Conference Call – September 2004

Good morning everyone and thanks to Gustavo Cañonero and Deutsche Bank for organizing this call. It is a pleasure to have the chance, usually every three or four month, to summarize for you recent developments in the Chilean economy.

This is a special occasion, since today's call will mark the last one that we deliver jointly with Heinz Rudolph, who will be leaving us to take on new challenges in his career. I will leave it to him to explain what his plans are and introduce who will be replacing him in future calls. I cannot let this opportunity pass, however, without saying that it has been a great pleasure to share with him this forum for a number of years now, as well as working together on a number of other joint efforts. Successful coordination between a Central Bank and a Ministry of Finance depends not only on proper institutions, it depends also on the people that have to carry out that coordination. It has certainly been very easy to work with Heinz these years, thanks to his great attitude, capabilities and efforts. I thank him for this and wish him the best.

Let me now move on, and discuss recent macroeconomic developments in Chile, which will be based on the Monetary Policy report that the Central Bank released last week.

Since May, the time of our last conference call, the Chilean economy has continued to strengthen, in line with expectations we had then. This has been supported by a favorable international economic climate, as well as strong financial conditions at home that reflect the sustained impulse of monetary policy. This external scenario and the resulting higher terms of trade, together with a stronger-than-foreseen recovery in investment, offset the reduction in consumption that the increase in oil price could have provoked in the short run. In this context, we expect that output growth during 2004 will be between 5 and 5.5%, in the upper half of the range between 4.5 and 5.5% we forecast in May.

The increase in the price of crude oil, that we had considered before as a risk, is affecting Chile particularly in the form of higher inflation, which is now expected to come close to 3% per annum by year's end, although its transmission to other prices will be limited. This picture considers CPI inflation ranging between 3% and 3.5% during part of 2005, to then descend past 3% toward the end of the usual policy horizon of 24 months. This would leave behind the undesirably low inflation episode of the last quarters. Core inflation, that so far has been close to previous projections, will approach 3% towards the end of the projection horizon, due to the persistent bridging of capacity gaps and with a gradual reduction of the marked monetary impulse. Hence, in its monetary policy meeting of September, the Board considered it appropriate to raise the monetary policy interest rate by 25 basis points, based on the favorable behavior and good perspectives of output and domestic spending.

The current and expected external environment for the Chilean economy continues to be very favorable, despite the higher oil prices that for us are certainly adverse. After growing by an annual average of about 4.5% during 2004, Chile's trading partners are expected to slow down somewhat, to around 3,5% annual next year, but still exceeding the average of the past few decades. Regarding oil prices, our current baseline scenario considers a price for *Brent* oil near US$37 per barrel this year and US$34 next, to approach US$28 only in the long term, a substantial upward correction of projections from the last *Report*. In spite of it all, Chile's terms of trade remain high, thanks to export prices —especially copper— above the ones forecasted a few months back. Today's projections place the average price of copper at US$1.26 per lb. this year and US$1.15 per lb. in 2005. Foreign financing conditions continue to be very positive, although sovereign spreads may rise with the normalization of the monetary impulse in the main economies.

In Chile, the expansionary monetary policy impulse has been transmitted through the various financial channels, including rapid growth in household consumption and housing loans, and a pick up in bank credits and other financing instruments to companies. In the fixed-income market, long-term interest rates have remained stable, even declining somewhat since May. The different monetary aggregates show, after many years, simultaneous increases in their growth rates.

Since May and until a while ago, the peso was somewhat more depreciated than was implicit in our previous forecasts. Such depreciation coincided with a similar response of other currencies and asset prices in emerging economies, responding to the possibility of a faster increase in interest rates in the U.S. More recently, these movements reversed as expectations moderated. In any case, our estimates of the real exchange rate, consistent with its long-term fundamentals, are slightly lower than the current value of the real exchange rate.

The Chilean economy is adjusting well to the implications of the present macroeconomic scenario, including an increase —partly temporary— in the terms of trade. This is apparent in higher growth rates of domestic expenditure, together with a substantial improvement in the external accounts.

In this sense, the dynamics of private disposable income, one of the most relevant variables for consumption behavior, has been affected mainly by the rise in the price of fuels, which particularly influences households with restricted access to credit markets. On the other hand, the increase in copper prices has had an impact mainly on the public sector's income and in payments to foreign-owned factors. Therefore, it is expected that, unless a dramatic fall in oil price occurs, in the second half of this year consumption figures will not continue to show the acceleration observed in the past few quarters, a condition already visible in some measures of durable consumption.

Although unemployment figures from the National Bureau of Statistics (INE) for the first semester showed an increase beyond their normal seasonal highs, for the moment there is no evident inconsistency of the aggregate labor market information with the faster pace of economic growth and the level of labor costs. Higher unemployment and the relatively stagnant total national employment as measured by the INE are associated basically to a reduction in self-employment and lower occupation in agriculture. On the other hand, salaried labor —substantially more sensitive to the business cycle than self employment— is showing annual growth rates not seen for the past several years. The behavior of salaried labor can be observed in other measures, such as the number of affiliates to the Chilean

Security Association and the vacancy indicator. The University of Chile's survey, meanwhile, shows a more promising labor market situation.

Hence, household spending is not expected to show additional signs of weakness attributable to the current behavior of the labor market. This matter, however, must be monitored with special caution in the quarters to come.

In the second quarter of this year, investment returned faster than predicted to a trend consistent with the macroeconomic impulse, characterized by favorable external conditions and expansionary monetary policy. In particular, imports of capital goods reached their highest levels since 1998, while information from the Capital Goods Corporation reveals improved expectations for the near future, consistent with other measures of expectations and with corporate earnings, particularly in export-oriented enterprises. This and other recent trends allow us to anticipate that this year, the ratio of investment to GDP (in constant terms) will reach 24%, its highest level of the last five years.

Exports and imports have been growing faster than expected in May. The expected value of exports for the year is above US$30 billion, with a significant positive trade balance. Thus, the current account surplus for this year is expected to be in the range of 2.5% to 3% of GDP, more than forecasted a few months back. The volume of exports and imports also show strong dynamism, particularly in manufacturing and mining, although their growth rates have been affected temporarily by recent sharp increases in productive capacity and drops in inventory in the mining sector.

In the second quarter of this year, manufacturing activity continued to grow at around 5% per annum. This was explained both by the behavior of consumer-oriented producers since the middle of last year, and by the results of natural-resource-related sectors, especially fisheries and wood pulp. It should be mentioned that the current constraint on natural gas supply from Argentina between June and August was almost 70% less than considered in May's *Report*, and lately it has virtually disappeared.

The economy is thus approaching a GDP growth rate between 5% and 5.5% for this year, with domestic expenditure increasing at a similar pace. Towards 2005, a number of factors combine to determine growth. Despite the expected slowdown in the world economy and the increase in oil prices, the expansionary monetary conditions and the normalization of investment will contribute to growth rates in the 4.5% to 5.5% range next year, with domestic expenditure around one point above these numbers. This growth scenario does not differ much from private projections such as the Central Bank of Chile's expectations survey and analyses reported in *Consensus Forecasts*. The current account balance is expected to post a surplus larger than forecasted in May, thanks to national savings recovering more strongly than investment. This yields a current account surplus between 2.5% and 3% of GDP this year, and around 1% in 2005.

These projections are based on an interest rate path associated with a monetary impulse that declines gradually over the next few years, consistent with achieving the defined inflation target range centered on 3%, that is comparable with the rates that can be derived from the prices of financial assets. On the other hand, the baseline scenario considers a slight appreciation of the exchange rate over the next two years from its level of the past ten days. These working assumptions must not be taken as a commitment from the Central Bank with respect to the future conduct of monetary policy. Other factors, such as the actual evolution of inflation, growth and some key prices, will produce changes in inflation projections over the usual policy horizon and, thereby, on the course of monetary policy.

Trend growth prospects for the Chilean economy have remained fairly unchanged, although the recovery of investment and of the cyclical component of total factor productivity should favor an increase in the growth rate of productive capacity in the short term. Thus, for the next two years, trend growth is still expected to go from around 4% to slightly below 5%. No significant short-run effects on productive capacity are expected from higher international fuel prices. Thus, existing excess capacity should tend to clear progressively.

This bridging of capacity gaps, plus the gradual decline in unemployment rates, are crucial elements underlying the Central Bank's medium-term inflation projections. The evolution of labor costs will also have a decisive effect. Today, core inflation CPIX1 is expected to continue increasing along the same lines as this year, concluding the period of undesirably low inflation and returning to the target range.

Recent news came mainly from the strong rise in fuel prices, which will result in one point of higher CPI inflation by year's end. Although in principle this is a cost-side shock with only a one-time effect on the price level, given the magnitude and persistence of the oil price increase, by early next year the trajectory of inflation will be above the projections of some months ago.

First, due to wage- and other price-indexation mechanisms, part of the increase in CPI inflation will be gradually transmitted to costs and some specific prices. Second, the increase in import costs due to the higher price of fuels and, more generally, to a higher forecast of world inflation, will add to the underlying cost pressures. Finally, retail margins have stopped compressing, and some components that are more closely linked to domestic supply and demand conditions, have even shown a recovery since early in the year, which is expected to continue.

The persistence of the oil price increase and the magnitude of its transmission to core inflation will have to be closely monitored in coming quarters. Our projection scenario considers that the degree of indexation of the Chilean economy today is less than it was in the past, and that margins can temporarily absorb part of the higher import costs.

All considered, we expect annual CPIX1 inflation to average around 3% over the projection horizon, while CPIX and CPI inflation will average slightly less than 3%. This is consistent with CPIX1 inflation converging from its spot rates of 2% to somewhat above 3.5%, and declining gradually to 3% in the course of 2005 and 2006.

The expected inflation rate that can be deduced from the Central Bank's expectations survey and from *Consensus Forecasts*, as well as from inflation compensation implicit in differentials between nominal and indexed interest rates, is at or below 3% per annum at different terms.

Although conditions continue to be favorable, the economy is still exposed to risk scenarios that may drive inflation and output growth figures away from the projections in our baseline scenario. Internationally, there is uncertainty about the short- and medium-term behavior of oil priced, and about the impact of the evolution assumed for oil priced on the pace of global activity and inflation in the main economies. In addition, fiscal and external imbalances have persisted in the largest economies, and so the possibility still exists of sudden adjustments that may introduce additional volatility in international financial markets. Risks for the baseline scenario might be magnified by an overreaction of economic agents to an unexpectedly steep rate cycle in the US, affecting the more indebted emerging economies with more intensity.

With regards to domestic activity, the most notorious risks are associated to the behavior of consumption and investment in the short run. On the one hand, so far high oil prices have been assumed to have a limited impact, and the recent evolution of the labor market has been considered to place no additional risks on household expectations. Both elements must be carefully assessed in the quarters to come. On the other hand, the recovery of investment was a surprise, but for the time being it is being taken as a sooner than expected normalization, without resulting in the next few years in a substantially higher gross capital formation ratio to GDP than estimated for this year. However, it is possible for this component of expenditure to react more intensely than expected to the current expansionary monetary conditions and to positive macroeconomic scenarios both outside and inside our borders.

Finally, the baseline projection scenario assumes that the transmission of the increase in fuel prices to core inflation will be limited. What will be the final magnitude of this transmission, particularly its effects on wages, inflation expectations and actual inflation, only time will tell. Similarly, only time will reveal the actual effect, if any, of the shortening of the working day on Chile’s macroeconomic scene.

The implications of all these risks on the Chilean economy and on monetary policy are not evident, because direct price pressures combine with other developments that influence the behavior of capacity gaps. However, the Central Bank’s Board estimates that, overall, the balance of risks associated to the evolution of output is balanced, and that for inflation it is biased upward.