

# Chile Watch

Economic Research Department

Second Semester 2009



Confidence returns and with it, recovery.

Fiscal and monetary stimulus withdrawal will be gradual.

Strong peso appreciation, along with high volatility, reopen the debate over intervention

# Index

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## Executive Summary

The international scenario in November 2009 is more benign than six months ago, when financial tensions were running high. The stabilization of the financial markets, improved prospects for emerging Asia (particularly China) and a scenario pointing to U.S. recovery and stabilization in Europe, are certainly all elements that have contributed to improving expectations for the global environment that Chile will face in the immediate future.

On the domestic front, business and consumer confidence in the economic situation has also improved and reached above-neutral levels, with prospects for the twelve-month horizon even more optimistic. This recovery in confidence has been assisted by the favorable performance of the indicators of economic activity, both on the supply and demand side.

On the supply side, the negative performance of key sectors during the downward phase of the cycle has been reversed. In particular, mining, construction and industry have accumulated various months with positive marginal growth. This performance should be maintained in the future, given the progress in the fundamentals of these markets. In the case of mining, improved current and forecast prices are resulting in projects being reactivated as they are once more profitable; in construction and industry, the reduction in inventories is leading to increasing prices and production levels.

The main supporting factor on the demand side has been public and private consumption. Non-durable goods and services have made a significant contribution to private consumption, as has the recovery of marginal growth in durable goods. In the future, the goods news in the labor market suggests that this trend will be strengthened. In terms of gross fixed investment, the latest report from Corporación de Bienes de Capital indicates a significant boost to investment, which will be based on projects that are reactivating or starting up because of improved expectations in the mining, energy and construction sectors. Finally, recovery of both consumption and investment allows us to anticipate that the inventory component, which has had a negative impact on growth in recent quarters, will move into positive territory, probably starting in 4Q of this year.

This has led to an upward revision of growth forecasts to -1.2% for 2009 and 4.1% for 2010.

In terms of inflation, even though in October 2009 it stood at -1.9% y/y, far below the target inflation level, data from the most recent months show a change in the trend. The forecast is for 2009 to close at -0.7% and 2010 at 2.5%, slightly under the Central Bank target.

With growth at close to potential, inflationary pressures in check and an appreciating exchange rate, a gradual withdrawal of expansive policies has been announced. First, in fiscal policy: spending will increase by 4.3% and the tax reductions introduced as a temporary measure this year will be withdrawn. Second, in monetary policy: a gradual withdrawal of complementary measures has already been scheduled and the Central Bank has announced that the policy rate will be maintained at its current level at least until the second quarter of 2010. This should be enough to address the risk for growth represented by the appreciating exchange rate.

To sum up, after a 2009 of contrasts, we anticipate the economy will return to balanced growth that is close to potential in 2010, boosted by domestic and external demand.

# 1. International Outlook: Global economic prospects improve...

Since the middle of the year the world economy has been giving clearer signs of recovery. The sensation of free fall prevalent at the end of 2008 and the start of this year has given way to relative stability and, in some cases, moderate growth.

The change in the trend has been favored by the exceptional stimulus measures adopted in most economies. The measures have been implemented both on the monetary front (substantial reductions in the intervention rates, massive injections of liquidity and unconventional operations with assets) and the fiscal front (fiscal stimuli that have boosted sectors such as the automobile industry, and have helped temporarily sustain the income and spending of private agents).

**... although latent risks of a downturn in the short term continue, above all in the most advanced economies**

Nevertheless, the fundamentals of the world economy continue to be fragile and the risks of a downturn are therefore present in the short term. The main risk is a possible premature withdrawal of the stimulus packages, above all in the most advanced economies, and uncertainty over whether private-sector spending can replace public spending as the main driving force of recovery. In developed countries, growth during the expansive phase was boosted by domestic demand, supported by the increase in disposable income and also very high private debt. This will not recur in this new phase of the cycle. The labor market figures will also not contribute to a swift emergence from the crisis, since the rate of job destruction continues to be very high in many economies.

For all these reasons, the biggest challenge now facing economic policy is the timely and well-planned withdrawal of the public, fiscal and monetary support programs.

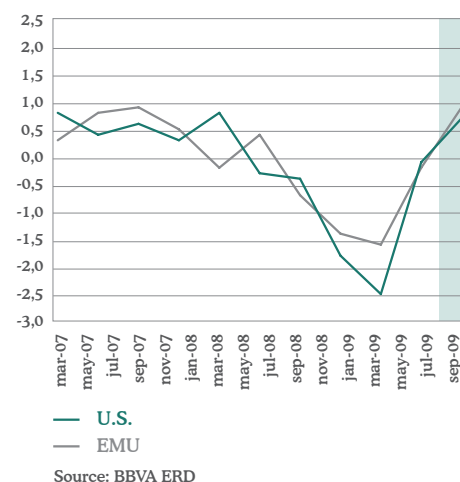
In this situation, the most probable scenario would point to a maintenance of low official rates for an extended period, as it does not appear likely that there will be a significant upturn in inflation, given the high productive capacity available. However, maintenance of the stimuli over time could also have detrimental consequences, since they distort the incentives to take decisions on adjusting balance sheets and question the sustainability of the public accounts in many economies.

It therefore appears probable that central banks will gradually try out possible alternatives to bring their liquidity policies back to normal when the time comes. The evidence of recent weeks shows the importance of communication on the part of the monetary authorities during this phase. They have to separate what is said about the design of the exit strategies from the moment of their application, which should be delayed until the economy gives signs of self-sustained recovery.

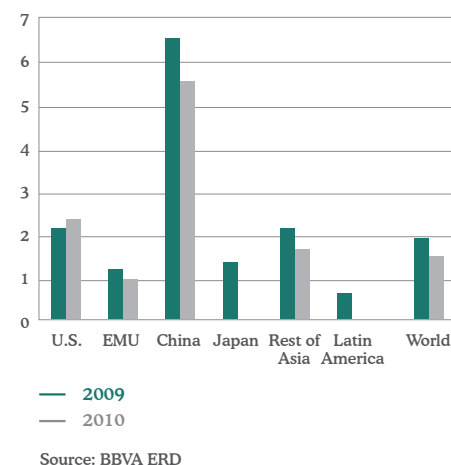
Although the financial tensions have steadily reduced since the maximum levels after the Lehman collapse, the current situation is far from being fully satisfactory. In fact, the levels of tension in the markets are still a long way from pre-crisis levels. The biggest progress so far has been in the interbank markets. The 3-month OIS spreads in the U.S. and the EMU are currently at 18-month lows, despite the fact that these markets still depend on injections of liquidity by central banks.

The reduction in risk premiums has been extraordinarily swift over recent months. U.S. bank CDS reached their minimum levels since the start of the crisis, and European CDS were at their lowest level for nearly a year before stabilizing. Caution appears to have taken hold in

## U.S. and EMU: GDP Growth (quarterly % change)



## Fiscal and Budget Programs (% GDP)



## Indicator of Financial Tension (100=January-07)



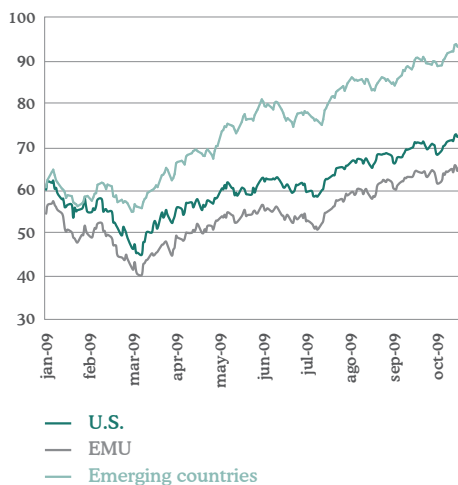
The first standardized principal component of the OIS spread series, implicit U.S. stock market volatility, bank and corporate CDS.

## Interbank Markets: 3-month OIS Spread (3M Libor-3M OIS)



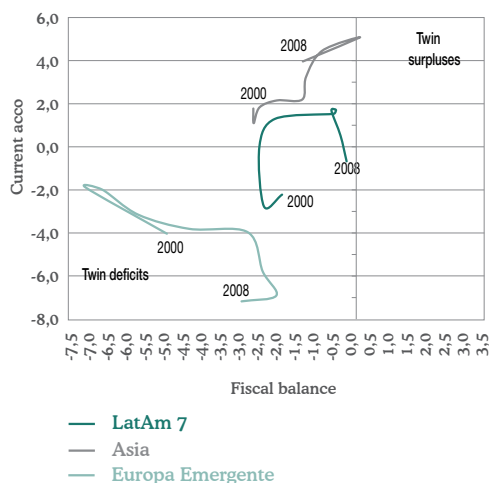
Source: Bloomberg

## Equity Markets (july 2007=100)



Source: Bloomberg y MSCI

## Current Account and Fiscal Result 2000-2008 (% GDP)



Source: WEO, IIF, BBVA.

**LatAm 7:** Argentina, Brazil, Chile, Colombia, Peru, Mexico and Venezuela. **Emerging Europe:** Poland, Hungary, Czech Republic, Slovakia, Estonia, Latvia, Lithuania, Bulgaria, Rumania, Turkey and the Ukraine. **Asia:** China, Hong Kong, India, Indonesia, Korea, the Philippines, Singapore, Taiwan and Thailand.

most markets (including equity), in a scenario in which a historically high level of risk aversion still predominates.

## Emerging economies, the new motor of global growth...

Economic recovery is very uneven. In general terms, emerging economies are on a more solid path to recovery than developed ones. This can be explained by a number of factors that set these economies apart and have made it easier for most of them (with the exception of Emerging Europe countries) to cope with more expensive funding markets and the contraction in economic activity and employment. Specifically, these factors include the following: their lower exposure to the financial crisis, above all in its initial stage; the success of the fiscal and monetary stimulus packages implemented after the start of the crisis; the growth in commodity prices in recent months; the modest recovery in world trade after its collapse at the end of 2008; and, perhaps most importantly for stable long-term growth, the earlier efforts made in many of the countries to promote and practice a policy of macroeconomic stability.

Among developed economies, the U.S. appears to be in a better position than Europe. In particular, the fiscal stimulus in the U.S. will have a relatively greater impact on growth over the coming years. In 2010 it is expected to have an impact of 3 percentage points (pp), compared with 1.5 pp in Europe. The most probable scenario for the U.S. economy is moderate growth, as there is no certainty that once the public stimulus ends, the private sector will recover its high level of sustained growth. In addition, questions such as unemployment or the public accounts are still sources of obvious concern.

In Europe, the fiscal stimulus will be comparatively lower in 2010, and vary among the different countries. The recovery in economic activity will also be delayed by the greater rigidity in the European labor market.

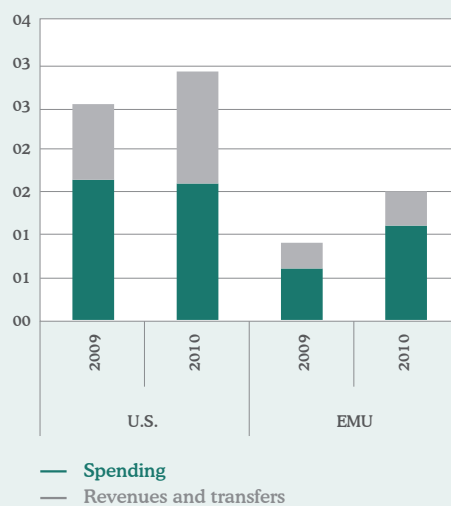
The signs of recovery in activity are already clear in emerging countries, although with some notable variations. China, for example, has already returned to high growth rates, partly as a result of an extremely rapid increase in credit and other stimulus measures. In Latin America, most countries are already showing signs of positive growth in the third quarter. However, there is more risk in the situation of Emerging Europe economies, which are weaker in macroeconomic and financial terms.

## Commodity prices recover in this more positive context

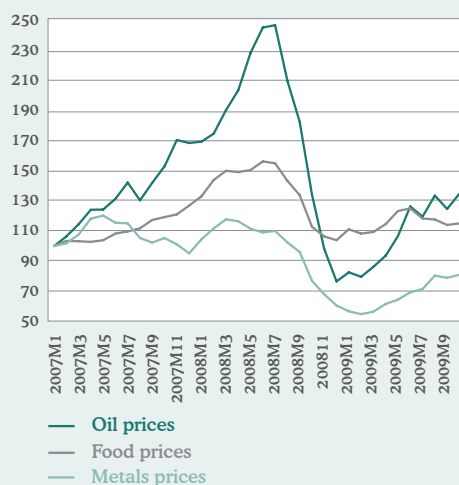
Strong demand, above all from China, and the prospects of a recovery in developed countries in 2010, have greatly supported commodities, which began to recover together with the equity markets. In recent months, the fall in risk aversion and the weakness of the dollar have attracted financial investment to these markets and supported a recovery in prices. This has eased the pressure on public funding felt in some emerging economies at the start of the year, and given additional support to the appreciation of the currencies of those countries that are rich in natural resources.

The price prospects for 2010 will depend on synchronizing the recovery of industrial production in developed countries with the normalization of demand from China. As we expect that Chinese demand will return to normal before the recovery in industrial production, we estimate that the fundamentals point to a moderate correction in commodity prices in the coming months, followed by new rises as the recovery in global demand begins to manifest the restrictions on extending supply capacity in the coming years.

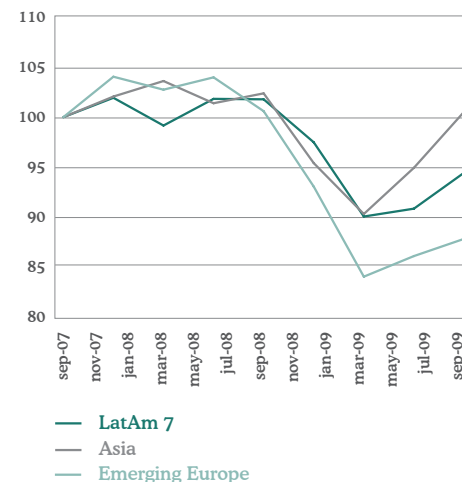
## U.S. and EMU: Contribution of the Fiscal Stimulus Packages to GDP Growth (pp)



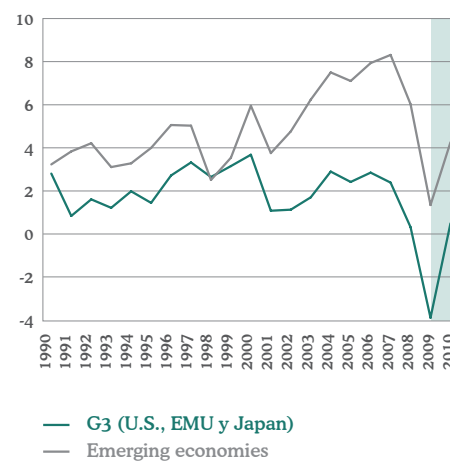
## Commodity Prices (january 2007=100)



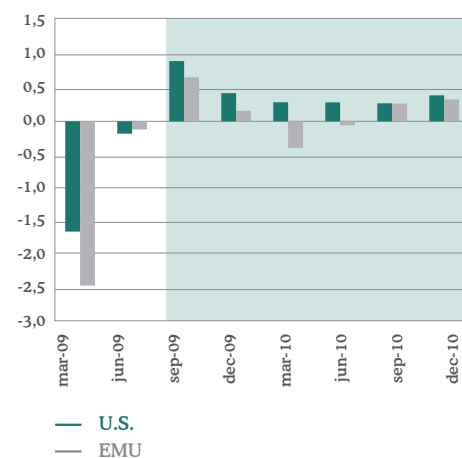
## Industrial Output (inex, 2007:3=100)



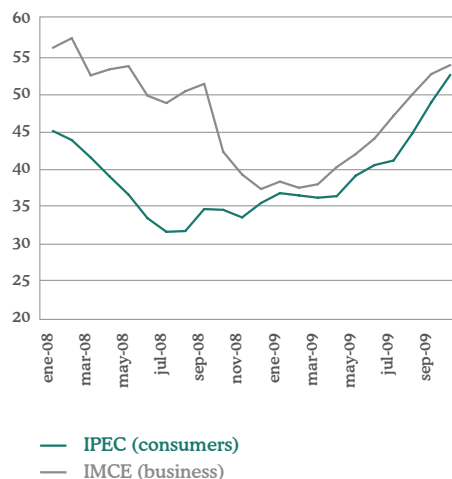
## Emerging Economies and G3: GDP Growth (year-on-year change)



## U.S. and EMU: GDP Growth (quarterly % change)



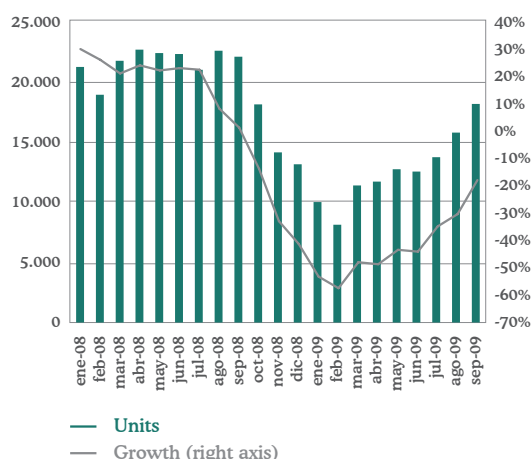
## Consumer and Business Confidence



Source: UAI-Icare and Adimark.

## Car Sales

(units/month and % var. y/y)



Source: ANAC and BBVA.

## Aggregate Demand in Chile

(y/y % change)

	2008	2009f	2010f
Domestic demand	7,4	-5,5	6,7
Consumption	4,2	1,0	2,8
Private	4,3	-0,1	2,6
Public	4,0	6,9	4,0
Investment (GFCF)	19,5	-14,7	7,9
Exports	3,1	-3,6	5,9
Imports	12,9	-12,3	11,9
GDP	3,2	-1,2	4,1

Source: BCCh and BBVA

## 2. Macroeconomic Outlook: Confidence returns and with it recovery

The international scenario described above is more benign than six months earlier when financial tension still persisted. Most countries in the region have revised their growth forecasts for 2009 slightly upward and even more so those for 2010. Chile is no exception.

### The better international conditions have favored stabilization in the external sector. How lasting will this situation be?

Better perspectives for the emerging Asia block, in particular China, the scenario of U.S. recovery in 2010, and stabilization in Europe, are undoubtedly elements that have contributed to the strengthening of external demand. If to this we add the fact that the last quarter of 2008 constitutes a very low base for comparison for the equivalent quarter of 2009, we can expect that not only will the external accounts stop falling, but will begin to grow. This is demonstrated by the figures of the September trade balance, with the first positive growth for exports for a year (9.3% y/y).

This more favorable international background is unstable by nature, as we cannot discount a premature withdrawal of fiscal stimuli, in particular in developed economies. From the point of view of the Asian block, and given the importance of China as Chile's trade partner, 2010 can be discerned as a good year, without greater risks to the continuity of the fiscal support plans. However, in the medium term (2011) these plans may be terminated, thus leading to a slowdown in demand.

### Consumer and business confidence increases

On the domestic front, business perception on the current (and future twelve-month) performance of the economy has experienced a strong upturn, after stabilizing at around 37 points in the first quarter of the year. Starting with the September survey, the indicator rose above the 50 point threshold. The 53.59 points posted in October now positions business confidence in optimistic territory. In the case of consumers, whose index of confidence fell much more drastically (to 31.6), recovery has also been pronounced, to 52.3 points in October.

This greater optimism is reflected in increased sales of durable goods. For example, monthly car sales are increasing and have exceeded expectations, above all in the last month. A similar phenomenon can be seen in the real estate sector, even though it did not suffer such a dramatic fall, at least not in the residential sector, thanks to strong state support.<sup>1</sup> The employers' association for the sector (the Chilean Chamber of Construction) has revised upward projected sales to the end of the year. They now expect a rise of 2.5% on 2008, compared with their March forecast of a 11.2% fall.

### The new macroeconomic scenario 2009-2010

Amidst this background we have revised our macroeconomic projection and returned to the growth figure published in the last Chile Watch (-1.2%), which in the interim had been revised down (-1.5%). We are revising our growth forecast for 2010 as well, from 3.5% to 4.1%. It is worth highlighting that in its last monetary policy report (IPoM September 2009), the Central Bank estimated that real growth would be within a range of 4.5% and 5.5% in 2010. Thus, our forecast is below the Central Bank's estimate.

<sup>1</sup> See the Chile Real Estate Report 2009 for a complete review of the effects of the crisis in the sector.



### Supply-side factors that explain the improved prospects

There are three key factors on the supply side that would support the recovery described above. First, despite the disappointing result in September, prospects for industry are favorable. The fall in September compared with September 2008, rather than being a break in the trend, can be explained by the reduction of inventories, the major decline in the salmon industry and a high base for comparison. Investment in the sector has also gained strength, so we can expect that the recovery will be maintained and that growth in 2010 will be positive, although far below the 2008 average.

Second, there is mining. Its performance has been volatile, with copper prices exceeding all expectations, but it has now begun to reactivate investment projects and a positive performance is expected for 2010.

Finally, the construction sector was not only been helped by renewed confidence, but is facing lower costs to those a year ago. As a result, projects that were not considered profitable at the time would now be so, and have begun to reactivate. The most outstanding example is the Costanera Center project, whose paralysis symbolized the start of the crisis in Chile. There are indicators that it will be reactivated soon.

### Demand-side factors that explain the improved prospects

Among the main factors for recovery of demand is the upturn in investment as the uncertainty of last year begins to moderate. As an example, according to the survey of projects carried out by Corporación de Bienes de Capital, the projects scheduled between 2009 and 2013 amount to US\$64 billion, of which US\$17,597 million correspond to 2010. This forecast is 7% higher than that estimated in June 2009, and can largely be explained by the increases in mining, although projects will increase in all the sectors. In addition, we also expect a positive contribution from inventories, with the negative contribution between the fourth quarter of 2008 and the second quarter of 2009 being reversed. In fact, business surveys indicate that the perception of excess inventories has decreased, while the current situation of demand is improving (see the IPOM Monetary Policy Report, September 2009).

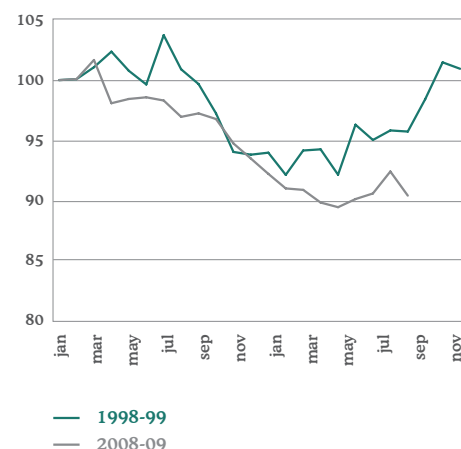
Fiscal and monetary policy has been fundamental in this process, as we anticipated in the previous edition of Chile Watch. Low interest rates and the subsidy payments made by the government, together with the high real wages due to low (even negative) inflation, all boosted retail sales. Thus we expect an upturn in private consumption, in line with the leading indicators of real commerce sales and supermarket sales.

In 2010, the fiscal stimulus will be maintained, with the budget still applying the structural balance rule (see box for more details), while monetary policy will continue to be expansive throughout the year. Thus expectations for consumption are promising, although as unemployment remains high and growth in real wages stabilizes, this recovery will not be as strong as that of investment.

### The labor market exceeds expectations

The labor market has performed better than expected during the second half of 2009, largely because of a combination of countercyclical fiscal and monetary policies. Fiscal policy helped contain the fall in employment via subsidies and incentives for hiring (and for not laying off) and by increased execution of public works. In fact, the Finance Ministry (in a joint report with the Ministry of Labor and Social Welfare) estimates that about 125,000 jobs are directly linked to this factor.<sup>2</sup> Monetary

### Industrial Physical Production & ISM Seasonally Adjusted Index



Source: INE and BBVA.

### Monthly Index of Construction Activity (12-month % change)

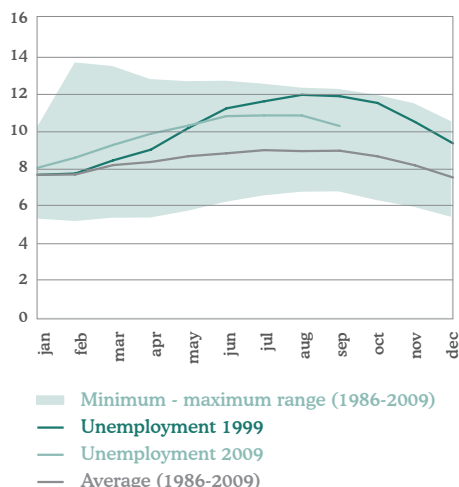


Source: Central Bank of Chile.

<sup>2</sup> Ministry of Finance/Ministry of Labor and Social Welfare (2009), "Programas de empleo con apoyo fiscal. Second semester, 2009", Santiago de Chile.



## Unemployment Rate



Source: INE and BBVA.

policy created room for funding small companies. This in turn prevented the mass bankruptcies (and consequent loss of jobs) that occurred during the Asian crisis. Thus the unemployment rate reached a maximum of 10.8% in the rolling quarter May-July and then stabilized at this level before registering a surprising fall to 10.2% in the quarter ending in September.

Employment has also performed better than expected. In particular, salaried employment was expected to fall around 3% to the end of the year, but fell 2.7% in the rolling quarter July-September, which is a significant improvement in the margin. Self-employment, however, compensated the fall in salaried employment to a limited extent. According to the ILO, these changes in the growth of employment by occupational category may be the result of a certain trend of greater informality in the labor market, as a significant part of the management of informal companies or businesses is carried out by independent workers (see ECLAC-ILO bulletin, September 2009, No. 2).

In all, we expect the unemployment rate will fall to 9.2% at the close of the year, with an annual average of 9.7% in 2009, and that total employment will begin to grow in the margin. This will take place in a context of increasing real wages, due to largely negative inflation registers. In any event, in around 2010 this trend will begin to moderate as an upturn in inflation begins, as we will now explain.

### Inflation in negative territory, but will stabilize by the end of the year

In the last quarter, inflation has maintained the falling trend of the initial months of the year in the context of a depressed domestic demand and significant excess capacity. In June 2009, 12-month inflation fell to 1.9%, so for the first time since 2004 it was below the lower limit of the Central Bank of Chile tolerance range (2%), and starting in August it was even in negative territory.

Thus annualized inflation fell from a high of 9.5% in November 2008 to -1.9% in October 2009. Core inflation as defined by the CPIX, which does not include fresh fruit and energy, accumulated a rate of -0.4% over 12 months and -1.1% for the year.

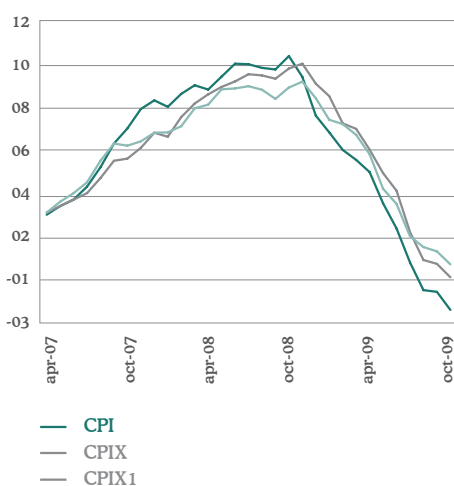
It is important to highlight that core inflation as measured by the CPIX1 (which is particularly relevant in recent months, as it excludes regulated prices, in particular electricity prices that have experienced major reductions) varied positively in September (0.3%) and remained stable in October, thus reversing the negative figures registered in previous months. It is now more in line with the medium-term target of the Central Bank.

### Commodity price changes seem to be having a moderate impact on domestic inflation

The increase in fuel prices over recent months on the international markets has impacted domestic prices. Nevertheless, this transfer has been partially compensated by the appreciation of the peso, and the phenomenon of the intense transfer of 2008 has not been repeated. What is more, if international fuel prices and the nominal exchange rate are maintained at current levels, fuel prices will have no effect on inflation in the coming months.

At the close of this edition the nominal exchange rate accumulated an approximate appreciation of 21.7% over the year and 8.8% in the latest month. The rate will probably correct to its equilibrium level, which we estimate at 10% above its current value. Nevertheless, if this appreciation is delayed or only partially corrected, it may take longer than forecast for inflation to return within the Central Bank's tolerance range. The

## Inflation (% y/y change)



Source: INE and BBVA.

Monetary and Exchange Outlook below discusses the policy options for the Central Bank in this respect.

For the last quarter of the year we expect average inflation of 0%, so that 2009 should end with a growth in prices of -0.7%. This forecast is practically the same as the -0.8% forecast by the Central Bank of Chile in its last Monetary Policy Report (September 2009). Our inflation forecast for 2010 is 2.5%, slightly under that of the Central Bank, and consistent with a less optimistic view of the recovery in economic activity.

### Inflationary Expectations for 11 Months



Source: Bank of Chile (BCCh).

### Inflation Forecasts (% var.)

	2009		2010	
	Monetary Policy Report	BBVA	Monetary Policy Report	BBVA
CPI December	-0,8	-0,7	2,8	2,5
Average CPI	1,7	1,7	2,5	1,7

Source: Central Bank of Chile and BBVA.

## Box 1: Exceptional measures in exceptional circumstances

The serious global financial crisis unleashed at the end of 2008 has required a reconsideration of the role fiscal policy should play. Since the start of the decade, fiscal policy in Chile has been based on a structural rule that sets a target surplus corrected by transitory revenue variations. Specifically, between 2001 and 2006 the rule set a structural surplus of 1% of GDP. In 2007 the target was lowered to 0.5% of GDP. Since 2006, with the enactment of the Law on Fiscal Responsibility, central government has had to make regular reports on the implications and effects on the structural balance of its fiscal policy, but it does not set a target.

Given the size of the shock experienced in the last quarter of 2008, in January 2009 the government decided to apply a series of countercyclical measures that involved a temporary reduction of the surplus in the fiscal rule to that of a structural balance.

### Chile has had sufficient room to implement a strongly countercyclical fiscal policy

This could be done despite the economic contraction and the fall in the price of copper, because the fiscal rule allowed savings to be made during the expansive period before the crisis. In October 2008 Chile's sovereign funds amounted to US\$ 20,350 million, equivalent to about 12.5% GDP, allowing Chile to achieve a position of net creditor.

This allowed the funding of temporary tax reductions and increases in public spending, including advances in the implementation of the pension reform of 2008. The total effect on the public balance will be over US\$ 3.6 billion, composed of a fall in tax revenues of 0.8% of output and a 1.7% increase in spending. We estimate that the real expansion of public spending in 2009 will be 20.4% and the real reduction in income will be 17.7%, thus achieving a deficit of 3.9% of GDP and an effective structural deficit (ex-post) of 1.6% GDP.

The fiscal stimulus will remain in place in 2010. In accordance with the overall figures contained in the national budget for next year, real expansion of spending in 2010 will be 4.3%, consistent with a deficit of 1.9% of GDP. If

added to other fiscal obligations this would imply funding needs of US\$ 5,519 million, which can be funded with the accumulated savings in the sovereign funds.

Although a real expansion of 4.3% in spending appears modest, it should be taken into account that the base for comparison is the effective public spending for 2009. In other words, the proposed budget for 2010 would maintain the strong fiscal stimulus for one year more.

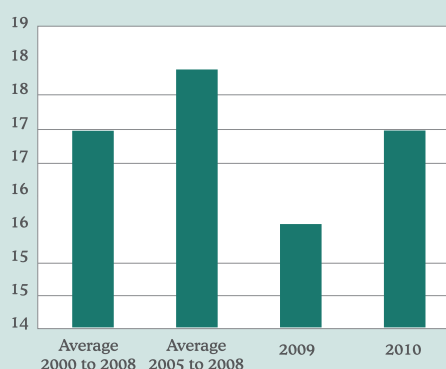
An even more expansive budget could be counterproductive in terms of stimulating economic activity. A major budget deficit for 2010 would have to be financed by liquidating additional resources from sovereign funds. This would put pressure on the exchange rate and interest rates, and thus to a certain extent counter the expansive effect. In fact, maintaining the tax reductions of 2009 would raise the deficit by more than US\$ 1.2 billion, and thus increase the volume of foreign currency that had to be liquidated in the market.

### Fiscal Financing Requirements and Sources

	2009	2010
Deficit	4.867	3.794
Banco Estado	500	-
Codelco	1.000	-
ENAP	500	-
Retirement bonds	1.782	1.565
Debt payment	850	159
Funding requirements	9.499	5.519
Economic and Social Stability Fund (FEES)	6.499	519
Debt	3.000	5.000

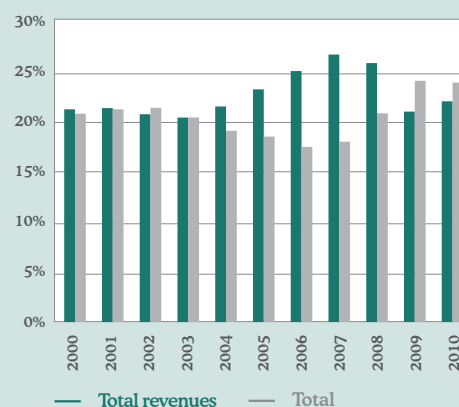
Source: BBVA

### Net Tax Revenues as Percentage of GDP



Source: Budget office and BBVA.

### Budget Revenues and Expenses as % GDP



Source: Budget office and BBVA.

### 3. Monetary and Exchange Outlook

**In the second half of the year, the Central Bank has continued with its strongly expansive policy, lowering the rate to a historic 0.5%...**

After its June meeting, in which the Board of the Central Bank reduced the monetary policy rate (MPR) by 50 basis points from 1.25% to 0.75%, the market did not expect more reductions, and this could be seen as implicitly reflected in asset prices. However, the fall in inflation to below its tolerance range and the weakness of economic activity in Chile and the world led the Central Bank to reduce the MPR in its July meeting to 0.5%.

**... as well as introducing exceptional measures that indicate to the market its commitment to maintaining the rate low.**

Given that 0.5% was estimated as the lowest level to which the rate could fall without interfering with the normal operation of the money markets, and given the need to implement a more expansive monetary policy, complementary unconventional measures were taken. Among these are the implementation of the Term Liquidity Facility (FLAP).<sup>3</sup> At the same time, it adjusted the issue plan for PDBC bonds at maturities of under a year, and the Central Bank 2-year Nominal Bonds (BCP-2) and 1-year Discountables (PDBC-360) were suspended for the rest of 2009. In its October meeting, the Central Bank stated that the MPR would begin an upward cycle in the second quarter of 2010. These measures have initially been positively received and have above all affected short rates, with a significant transfer to short-term lending rates.

At the start of November, the Central Bank announced the gradual withdrawal of the current liquidity support measures (swap and repo transactions) implemented in 2008, and in its policy meeting in November it announced the gradual withdrawal of the FLAP until their termination in May 2010.

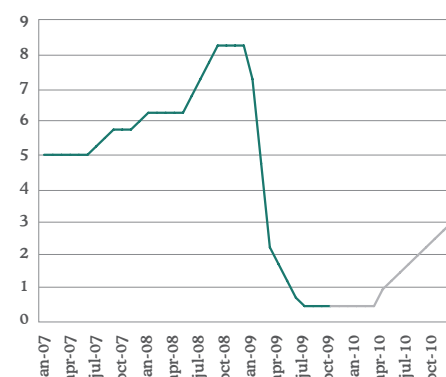
Our monetary policy outlook is in line with that announced by the Central Bank of Chile. The rate should begin its upward cycle starting in April 2010, although the November meeting of the Central Bank pointed out that the pause could extend beyond this date. In addition, we consider that the rate will close 2010 under market expectations (3% is our forecast), although our economic activity outlook is less optimistic than Central Bank outlook and we also forecast a lower inflation.

#### The Chilean peso appreciates against the dollar

The major relaxation of monetary policy had no impact on the exchange rate, which has been appreciating strongly against the dollar since mid-October. However, the real multilateral exchange rate would appreciate by only 5% compared with our estimated equilibrium level. This process can be explained in part by the weakness of the dollar on the international markets, but also by particular factors such as a sustained rise in the price of copper (more than 30% in the second half of the year), the use of an additional US\$4 billion from the Economic and Social Stabilization Fund and the net sale of dollars by the Pension Fund Administrators (AFP).

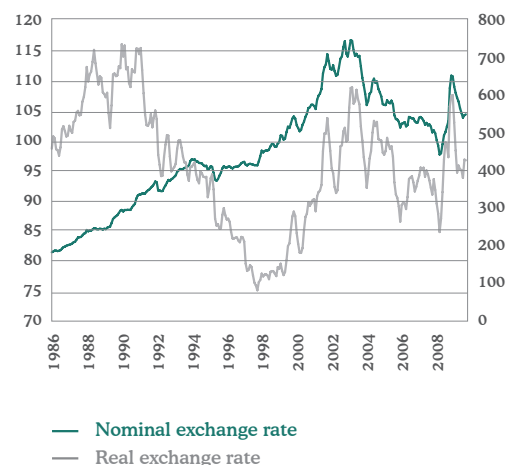
In addition, at the end of October Brazil fixed a tax on capital flows to prevent pressure against its currency. This led to a reduction in carry-

#### Monetary Policy Rate



Source: Central Bank of Chile.

#### Real and Nominal Exchange Rate



Source: BCCCh

#### Multilateral Exchange Rate Index



Source: Central Bank of Chile.

<sup>3</sup> The Term Liquidity Facility (FLAP) is a liquidity facility for banks at 90 and 180 days, with a rate equivalent to the current MPR at the time of financing.

trade transactions between Chile and Brazil in the margin (although they cannot be completely ruled out, because of the interest rate spread between Brazil and Chile). This showed the appreciation of the peso had gathered pace and revived discussions on the appropriateness of an intervention by the Central Bank. Although we believe that the probability of an intervention is directly related to the rate of appreciation, an announcement by the Board of the Central Bank expressed its concern about how the level of the exchange rate could affect speculative movements. If this were not enough, there could be a sterilized intervention such as in mid-2008 (in which the peso-dollar rate reached 430 pesos) and, as a final resort, control of capital flows similar to that introduced by Brazil (although we consider this less probable).

Finally, the recent decision to increase funding of the public budget with domestic debt, from US\$4.5 billion to US\$6 billion, aims to reduce upward pressure on the exchange rate caused by financing fiscal expenditure with external resources.

## Box 2: The National Consumer Price Index: an improvement that has not come without cost

The change in the base of the price index from December 1998 to December 2008 brought with it surprises in terms of the performance of inflation. Now that the new national price index with the 2009 base and nationwide coverage will be introduced in January 2010, it is worth asking whether there will be any new surprises.

The preliminary figure released by the National Institute of Statistics (INE) give grounds for some tranquility, due to the absence of major methodological changes and not very significant variations in the weightings of the components of the national CPI base 2009 compared with the weightings of the CPI base December 2008. However, discontinuing the measurement of inflation for Gran Santiago represents problems for constructing long inflation series for analytical purposes.

### The good news is that the most significant methodological changes were made in the move to the December 2008 base

The previous change of the base involved moving from a basket of 8 groups and 482 products to one of 12 divisions and 368 products. More significant than this change in categories was the updating of the basket of consumption based on the results of the VI Family Budget Survey of 2007, which determined the change in weighting of the different products in the basket, as well as the disappearance of some and the introduction of others as a result of the change in patterns of consumption.<sup>4</sup>

The most important change in moving to the 2009 base has been the coverage of the index, as it changes from being an index restricted to Gran Santiago to one that covers more than 80% of the urban population of the country.

As can be seen in the table opposite, there are no major changes in the weightings of the indices with a December

2008 base and the 2009 base.<sup>5</sup> Additionally, the divisions, groups, classes, subclasses and products are maintained, with only the number of products in 5 of them being increased to incorporate products of regional importance, such as wood or transport costs using the subway or microbus.<sup>6</sup>

Another change is the use of an annual base instead of a monthly base. This reduces any influence that seasonal factors may have on the prices in the monthly base.

Finally, another minor change (although improvements are being studied) is that relating to quality-based adjustments that cover changes in models and technological improvements of particular importance in cars, computers and technological products in general.

The most important thing to take into account with regard to the methodological changes involved is that these changes will probably have an smaller impact on the performance of the index than those observed in 2009 as a result of the previous change in the base.

### Weighting of Indices, base December 2008 and 2009

Category	Weight 2008	Weight2009
1 Food and non-alcoholic beverages	18,55289	17,87253
2 Alcoholic beverages and tobacco	2,03580	2,10142
3 Clothing and footwear	5,04234	5,07003
4 Accommodation, water, electricity, gas and other fuels	12,86283	12,73379
5 Furniture and home furnishings	7,20323	7,21683
6 Healthcare	5,30144	5,52446
7 Transport	18,97508	18,73769
8 Communications	4,52424	4,00767
9 Recreation and culture	8,79103	9,22545
10 Education	5,85991	6,19300
11 Restaurantes/hotels	5,34009	5,92649
12 Various goods and services	5,51113	5,39064

Source: INE.

<sup>4</sup> Other relevant methodological changes made when moving to the December 2008 base were the use of Laspeyres' index, with fixed weightings in an arithmetical aggregation, instead of a modified Laspeyres' index with geometrical averages with fixed weightings at higher levels; the elimination of the smoothing out of clothing price peaks; the updating of points of sale in accordance with changes in the buying patterns of Chileans; and adjustments in the dates and number of price checks made, as well as their locations.

<sup>5</sup> It should be pointed out that these weightings are preliminary, as adjustments have to be made due to the incorporation of Arica and Valdivia, and the market studies that are being carried out on some products, including medicines, wines and telecommunications.

<sup>6</sup> It should be remembered that for Gran Santiago, since the introduction of Transantiago and the previous change of the base, the relevant product is multimodal transport.

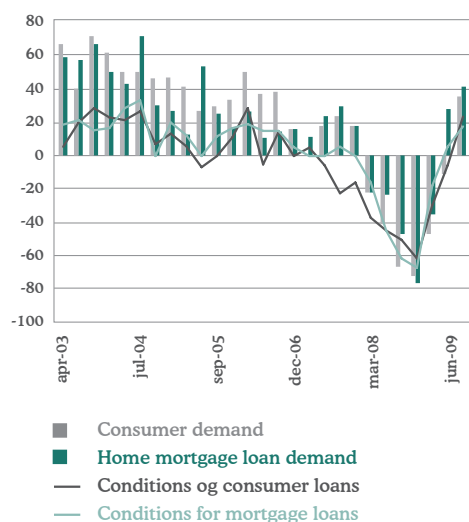


### Interest Rates of Home Loans (annualized % rate in UF, over 3 years)



Source: Central Bank of Chile.

### Loan Conditions (\*) and Demand by Type of loan



Source: Central Bank of Chile.

(\*) Difference between the percentage of people surveyed who considered that the criteria for approving loans were less restrictive and the percentage who considered these criteria were more restrictive.

## 4. Financial Outlook

### The decrease in the monetary policy rate has been transmitted to the market rates, although with very different intensity

In general, the transmission of the Central Bank rate cuts to the different loan types has been effective. Thus the rates for consumer loans have even fallen below pre-crisis levels. Similarly, the fall in commercial lending rates has varied, with those with terms of more than a year being more resistant to cuts. The rates for housing loans fell sharply until April 2009 to 4.42%. Since then, they have not changed significantly, so the transmission of monetary policy has been more restricted lately.

There are various factors behind these differences in the monetary policy pass-through, but they are mainly related to the policy rate expectations in different time horizons and the supply of financial instruments at different maturities. Thus the improved expectations with regard to the performance of the economy in the medium and long term has meant an upward adjustment of the MPR forwards and of the yield curve for long-term debt. Another factor highlighted by the Central Bank in explaining the reduced transmission, and even some increases in long-term rates, is the use of domestic securities as a refuge against increased risk aversion.

The Central Bank's survey of Bank Lending indicates that in general the conditions for granting loans to big companies, SMEs and individuals are now less restrictive.

### Lending flows tend to stabilize, even grow, in all segments

In general funding to companies has remained stable. In bank lending, growth in total lending flows has tended to stabilize around zero, while the seasonally-adjusted series of corporate lending also increased once more to positive figures in August and September. In addition, companies have been able to access long-term finance through the corporate bond market, which continues its boom with attractive spreads, although these are falling in the margin. It is worth pointing out that the existence of institutional investors allowed companies to diversify and make their funding sources more flexible through the issuance of long-term instruments when both external and banking funding was restricted.

International interest rates in dollar terms have continued to fall, and the cost of external funding tended to stabilize in the third quarter after significant falls in the initial months of 2009. In this context, Comex lending flows tend to have stabilized, although this is the segment that is expected to fall the most in 2009, and to perform worst in 2010 in relative terms. This is in line with the poor performance of foreign trade from the start of the crisis in September 2008 until now, with exports showing year-on-year growth of -26%, while the same indicator shows imports have fallen -22%.

In contrast, prospects for the mortgage loan segment are good, with an average growth rate of over 10%. Overall, lending will grow by around 5% in 2009 and 7% in 2010.

### The banking system improves its profitability with moderate increases in credit risk indicators

The composition of bank placements by currency has remained stable, and banks have an extremely limited exposure to exchange rate mismatch. In addition, the banking sector has posted significant increases in profitability, together with an improvement in non-performing loan figures that has been a positive surprise, both in terms of levels and the early improvement.

## Main Economic Indicators

	2007	2008	2009(p)	2010(p)
<b>Activity</b>				
Nominal GDP (\$, billion)	85.621	88.535	88.941	94.065
Nominal GDP (USD billion)	163,9	169,5	160,5	166,3
Real GDP (% variation)	4,7%	3,2%	-1,2%	4,1%
<b>Inflation. end of period</b>				
CPI (%)	7,8%	7,1%	-0,7%	2,5%
<b>Interest and Exchange Rates, end of period</b>				
TPM	6,00%	8,25%	0,50%	3,00%
Exchange Rate	499,28	649,00	560,00	564,00
<b>Public Accounts</b>				
Fiscal Surplus/Deficit (% GDP)	8,7%	5,0%	-3,9%	-1,9%
<b>External Sector</b>				
Exports (USD billion)	67,7	66,5	50,9	55,7
Imports (USD billion)	44,0	57,6	40,7	44,9
Trade Balance (USD billion)	23,6	8,8	10,1	10,8
Current Account (% GDP)	4,4%	-2,0%	2,7%	1,9%
International Reserves (USD billion)	16,9	23,2	26,5	26,0

## International Context

Commodities (end of period)							
2008		2009	2010	2008		2009	2009
Brent (USD/barrel)	45,6	60,6	68,3	Soybean (USD/t.)	343	368	339
Copper (USD/t)	3.070	5.732	3.969	Corn (USD/t.)	144	130	136
				Wheat (USD/t.)	216	168	160

Real GDP (%)				Inflation (% , end of period)*					
2007		2008	2009	2010	2007		2008	2009	2010
USA	2,1	0,4	-2,5	1,5	2,9	3,8	-0,7	1,1	
EU	2,7	0,6	-3,8	0,2	2,1	3,3	0,3	0,8	
Japan	2,3	-0,7	-5,3	1,1	0,5	1,0	-1,5	-0,3	
China	13,0	9,0	8,3	9,3	4,8	5,9	-1,1	1,2	

Latin America								
Argentina	8,7	5,7	-2,5	2,6	8,5	7,2	7,5	10,0
Brazil	5,7	5,1	0,0	4,7	4,5	5,9	4,2	4,6
Chile	4,7	3,2	-1,2	4,1	7,8	7,1	-0,7	2,5
Colombia	7,5	2,4	0,1	2,4	5,7	7,7	2,4	3,8
Mexico	3,3	1,4	-7,2	3,1	3,8	6,5	4,0	5,2
Peru	8,9	9,8	1,1	4,3	3,9	6,7	0,6	2,1
Venezuela	8,4	4,9	-2,1	-0,5	18,7	31,3	29,3	35,1
LATAM <sup>1</sup>	5,7	4,0	-2,6	3,5	5,8	8,1	5,6	7,1
LATAM Ex-Mexico	5,7	4,9	-0,6	3,6	6,7	8,6	6,0	7,1

\* USA and EU Inflation: Average of period.

	Public Sector Balance (% GDP)				Current Account Balance (% GDP)			
	2007	2008	2009	2010	2007	2008	2009	2010
USA	-1,2	-3,2	-9,9	-9,5	-5,2	-4,9	-2,6	-2,0
EU	-0,6	-2,0	-6,6	-7,2	0,1	-1,1	-0,8	-0,3
Japan	-0,4	-0,5	-0,9	-1,0	-4,9	3,2	2,1	2,1
China	0,7	-0,4	-3,8	-4,4	11,0	9,8	5,3	4,7
Latin America								
Argentina <sup>2</sup>	1,1	1,4	-2,0	-0,4	2,9	2,2	2,8	2,5
Brazil	-2,8	-2,0	-3,5	-2,6	0,1	-1,8	-1,0	-2,2
Chile <sup>2</sup>	9,9	4,9	-3,9	-1,9	4,4	-2,0	2,7	1,9
Colombia	-2,7	-2,3	-4,2	-4,5	-2,8	-2,8	-2,4	-1,6
Mexico	-1,1	-2,1	-3,0	-3,7	-0,8	-1,4	-1,0	-1,5
Peru	3,1	2,1	-1,8	-1,1	1,1	-3,3	-1,3	-2,0
Venezuela <sup>2</sup>	4,5	-0,2	-4,6	-6,3	9,0	13,1	1,4	2,5
LATAM <sup>1</sup>	-0,6	-1,1	-3,3	-3,0	0,8	-0,4	-0,4	-1,0
LATAM Ex-Mexico	-0,1	-0,5	-3,4	-2,7	1,4	-0,1	-0,1	-0,6

<sup>1</sup> Average of the 7 mentioned countries. <sup>2</sup> Central Government.

Exchange Rate (vs \$, end of period)					Official Rate (% , end of period)			
	2007	2008	2009	2010	2007	2008	2009	2010
USA					4,3	0,5	0,10	0,10
EU (\$/euro)	1,5	1,3	1,4	1,3	4,00	2,50	1,00	1,00
Japan (yenes/\$)	113	96,1	98	101				
China (cny/\$)	7,6	7,0	6,8	6,8	7,47	5,31	5,31	6,12
Latin America								
Argentina	3,1	3,4	3,9	4,3	13,52	19,08	13,50	14,03
Brazil	1,8	2,3	1,7	1,6	11,25	13,75	8,75	10,25
Chile	499	649	560	564	6,00	8,25	0,50	3,00
Colombia	2.015	2.244	2.020	2.070	9,50	9,50	4,00	4,75
Mexico	10,9	13,0	13,2	12,7	7,50	8,25	4,50	4,50
Peru	3,0	3,1	2,9	3,0	5,00	6,50	1,25	2,00
Venezuela	2,2	2,2	2,2	2,2	11,40	16,20	15,20	13,80

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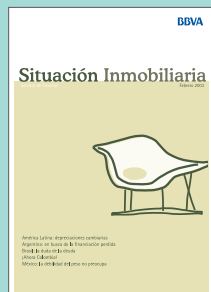
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