

Recent Macroeconomic Developments in Chile: January 2005¹

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Hello everyone and thanks to Alberto Ramos and Goldman-Sachs for organizing this conference call. It's my pleasure to have the opportunity to present to you recent events and prospects for the Chilean economy. As announced by Alberto, I am here with Luis Eduardo Escobar, Coordinator of International Organizations at the Ministry of Finance, who joins us in this type of call for the first time. I welcome him, and wish him a great performance.

In my presentation, I will address short-term macroeconomic developments and prospects, focusing mainly on growth, inflation, and financial market variables. My report will be largely based on the presentation made yesterday by the Governor of the Central Bank, Vittorio Corbo, at the Senate, when we released our January 2005 Monetary Policy Report.

I have good news: the macroeconomic scenario for the Chilean economy looks quite favorable. Everything suggests that, after the period of relatively slower growth observed in the Chilean economy between 1998 and 2003, on average below 3%, we began in 2004 a period of faster growth that should last for a while. Also, inflationary pressures appear to be limited, so that, in order to maintain expected inflation in line with our target of 3% in a twelve to twenty four month horizon, this environment of faster growth is consistent with a gradual normalization of the monetary policy rate towards a neutral rate.

The international scenario during 2004 was very positive for the Chilean economy, thanks to rapid world economic growth, soaring copper prices and favorable financial conditions. For 2005 and 2006, our projections considers a gradually decelerating overall activity that will reflect the fading effects of the monetary and fiscal impulse of recent years as well as the impact of the high oil price. We also foresee a downward trend for the copper price, as the unusual increase in demand tones down and production capacity increases. We expect oil prices to remain high during 2005, but to show a slow decline toward 2006. In addition, our base scenario considers a gradual and smooth accommodation of macroeconomic imbalances in the main economies.

Locally, monetary and financial conditions provide important stimulus. While the Central has continued with the gradual process of normalization of monetary policy that it began in September, reflected by a 25 basis point increase in the monetary policy rate in November, and another 25 basis point in January, monetary conditions remain expansive, with a policy rate than now stands at 2.5 % in annual terms. The marked monetary stimulus can be observed in the growth rates of various monetary and credit aggregates. Also, corporate loans are showing increased dynamism.

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On the exchange rate market, the peso dollar exchange rate has shown significant swings in recent months, mostly due to the movements of the US dollar against most currencies in the world. In net terms, since our last conference call in September, the Chilean peso has appreciated by 8.7% with respect to the dollar, 4.0% with respect to the yen and 1.5% with respect to the euro. In consequence, the peso has experienced a smaller multilateral appreciation, in both real and nominal terms.

Regarding output and demand, the data for the second half of 2004 reflected more clearly than in the first half of the year the good external conditions and the impulse of monetary policy. Manufacturing activity increased its dynamism, and the lagging gross capital formation of late 2003 rebounded strongly. Meanwhile, private consumption stayed robust despite high fuel prices, and exports showed renewed momentum. In the labor market, after weak indicators by mid-year, employment resumed growth and the rate of unemployment decreased, albeit gradually because of an increased participation rate. This picture, combined with continuing favorable conditions internationally, and a persisting macroeconomic policy impulse, anticipates a somewhat faster closure of output gaps than previously estimated.

Compliance with the fiscal rule in a context of strong public income recovery due to the acceleration of economic growth and a high price of copper, has resulted in a substantial increase in public savings, and a fiscal surplus estimated at more than 2% of GDP in 2004. Meanwhile, the net consolidated debt of the Central Government and the Central Bank is estimated at nearly 5% of GDP at the close of 2004, down from 7.4% in 2003. The 2005 budget considers an increase of public expenditure from the year before, in the context of the current fiscal rule, which will add to the macroeconomic impulse that monetary policy will continue to produce.

Regarding the external balance, in turn, higher terms of trade have contributed to generate an increase in public and national saving even larger than the substantial increase in investment, helping to consolidate a current account surplus for 2004. The twin surpluses, in the external current account and in fiscal accounts, provide the economy with a good cushion to confront the effects of a less favorable scenario in the international economy.

Recent fluctuations in activity and spending have altered our estimates of production capacity only moderately. Thus, the accumulation of news has caused no material change in the most likely medium-term scenario for the economy's trend growth. The foreseeable trend of total factor productivity, together with the increase in the investment rate, implies that GDP's trend growth would go from roughly 4% for the year 2004 to closer to 5% per annum toward the end of the projection horizon.

As a result of all the above, we have revised our figures on growth and now estimate that Chile's rate of growth during 2004 was 5.8 percent, and forecast that it will reach a number between 5¼% and 6¼% in 2005, to decelerate somewhat and gradually fill the still existing capacity gaps in 2006. These figures are higher than the ones we forecast four months ago, when we had forecast a growth rate between 5.0 and 5.5% for 2004 and between 4.5 and 5.5 for 2005. According to our projections, domestic demand should increase fairly more

than GDP, so that the current account surplus will fade slowly in 2005 y 2006, a condition that will also be influenced by the normalization of the terms of trade.

Let me now turn to inflation. As has been the norm in recent years, CPI inflation figures have been temporarily affected by the volatility of fuel prices and of the exchange rate. Since these effects do not tend to be long lasting, it is thus especially important to look at core inflation measures, which exclude the prices of goods and services that are more volatile. During the past few quarters, core inflation measures have slowly increased, at a pace below previous forecasts. This has been the result of reduced price pressures due to a trend of very mild increase in unit labor costs, as nominal wages have increased slowly and labor productivity has been growing fast, as well as no signs so far of a relevant increase in pricing mark-ups. All of this has allowed CPI inflation to converge the target range at a gradual pace.

Given these trends, the foreseeable performance of unit labor costs and faint evidence of pressures from mark-ups overall suggest that inflationary pressures in 2005 will be weaker than previously forecast. If fuel prices decline as expected, projected CPI inflation will remain close to the lower end of the target range, and maybe even below 2% for some time during the year.

Toward the medium term, however, we estimate that the faster than expected closing of gaps will counterbalance said reduced price pressures, so that the inflation forecast for the end of the projection horizon is not materially different from that made last September. Thus, and partly as a result from the gradual normalization of the monetary impulse, CPI inflation is expected to reach an average of 2.9% per annum during 2006, and 3.2% at the end of the projection horizon. Core inflation is expected to continue on an upward trend similar to the one seen in 2004, after the deceleration of late 2003, and barely above 3% toward 2006.

In this context, the Board of the Central Bank believes that, in the baseline scenario, it will be able to continue with the gradual normalization of monetary policy, whose precise pace will depend on how the relevant indicators unfold in time. As a working assumption, projections in the *Report* released yesterday are based on the premise that monetary policy interest rate increase at a barely higher pace than the one implicit in asset prices in the last two weeks, and consistent with CPI inflation's gradual convergence to 3%.

The main risks to this central scenario are associated with developments in the international economy. The gradual slowdown of worldwide activity can be sharper than forecast, especially in the context of a strong and disorderly adjustment of current accounts, interest rates and currencies in the main economic areas. The international oil market continues to be tight, and the risk of geopolitical problems persists, so the oil price may deviate from the path considered in the projected baseline scenario, or its contractionary effects on the world economy may exceed present estimates. In any case, the increased financial strength shown by emerging economies —Chile included— makes them less vulnerable to these developments than in the past.

Locally, the main uncertainties are believed to come from the possibility that domestic output and expenditure react more intensely than foreseen to the current favorable macroeconomic conditions. The baseline scenario considers that output surprises of the past few months will not be repeated. However, the large increase that the various monetary aggregates continue to show may be an indication that this dynamism will persist. Also, it cannot be ruled out that the improved outlook for the labor market, the better growth prospects, or simply more optimistic expectations, will lead to an increase in consumption and investment that will exceed those considered in the baseline. On the price and cost side, alternative scenarios can be outlined where mark-up pressures result in a faster acceleration of underlying prices than that considered in the central scenario. The effects of a recent legal reduction in the number of working hours per week over the economy at large are yet to be seen. It is also possible to consider scenarios where the peso shows a new appreciation relative to the US dollar over and above the one observed so far, for example because of an additional depreciation of the dollar in international markets. Finally, estimations assume that, as in last year, problems in the provision of natural gas from Argentina will have no major macroeconomic implications, aside from their effects on specific sectors.

The implications of alternative scenarios over monetary policy in Chile depend critically on how they show up in medium-term inflationary pressures. Overall, the Central Bank estimates that these scenarios configure a balance of risks that is in equilibrium for growth and upward biased for medium-term inflation.