Recent Macroeconomic Developments and Prospects in Chile: May 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.

As you probably know, we presented our Monetary Policy Report last Wednesday. Therefore, many of my introductory remarks will be based on the macroeconomic outlook discussed in it.

Our current evaluation is that the Chilean economy continues on a fairly orderly, expansionary cycle, facing extraordinary external conditions, in particular very good terms of trade thanks to record-high copper prices. Domestic demand and activity growth rates are proceeding gradually towards trend, while the output gap is expected to close this year.

We expect the economy to grow between 5 and 6% this year, and continue to be above trend in 2007, when the output level will be slightly above potential, that is we will have a small, positive output gap.

Regarding inflation, we evaluate that the large rise in world oil prices does involve some temporary increase in CPI inflation. However, inflationary expectations have remained well anchored at 3%. In the past few months, annual CPI inflation has hovered around 4% and core inflation CPIX1 approached 3%, both in line with earlier forecasts. Going forward, we expect annual CPI inflation to be 3.4% by year end, to later converge to 3%. CPIX1, one key core inflation measure in our analysis, will be slightly above 3% next year due to output gap dynamics and a moderate depreciation of the real exchange rate.

This scenario has allowed the Central Bank to continue the gradual normalization of monetary policy. We still believe that there is an expansionary bias, and expect —in the most likely scenario—to reduce it further in order to ensure the convergence of inflation to 3% in our policy horizon of 12 to 24 months. Of course, the timing of the interest rate adjustments will depend on the implications of incoming data on inflation forecasts. Our forecasts consider, as an assumption, adjustments in the next quarters at a pace similar to the one implicit in the term structure observed the 2 weeks prior to the closing of our report.

Let me now analyze a few of issues underpinning this outlook in some more detail.

As you may know, current external conditions are unusually favorable for the Chilean economy. World activity is growing strongly and more balanced across regions. Copper prices have increased briskly, something that was not included in any earlier forecasts.

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Thus, despite soaring oil prices, our terms of trade will increase substantially this year (by 12.6% instead of a 4.4% decline that we forecast in January). Given the property structure of copper in Chile, this large jump in terms of trade does not translate directly into private disposable income and increased aggregate demand. First, foreign ownership means that a portion of profits is repatriated. Second, the government, given the 1% surplus rule for fiscal policy, saves a considerable part of the shock. I should also mention that in our evaluation the recent escalation of copper prices is difficult to explain and therefore has a large transitory component.

Our forecasts assume that fiscal policy continues to operate under the structural surplus rule, with an increase in reference copper prices for 2007 that reflects the evaluation that the current highs are not likely to last. The effect of the extra earnings from copper sales on the short-term peso valuation has also become important. The fiscal authority's announcements regarding how this surplus will be managed help to attenuate this effect. I should mention that Macroeconomic policy in general, and fiscal policy in particular, are key to understand why despite this large shock the economy is performing quite orderly. With a more expansionary fiscal policy, the peso would be more appreciated and the interest rate would be higher. Going forward, given the amounts involved, changes in the reference price of copper do make a difference.

Our baseline scenario also considers that, despite the monetary policy adjustments since September 2004 —we have increased the monetary policy rate from 1.75% to 5% currently— it is still below neutral. Furthermore, considering credit expansion and the structure of interest rates, financial conditions are expansionary, despite long term rates having increased somewhat in the last few weeks.

Regarding the exchange rate, our report explicitly says that taking as reference the average of the two weeks prior to the statistical closing (almost 516 pesos per dollar), we estimate that this figure is marginally below various estimates for the real exchange rate consistent with its long term fundamentals, particularly the terms of trade. Thus, as a methodological assumption for our projections, we assume a moderate depreciation of the peso in real (and multilateral) terms.

Regarding short run output dynamics, we see that in the first quarter of this year, domestic demand decelerated, confirming our prior forecasts. Export value hit record highs in the first quarter of this year, mainly because of the high copper price. Manufacturing volume growth remained strong, while agricultural figures reflected a poor fruit production. Output growth rate was close to 5%, affected by specific situations in some sectors. We consider the deceleration in the first quarter mainly transitory, and expect growth to be stronger in the second half of this year.

Overall, the labor market shows some changes with respect to early in the year. The most outstanding are the sustained growth in salaried employment and the rise in labor participation. Unemployment has increased in the late readings, in line with the view that overall slack in the economy is not substantial. Wage growth has decelerated from rather high figures, but unit labor cost growth rates are higher than those of the end of 2005.

As always, there are several risks in our baseline scenario. Probably the most important one is how will the economy absorb the large terms of trade shock. We also have many uncertainties about the world economy, including financial conditions, inflation pressures, the impact of corrections in the housing market, and global imbalances. Beyond the effect of copper prices, we think that internally we could have some more domestic demand growth given the solid pace of job creation and the expansion of credit. In fact, we think that the balance of risks for growth is biased to the upside.

Many thanks for your attention.