Conference Call – June 4th 2004

Hello everyone and thanks for dialing in. My presentation today will be based on the Monetary Policy Report that the Governor of the Central Bank of Chile, Vittorio Corbo, presented to the Senate Finance Committee last Tuesday.

Overview

Chilean economic growth is gradually strengthening thanks to the improving world economy, expansive monetary conditions and the more optimistic outlook of both the business sector and consumers. In the most likely macroeconomic scenario, the Board considers that output growth should rise to the level foreseen in January, that is 4.5% to 5.5%, while consumer price inflation (CPI) should reach the lower level of the target range by the end of this year and converge to 3% by end-2005. These are the core projections, and in what follows I will elaborate on what lies behind these projections. At the end of this presentation, I will also talk about the threats that might affect them.

External environment

On the external environment I will say very little, since you are probably very well informed. The basic point is that it has improved considerably since te beginning of the year. There is increasingly stronger growth in the world economy and the improved world scenario has substantially boosted commodity prices, especially copper, in the past 12 months. Also, despite well known risks, international financial conditions remain quite favorable. Perhaps the only concrete bad news so far has been in oil prices, which have been pushed up by increased demand and by geopolitical risks in the Middle East. Nonetheless, the way we foresee export and import prices developing will produce a greater improvement in terms of trade than we had previously forecast.

Regarding the financial environment facing emerging economies, although it remains favorable, it has recently been shadowed by expectations of a cycle of interest rate hikes in the United States, raising concerns about liquidity in emerging economy debt markets, and increased wariness to risk and wider spreads in emerging economy sovereign risk premiums.

Our country is on a very good footing to adjust to the new conditions. Firstly, Chile has a framework of macro policies – fiscal surplus rule, monetary policy with inflation targeting and a floating exchange rate - and a low inflation rate that can assimilate this new reality by price rather than volume adjustments. Secondly, the Chilean banking system is well regulated, supervised and capitalized and has shown in the past that it is resilient to shocks. Thirdly, the way in which both the private and public sectors of the economy have absorbed the recent terms of trade improvement has resulted in a current account surplus and thus strengthened our economy to face abrupt changes in the international financial situation. Consequently, the global financial conditions facing us continue to be favorable, as we can see by the sovereign spread which is only fractionally above its past minimum levels.

Domestic environment

Chilean economic growth is expanding in line with our previous report's forecast and should continue that way for the rest of the year. Several factors are behind this growth: firstly, the improved external environment - better terms of trade, markets more favorable to our exports, good conditions of access to international financial markets - boosts export growth as well as consumer and business-sector confidence. Confidence has dipped recently but in general remains high. Secondly, monetary and financial conditions are very favorable with monetary policy rates and lending rates at all-time low levels. Thirdly, investment is recovering as growth consolidates. With these factors in mind we can confidently forecast the 4.5% to 5.5% growth rate for this year.

Restrictions on natural gas supplies from Argentina will affect this year's growth to some extent because they imply greater energy production costs and they will hurt some manufacturing industries. However, according to the information now available, a four-month restriction of 7 million cubic meters of gas a day would only cause a 0.1% drop in the growth rate. But, if restrictions were more severe, the effects would not be proportionately worse because increasingly less efficient methods of replacing gas would have to be used.

With regard to the components of domestic spending, increased national income is producing the expansion in private consumption that we forecast at the beginning of the year and investment is starting to be more consistent with the economy's current expansive cycle. Investment should continue to strengthen throughout the year for a series of reasons. Firstly, the satisfactory trend of firms' profitability. Secondly, they are enjoying favorable conditions for financing. Thirdly, idle capacity is being gradually taken up. And fourthly, business confidence is strong. Increased private consumption together with investment recovery should bring domestic spending growth in 2004 to a half to one whole percentage point more than GDP growth. At the same time, improved external conditions and Chile's greater integration into the world economy provide an impetus to exports, with agricultural and industrial exports both growing by more than 10% a year. Output and domestic spending growth, together with improved terms of trade and a real exchange rate slightly below the current value, should result in a balance of payments current account surplus of over 1% of GDP. If world growth in 2005 slows slightly, as in our central scenario, output should still expand with an additional reduction in idle capacity.

On the labor front, job creation has slowed since the end of last year. This reflects, on the one hand, significantly higher productivity which enables firms to grow without taking on more workers and, on the other hand, the end of a pronounced cycle of rising employment. As we advance in the growth cycle, there should be a more significant increase in employment and this is already perceptible in vacancy statistics. It should be pointed out that recent rises of the seasonally adjusted unemployment rate basically reflect expansion of the workforce as we advance in the growth cycle and not loss of jobs.

The peso-dollar exchange has risen in recent months for several reasons. On one hand, the dollar has appreciated against several currencies in international markets as a result of the consolidation of growth in the United States and in expectation of interest rate rises. On the other hand, the drop in copper price from the very high levels reached in mid-April has made itself felt. The recent depreciation of the peso is in fact very similar to that of the currencies of industrialized countries that export commodities such as Australia and New Zealand. Chile's best means of protection against turbulence in international financial markets are our current floating exchange rate system, inflation targets and a structural surplus rule. Nevertheless, the Central Bank will maintain its option of intervening in the exchange market in the event of the peso price varying markedly from a value coherent with our sound economic bases and with the variables that determine it.

With regard to inflation, the lower annual inflation rate anticipated for this year in the January *Monetary Policy Report* has materialized, although the measures of underlying inflation (CPIX and CPIX1) are somewhat below what were then foreseen. Total CPI inflation, on the contrary, is close to forecast with the higher-than-expected domestic fuel price inflation offsetting the lower underlying inflation. The behavior of inflation in the future depends mainly on three factors and how they evolve: (1) idle capacity (2) unit labor costs, prices of fuels and imported commodities and trade margins; and (3) inflationary expectations.

With regard to the first, recent evidence shows that spare capacity has only marginally been reduced and this should continue gradually.

With regard to costs, despite recent real-earnings growth associated with the unexpected drop in inflation, growth of unit labor costs has slowed thanks to increased productivity. Domestic fuel prices should go down gradually during this year and next. Prices of imported commodities, on the other hand, should start to go up as deflationary effects of last year's peso appreciation dissipate and in response to the moderate rise in relevant external inflation caused by higher world inflation. Trade margins, although not so tight as they have been on previous occasions, should start to expand as economic growth progresses.

Inflationary expectations, however it is measured, are higher than the minimum levels at end-January and close to 3%. Two factors account for these expectations. In the first place, recent international fuel price increases and depreciation of the peso and, in the second place, the Central Bank's reiteration of its inflation target at the beginning of the year and backing up that target by reducing the monetary policy rate by one percentage point.

Finally, with regard to the direct effects on inflation of any natural gas supply cuts, these will be limited since electricity has a weight of 1.6% in the CPI basket and natural gas for home use only 0.4%. Quantitatively the new telephone charges have more downward effect on the CPI.

In the central scenario of our projections, annual inflation should return to the lower level of the target range by end-2004 and then gradually converge towards 3% by end-2005. Nevertheless, in the short term, monthly inflation rates will fluctuate according to the behavior of fuel prices and regulated prices.

Scenarios of risk

Our central scenario is threatened on both the external and the domestic fronts. On the external front the main risks are (1) in the short term, a higher-than-expected external interest rate rise which could lead to greater degrees of turbulence in the economies of our region with possible consequences on country risk ratings and exchange rates. (2) The price of oil may not go down as soon as expected or may even go up, thereby affecting inflation and eventually consumption. (3) China must gradually stabilize its growth rate. Braking too quickly would have collateral negative effects, albeit manageable, on the world economy and on terms of trade. (4) The timing and the way in which fiscal imbalances are corrected in some developed economies, especially the United States, pose a threat in the medium term.

On the domestic front, the main risks are (1) a more severe reduction in supply of natural gas from Argentina. As we mentioned before, recent supply problems have a limited effect on the economy but a more severe reduction would produce more drastic effects. (2) Domestic spending could react faster and more intensely to the improved external scenario envisaged for this year and next.

In the light of all these factors, the Central Bank considers that, in the central scenario, growth is soundly balanced whereas inflation tends slightly upwards.

Conclusions

As a whole, the information provided by this *Monetary Policy Report* confirms the promising external and domestic situations facing the Chilean economy. We can therefore reiterate our projection of GDP growth reaching 4.5% to 5.5% during 2004. Towards 2005, idle capacity should continue to be taken up and inflation should return to the center of the target range, that is 3%.