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

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I thank HSBC for hosting this call, as well all of you that dialed in for giving me an opportunity to make some remarks on Chile's recent economic developments and prospects. I will base my presentation on the latest Monetary Policy Report issued by the Central Bank, released yesterday to the public, and which you can download from our web site, www.bcentral.cl.

The highlights of this report are the following:

- We estimate that growth during 2005 reached 6.3%, in line with the forecast we made in September, and maintain our forecast that the growth of GDP in 2006 will be between 5¼ and 6¼%. We expect the composition of growth on the demand side will be more balanced, with domestic demand growing at a more sustainable rate of 6.6% in 2006, slowing down from an estimated 11.1% growth in 2005.

- We forecast that annual CPI inflation will be around 4% in the short run, will then fall below the center of our target range of 3% during some quarters, to finally converge to such target.

- Our forecasts make the assumption that the monetary policy rate will continue to increase at pace comparable to the one implicit in the recent market interest rate structure, which is slower than the one observed during the second half of 2005. Also, our forecasts assume that the peso will depreciate somewhat in real terms in our projection horizon, relative to the values observed during the two weeks prior to January 9.

Let me now get into some of the details.

Prospects for the external environment relevant to the Chilean economy have improved in recent months. Global growth has strengthened, as have terms of trade thanks to record-high copper prices. The oil price has been on average slightly above US$60 per barrel, down from the high levels triggered by the hurricanes in the Gulf of Mexico last August. Inflation hikes in the main developed economies so far have proved to be temporary, associated to the evolution of fuel prices, while financial conditions for emerging economies remain favorable.

Over the medium term—this year and beyond—today's extraordinary external conditions are expected to return to normal. The terms of trade should slowly decline as the favorable cycle of the copper price unwinds and external monetary conditions continue their normalization process.

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[1] Presented at the conference call "Chile: Quarterly Review Fiscal, Monetary, and Growth Prospects", hosted by HSBC Securities on January 19, 2006, and offered jointly with Luis Eduardo Escobar, International Organizations Coordinator of the Ministry of Finance of Chile.

Domestically, market interest rates have adjusted upward since our last conference call in September, after a prolonged period in low levels. The prospects of a transitory rise in inflation, combined with recent rises in the monetary policy rate (MPR) and in external interest rates prompted an increase in the market rates on medium- and long-term documents issued by the Central Bank, particularly indexed ones. This effect has faded somewhat lately, thanks to the impact on expectations of low monthly inflation, lower international price of fuels and the unpredicted appreciation of the peso.

Despite the above, monetary policy is still expansionary. The MPR is below its level defined as neutral, which also reflects on its expected future path, as derived from the current interest rate structure. On the other hand, loans to individuals and to firms continue to rise strongly, while the growth of money aggregates has picked up again.

Since the last Report, the peso has appreciated significantly, in both real and nominal terms, linked to better terms of trade, as well as of liquidity and high appetite for risk in international markets. The assessment is that the peso has strengthened beyond various real exchange rate estimates consistent with long-term fundamentals, particularly the terms of trade. Had fiscal policy been less austere, the peso would have appreciated further. As a methodological assumption for the projections in this Report, the peso is forecast to show a moderate depreciation in the projection horizon, in line with the baseline scenario that considers a gradual normalization of external conditions.

Domestic demand has continued to grow vigorously, mainly due to its imported component. Consumption has remained rather insensitive to the rise in fuel prices, probably because of the favorable financing conditions for households combined with good indicators in the labor market. Durable purchases have grown fast, supported partly by the appreciation of the peso.

The dynamism of gross fixed capital formation brought another surprise in the last quarter of 2005. Excluding the one-off effect of sizable imports of transportation machinery, the imports of capital goods have remained stable at higher than expected levels, thus changing slightly upwards our forecast trend growth for 2006.

The increase in investment, especially in imported capital goods, and the strong increase in durable consumption—largely also imported—suggest that households and firms are reaping the benefits of present conditions to bring the stocks of capital and durable goods closer to desired levels. Because this is thought to be a once-and-for-all phenomenon, it is consistent with a widening of the private deficit and with the perception that the recent real peso appreciation is, to some degree, transitory.

Export volumes resumed their annual growth trend after the one-time deceleration of some manufacturing shipments in the third quarter of 2005. Last year, mining volume exports dropped, and only a gradual reversal is expected for coming years as new copper projects start up. Imports, meanwhile, have reflected the recent trends of domestic demand.

The current account is estimated to have finished 2005 with a small deficit of 0.4% of GDP. Underlying the balanced current account is a marked disparity between the public sector and the private sector. While the former accumulated a surplus of over 4% of

GDP, the latter shows a somewhat larger deficit. Thus, the private sector has accommodated—partly through financing—the real effect over its disposable income of oil price escalation. This process does not seem to be worsening; rather, domestic demand is expected to begin decelerating some time during the first half of this year.

Updated information of the communications sector leads to an upward revision of GDP for 2005 of three tenths of a percent. Considering this, GDP growth is estimated to have reached 6.3% in 2005, and is expected to gradually converge in 2006 to its trend growth, achieving an expansion of between 5¼ and 6¼%. This pattern of aggregate growth responds to the natural behavior of the business cycle after eight quarters of expansion.

Labor productivity remained stable throughout the second half of 2005, after the large increase of the beginning of the year. Nominal remunerations grew around 6% annually, so unit labor costs increased in the margin more than core inflation. Despite the transitory component due to the activity pattern and the ongoing expansion of wage employment, the scenario of higher costs is qualitatively consistent with projections in previous Reports, and this is one of the factors behind the normalization of trend inflation.

Recently, price swings of some perishables have caused a high degree of inflation volatility. After substantial increase in part of the third and fourth quarters, these prices seem to be normalizing, and this may result in negative annual variations by the end of the year.

In the baseline scenario, to the extent output gaps are closed—which may already be occurring in some sectors—core inflation is expected to exceed its rates of the last two years, somewhat above 3%. This is thought to be transitory and mainly related with the business cycle and, to a lesser extent, with the transient effect of the high oil price. Annual CPI inflation, meanwhile, after approaching 4% in the short run, should be below 3% for several quarters this year and next, even approaching 2% in some particular months, when the change in the basis of comparison reflects the high fuel prices that prevailed during part of 2005.

This scenario is consistent with the methodological assumption that during the next several quarters the monetary policy normalization process will proceed at a pace comparable with the one implicit in the prices of financial assets over the last two weeks. This pace is slower than the one observed in the second half of last year.

All the measures of expected inflation have dropped significantly, after increasing because of the uncertainty associated to the persistence and propagation of the price increases in fuels and perishables. This tends to confirm the previous scenario, where the inflationary effect of the oil price hike is temporary and inflation converges to 3% over a policy horizon of 12 to 24 months.

As usual, the main risks come from abroad. Currently, the risk of a drastic deterioration of global financial conditions because of stronger inflationary pressures in developed economies or unexpected rises in long-term interest rates and sovereign premiums seems somewhat less likely.[2] However, still present are the negative global risks

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associated to geopolitical turmoil, terrorism, the bird flu, the effect of high oil prices, and an adjustment in real estate prices in the US. Also, markets indicate some concern about risks in some Latin American economies. On the other hand, there also are risks on the upside in the external environment relevant for Chile. In particular, an extension or accentuation of the favorable copper price cycle cannot be ruled out.

Domestically, there is the risk of reduced inflationary pressures if the acceleration of underlying (CPIX1) inflation was due to a higher passthrough from the oil price rather than a closing of the output gap in line with the baseline scenario. This issue is still uncertain, and only time will tell. In addition, the persistence of a strong peso cannot be ruled out. On the other hand, there are risks of higher price pressures if the deceleration of domestic demand —part of which occurred in late 2005— does not continue. This may prompt an enlargement of the current account deficit at trend prices and/or increased pressure over gaps and over inflation.

As usual, doubts remain regarding the true magnitude of the present output gap. However, there seems to be no indication of higher risks in either direction. Overall, the Bank estimates that risks affecting activity and inflation are balanced.

To conclude, last year was a very good year for the economy, and in the base scenario, the present one is likely to be very good too. We expect growth to slowdown a bit, but not very much, and inflation to fluctuate around the target. There are risks, but they seem to be balanced.

Thanks.