



# Monetary Policy in the Current Environment: the Case of Chile

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# Outline

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- Introduction
- Policy responses
- Strengths of the Chilean economy
- Recent trends and prospects
- Final remarks



# Introduction



# Introduction

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- The effects of this economic and financial crisis, the most severe in decades, are being felt with great intensity across emerging economies with no exception.
- The Chilean economy enters this crisis with sound fundamentals and this has allowed economic authorities to take decisive policy actions.
- Policy responses have evolved over time depending on the circumstances, although they have remained consistent with the policy framework in place and have been well coordinated



# Policy responses



# Policy responses

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- The transmission of global financial crisis to domestic markets and the subsequent policy responses by the Central Bank have gone through different stages.
- Initially, local effects were only seen in very specific financial markets. However, their macro impact was not significant, so policy response continued to be determined mainly by local developments. Monetary policy was in a moderate and gradual tightening process. From mid 2007 to mid 2008, the policy rate had been raised in 5 opportunities, 25 basis point each time.
- In the 1Q2008, global tensions intensified leading to a significant appreciation of most emerging market currencies against the USD. The Chilean peso was not an exception.



## Policy responses

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- The perception of significant risks in global markets, including the increased probability of a major deterioration of financial conditions, led the Central Bank to announce a program of USD 8 billion reserve accumulation to be carried out in a period of 8 months starting in April 2008.
- This intervention in the foreign exchange market was announced at a time when the real exchange rate was considered to be well below levels consistent with its long term fundamentals. However, the program was aimed to strengthen the international liquidity position, so no target was set for the exchange rate.
- This was the first intervention since 2002 and the third since the floating exchange rate regime was adopted in 1999. It must be noted that interventions under “exceptional circumstances” are not ruled out under this regime.



## Policy responses

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- By mid 2008, global inflation outlook deteriorated markedly as commodity prices reached historical peaks. Domestic inflation showed a sharp rise mainly due to food and energy price increases. Headline inflation went well above its target range, peaking over 9% in the second half of the year. Core inflation and inflation expectations followed the same upward trend.
- These inflationary pressures came at a time when the economy was growing and few slacks were identified. In those circumstances, the Central Bank raised the interest rate by a cumulative 200 basis points in four months and announced that it would keep on hiking to bring inflation back to the 3% target within the policy horizon.



## Policy responses

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- After September last year, the global financial crisis intensified and the macro environment changed severely. World growth prospects showed a severe downshift and commodity prices collapsed. On the positive side, this new scenario brought an improved inflation outlook.
- The impact across emerging economies was severe. Chile was not an exception, as its economic outlook changed drastically. As an unusual action, the Central Bank updated and published its baseline scenario in November before the release of the next report scheduled for January.



## Policy responses

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- At that time, significant effects were observed in most domestic financial markets (money, foreign exchange and stock markets). Serious, although transitory, tensions were seen in money markets. For the first time since the beginning of the global financial crisis, the Chilean peso came under pressure. Banks tightened credit conditions, while business and consumer confidence indicators showed an abrupt deterioration.
- The Central Bank reacted with a set of policy actions. First, the reserve accumulation program that started in April was terminated (Sep 29<sup>th</sup>). With this, close to 75% of the expected reserve accumulation was completed.



## Policy responses

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- Then, extraordinary liquidity provision programs for USD and Chilean peso were set to mitigate tensions in money markets. The range of acceptable collaterals and maturities for credit facilities became more flexible than usual. These policy actions were decisive to ease liquidity and funding tensions in local markets.
- And third, the stance of monetary policy was softened. Despite previous announcements that further tightening was necessary to bring inflation back to the target, the policy rate was kept constant throughout the 4Q2008 and an explicit downward bias was introduced in December that year, providing a signal for the start of a policy easing cycle.



## Policy responses

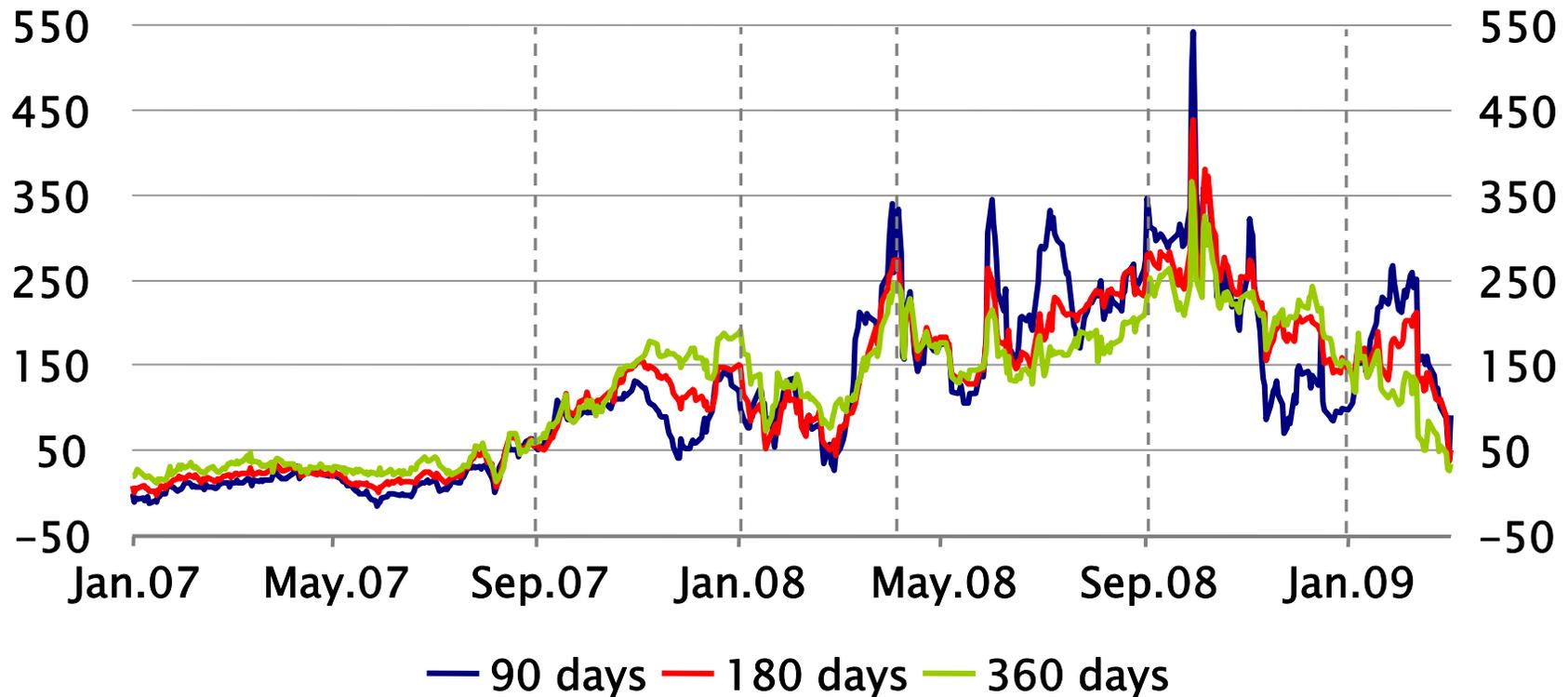
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- In January, the Government announced a USD 4,0 billion fiscal stimulus package, which is being carried out.
- During the first quarter this year, the Central Bank moved fast and decisively to provide the anticipated monetary stimulus, considering the rapid deterioration of the macro environment, As a result, the policy rate came down from 8.25% to the current level of 2.25% in just three months.



Global turbulences were reflected in significant, although transitory, liquidity and funding tensions in domestic markets in the fourth quarter of 2008.

Spread between onshore USD rates and Libor (\*)  
(basis points)



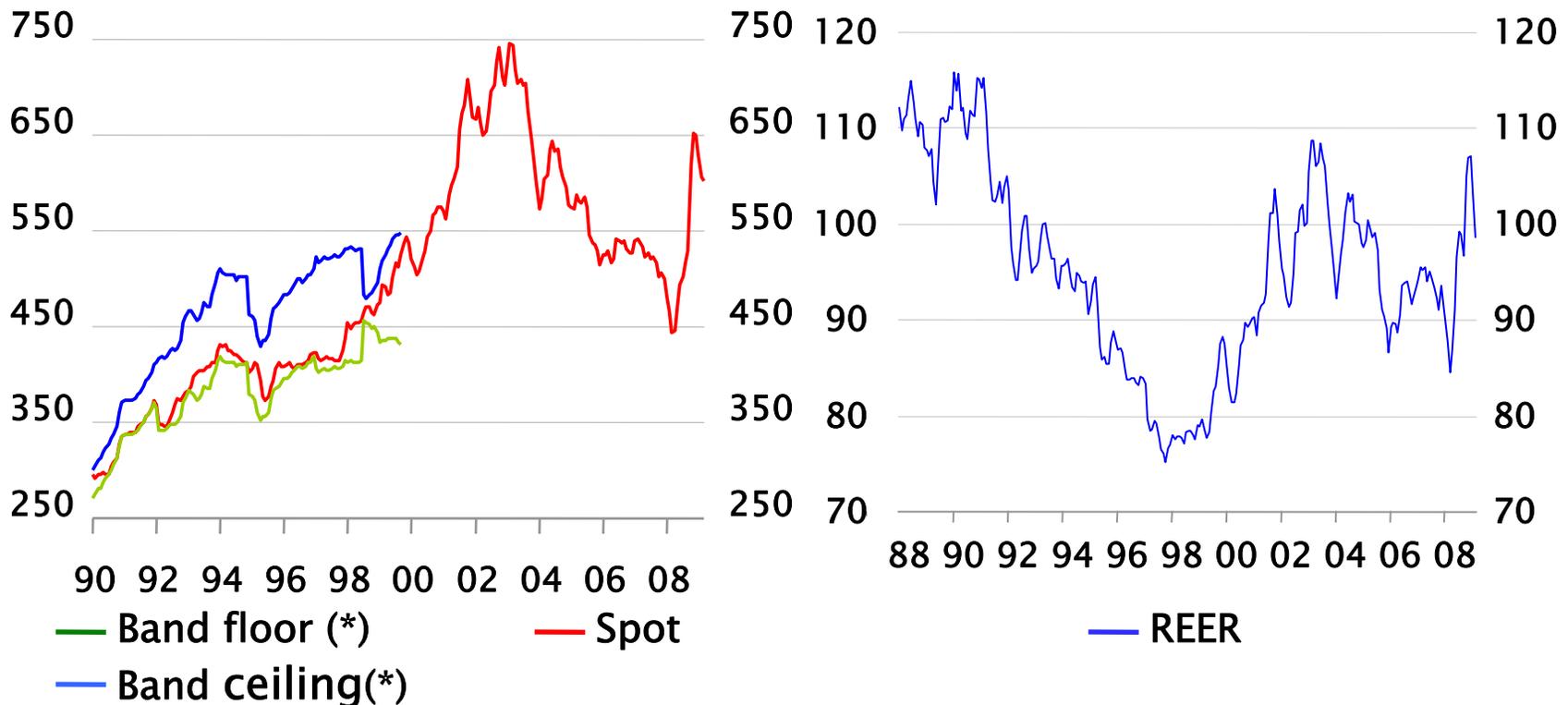
(\*) Dotted line marks periods of global turbulences.

Source: Central Bank of Chile.



After a significant appreciation in early 2008, the nominal exchange rate depreciated markedly late in the same year. Nevertheless, the current real exchange rate has recently been approaching historical averages.

### Nominal and Real Exchange Rate (CLP/USD; index, 1986=100)



(\*) The exchange rate bands are the upper or lower limit of a range inside which the exchange rate is allowed to float. This system operated until September 1999.

Source: Central Bank of Chile.



# Strengths of the Chilean economy



## Economic and financial fundamentals do matter

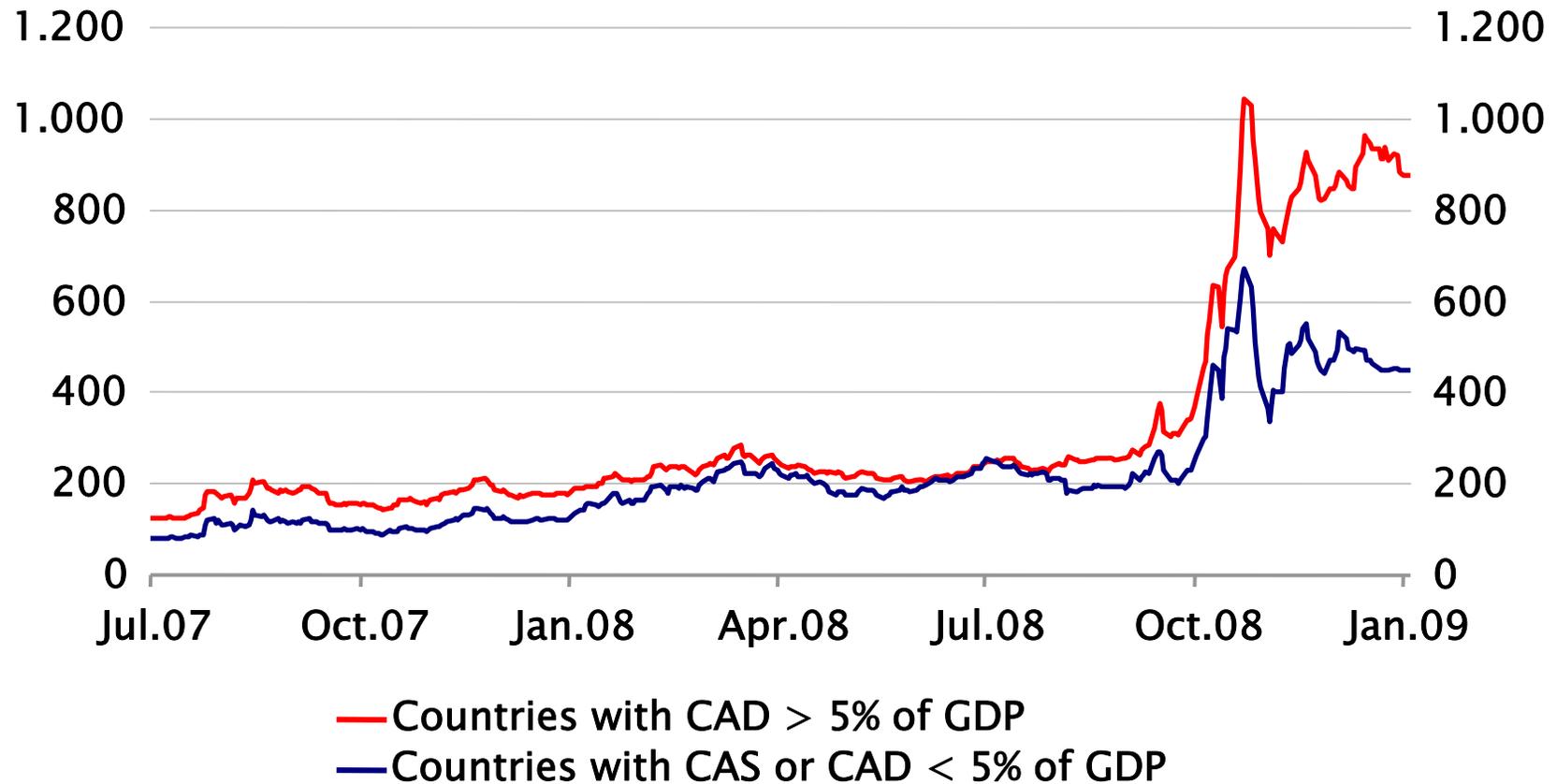
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- This global crisis is affecting emerging economies with no exception. However, markets continue making a difference, as financial conditions (sovereign spreads, access to finance and market volatility) have deteriorated less for countries with strong economic and financial fundamentals.
- In addition, the possibility for using fiscal and monetary policies to mitigate the effects of the crisis remains larger for countries with solid fundamentals.



# Sovereign risk premiums have increased markedly for countries with weak fundamentals.

Sovereign Risk Premium According to the Current Account Size (\*)  
(basis points)



(\*) Sovereign risk premium measured by CDS spread.  
Sources: Bloomberg and International Monetary Fund.



## Chile entered this crisis with sound fundamentals, as shown by:

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1. A responsible and predictable fiscal policy which guarantees public sector solvency over time.
2. A credible monetary policy conducted by an independent central bank under an inflation targeting regime supported by a floating exchange rate which provides flexibility to absorb abrupt changes in external conditions like the one we have experienced during this crisis.
3. A good regulatory and supervisory framework for the banking system and capital markets.



## Chile entered this crisis with sound fundamentals, as shown by:

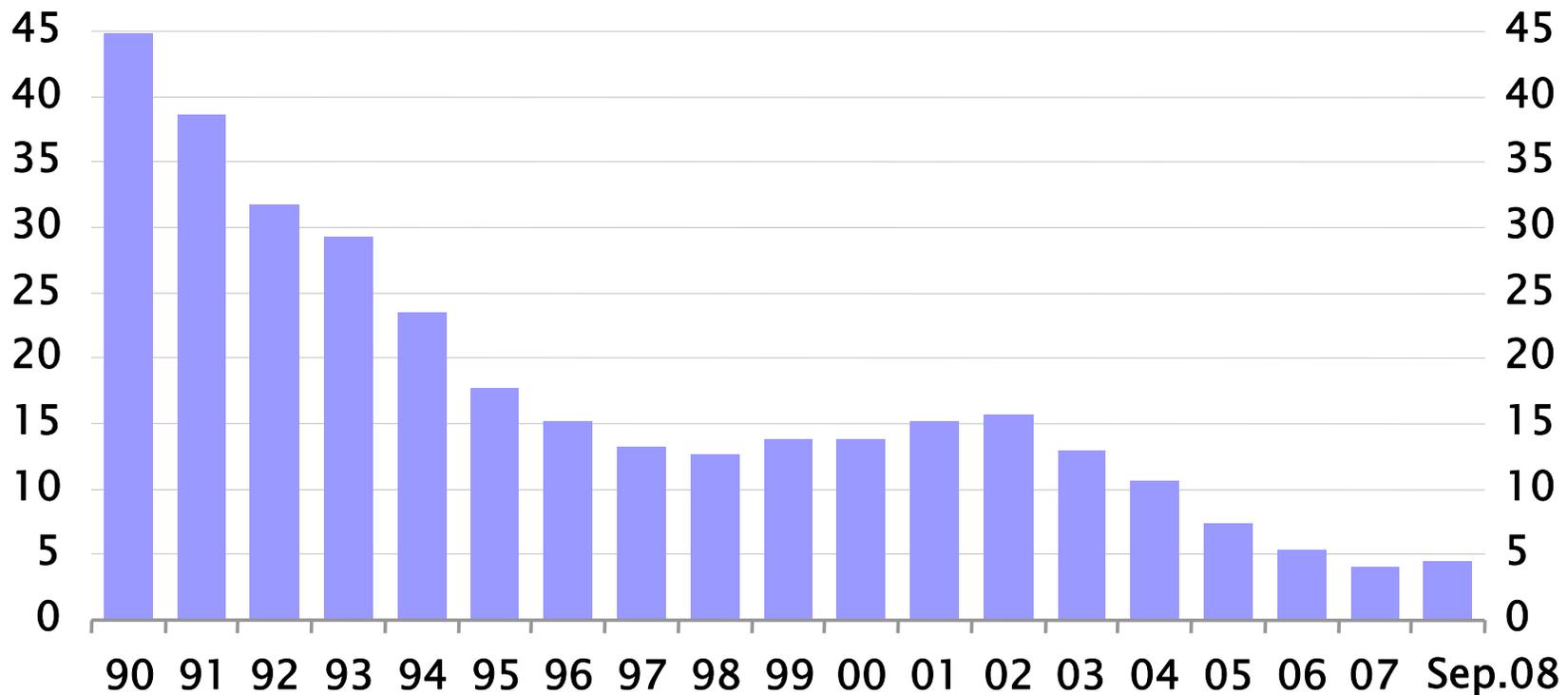
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4. A safe and sound banking system which has been affected by transitory liquidity and funding tensions but continues functioning and accomplishing its crucial roles.
5. A relatively deep capital market that provides an alternative source of finance, mainly for medium and long-term financing. Although, this market has also been affected by some tensions, it has never stopped working and playing its role.
6. International liquidity and solvency positions are quite solid as a result of reserve accumulation by the Central Bank, Government savings from copper windfall revenues and increased diversification of pension funds.



# Government debt has declined over time and currently remains at a low level.

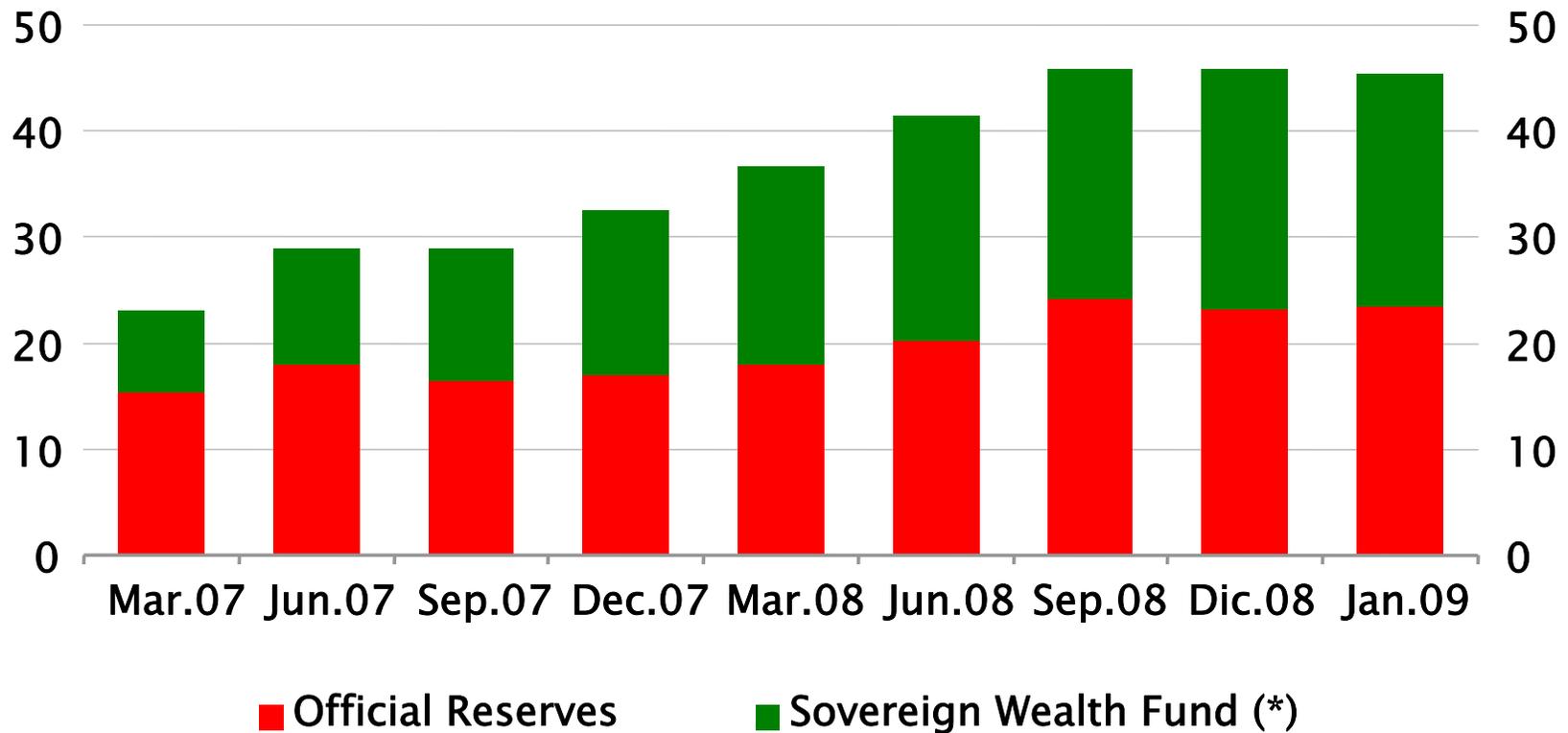
Government Debt  
(percentage of GDP)





# Foreign assets held by the Central Bank and the Treasury currently reach over USD\$45 billion.

Net International Reserves and Sovereign Wealth Fund  
(USD billions)



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



**The banking system appears fundamentally safe and sound, and it does not show the vulnerabilities observed in developed countries.**

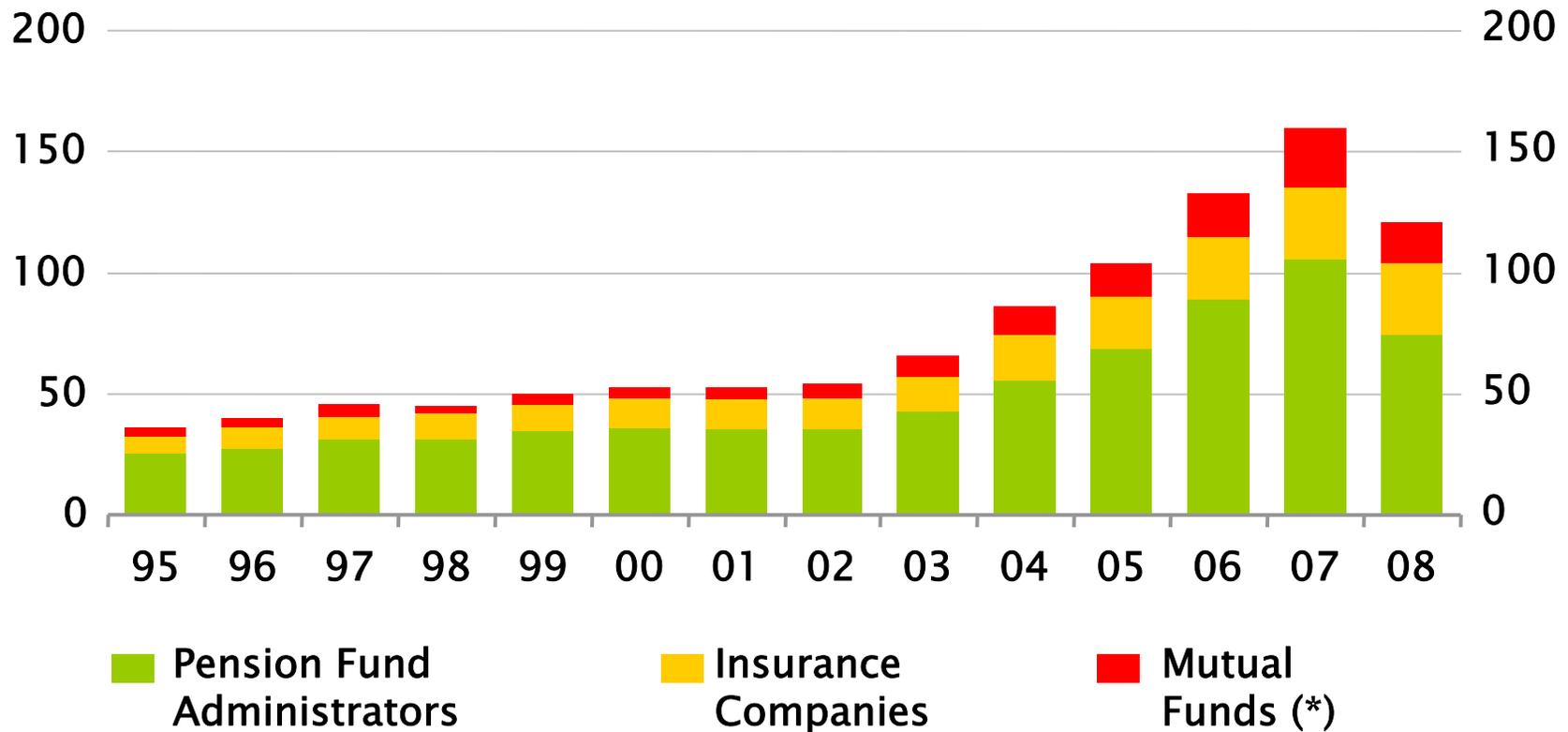
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- The traditional business model, based on relationship with clients, is the one that prevails.
- Foreign exchange exposure is quite low and adequately matched.
- No toxic assets appears in banks' books.
- Regulation and supervision has been modernized over time, but they continue being quite strict and effective.
- Capital, profit and efficiency ratios confirm the vision of a safe and sound banking system.



A relatively deep capital market, where institutional investors are key players, is and continue being an alternative source of finance, mainly for long-term horizons.

### Financial Savings by Institutional Investors (USD billions)

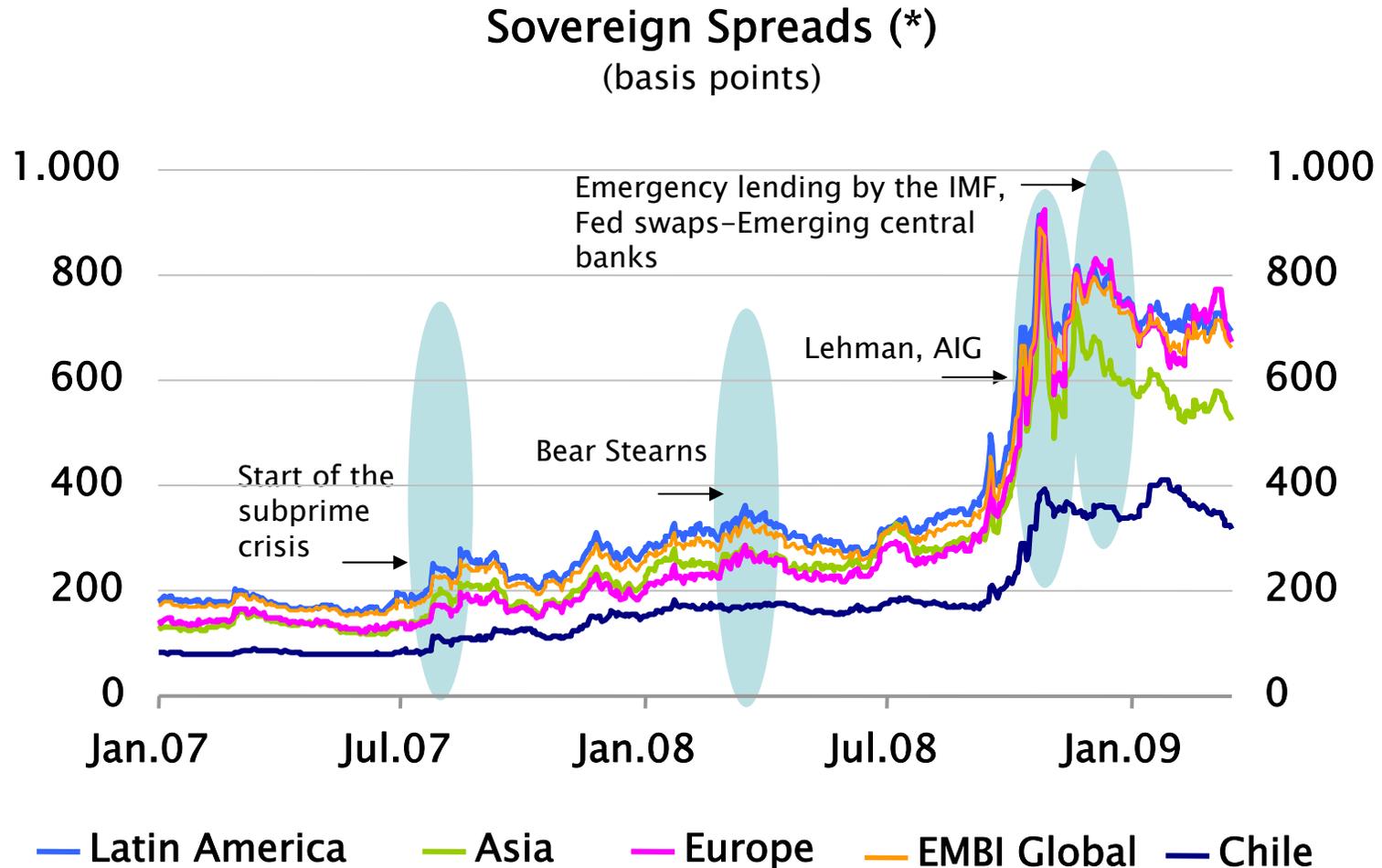


(\*) September 2008 data.

Sources: Superintendence of Securities and Insurance and Superintendence of AFP.



These sound fundamentals are recognized by markets, as Chile's sovereign spread has remained well below the average for emerging economies.



(\*) Considers JPMorgan's Emerging Market Bond Index.  
Sources: Bloomberg and JPMorgan.

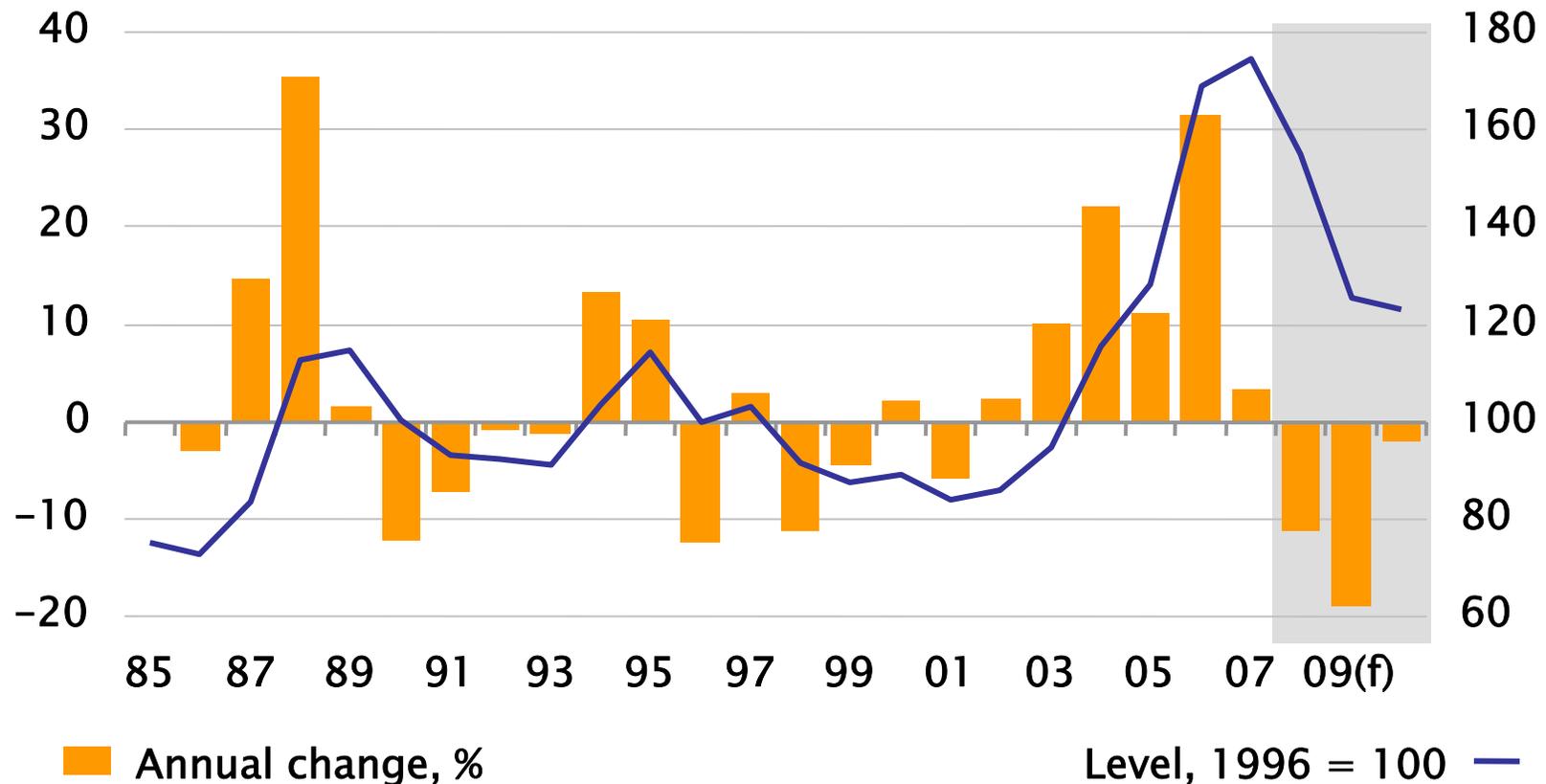


## Recent trends and prospects



# Terms of trade will decline in 2008–9, although its level will remain high by historical standards.

### Chile's Terms of Trade

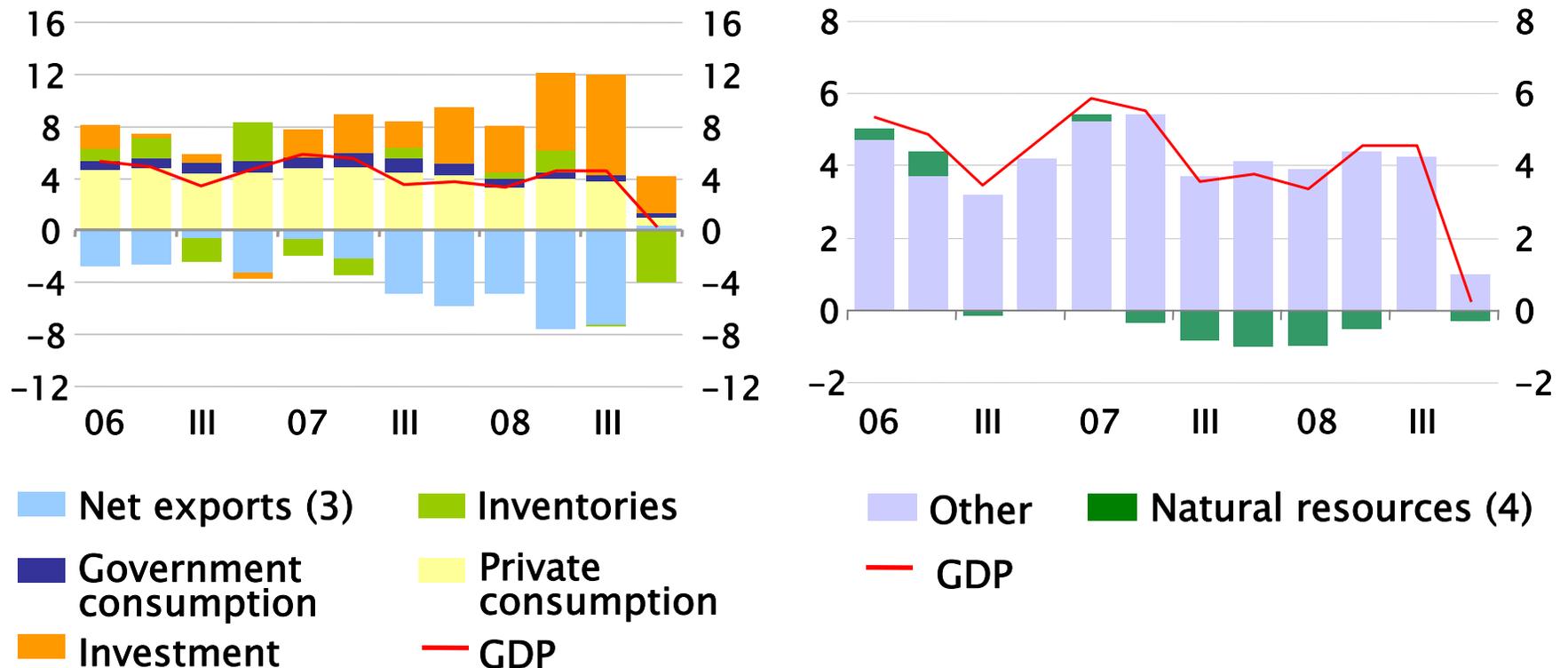


(f) Projections consider international baseline scenario assumptions from Monetary Policy Report, January 2009.  
Source: Central Bank of Chile.



Domestic demand and economic activity and, particularly those components more sensitive to credit conditions, have decelerated sharply.

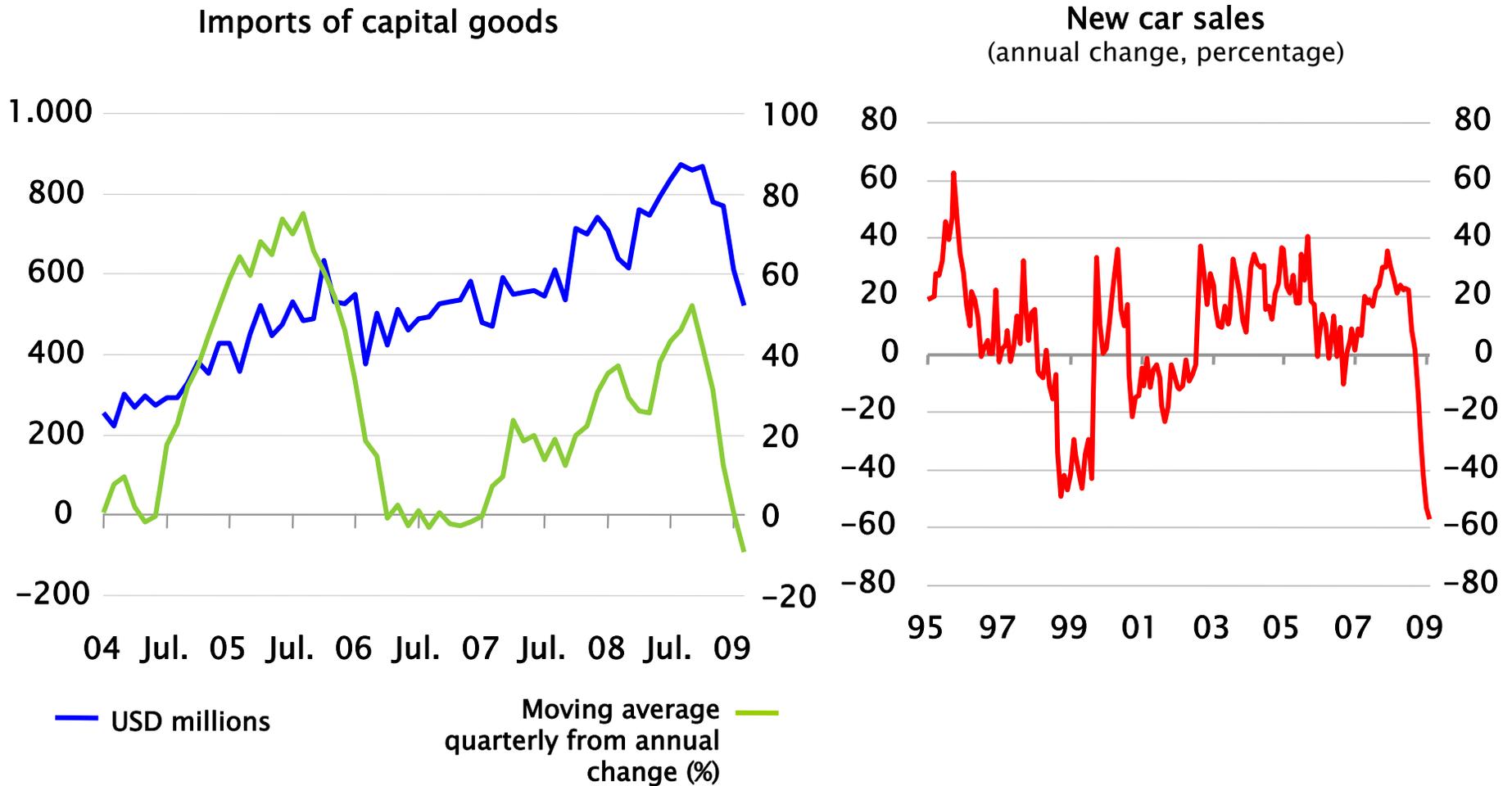
Contribution to GDP Growth (1) (2)  
(real annual change; percentage points)



(1) Data published on March 18<sup>th</sup>, 2009. (2) Contribution by sector corresponds to GDP at factor cost and bank charges. (3) Goods and services exports minus goods and services imports. (4) Corresponds to the sectors: mining, fishery and electricity, gas and water. Source: Central Bank of Chile.

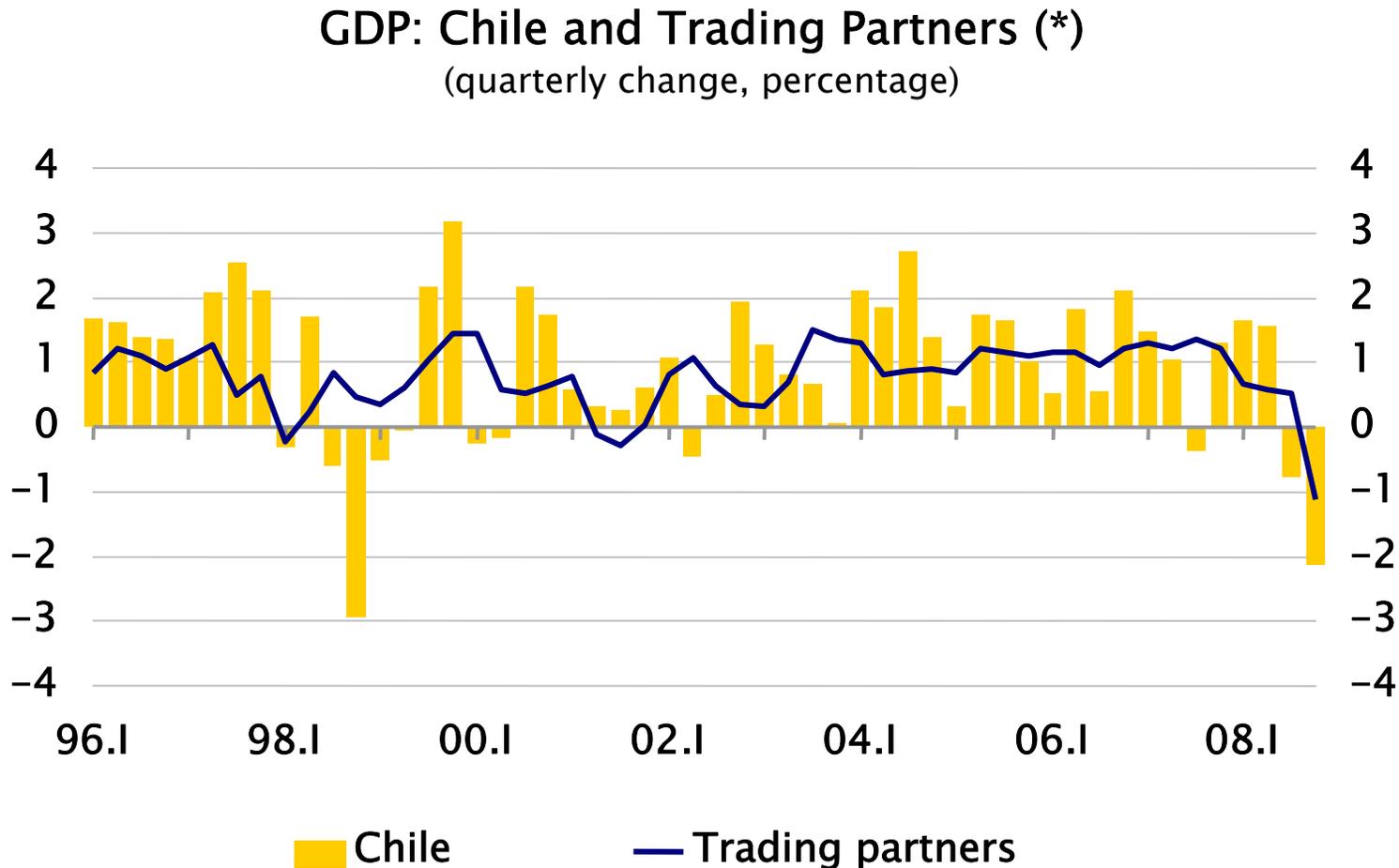


The fall observed in 4Q2008 is related with the extreme caution of consumers and businesses in their spending decisions.





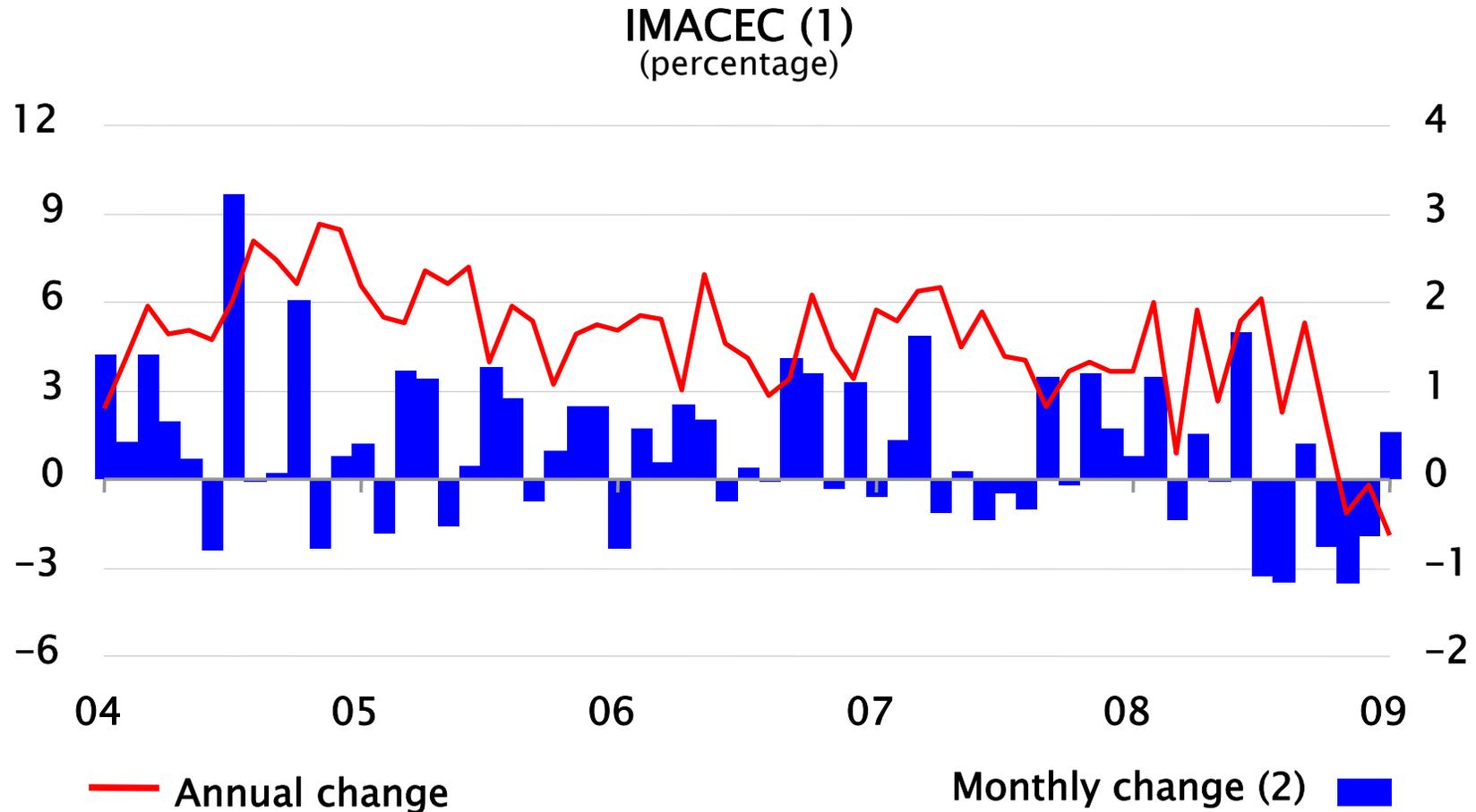
This domestic slowdown tends to coincide with that of Chile's trade partners.



(\*) Seasonally adjusted series.  
Source: Central Bank of Chile.



# Recent information suggests that economic activity has not shrunk further in the 1Q2009.



(1) Monthly indicator of economic activity.

(2) Seasonally adjusted.

Source: Central Bank of Chile.



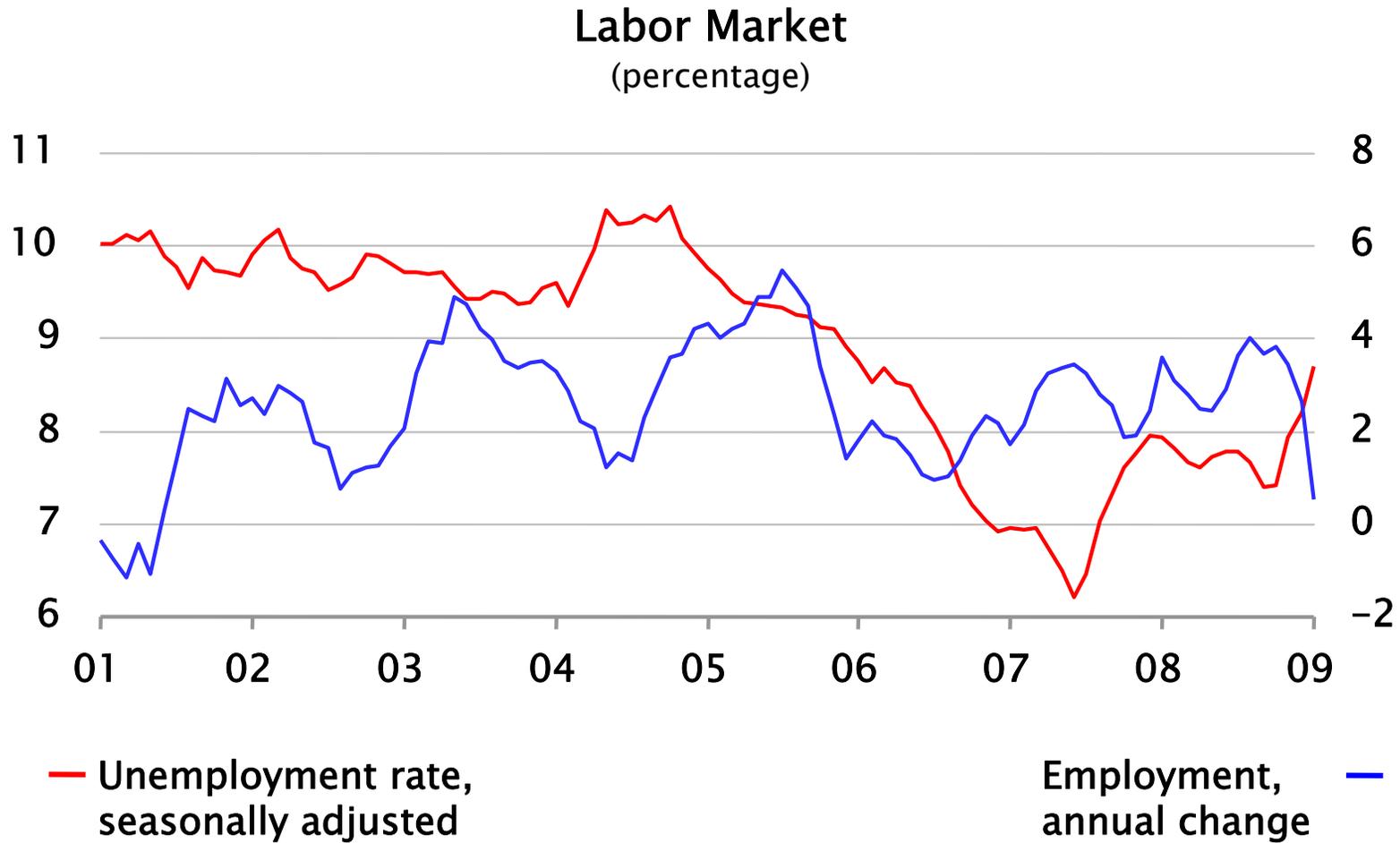
**Domestic growth for this year, in the most likely scenario, will be below our January forecast (2–3%).**

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- The world scenario has deteriorated and the forecast for world growth has been adjusted downward significantly in recent months.
- Domestically, business and consumer confidence is still low and, as a result, spending decisions are proceeding with extreme caution.



# The labor market is reflecting this adverse domestic macro environment.

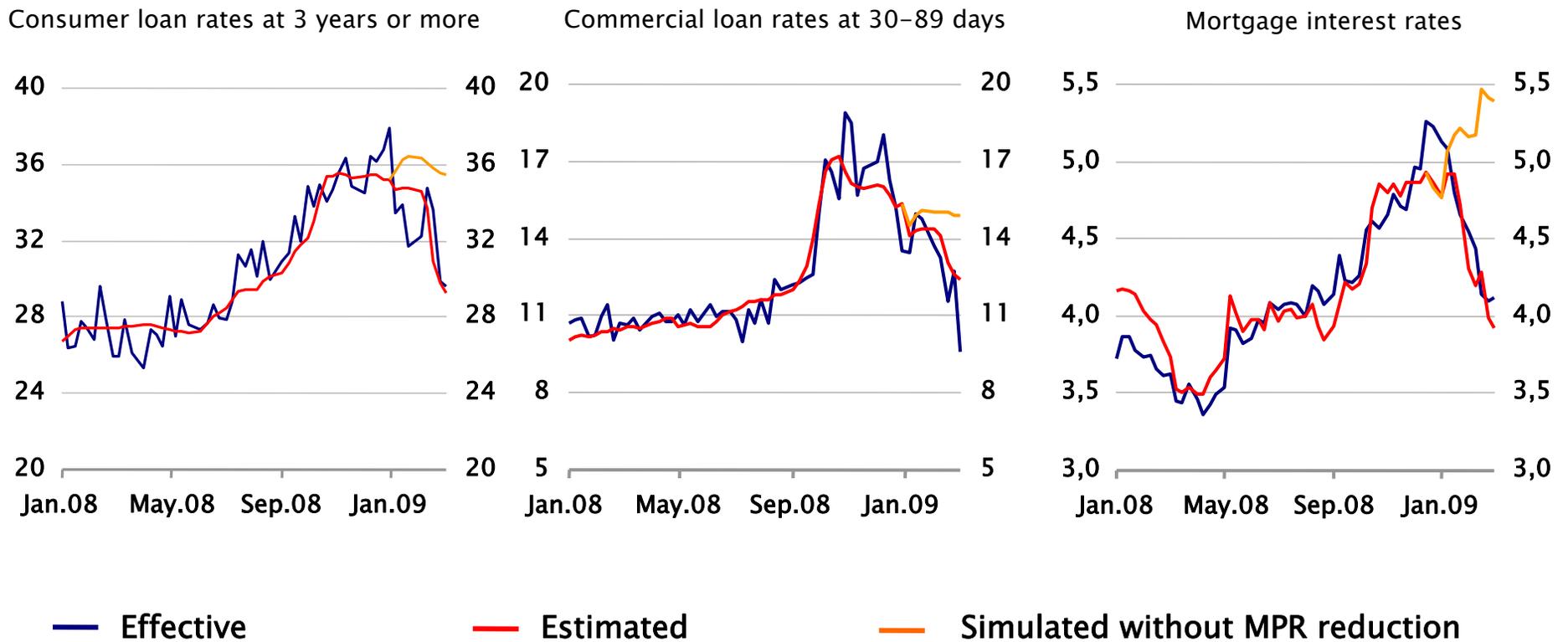


Sources: Central Bank of Chile and National Bureau of Statistics.



Although the perception of credit risk remains high since 4Q2008, lending interest rates are being adjusted downward, consistently with the reduction in policy rate.

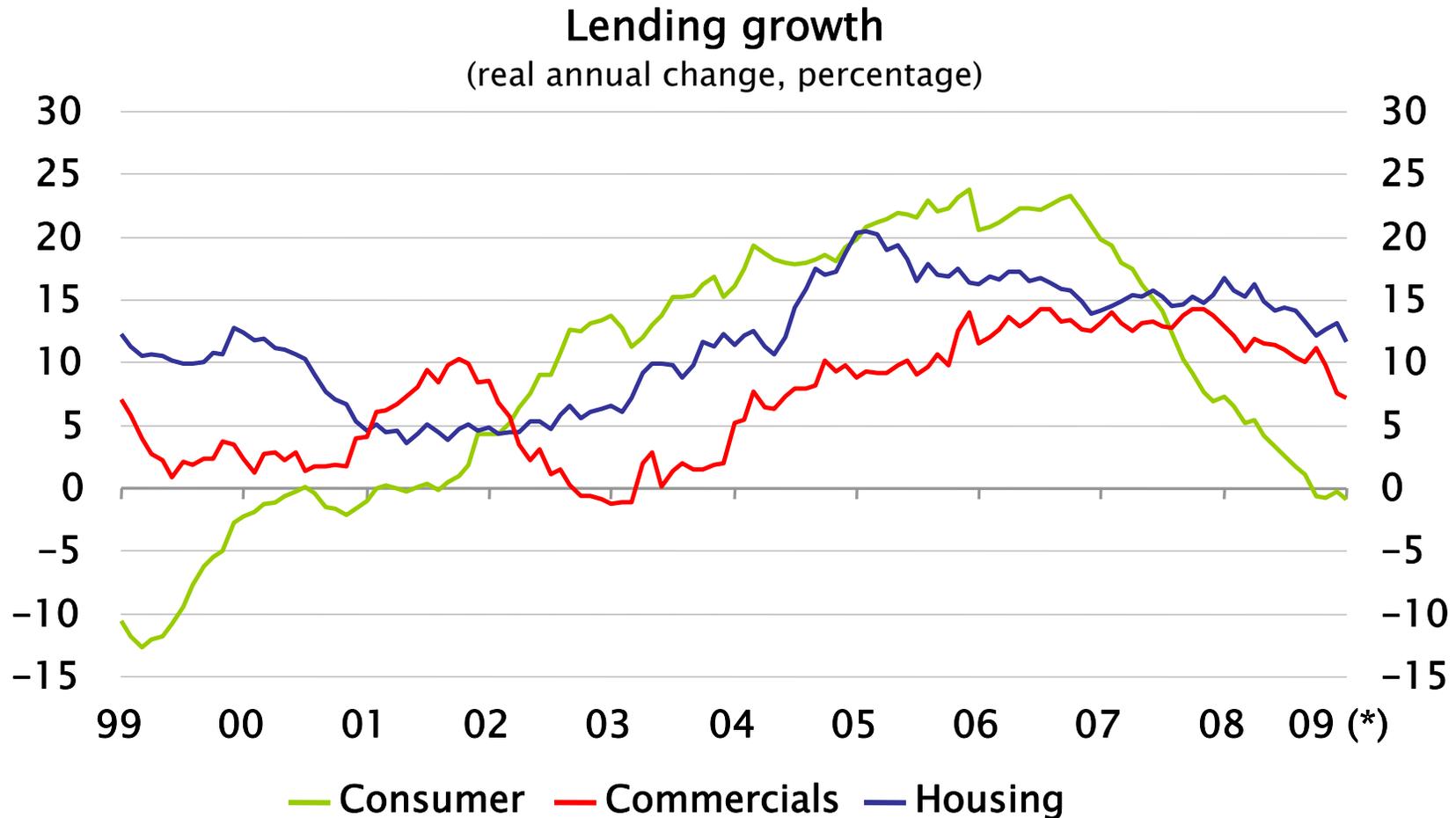
### Lending interest rates: effects of a reduction in the MPR (percentage)



Source: Central Bank of Chile.



Credit aggregates have slowed down particularly since September 2008, although recent data show some degree of stabilization.

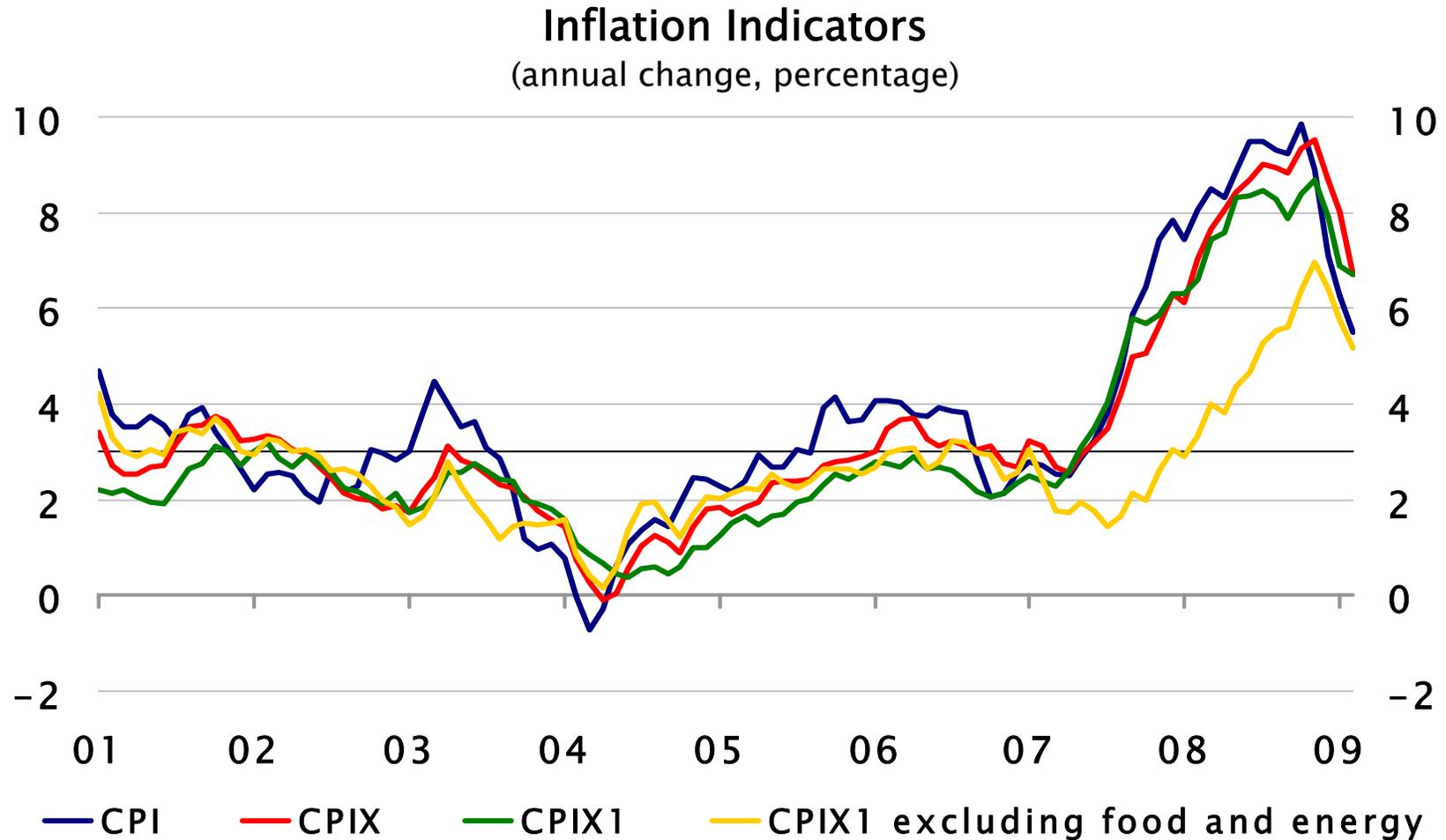


(\*) February data are preliminary.

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



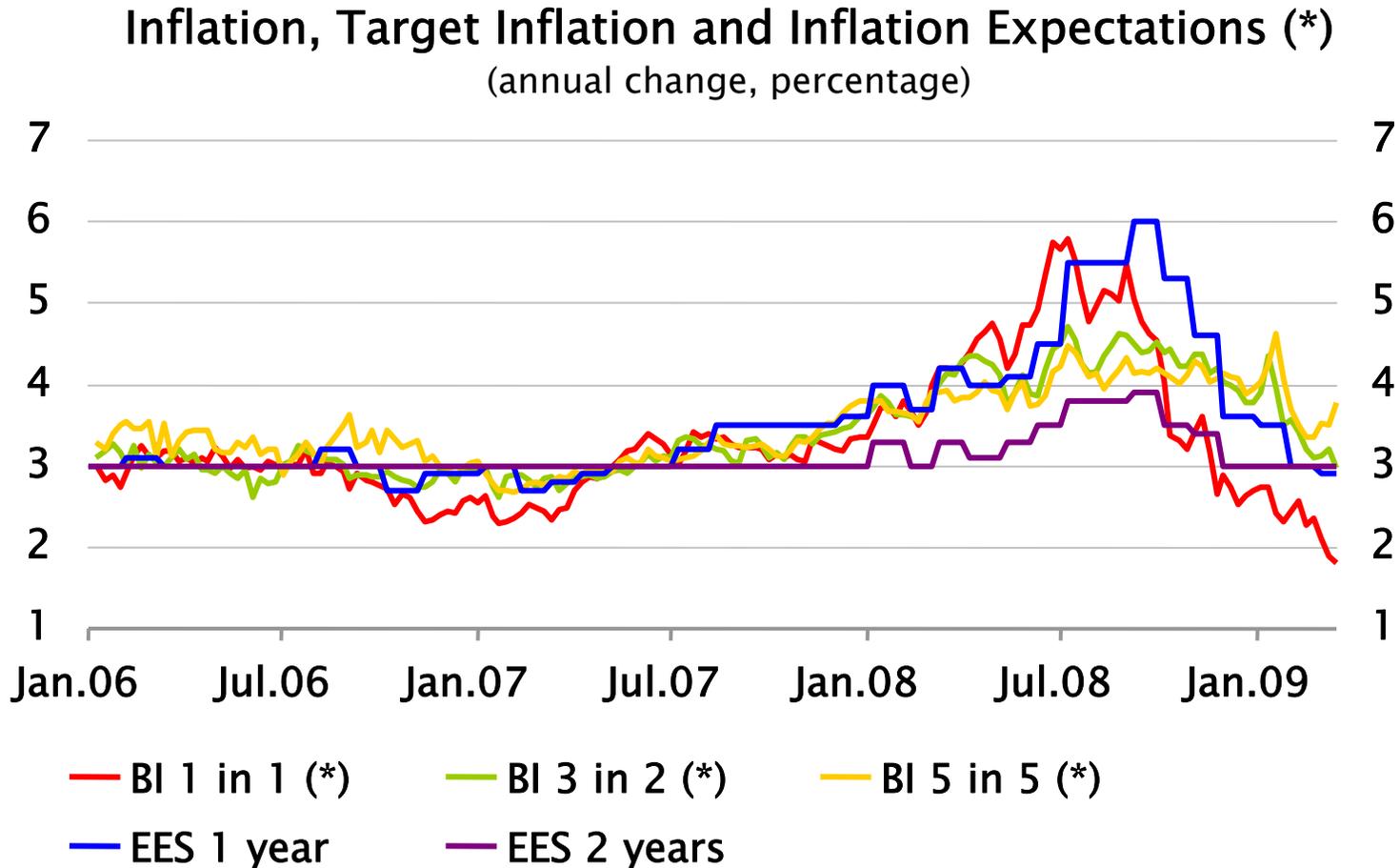
Headline and core inflation have come down fast and revealed low inflationary pressures.



Sources: Central Bank of Chile and National Statistics Bureau.



## Prospects for inflation indicate a rapid approach to the 3% target.

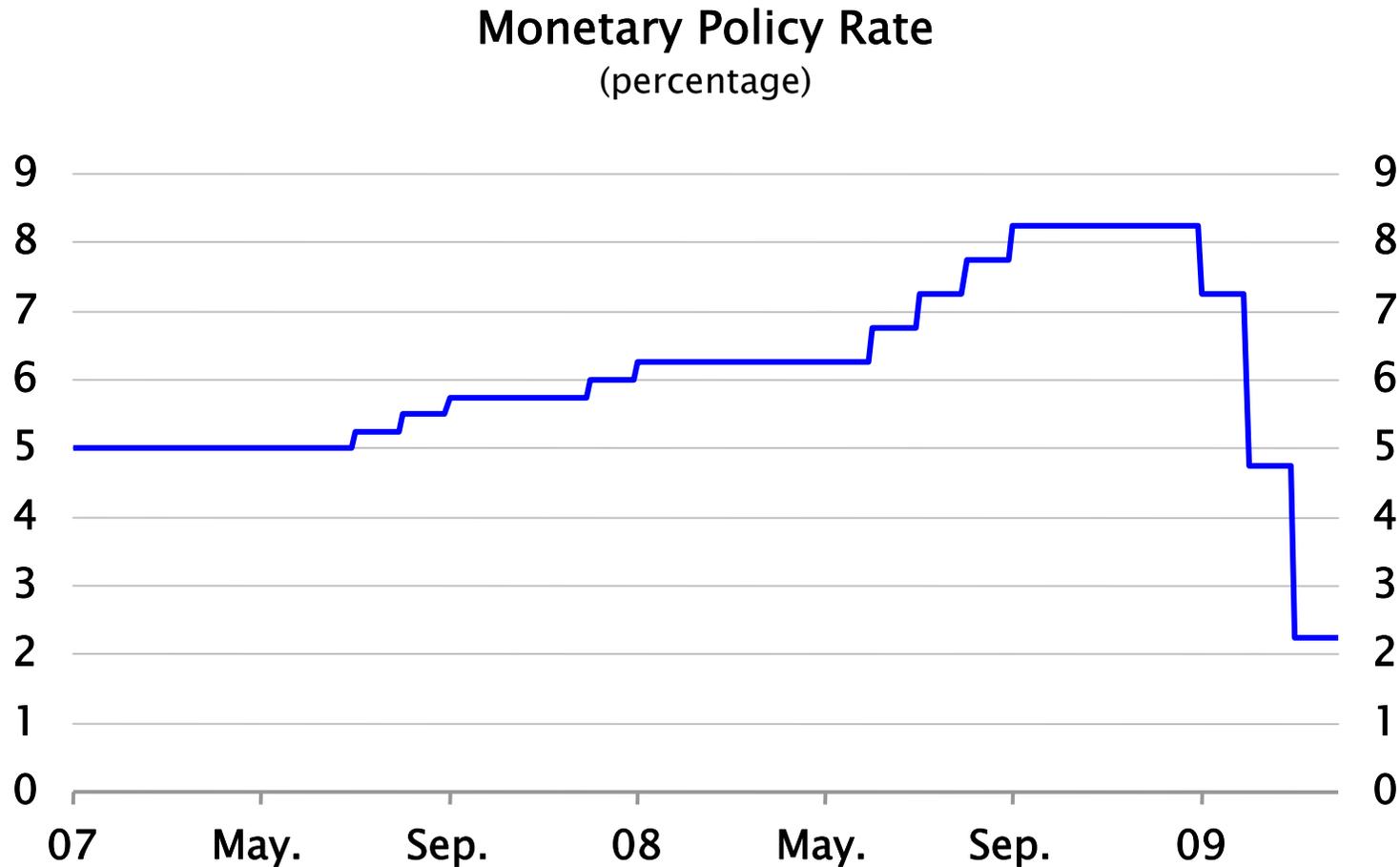


(\*) Considering breakeven inflation (BEI) based on forward instruments and the Economic Expectations Survey (EES).

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



In this context, the response of the Central Bank has been to soften monetary conditions fast and resolutely.

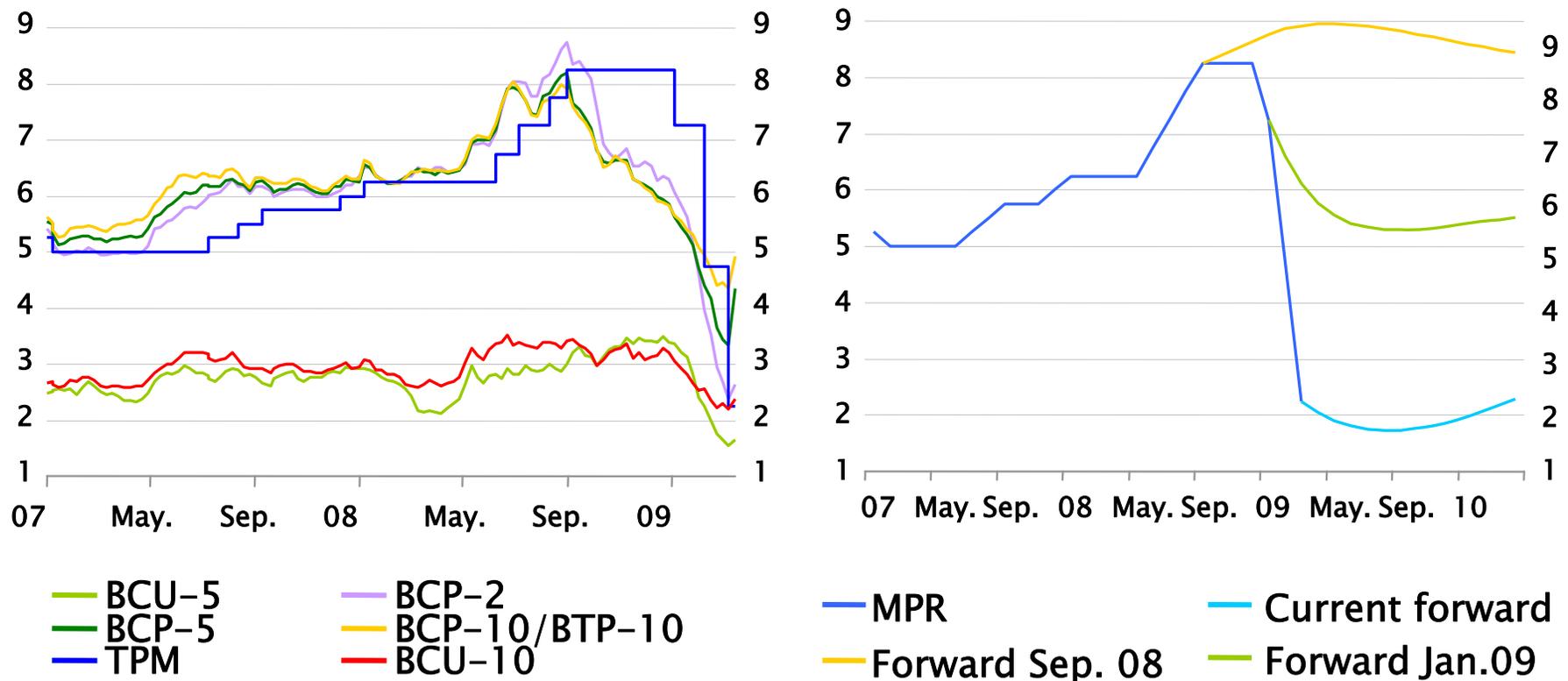


Source: Central Bank of Chile.



The Central Bank considers that further cuts may be necessary, although their magnitude and frequency will tend to follow historical patterns.

MPR, Interest Rates on CBC instruments and Forward Curve (\*)  
(percentage)



(\*) First figure based on weekly averages.  
Source: Central Bank of Chile.



# Final remarks



## Final Remarks

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- Policy responses to the global crisis by the Central Bank have taken place in different stages and have been dependent on the way this crisis has been transmitted to the domestic economy.
- Given its solid fundamentals, both fiscal and monetary policies are prepared and are being used to mitigate the impact of the crisis on the domestic economy. A significant fiscal stimulus package was announced and is being implemented and, simultaneously, the Central Bank has moved decisively and cut policy rate by a cumulative 600 basis point in the last three months.
- The risks ahead are enormous and more adverse scenarios can not be ruled out. For this reason, a key challenge is to keep an adequate policy coordination.



# Annex



# Snapshot of the Chilean Economy

|  | 2005     | 2006     | 2007     | 2008     |
|--|----------|----------|----------|----------|
| Gross Domestic Product (billions of USD)   | 118.2    | 146.8    | 163.9    | 169.5    |
| Real GDP growth (%)  | 5.6      | 4.6      | 4.7      | 3.2      |
| Consumer prices (annual % change Dec/Dec)  | 3.7      | 2.6      | 7.8      | 7.1      |
| Population (millions of inhabitants)   | 16.3     | 16.4     | 16.6     | 16.8     |
| Exports of goods FOB (millions of USD)   | 41,267   | 58,680   | 67,666   | 66,456   |
| Imports of goods FOB (millions of USD)   | 30,492   | 35,900   | 44,031   | 57,610   |
| Current account balance (% of GDP)   | 1.2      | 4.9      | 4.4      | -2.0     |
| Foreign exchange reserves excl. gold (millions of USD, as of 31 Dec. of each year) | 16,960.1 | 19,424.6 | 16,904.7 | 23,156.6 |
| Foreign debt (% of GDP)  | 39.1     | 33.7     | 34.0     | 38.2     |
| Average exchange rate (Chilean pesos per dollar)                                   | 559.8    | 530.3    | 522.5    | 522.5    |

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



## Baseline Assumptions for Key External Variables

(figures are annual averages)

|   | 2008 (e) |        |        | 2009 (f) |        |        | 2010 (f) |        |        |
|---|----------|--------|--------|----------|--------|--------|----------|--------|--------|
|   | Sep.08   | Nov.08 | Jan.09 | Sep.08   | Nov.08 | Jan.09 | Sep.08   | Nov.08 | Jan.09 |
| WTI oil price<br>(US\$/barrel)              | 115      | 105    | 100    | 116      | 70     | 50     | 115      | 80     | 60     |
| LME copper price<br>(US\$ cents/lb)         | 350      | 320    | 317    | 310      | 165    | 150    | 300      | 190    | 160    |
| Terms of trade<br>(annual change, %)        | -5.9     | -10.5  | -11.1  | -7.2     | -18.2  | -19.1  | -4.3     | -2.5   | -2.0   |
| External prices (US\$)<br>annual change, %) | 14.1     | 12.2   | 12.0   | 3.3      | 0.5    | -0.8   | 2.8      | 4.8    | 5.5    |

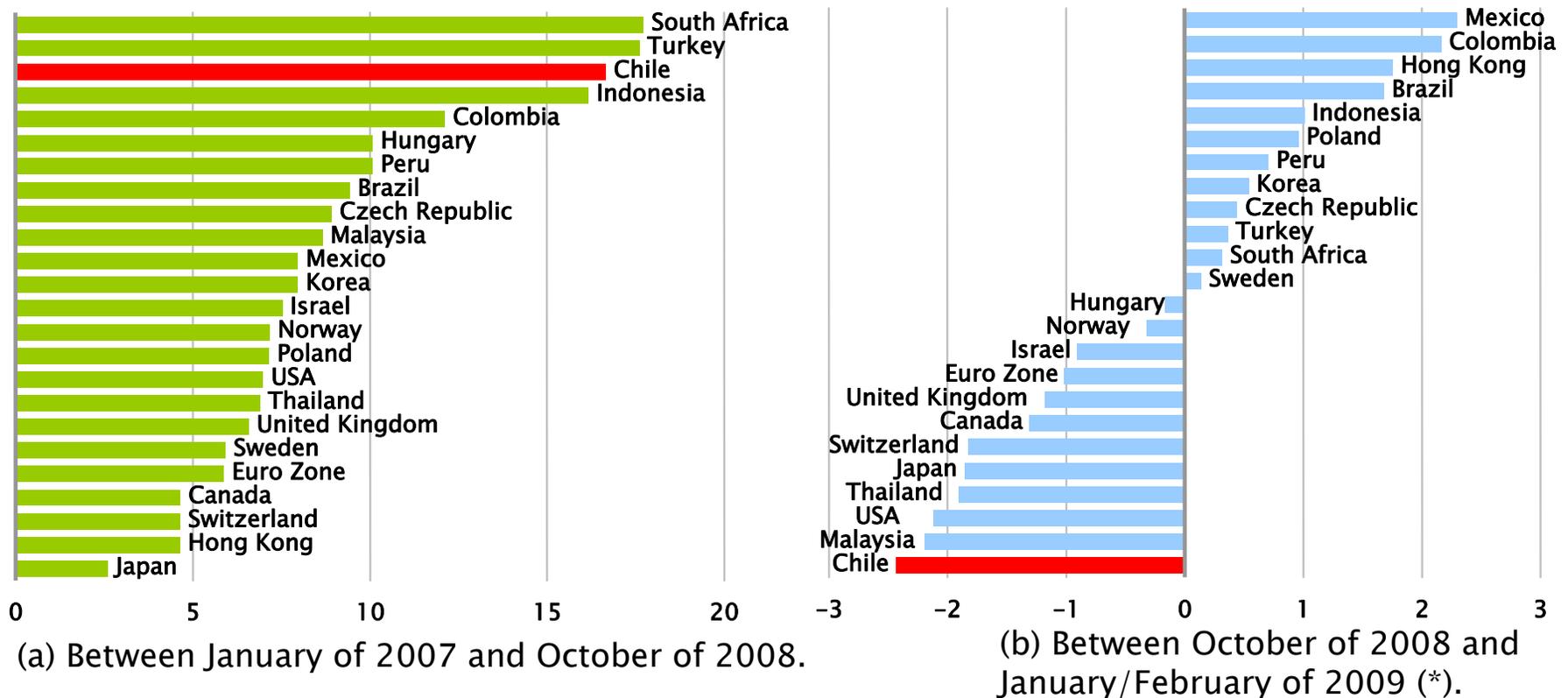
(e) Estimate; (f) Forecast.

Source: Central Bank of Chile.



Price changes at the world level are transmitted rapidly to the Chilean economy. This explains why Chile experienced a large increase in inflation until October last year, followed by a significant reduction thereafter.

### CPI: Accumulated change by country (percentage)



(\*) For Canada, Hong Kong, Hungary, Israel, Japan, Malaysia and United Kingdom data corresponds until January of 2009. For the others, until February of 2009. Sources: Statistics institutions of each country.