Recent Macroeconomic Developments in Chile: Quarterly Review
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Hello everyone and thanks for giving me the opportunity to address the growth and monetary prospects for the Chilean economy. In this occasion, my report will be based on the presentation recently made by the Governor of the Central Bank, Vittorio Corbo, at the Senate, when we released our January 2004 Monetary Policy Report.

The Chilean economy's outlook for growth has significantly improved since our last conference call thanks to the upturn in the world economy and the fact that throughout these difficult years Chile has kept its macroeconomy in order which has allowed an expansive monetary policy.

Four factors in the international environment have been of particular importance. These include: (1) increasingly stronger growth in the United States and the emerging economies of Asia; (2) higher commodity prices, which have caused a considerable improvement in our terms of trade; (3) more favorable international financial conditions; and (4) greater calm in our region, with Argentina and Brazil gradually recovering.

Our own domestic situation is appropriate to take advantage of the improved world environment, which should lead to increased domestic spending and economic growth. The domestic factors boosting growth are: (1) better outlook for the labor market; (2) greater consumer confidence; (3) inflation below the target level with a significant output gap, which allows the Central Bank to be very active; and (4) macroeconomic conditions that favor a recovery of investment. The combined effects of these external and domestic factors have led us to revise our growth forecast for 2004 upwards to between 4.5% and 5.5%. We estimate that growth for 2003 was 3.2%, in line with the forecast of last September.

Rising private consumption and a likely recovery of investment expenditure should make domestic spending this year increase at a rate some 2 percentage points above that of GDP growth, without causing any imbalances. Exports of goods and services should continue to increase thanks to the improved world economy and the opportunities opened up by recent trade agreements with the European Union and the United States. The pace

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of domestic spending and output growth, together with improved terms of trade, and assuming a real exchange rate around the current level, should lead to a current account deficit of about half a percentage point of output in 2004. If the central scenario of an expansive world cycle is maintained, output growth should be even better in 2005 and the current account deficit should be close to 2% of GDP.

In recent months, inflation has dropped substantially and unexpectedly, mainly as a result of surprises in costs. Among them, an important surprise has been the rapid appreciation of the peso, which has affected the prices of tradable goods and the domestic prices of fuels and regulated prices (transportation and basic utilities). We estimate that the appreciation of the peso since September to date alone accounts for 0.8 percentage points of the drop in inflation compared to what we had forecast in our previous *Report*. Another factor that has contributed to the sharp drop in inflation in recent months has been the lower prices of non-perishable goods achieved by improved efficiency and greater retail competition. This factor accounts for some 0.6 percentage points of the drop in inflation, again compared to our forecast in the previous *Report*. Thirdly, fuel prices in dollars have been lower than we had foreseen and this explains a further 0.2 percentage points of the drop in inflation to December. Finally, another 0.3 percentage points can be attributed to the lower inflation passing through to other prices because of indexation and other factors. These elements will continue to pull down twelve-month inflation during the next two quarters. In addition, during this period, twelve-month inflation figures will compare current prices with the exceptionally high prices that prevailed last year around the war in Iraq, when prices of oil and its by-products soared. All these factors make us expect that twelve-month inflation will drop to negative values during some months of the first half of this year, even reaching down to around -1% in March.

Although this drop in inflation, mainly due to cost factors, is basically transitory, it will persist to a certain extent because of its effects on index-linked prices. It could also be made more persistent because low inflation may lower expectations of inflation of price and wage setters. Our estimate is that these supply shocks are likely to affect inflation until the end of our projection horizon. It was precisely to counteract these effects and prevent expectations of twelve-month inflation falling substantially below 3%, which would drag down inflation in 2005, that the Central Bank Board at its meetings in December and January decided to lower the monetary policy rate by 50 basis points in each occasion. The main aim of these measures is to redirect inflation to the center of the target range, that is to 3% within a 24-month horizon, and to encourage economic agents to use this value when setting prices. Given that monetary policy changes usually have a lagged effect on inflation, we don´t expect these changes to have much of an impact in the short term, but they will wield an effect on inflation over one or two years. In a scenario of economic activity growing at the level expected for 2004, with an additional closing of the output gap in 2005, and supposing that oil prices conform to the *Report's* forecast (US$27 in 2004 and US$24 in 2005), and that the real exchange rate stays around the level observed during the last month- as well as other assumptions about work detailed in the *Report* - then consumer price inflation in the twelve months to December should be 2% for 2004 and 3% for 2005. Core inflation, in turn, should reach 2.7% this year and 3.2% by end-2005.

With regard to recent behavior of the peso-dollar parity and the real exchange rate, there are several factors to consider. Firstly, the dollar reached a very high value towards the end of 2002 and in the first quarter of 2003 because markets were apprehensive due to the risk presented by Brazil and beset by uncertainty about the outcome of the war in Iraq. Secondly, the dollar has fallen sharply against the main currencies of the world and this has also affected the peso. Thirdly, the factors that determine the real exchange rate have recently been affected by a series of developments that have driven it to appreciate. Among these developments are: a strong and sudden rise in the current and projected price of copper; improved external financial conditions, thanks to low international interest rates and the significantly better financial condition of Brazil; and a more encouraging outlook for growth of the Chilean economy in 2004 and 2005. The importance of the dollar's weakness in the recent appreciation of the peso against the dollar can be seen by observing that, with a real exchange rate with respect to the five main currencies (RER-5) similar to the one of the last month, and with the international exchange parities of December 2001, before the dollar began to weaken on international currency markets, the exchange rate today would be 660 pesos to the dollar. It should also be pointed out that this appreciation of the peso is not in response to financial imbalances or arbitrage problems caused by speculative capital. In fact, we have recently been seeing net capital outflows, primarily of pension fund investment abroad.

In summary, everything appears to indicate that 2004 will be a good year for growth, while twelve-month inflation will be expectionally low during most of the year due to recent surprises in costs. The Central Bank does not want the recent and unexpected drop in inflation to persist, and consequently, has aggressively confronted it in order to bring inflation to the 3% target, confirming the countercyclical role of monetary policy in a scheme of inflation targeting and floating exchange rate.

Finally, it bears repeating that these forecasts constitute the central scenario considered most likely. Of course, there are relevant risks that create alternative scenarios, both for growth and for inflation. On the external front, a main risk has to do with the evolution of the dollar against other currencies -particularly a further weakening of the dollar that could delay inflation returning to the 3% target set- and the evolution of international interest rates -where rate hikes could have negative effects on some countries of the region, complicating the external environment, particularly the financial conditions. On the other hand, world economic growth may be faster than expected, with copper and other export prices rising further. On the domestic front, some of the main risks are: (1) that spending and economic activity do not pick up because, for example, the external environment does not rebound as expected; (2) that investment growth remains weak despite the improvements observed in the conditions favoring it; (3) that private inflationary expectations remain stubbornly below 3%; and (4) that the rise in nominal earnings is not in line with the low rates of inflation observed, which means that labor costs would exert inflationary pressures. The latter two risks point in opposite directions regarding inflation, and highlight the fact that the lack of precedent in Chile regarding the short-term scenario of negative inflation outlined above raises the uncertainty about its consequences on inflation expectation and price and wage setting.

Nonetheless, the Central Bank considers that risks for growth and inflation are balanced. In particular, we believe that the current expansive direction of monetary policy is consistent with inflation reaching the center of the target range within the projection horizon, that is, on average below 2% in 2004 and close to 3% in 2005.