Recent Developments and Prospects for the Chilean Economy[1]

Pablo García Silva
Director of Research and Chief Economist
Central Bank of Chile

Good morning and thank you for the opportunity to analyze with you the growth and inflation prospects for the Chilean economy. As is usual at this time of the year, we presented our Monetary Policy Report to Congress on September 11th. Most of the introductory remarks below will be based on the macroeconomic outlook discussed therein. Kevin Cowan, Director of Financial Policy, and Beltrán de Ramón, Director of Financial Operations, are also attending.

The inflation outlook faced by the Chilean economy has deteriorated drastically in the past few months. Inflation hit 9.5% y-o-y by mid year and inflation expectations have shown important increases. The BCCh has reacted forcefully to these developments, raising the monetary policy interest rate by 200 basis points since June, while stating that the future path of the policy rate contemplates additional adjustments to ensure the convergence of inflation to the target.

We can see a number of determinants behind the increase in inflation. External inflation, computed from producer prices in dollars of our main trading partners, is forecast to rise by 14% this year, significantly more than the 4.6% average of the period 2000-2007. This is largely due to hikes in commodity prices that, together with effective inflation levels, have responded to a still-strong global economy in spite of the slowdown in developed countries. The increase in domestic prices of food products explains four percentage points of annual CPI inflation as of August 2008, affected by their significant worldwide increase. Energy and fuels have contributed directly to two percentage points of higher CPI, while its indirect impact into the cost structure of the economy could be of an equivalent magnitude.

Immediately after the Bank announced its reserves purchase program in April 10th of this year, the nominal exchange rate depreciated between $15 and $20. Subsequently, changes in global financial conditions and commodity prices, among other factors, contributed to a further depreciation of the peso, to between 510 and 525 pesos per US dollar in the two weeks prior to the close of our September Report, some 13% weaker than the figures in our May Report. Much of the movements in the exchange rate over the past couple of months have responded to global dollar strength and the weakening of commodity currencies. Nominal exchange rate movements have had an impact on specific indexed tariffs and prices, but the current level of the nominal exchange rate does not differ much from its level a year ago and thus it hardly has had a material impact on y-o-y inflation rates. In any case, it is difficult to assign a significant part of the depreciation since April to the intervention.

Apart from these specific aspects, the main development over the past few months has been a higher persistence of inflation and an increased propagation of the inflationary process towards goods and services not directly linked to international pricing conditions. Inflation excluding all energy and all food products contributed, as of August, to slightly less than three percentage points to y-o-y inflation, while over 2001-2006 that contribution averaged less than half that figure. Strong domestic demand growth could have avoided margin compression leading to a stronger than usual pass-through of higher cost pressures—notably energy— to final prices. Other factors could be a reawakening of indexation practices, increased inflation expectations by price setters, and lower capacity slack than expected, particularly in sectors other than mining and energy and more sensitive to aggregate demand changes. The precise contribution of these factors, or others, in explaining the increased inflationary trends will only be precisely estimated once inflation abates. However, the implications on monetary policy are unambiguous: a tightening of monetary policy is called for, so as to generate the necessary disinflationary slack needed to achieve convergence towards the inflation target.

In the baseline scenario, constructed from consensus views on global growth, future contracts for the prices of commodities, and a level of the real exchange rate that is similar in the long run to the one observed at the close of our Report, inflation converges to the 3% target in 2010. In this baseline, GDP growth reaches between 4.5% and 5.0% this year, while slowing down to between 3.5% and 4.5% in 2009. This trajectory translates into a growth rate of around one percentage point below trend over the policy horizon.

[1] Presented at the Conference call "The Recent Monetary Policy Report", hosted by Deutsche Bank on September 23, 2008.

According to consensus views, world growth will remain above its average over the past twenty years, thanks to the performance of emerging economies. The prices of both oil and foodstuffs will hover around their present levels over the next two years so, although they will not be a source of increased inflation, they will not help in reducing costs either. Therefore, the external conditions will not help markedly to generate this slack and trend disinflation in the baseline scenario. The main driver of the output growth dynamics will be the deceleration of domestic demand, thanks to the tightening of monetary policy, the normalization of the spending cycle in durables and some components of capital formation, and with public spending growing at a slower pace than this year, in line with recent announcements by the Ministry of Finance and the limits imposed by the structural surplus rule.

It is assumed in the forecast that inflation expectations and future wage dynamics are consistent with the transient nature of the deviation of inflation from target. Current increases in unit labor costs should return to levels consistent with the target in the projection horizon. This will be helped if future wages increases do not only reflect past inflation, but also that the return of inflation to target is completed in a limited period of time. Similarly, the baseline scenario is constructed with pricing decisions that are based on inflation expectations in line with the target.

With this set of assumptions, although monthly CPI figures should be milder over the fourth quarter, annual CPI inflation will remain high for the rest of the year, descending over the course of 2009 and reaching the 3% target in 2010. As always, these forecasts serve as a framework for the formulation of policy, and risks have to be accounted for. On this occasion, after examining alternative events, the Board estimates that the balance of risks for inflation is biased upward in the short term, but unbiased over the projection horizon, while the balance of risks to growth is tilted downwards. The main sources of uncertainty lie in global conditions and the degree of persistence and propagation of local inflation.

Externally, the balance of risks to growth is clearly tilted towards the downside, as the consensus view considers that emerging economies will keep on decoupling from the developed economies credit cycle and that the latter experience a pick-up in growth by 2010. Both aspects are subject to a high degree of uncertainty, as the most recent episodes of turmoil and financial instability attest. However, it is too early to quantify and assess the consequences of the global financial crisis currently unfolding on growth in the US and elsewhere, as we are not likely to see the end of the turbulences anytime soon or their actual impact on real variables in emerging economies for a couple of quarters.

Although the Chilean economy is unlikely to be immune to global turmoil, it has never been better prepared, thanks to a prudent fiscal policy, a monetary policy oriented towards stability, the floating exchange rate regime, the accumulation of reserves and fiscal savings abroad, and particularly, a sound financial system.

The implications of alternative global scenarios on local inflation are less clear cut than the balance of risks for growth. On the one hand, softer global growth should have an effect on commodity prices. How these play out on inflation and internal prices depends however on the reaction of the exchange rate and, for instance, the relative impact on the price of oil vs. the prices of other commodities. Internally, the main source of uncertainty is the degree of persistence and propagation of inflation in coming quarters. To the extent that macroeconomic variables drift away from the baseline scenario, jeopardizing the achievement of the inflation target, the BCCh would have to react accordingly. Conversely, if slack increases more than expected while inflation expectations and wage dynamics are consistent with the target, it will not be necessary to incur in additional disinflation costs.

In our monetary policy framework, it is normal for any price shock to have some degree of propagation to other prices. This forms the rationale for having a policy horizon of two years. However, it is the responsibility of monetary policy to avoid that unexpected shocks to inflation become entrenched in expectations and in the price setting process. The baseline scenario considers a path for the monetary policy rate that, over the short run, is above the set of private sector expectations prevailing at the statistical closure of our monetary policy report in early September.