

Remarks on Chile's Recent Macroeconomic Developments (Quarterly review - conference call 09.04.03)*

Hello everyone and thanks for dialing in. It's my pleasure to have the opportunity to present to you the recent events and prospects for the Chilean economy, together with Heinz Rudolph, and with the support of JPMorgan on this occasion. First I will address some short-term macroeconomic developments, focusing mainly on growth, inflation, and financial market variables, and then I'll say a few words about recent events at the Central Bank. Heinz will address the Corfo-Inverlink affair and its consequences.

1. Recent macroeconomic developments and prospects

Regarding growth, the good news is that available indicators suggest that the moderate acceleration of domestic demand and output observed since the second quarter of last year-- which led to growth rates of 3.2 and 4.1 percent, respectively, in the fourth quarter-- continued during the first three months of 2003. Consumption of durables was particularly high during the first quarter. In line with expectations, there also have been signs of a build up of inventories. Employment and output, in turn, have also shown increased dynamism this year.

The above, however, should be qualified because more recent news from the real sector provide mixed signals on the margin. Domestically, while recent data on industrial output and aggregate employment are consistent with the perspective of increased growth, the strength of some domestic demand indicators, such as consumer durables and real estate sales, has toned down on the margin. Also, consumer confidence has dropped, although this is probably related to the situation in Iraq, and volatile oil and transportation prices, so that a resolution of the war may also quickly revert those perceptions. On the international front, in turn, beyond the uncertainties associated with the war in Iraq, there are also doubts about the pace of the world economy's recovery. Fortunately, the financial situation of the region has strengthened.

In this context, the projection we provided in January that output in 2003 will grow faster than last year, accelerating from 2.1% in 2002 to a number between 3 and 4% this year appears to remain broadly valid. Similarly, the caveat we made that there was a downward risk on this projection also needs to be noted. The bank will provide an updated assessment of its projections in the Monetary Policy Report to be issued next May.

On the inflation front, in turn, the main news has been the high inflation rates observed in February and March, which imply that annual inflation in the period ending in March climbed to 4.5 percent. This increase in inflation is not surprising, given the high prices of oil and its derivatives that were seen in the weeks before the start of the war in Iraq. Core

* Hosted by JPMorgan and offered jointly with Heinz Rudolph, Director of International Finance and Capital Markets, of the Chilean Finance Ministry.

price measures such as the CPIX, which excludes from headline inflation fruits, vegetables and fuels, show that underlying inflationary pressures remain well subdued, with annual rates well in the lower half of the target range of 2 to 4 percent.

Even before the reduction in oil prices that followed the start of the war in Iraq, the Central Bank assessed at the time that underlying price pressures continued within the forecast margins, while inflation perspectives for the 24-month projection horizon used to determine monetary policy remained in line with the target. This view has been shared by the markets and analysts, whose inflation expectations as revealed by the comparison of indexed and nominal debt instruments as well as direct surveys converge around three percent.

In this context, the developments of the past weeks, particularly the decline in the price of oil and its derivatives, has tended to confirm the view that the increase in inflation of the past few months is essentially transitory. Given the current scenario, and insofar as this scenario of reduced oil prices remains, inflation can be expected to be within the band very shortly.

To complete this brief report on recent macroeconomic developments, let me note that the main financial variables during this period have been either quite stable, or moved mostly in response to concerns about the external scenario. In particular, interest rates on Central Bank papers were rather stable, with little fluctuation in short-term rates--centered around the policy rate of 2.75 annual percent and the expectation that rates will increase in the second half of the year--, and long-term rates that moved mainly according to external news or changes in monthly inflation. The foreign exchange value of the peso, in contrast, appears to have fluctuated mostly due to developments abroad related to the situation in Iraq, the world economy and the region, having depreciated until mid-march, when it reached levels of up to 760 per dollar, and appreciated afterwards to current levels around 720. Finally, the spreads of Chile's sovereign bonds remained quite stable throughout most of the period, except after mid-March, where we have seen a drop of about 30 basis points.

2. Recent Developments at the Central Bank

As you probably know, at the Central Bank we will soon have a new Governor, as Dr. Carlos Massad presented his resignation on March 31, which President Lagos accepted effective May 1. The resignation of Dr. Massad, as he indicated in a letter to President Lagos, which you can find at the Central Bank's web site, is due to the fact that he finds it very difficult to continue given the recent events, and the discussion that they have generated. These events and discussion are related to the discovery, due to an investigation ordered by the Governor himself, that his second secretary was stealing and sending market sensitive information to the General Manager of the stock brokerage arm of a financial holding named Inverlink.

On the theft of information, it is important to note that the Central Bank, led by the Governor and the Board, undertook rapid and complete measures to counteract the criminal acts and to eliminate or at least reduce the chance that they will be repeated in the future. Also, despite the additional workload that all this has generated, the bank has continued to work on improving its processes and policies, modernizing and making them more efficient

and transparent. If there is interest in the audience, I can provide some detail on these developments later on.

Following Dr. Massad's resignation, the President proposed Dr. Vittorio Corbo as a new Board Member, which will be voted upon in the Senate next Tuesday, where it is foreseen that he will amply surpass the simple majority required to be approved. Dr. Corbo is a highly distinguished and respected Economist, with a long list of publications, and an impressive record of policy and applied work in macroeconomic issues, both domestically and abroad. He has also strongly supported the inflation targeting and floating exchange rate policy framework that the Central Bank has adopted.

3. Final remarks

To conclude, during the first quarter of 2003, we appear to have seen a continuation of the higher dynamism that the Chilean economy showed during the last quarter of last year, with underlying inflationary pressures subdued despite the higher oil prices caused by the anticipation of war in Iraq. Looking ahead, the economy appears to be in a good position to grow faster this year than last year--with the specific outcome depending partly on how the world economy evolves--, and there is little doubt that headline inflation will return to a figure within the target range, at a pace that will be quick if the recent reduction in oil prices is sustained.

Finally, I would like to add, as a personal comment, that it has been a great honor and pleasure for me to work at the bank for more than two years under the presidency of Governor Massad. As deputy governor Jorge Marshall has said, he is the most prominent Governor the Central Bank has had. Also, let me share with you that it is my strong belief, and I am sure one my colleagues share, that Dr. Corbo will make a great contribution to the Central Bank and the Chilean economy.