

## **Chile: Quarterly Review Fiscal, Monetary and Growth Prospects and the Budget Law for 2004<sup>1</sup>**

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Hello everyone. Thanks for dialing in. I will say a few words about recent macroeconomic and monetary developments and then Heinz will refer to the fiscal situation.

In recent years, the main selling point of the Chilean economy has been its stability. The economy has been able to withstand significant external shocks, including the slowdown or recession of the world economy and its impact on demand for Chilean exports, the high oil prices, and the problems in neighboring countries. Despite this adverse environment, the economy has continued to grow. Although this has been at a slower rate than in the period 1986 to 1997, it compares favorably with Chile's experience in the past and that of other economies. Also, inflation has been maintained under control and the financial sector, the fiscal accounts, and the external accounts have remained very solid.

The main news I have to report today is that the view that the Chilean economy, in addition to maintaining its positive fundamentals, will soon start to again grow at a faster rate, is consolidating. Last September the Central Bank published its latest Monetary Policy Report, and the forecasts we are now making are that, after reaching a growth rate of 2.1% last year and between 3 and 3.5% this year, the economy will grow between 4 and 5% in 2004. The Ministry of Finance has projections that are consistent with these numbers. These figures are not substantially different from the ones we had considered in May's Monetary Policy Report, but the good news is that now we have more information that tends to validate them. Indeed, while in May the balance of risks for activity was on the downside, in the September report we balanced our assessment. And that assessment, I have to say, did not take into account the improvements in the external environment of the last month or month and a half.

What is behind these improved perspectives? Of course, a major cause, of which you are well aware, is the improved external environment. World economic activity is picking up; our external terms of trade are also improving (copper prices have reached levels of almost 90 cents per pound) and external financial conditions are more favorable. I don't think I need to get in to any detail about the improved external outlook, as you know the subject well.

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<sup>1</sup> Presented at the Conference call "...", jointly hosted by Deutsche Bank and JP Morgan on October 22, 2003, and offered together with Heinz Rudolph, Director of International Finance and Capital Markets of the Ministry of Finance.

As a result, we also see increasing signs that economic growth is starting to pick up. In this regard, you may recall that, while domestic activity has been increasing since mid-2002, during the second quarter of this year the recovery weakened somewhat (GDP growth fell from 3.5% in the first quarter to 2.7% in the second quarter). However, the causes for this were transitory and now show evidence of fading. Partial third quarter expenditure figures show to us that strength continues, despite the fact that August growth was weak due to some temporary factors (August's indicator of monthly economic activity, Imacec, grew 1.2% in 12m).

In particular, numbers for consumption and household expectations are consistent with this gradual increase in the rate of growth. In September, the consumer confidence survey prepared by Adimark (IPEC) showed its highest value since early 2000. Also, recent growth in supermarket sales (7.1% in August) validates the increased optimism shown by the consumer confidence surveys.

On the investment side, in turn, capital formation has shown moderate strength, with gross fixed capital formation bordering 22.7% of GDP during the last quarters. With the improved prospects for overall economic activity, and improved indicators of company profitability and stock market quotes (IPSA has increased more than 50% this year), a higher level of investment in construction and machinery is expected next year.

Regarding internal financial conditions, these also are reflecting the improved perspectives and remain expansive.

In financial markets, one of the most noteworthy events of the last few weeks has been the appreciation of the peso with respect to the dollar (7.2% with respect to September 1; 647\$/US\$ Oct. 17 vs. 697\$/US\$ Sept. 1). Various elements can explain this appreciation. First, as you know, there is a generalized depreciation of the dollar on international financial markets (dollar has depreciated approximately 6% with respect to the Euro since early September). Second, as I mentioned before, terms of trade for the Chilean economy have improved significantly in the past weeks. Third, local interest rates have tended to increase while external rates have decreased, to which can be added the fall in our sovereign spreads (in early September the 2012 Chilean bond was trading at about 100 bp and is now at 73 bp).

In any case, the real multilateral exchange rate has tended to appreciate less. Currently, the real exchange rate is at levels similar to the average observed since early 2001. The exchange market functions well and the float provides flexibility to the economy.

Despite marginally lower credit growth and an increase in long term and lending rates, monetary conditions in Chile continue to be expansive. The moderate increase in interest rates is in line with the improved perspectives for the economy. Credit expansion remains strong, especially consumer credits (nominal 17% y/y in August; nominal annual average 16.7% y/y). Monetary aggregates continue to stabilize after the increases shown in the first few months of the year (M1A grew 16.7% y/y in September, while in March growth was 29.7% y/y).

Inflation pressures, in turn, remain subdued. As you know, the Central Bank uses its policies flexibly to confront more lasting deviations, in either direction, between projected inflation and the established target of 3% plus or minus one percentage point. Until now, the path of inflation (Sept: inflation +0.2% m/m; 2.2% y/y) has remained around the target, although core inflation (Sept.: 0.3% m/m; 2.3% y/y) has followed a path below what was anticipated a few months ago. The most recent figures indicate that price pressures are below what was foreseen and CPI is even expected to fall below 2% in some months. This, however, is expected to be a brief, transitory situation. With the information available, projections for inflation for the next 12 to 24 month remain around 3%. These medium term trends are influenced by several factors, including a process of gradual decompression of profit margins and increased unit labor costs. Inflation expectations from the survey of the private sector remain at 3.0% for one and two years, similar to earlier months. The expected inflation obtained from the difference between nominal and real rates shows a reduction, probably related to the recent path of the nominal exchange rate.

Returning to economic activity, and looking beyond 2004, there are favorable conditions for the current economic recovery to become sustained growth. In addition to the fact that all structural reforms implemented in previous years and decades remain in place, and that fundamentals relating to public finances, the financial sector, monetary policy and external sector have resisted well the adverse external shocks of recent years, one factor supporting faster growth in coming years will be the free trade agreements that Chile is engaging in with its main trading partners. In addition to the one which is in place since February with the European Union, the American Congress already approved a our free trade agreement with the US and we expect that this afternoon the Senate will approve the same one on our side, so that by January we should have it in place.

Estimates of the effects on growth of the agreement with the US are positive but uncertain, with skeptics claiming that the impact will be almost negligible, while optimists indicating that it may contribute with up to one additional percentage point per year for the next ten years. The magnitude of the estimated effects depend partly on whether one considers only the effects due to the reallocation of resources, or also the investment and dynamics effects of the agreement.

To conclude, there are good reasons to expect a faster growth rate in 2004 and beyond, including the improved outlook for the global economy, the improved mood in Chilean consumers and financial markets, the expansive monetary policy in place, coupled with the automatic stabilizers of the fiscal policy rule in place, to which I prefer not to refer to because it will be addressed by Heinz, and the trade agreements that Chile is implementing with its main trading partners. Inflation, in turn, is under control, and the Central Bank remains alert and will be ready to adjust its currently expansive monetary policy in order to maintain inflation within the target band.