary expectations assume similar prospects and remain around 3% for the medium term.

EES: Expected inflation
(annual change, percentage)





The materialization of global recovery is crucial for domestic economic activity and inflation prospects.

World growth (*) (annual change, percentage)

	Ave. 90-99	Ave. 00-07	2008 (e)	2009 (f)		2010 (f)		2011 (f)
				MPR May 09	MPR Sep.09	MPR May 09	MPR Sep.09	MPR Sep.09
World	2.9	4.1	3.2	-1.2 ▲	-1.0	2.1 ▲	3.3	4.2
World at market ER	2.4	3.2	2.0	-2.3 ▲	-1.9	1.4 ▲	2.6	3.5
United States	3.2	2.6	0.4	-3.0 ▲	-2.6	0.5 ▲	2.3	3.3
Euro zone	2.2	2.1	0.7	-3.5 ▼	-3.7	0.4 ▲	0.6	1.4
Japan	1.5	1.7	-0.7	-7.2 ▲	-5.4	0.9 ▲	1.3	1.8
China	10.0	10.1	9.0	6.5 ▲	8.3	7.5 ▲	9.3	9.5
Rest of Asia	5.5	5.0	3.0	-1.9 ▲	-1.3	1.4 ▲	3.8	4.5
Latin America	2.7	3.6	4.2	-2.0 ▼	-2.8	1.5 ▲	2.9	3.5
Commodity exporters	2.7	3.1	1.0	-1.7 ▲	-1.2	0.9 ▲	2.0	2.7
Trading partners	3.1	3.6	2.9	-1.5 ▲	-1.1	2.0 ▲	3.1	3.9

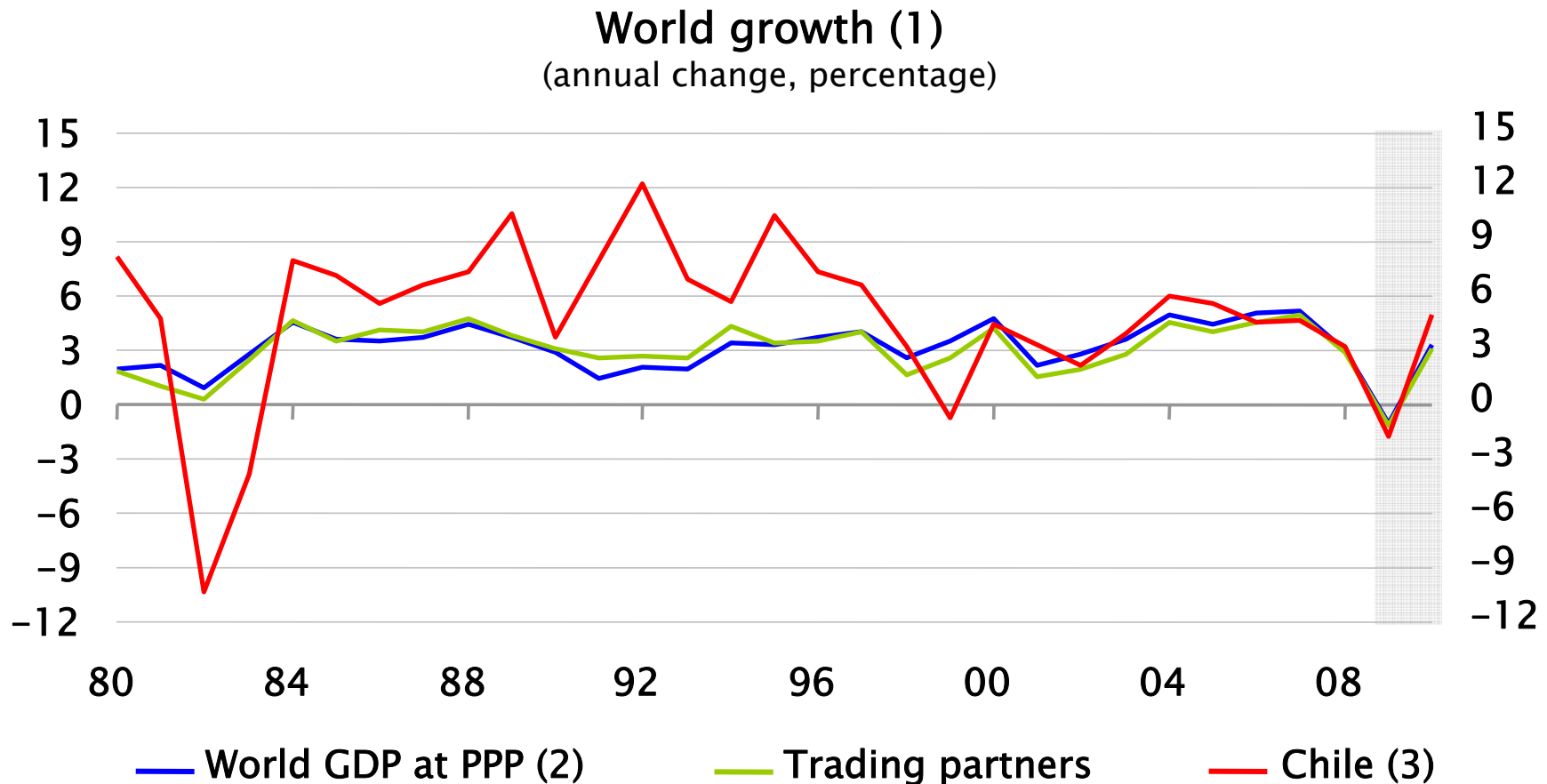
(*) Regional growth rates weighted by share in world GDP at PPP as published by the IMF's World Economic Outlook (WEO, April 2009).

(e) Estimate; (f) Forecast.

Sources: Central Bank of Chile based on a sample of investment banks, Consensus Forecasts and IMF data.



However, the Chilean economy has withstood the current external shock much better than previous ones.



(1) Gray area considers forecast as from 2009. (2) Regional growth rates weighted by share in world GDP at PPP as published by the IMF's World Economic Outlook (WEO, April 2009). (3) GDP growth in 2009 and 2010 corresponds to the mid point of the range projected in September's MPR.

Sources: Central Bank of Chile, IMF, and World Bank.



The baseline scenario also assumes higher commodity prices and increased external inflation in US\$ over the projection horizon.

Main assumptions of the international baseline scenario
(annual average)

	2008	2009 (f)		2010 (f)		2011 (f)
		May 09	Sep.09	May 09	Sep.09	Sep.09
WTI oil price (US\$/barrel)	100	52	61	64	77	80
LME copper price (US\$cents/pound)	316	180	230	185	260	250
Terms of trade (annual change, %)	-15.0	-13.5	2.5	-3.8	2.3	-2.5
External prices in US\$ (annual change, %)	11.9	-5.7	-6.6	7.0	8.0	3.2

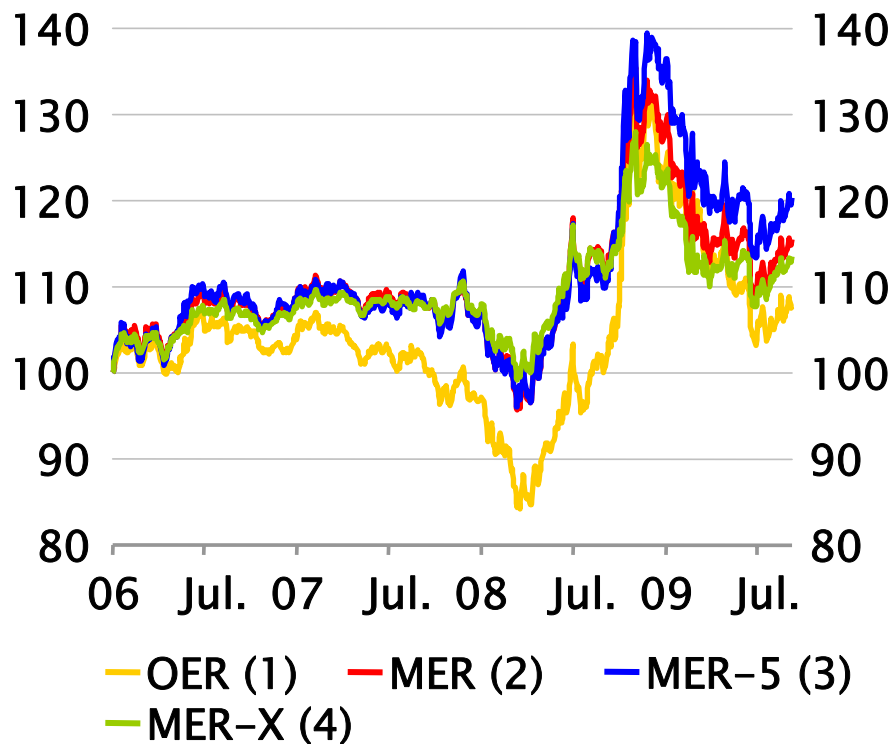
(f) Forecast.

Source: Central Bank of Chile.

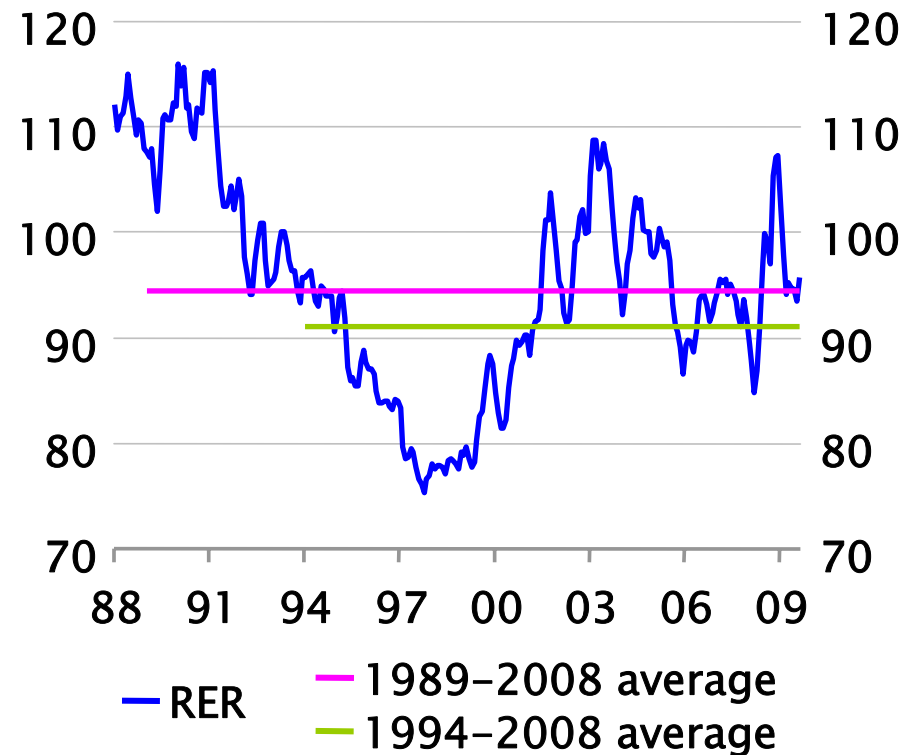


In addition, the real exchange rate (RER) is estimated to be in line with its fundamentals and the long-term RER will not be very different from current levels.

Nominal Exchange Rate
(index, 2/01/2006=100)



Real Exchange Rate
(index, 1986=100)

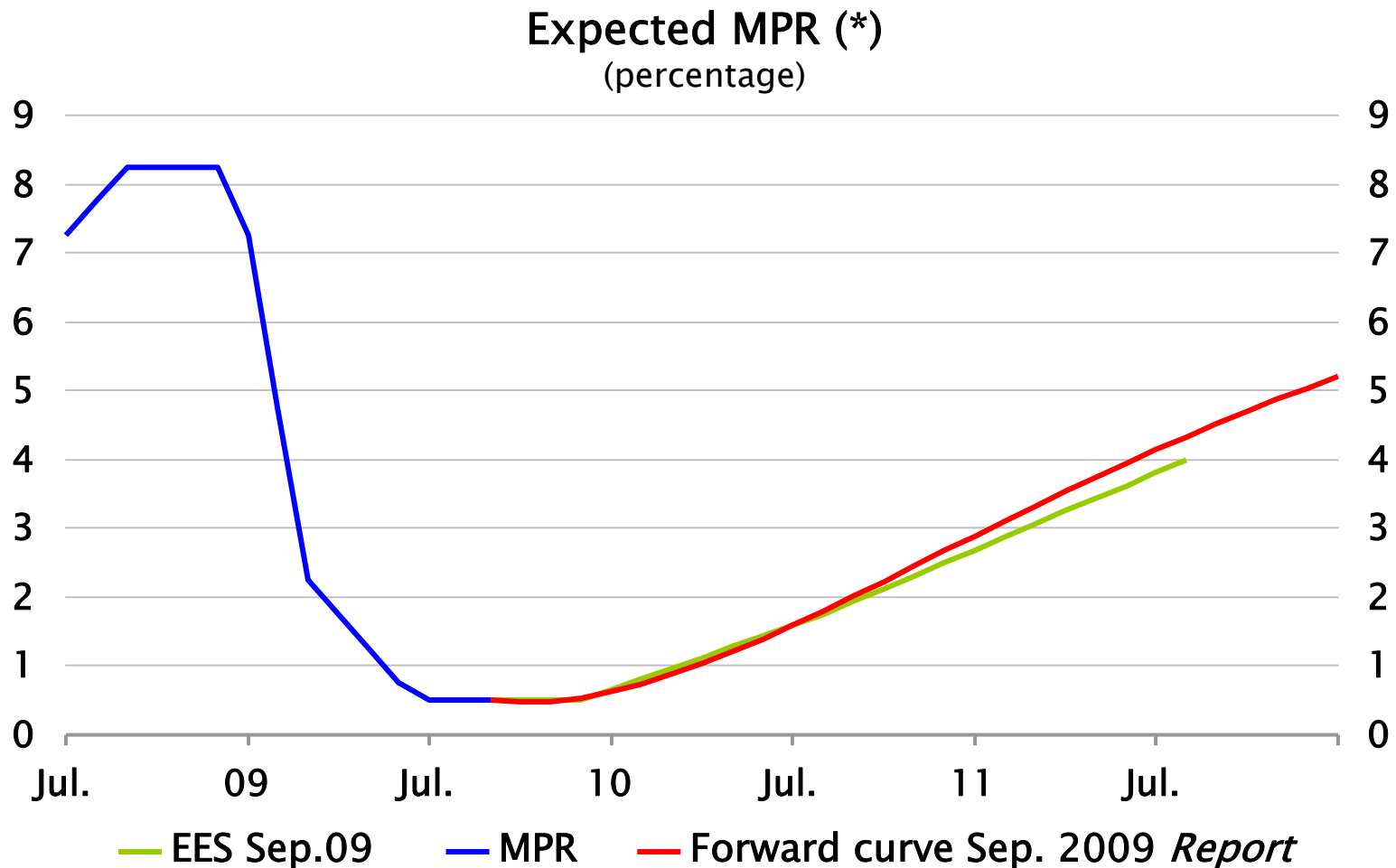


(1) Observed exchange rate. (2) Multilateral exchange rate. (3) Multilateral exchange rate using only the currencies of Canada, the Euro zone, Japan, the United Kingdom, and the United States. (4) Multilateral exchange rate excluding the U.S. dollar.

Source: Central Bank of Chile.



The baseline scenario assumes that the MPR will be kept at 0.5% for a prolonged period of time, to later resume a normalization path comparable to the one that can be inferred from financial asset prices. This suggests that this process might begin toward the second quarter of 2010.



(*) Forward curve based on weekly averages.

Source: Central Bank of Chile.



The Board estimates that the balance of risks for growth and inflation is unbiased.

- A major part of the risks is associated with the scenario of global growth and inflation.
- The aggressiveness of the measures implemented in the world over the past year, together with the expressed determination of policy makers to quickly control episodes of turbulence that might trigger generalized financial instability, make it unlikely for the volatility of September–October 2008 to occur again.
- However, there are risks in both directions with regard to world economic activity and inflation. A quick recovery is possible, but it may be the case that the signs of stability or moderated deterioration are transitory and growth prospects worsen again.
- Risks associated to global imbalances are still latent. Although into the nearest future those imbalances have been checked, their potential persistence through a lack of adjustment of current accounts raises some concerns on exchange rates.



An earlier withdrawal of the large monetary and fiscal stimulus, in Chile and around the world is an issue that has to be resolved carefully.

- The path implicit in market expectations suggests that a monetary normalization process should begin towards the second quarter of 2010.
- The coming quarters will be crucial in the assessment of when to begin withdrawing the stimulus package.
- From earlier episodes we have learned to be very careful in this monetary stimulus withdrawal, because there must be room for the recovery to settle.
- Accordingly, we must prevent the incubation of inflationary pressures away from the target, because they would only make the adjustment more costly.
- The Board will continue to evaluate the probability of risks and their possible consequences in domestic inflationary prospects, and it reiterates that it will continue to use its policies with flexibility in order for projected inflation to stand at 3% over the policy horizon.



Current Developments in the Chilean Economy

Central Bank of Chile