Recent Macroeconomic Developments and Prospects in Chile: September 2006[1]

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Good morning and thank you for the opportunity to analyze with you the last developments and prospects of the Chilean economy. We presented our Monetary Policy Report on September 13. Therefore, many of my introductory remarks will be based on the macroeconomic outlook discussed therein.

Headline inflation rose from slightly negative figures in early 2004 to around 4% in September 2005, and since then it has hovered around that figure due to the incidence of oil prices. Just to remind you, our target for monetary policy is to maintain CPI inflation within the range of 2 to 4% most of the time. Meanwhile, the monetary policy interest rate has been raised by 350 basis points since September 2004. This has encouraged an orderly convergence of core inflation measures toward 3% while keeping medium and long term expected inflation indicators well anchored.

Regarding economic activity, after nine quarters of output expanding above the trend, it has shown some signs of deceleration in the last few months. In the most likely scenario, however, GDP should resume stronger growth and the remaining output gap should close during next year. We forecast output growth to be in the range of 4.75 to 5.25% this year and between 5.25 and 6.25% in 2007. I will come back to the underpinnings of this shortly.

As for our major concern, inflation, we consider that lower that expected output growth during this year, combined with medium- and long-term inflation expectations in line with the target, a moderate increase in labor costs and the evidence of limited second-round effects from the fuel hikes, configure conditions that are appropriate for price stability. Going forward, we expect inflation to converge to 3%, with some short-run volatility stemming from base effects.

Our report considers that, although financial indicators are still supportive, it is possible that the current monetary stimulus is not far from one that might be considered neutral. Our estimates yield that, in the baseline scenario, additional increments to the interest rate will be necessary in order to keep forecast inflation around 3% per annum. However, these may take some time and will be data dependent.

Let me analyze a few issues in further detail:

External conditions continue to be favorable for the Chilean economy. For the time being, the world economy maintains substantial momentum. Terms of trade are projected to increase by 24% this year over 2005, more than foreseen in May, owing to both the higher price of copper and rises in other export products. The price of oil, after hitting new nominal peaks in July-August, declined in the past few weeks, approaching the price of 70 dollars prevailing at the closing of last May’s Report, declining further

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afterwards. Yet, we have corrected medium and long run projections for this price upwards.

Financial conditions for emerging economies look somewhat less buoyant than in the latest Report, but still very supportive.

Internally, our MPR is currently at 5.25%. In the most likely scenario, additional increases will be needed, although they may be fewer and farther between than in recent quarters. Indeed, on the one hand, the available information reveals contained underlying inflationary pressures. On the other, we think that the MPR is closer to its neutral level than we estimated some time ago.

The Chilean peso depreciated slightly less than 5% in real terms with respect to the closing of May's Report, and 1.5% since September 2005. Taking as a reference the average of the two weeks preceding the statistical close of our Report, the real exchange rate is believed to be consistent with its long-term fundamentals.

In the first half of the year, the annual growth rate of domestic demand declined as expected, although its composition turned out to be somewhat different from earlier estimates: Consumption has remained strong—especially its imported component—despite the effect of energy prices on household disposable income. Meanwhile, investment showed a faster than expected normalization, particularly imports of capital goods, after a lumpy stock accumulation during the second half of 2005.

Trend growth is estimated to be slightly above 5%. Next year, therefore, we in our baseline scenario we consider above trend growth. Besides a good global environment, the most important factors behind this assessment are the following:

First, considering firms' results, growing capacity use and good financing conditions, prospects for investment are good. This is already apparent in a substantial flow of new engineering projects and in machinery & equipment imports in recent months.

Second, the baseline scenario assumes that public expenditure continues to follow the structural surplus rule, which is consistent with a substantial expansion in 2007 due to the lagged effect of copper hikes.

And third, some of the factors that may explain the growth rate for this year falling below expectations should not be repeated and may even reverse next year. In particular, mining activity had one off production-related problems. Something similar is true for the increase in energy costs.

In 2006, the current account will show a surplus of 3.6% of GDP, explained by the large public savings. We expect a surplus of 2.2% of GDP in 2007, consistently with lower terms of trade and a slight recovery of investment. We are considering a copper price of 305 cents per pound for this year and 275 in 2007.

Regarding inflation, the growth rate of nominal wages has dropped and is back to where it was by the end of the second quarter of 2005. New employment figures have also allowed us to reassess the evolution of unit labor costs, which shows that underlying inflationary pressures are milder than before.

Annual CPIX1 inflation, our measure for core inflation that excludes oil, fruits and vegetables, and public utilities that are indexed to oil prices, has remained under 3%. So far, no significant second round effects on inflation have been observed related to the oil shock, aside from the regular ones coming from indexed prices and utility rates.

In our Report's baseline scenario, CPIX1 annual inflation will continue to slowly approach 3%, and be slightly and temporarily above 3% in 2007. Underlying this behavior is the closing of the output gap, a benign behavior of unit labor costs, and a real exchange rate that does not change much.

Headline inflation, in turn, after a few very short-run movements up and down due to base effects, should stay in the upper half of the target range for still some quarters, because of the higher price of fuels. Then, the expected convergence of the oil price to its long-term trend should result in a projected average CPI inflation slightly below CPIX1 inflation in 2008. In 8 quarters, annual CPI inflation is expected to be at 3%. Of course, if oil prices continue to be below our projection –close to US$ 70 per barrel for WTI at year end– inflation will be lower too.

Our forecasts are based on the events that are considered most likely and that make up the baseline scenario. As usual, there are many sources of uncertainty that may configure scenarios that are different from the one I have described.

We face the International risks that you most likely know very well. A deeper than expected deceleration in world activity is possible. Other contingencies include the oil price drifting away from projections and, of course, the unwinding of global imbalances.

Domestically, in the near future, mining activity falling short of projections for the year is a possibility that cannot be disregarded. Toward the medium term, a faster acceleration of output growth cannot be ruled out either. This may occur because the unidentified factors that have affected economic activity this year may reverse more strongly than predicted. It is also possible that the still favorable financial conditions cause domestic demand to grow faster.

On the other hand, investment might turn out to be less dynamic than is foreseen for next year. Latest indicators for housing sales are weaker and the rate of investment measured at constant prices is still high from a Chilean historical perspective.

Neither can we rule out low core inflation persisting for longer, implying an inflation trend below projections. And inflationary pressures might take a different path. In particular, recent and upcoming wage bargaining processes might trigger wage increases that could in turn become a source of inflationary pressures.

Our Board believes that, taken together, these contingencies bias this year's growth downwards, while growth in 2007 and inflation are balanced.