Recent Macroeconomic Developments and Prospects in Chile: January 2007[1]

Rodrigo Valdés
Director of Research and Chief Economist
Central Bank of Chile

Good morning. Let me first thank Piero Ghezzi and Jose Carlos Faria for organizing this conference call, and thank you for the opportunity to analyze with you the last developments and prospects of the Chilean economy. We presented our January Monetary Policy Report only two days back. Therefore, my introductory remarks will be based on the macroeconomic outlook discussed therein.

Our report stresses the fact that headline and core inflation have dropped to levels between 2% and 3%, significantly below our forecasts of September and earlier. This development seems to have responded to a lower-than-expected oil price, an unforeseen larger output gap due to lower growth in 2006 and reduced cost pressures. In this context, monetary policy was progressively adjusted in the last few months, including a 25-basis-point reduction in our last monetary policy meeting a week ago.

Our new forecasts consider that the output gap will persist for several quarters, despite we expect output to grow between 5 and 6% in 2007 (4.2% in 2006). In the baseline scenario, and after an increase in coming months due to base effects, inflation will hover around 2% for some quarters this year and next, to later converge to 3% over the policy horizon of around two years.

Monetary policy in this scenario will depend largely on the arriving data. As a methodological assumption, we consider that, in a couple of years, the MPR will be similar to what was implicit in financial prices before the last monetary policy meeting, but after following a trajectory that runs slightly below the one deduced from these prices.

Let me analyze what is behind these views in some detail:

The external scenario is still favorable for the Chilean economy. The main changes of recent months are the declines in the prices of oil and copper. The latter has dropped quite fast lately, although a gradual convergence to long-term levels is forecast. In our base scenario we assume a steady reduction in prices of these and other commodities, which should bring down terms of trade in 2007 and 2008.

External financial conditions and trading partners' growth prospects remain quite good. No big news in this front.

[1] Presented at the Conference call "Chile—Fiscal, Monetary, and Growth Prospects", hosted by Deutsche Bank and offered jointly with Luis Felipe Céspedes, Director of Economic a Financial Policy, Ministry of Finance, Chile, on January 19, 2007.

Domestically, we consider domestic financial conditions to be favorable. Long term interest rates are lower than they were a few months ago, and credit growth has declined marginally, but is still strong by historical standards.

Regarding output, we estimate GDP growth at 4.2% for 2006, below our earlier projections (and those of the private sector). Our report enters in some detail on what could explain this performance. In a nutshell, we had the combined effect of some one-off shocks in mining, a substantial energy shock —higher oil prices plus cuts in the provision of natural gas from Argentina—, a shift in the composition of consumption, which became unexpectedly more intensive in goods of foreign origin, which affected the results of part of the import-competing industry, and finally, less investment than we expected. Still, we estimate that domestic demand growth was above 7% last year (a figure not that different from what had been anticipated in previous Reports). The current account had a surplus of 3.5% of GDP in 2006, reflecting the high copper prices.

Going forward, we expect output growth to be between 5 and 6% this year. Behind this scenario, we are considering (i) the expected stronger fiscal impulse for next year (remember that expenditure, within the fiscal rule, will grow almost 9%); (ii) increased investment—which is captured in our investment intentions survey and is already materializing in imports; (iii) the assumption that the change in origin of non-durable consumption will not continue deepening, nor will energy costs increase as last year, and the one-off mining problems will not repeat themselves; (iv) increases in mining and wood pulp production capacity that are expected to be fully operative. In addition, macroeconomic conditions, both external and internal, should continue to be favorable, although taken together and with the normal lags, their drive should not differ much from that of 2006. Our scenario also considers that, for the time being, the information available is insufficient to change our estimates for trend GDP growth from September: slightly above 5% in 2006 and around that figure in 2007.

In our central scenario, domestic demand will grow above 6% this year, with investment growth up to almost 7%. Exports (of goods and services) will improve their growth rate from 4.3 in 2006 to almost 7%. Part of this reflects the expansion in copper and wood pulp industries.

As for inflation —the key in our IT framework— we expect a gradual convergence to 3% after being for some time around 2%. As I mentioned, headline and core inflation have been substantially below September projections. On the one hand, the oil price was lower than forecast, which explains a big part of the difference with respect to actual December 2006 inflation. On the other hand, underlying pressures have been reduced, with labor costs growing at low rates and some slack built over the course of last year. Ahead, the wider output gap, limited cost pressures and a smaller actual CPIX1 change explain most of the corrections. CPIX1 is a key core measure in our forecasting framework.

In our Report's baseline scenario, CPIX1 annual inflation remains around its present numbers for some quarters, to gradually converge later to 3%. Annual CPI inflation shows some swings, mainly because of the basis of comparison effect and changes in electricity rates, which bring it near 3% during the present quarter. Down the line it should be around

2% over the remainder of 2007 and beginning of 2008. This is grounded on the closing of the output gap, unit labor costs aligned with target inflation and the real exchange rate staying fairly close to its most recent values.

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 just described.

Internationally, most of the risks identified in the previous Report remain. Worth noting is what will happen in the US, in terms of both growth and inflation. In addition, oil prices may differ significantly from what we are assuming, global imbalances could suffer a fast turnaround, and we cannot rule out the possibility of a faster correction of the price of copper. In any case, we estimate that our economy's response to changes in the relevant external scenario will be milder than it has been in the past, thanks to the macro framework now in place.

At home, growth may be higher if investment picks up faster given the favorable cyclical conditions or because the effect of the fiscal impulse implicit in 2007's national budget ends up being bigger than forecast. The opposite is also possible, for example if a significant proportion of investing intentions does not materialize. Consumption could also surprise us, particularly by its composition.

We are also considering the risk that the slower growth of total factor productivity observed last year may not respond only to cyclical factors as assumed in the baseline scenario, but that it includes more persistent elements. This could trigger a downward correction to current trend GDP growth. It is also possible that the current output gap may be narrower than considered in the baseline scenario, which could imply a faster convergence of trend inflation to 3%. The low level of unemployment points in that direction.

Finally, on the inflation side we have risks pointing to both sides, including the effect of a persistent output gap and of a weaker peso.

All in all, the Board considers that, evaluated jointly, risks are balanced for both growth and for inflation.

Thanks for your attention.