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

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I thank Pablo Goldberg and Merrill Lynch for hosting this call, as well as those that dialed in for giving me an opportunity to make some remarks on Chile's recent economic developments and prospects.

There has been news in Chile since our last conference call in January. For instance, winter is approaching and, after several days of rain, we have today in Santiago a cold but beautiful day with a blue sky and snowy-white mountains. Also, a modern urban highway built, operated and paid up by the private sector began its operations, drastically reducing transfer time between uptown and downtown. More recently, on Wednesday this week, the Central Bank released its latest Monetary Policy Report, which will be the basis for my presentation today, and that you can download from our web site.

On the economic front, however, the broad picture is similar to what it was last January. As the analysis in the report makes it clear, everything suggests that, after the period of relatively slower growth observed in the Chilean economy between 1998 and 2003, we began in 2004 a period of faster growth that should last for a while. Also, inflationary pressures appear to be contained, so that, in order to maintain expected inflation in line with our target of 3%, this environment of faster growth is consistent with a gradual normalization of the monetary policy rate towards a neutral rate. Regarding the specific cyclical position of the economy, the Chilean economy is going through the current expansionary stage in a healthy manner, saving part of the temporary increase in income, while the main variables associated to output and expenditure are consistent with the cyclical upturn diagnosed a few months back.

On the external environment relevant for Chile, the main change since the beginning of the year has been an important increase in the price of copper and oil. As a result, we have revised our forecasts for 2005 for the average price of copper from 120 cents per pound to 139 cents per pound, and the average price of Brent oil from 39 to 48 dollars per barrel. Since our copper exports are much larger than our oil imports, the prospects for our terms of trade have improved, and now we expect them to grow 3.5% rather than fall 5%.

Regarding other main external variables, the growth of our trading partners forecast for 2005-2006 has not varied materially, although inherent risks have increased, especially because of high oil prices and their potential effects. Also, so far the tendency toward a normalization of monetary conditions in the US has not disturbed financial markets, and our sovereign spread has increased only slightly.

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In this context, output growth in Chile has continued to grow at a healthy rate in the range of 5.5% to 6% during the first half of this year relative to the first half of 2004, after the strong acceleration it posted in some quarters of 2004.

Domestic demand indicators have shown very robust growth over the first quarter of 2005. Recent information suggests that investment in machinery and equipment is still growing, although no longer at the unusually high rates of the second half of 2004. Meanwhile, investment in construction has shown increased dynamism. Consumption is stronger, driven by increased creation of new jobs, despite the fact that household confidence has fallen somewhat, probably affected by the high price of fuels in the local market.

Data on inventory accumulation suggest that this component continued to push domestic demand up in the first quarter. This, combined with strong investment dynamics, allow for favorable expectations for the future in the baseline scenario. Given the current high levels of investment, however, we do not expect this variable to contribute substantially to a further acceleration of domestic expenditure. Fiscal spending is expected to have a greater weight in domestic demand than in recent years, in line with the structural fiscal surplus rule.

Volume export growth decelerated in the first quarter, primarily due to reduced copper shipments. This however, reflects that last year's copper inventory decumulation implied an unusually high basis for comparison.

Summing up, and looking ahead for the year as a whole, we expect economic activity to grow between 5¼% and 6¼% during 2005. Underlying this forecast is our expectation that domestic demand will become a more dynamic player than in recent years, particularly private consumption. This will compensate the reduction in the stimulus due to the ongoing normalization of external conditions, and will favor the gradual absorption of current inventory levels. The gaps present in the economy, combined with accumulated balances in the external accounts, with an additional surplus this year, and the healthy figures shown by private and public savings, provide room for this expansion of domestic demand to materialize.

In the labor market, employment—particularly wage-earning employment—has been growing fast, consistently with present macroeconomic conditions. Only manufacturing employment remains flat or declining. Despite generally strong employment indicators, however, the unemployment rate has been declining more gradually because of the entrance into the labor force of a substantial number of individuals, especially women, that were formerly surveyed as inactive.

We estimate that the level and the pace of expansion of productive capacity have now exceeded previous estimates. Updated National Accounts data show that 2004 GDP was one half to one percentage point above previous forecasts, and growth in the labor force and in investment have been significant. The revisions are only marginal, however, partly because today's higher participation rates in the labor force are believed to have a cyclical component. Our current estimate is that trend GDP will approach a number around 5% in 2006, up from 4% in 2004.

The monetary policy impulse, though still considerable, has been reduced. Continuing with the process of gradual rises in the Monetary Policy Rate that the Central Bank began in September 2004, this rate was increased in February, April and May by 25 basis points on each occasion. The current monetary policy rate now stands at 3.25%. In this context, interest rates in nominal Central Bank instruments have increased a bit, credit conditions faced by various agents have tightened, and growth in monetary aggregates has slowed. Although inflation-indexed interest rates remain low, this situation is similar to that observed internationally. Some internal factors may also contribute, such as the recent increase in monthly inflation rates, as well as the increase in domestic savings and the reduction in net public borrowing.

The real exchange rate has been fairly stable for several months, aside from short-term fluctuations, despite improved terms of trade, an acceleration of activity and expenditure, and the process of monetary normalization. The baseline scenario considers as a working assumption that the real exchange rate will stay around the figures of the past two weeks over the projection horizon. In any case, fluctuations in the nominal parity between the peso and the US dollar are to be expected, as they are inherent to the floating exchange rate regime in place and are exacerbated by the movements of international parities.

From January to April this year, CPI inflation has been above previous forecasts, with monthly swings marked by seasonal effects, changes in utility rates and fluctuations in the domestic price of fuels. Unlike previous quarters, however, core inflation as measured by CPIX1, which excludes regulated rates and volatile prices, has shown no big surprises with respect to January's projections. Also, although the annual growth rate of nominal wages per hour has increased recently, hourly labor productivity has also posted substantial increases, allowing unit labor costs to remain stable at the present date.

Looking ahead, in the medium term we see higher inflationary pressures than in the past due to the direct effect and the propagation of the increase in fuel prices as intense as it has been recently. The increase in unit labor costs in our current baseline scenario, however, is comparable to previous estimates, and we do not see material changes in the effects that the progressive utilization of installed capacity will have on the inflation trend. In the short run, in turn, natural gas cuts from Argentina and recent amendments to our electricity legislation will have substantial effects on electricity rates in coming months, but their impact on overall CPI inflation will be minor because of its small share in the consumer basket. All in all, our forecast for CPI inflation in a 24-month horizon is somewhat above the center of our target range of 3% because of fuel price behavior, but converges to it within a few months after the end of this horizon.

In this context, we continue to project a gradual normalization of monetary policy, in order to maintain annual expected inflation around 3%. The actual pace of increases in interest rates will depend on the developments that unfold over the next months. As a working assumption, projections consider a path for the MPR that is similar to the rate implicit in market expectations over the past two weeks.

The principal risks associated with the world economy are well known and come from the price of oil, eventual drastic adjustments to current accounts, interest rates and currencies of the main economic zones that might affect the dynamics of world activity and introduce uncertainty into financial markets, and the risk that US growth will slow down sooner than estimated, or that core inflationary pressures might accelerate the process of interest rate normalization in the US economy.

Domestically, indicators for labor market and inventories considered in the baseline scenario are consistent with a more dynamic performance of private consumption in the next few quarters. If the strengthening of household spending is postponed, however, the impulse that domestic demand is now showing might weaken. On inflation, one source of risk comes from the effects that the recent reduction in the working week from 48 to 45 hours will have on unit labor costs and on the price level. Finally, I would like to note that the baseline scenario considers a limited effect from natural gas cuts on overall activity, although larger than last year's estimations due to larger cuts and the high costs of substituting to other sources of energy. This effect will be concentrated in specific sectors such as manufacturing and power generation. In any case, the actual magnitude of these effects will depend on a number of very uncertain elements, such as the actual size of cuts for the rest of the year, hydroelectric supply conditions (rain), and the evolution of oil prices in world markets, among others.

To sum up, our current forecasts for economic activity expansion between 5.25 and 6.25 per cent in 2005 and convergence of inflation to 3% continue in line with our previous expectations. In the Central Bank´s view, however, risks on the output growth rate are somewhat more biased to the downside. Regarding monetary policy, in turn, the most likely scenario is a continuation of the process of gradual normalization of the policy interest rate. This is consistent with the Central Bank's commitment to conducting monetary policy aimed at maintaining a path for expected inflation around 3% annually over the normal policy horizon of 12 to 24 months.

Thank you.