Recent Macroeconomic Developments and Prospects in Chile: September 2005[1]

Rodrigo Valdés
Director of Research and Chief Economist
Central Bank of Chile

Good morning and thanks for the opportunity to analyze with you the last developments and prospects of the Chilean economy.

As you probably know, we presented our Monetary Policy Report only two weeks ago. Therefore, many of my remarks will be based on this document.

We currently evaluate that domestic demand and economic activity continue in an expansion phase, showing more strength than was expected in the previous reports. Investment continuous to grow strongly, while increasing employment and more optimistic private expectations favor consumption growth, despite higher oil prices.

Good global conditions —namely strong world output growth, together with high copper prices and good financial conditions— and the support of domestic monetary policy have played a role in these developments. All in all, we expect growth to be between 6 and 6½ percent this year and in the range 5¼ to 6¼ percent in 2006.

In the inflation front, we have seen the core inflation trend rising gradually during the lasts months at approximately the expected pace. Today, annual headline CPI inflation and the various inflation trend measures are within the target range of 2% to 4%. However, higher oil prices and utilities raised CPI inflation to 3% sooner than expected. Morover, we are now forecasting that inflation will increase to around 4% during the first quarter of next year.

Going forward, in the most likely scenario, these once-and-for-all price increases and the narrowing of the output gap are not expected to have a persistent effect on the inflation trend. On the one hand, contained unit labor costs and the recent real peso appreciation should cushion other cost increases. On the other hand, a more importantly, the normalization of monetary conditions over the coming quarters is the key element that permits the increase in CPI inflation to be temporary and its convergence to 3% in the second half of 2006.

As a matter of fact, in the Monetary Policy meeting last week the interest rate was increased by ¼ point to 4%. Furthermore, the Board reiterated that, in the most likely scenario, it will continue to reduce the monetary stimulus, in order to maintain forecast inflation around 3% per annum in the next 12 to 24 months, that is our policy horizon. Of course, as always, the actual pace of adjustments will depend on incoming data.

[1] Presented at the Conference call "Chile—Fiscal, Monetary, and Growth Prospects", hosted by Citibank and offered jointly with Bernardita Piedrabuena, Macroeconomic Coordinator, Ministry of Finance, Chile on September 13, 2005.

Let me now analyze some of these developments in some more detail.

First I should mention that despite the higher oil price, the world scenario is still favorable for the Chilean economy. The terms of trade will increase this year almost 6% and, as you know, it is expected that growth of the world economy and of Chile’s trading partners will remain strong through 2005 and 2006. Copper prices will probably decline faster than oil prices so terms of trade for Chile should decline next year (8.5%). So far, the financial conditions faced by emerging markets are very good.

In our country, the expansionary stance of financial conditions has somewhat diminished in recent quarters. However, they still are clearly expansionary. For instance, the monetary policy rate is below alternative measures of what could be thought of as a neutral stance, long-term yields on indexed bonds are still low, while commercial credit and wider monetary aggregates continue to grow fast.

Regarding the exchange rate, you all witnessed the substantial peso appreciation between mid-June and mid-August. The real exchange rate moved approximately in tandem, and, to the closing of the Monetary Policy report, was 7% below levels of last May.

As happens with the price of financial assets, these movements have no clear-cut explanation. Our impression is that the better terms of trade scenario, that have become more persistent, combined with strong cyclical recovery and solid external accounts in the past few years, indicate that this realignment of the real exchange could be fairly persistent. Furthermore, we have stated that these fluctuations are normal in a floating regime.

The Chilean economy’s current expansion cycle had an early stage where investment and exports recovered during 2003-2004, accumulating a considerable surplus in the current account in 2004. Later on, it came the expansion of non-tradables and consumption, with the current account gradually moving to deficit. This transition has been accompanied by a strengthening of the peso in real terms.

As I mentioned at the beginning, domestic demand continues to expand vigorously. It grew 11% yoy during the first half of the year. Consumption continues to grow faster than output, in line with past forecasts while fixed capital formation continues to exceed expectations. As for fiscal policy, the revision of the parameters that underline the structural surplus rule of 1% of GDP will permit fiscal spending to grow above trend GDP growth during 2006. We will have the exact figures soon with the discussion of the budget.

Exports of goods and services have also contributed to growth, with an annual increase above GDP growth during the first half of 2005. The mining export volume actually declined, so greater manufacturing and agricultural shipments explain this positive performance. Imports, meanwhile, have reflected the large expansion of purchases of capital and intermediate goods.

In the second quarter this year, GDP expanded 6.5% yoy. This, combined with revisions to first-quarter figures placed annual GDP growth for the first half in 6.3%. As you probably know, July Imacec—known after the closing of our Monetary Policy Report—was less robust than in previous months. The available information points to circumstantial and probably temporary factors.

The labor market has performed in line with the favorable macroeconomic environment. In recent months, the seasonally adjusted unemployment rate has dropped substantially — close to 8% in the last reading— because of strengthened occupation. Year-on-year total employment grew

Overall, in this macroeconomic scenario we expect that the economy will grow between 6% and 6.5% this year. In its composition, non-tradable sectors should gain importance, as should domestic demand, particularly consumption. These trends should consolidate next year. With the world economy decelerating mildly, terms of trade declining somewhat, and the macroeconomic impulse being normalized in Chile and internationally, we think GDP could expand by 5¼-6¼%.

The trade balance will continue to show a substantial surplus, more than US$9.5 billion this year, and is expected to drop to a bit less than US$6 billion in 2006. The current account, in turn, should show a small surplus this year and a deficit close to 2% next year.

Regarding prices, in recent months headline CPI inflation has been affected mostly by the higher international fuel price and specific prices, such us utilities. Although it can be expected that the underlying inflation trend will be influenced by the faster closure of gaps and the higher oil price, this evaluation needs some caution. Indeed, the main indicators of core inflation continue to grow much more gradually than expected a year ago or earlier. Moreover, as I mentioned before, both the favorable evolution unit labor costs and the peso appreciation of recent months should help to ease some pressures coming from costs.

Taking all this under consideration, we forecast that the increase in annual CPI inflation to near 4% toward the turn of next year should be a temporary phenomenon, with contained second round effects. We expect CPIX1 inflation —a core inflation measure that excludes oil, perishable goods and utilities— continue to rise, approaching 3.5% during 2006 and part of 2007, to later converge to 3%. Similar price dynamics were present in early 2000 and early 2003, when large oil price hikes did not result in persistent deviations of CPI inflation from the target.

In recent weeks private inflation expectations have increased, especially for one year ahead and sooner. This movement, however, has been in line with the temporary increase in inflation projected in the *Monetary Policy Report*.

As always, there are several important risks in our baseline scenario. The main ones coming from the world economy are related with the oil price. There are also risks associated to a more pronounced deterioration in the external financial conditions relevant for the Chilean economy. Domestically, investment could surprise again with the strong dynamics it has shown so far. Finally, in the inflation front, the actual transmission of the increases in various specific prices on core inflation could differ of what we have assumed.

Many thanks for your patience.