BTMU Focus Latin America

Chile: macroeconomic performance

(1Q 2015)

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I) Chile: Growth Momentum (1)

▪ Robust results in 1Q need to be read with caution.

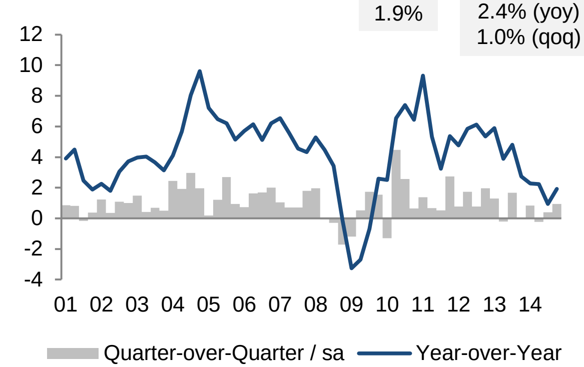
- Chile's export-driven economy expanded at 1.0% qoq pace (2.4% yoy) in Q1 2015, its strongest growth since late 2013. The long-awaited rebound, underpinned by positive export growth and robust mining production, came after several quarters of poor results, offering a faint glimmer of hope for the economy to accelerate this year and return to its potential rate of growth of about 3.5% in 2016. Yet, in this challenging environment of softening copper prices (copper makes up half of Chile's exports) and sagging Chinese demand (Chile's top trading partner), there were solid grounds for caution. First, government spending (excluding public investment) contributed 0.5 pp. to 1Q GDP growth on a yoy basis, meaning that more than one-fifth of the rebound came from loose fiscal measures that are not sustainable in the long run, at least not without putting public finances in jeopardy. Second, gross fixed capital formation (GFCF), a proxy for investment, dipped again in 1Q after a small gain in 4Q 2014, signaling that private investment and business confidence are probably still weak.

Figure 1: GDP Growth

% real change

2014
1.9%

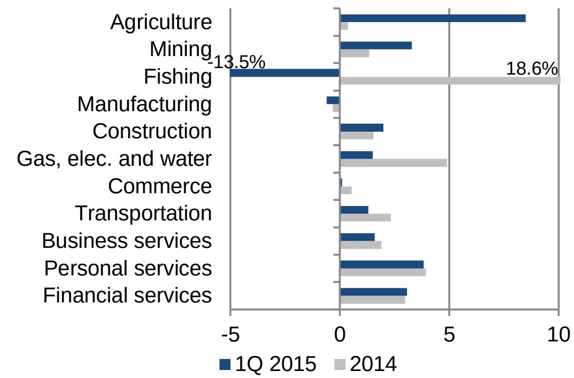
1Q 2015
2.4% (yoy)
1.0% (qoq)



Source: Central Bank of Chile; BTMU

Figure 2: GDP by Sector

% real change yoy



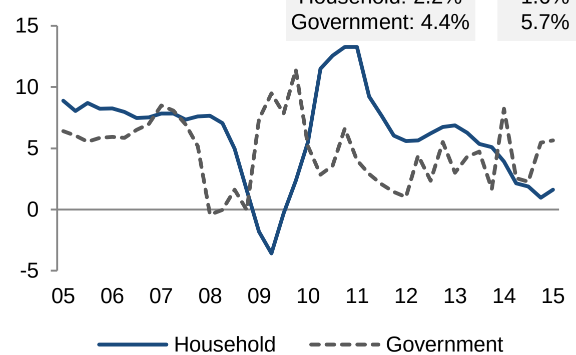
Source: Central Bank of Chile; BTMU

Figure 3: Consumption

% real change yoy

2014
Household: 2.2%
Government: 4.4%

1Q 2015
1.6%
5.7%



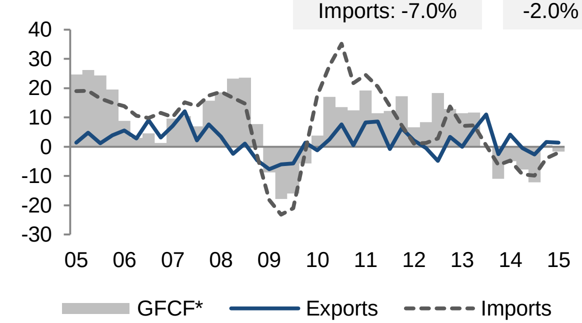
Source: Central Bank of Chile; BTMU

Figure 4: Investment, Exports and Imports

% real change yoy

2014
Investment: -6.1%
Exports: 0.7%
Imports: -7.0%

1Q 2015
-1.7%
1.4%
-2.0%



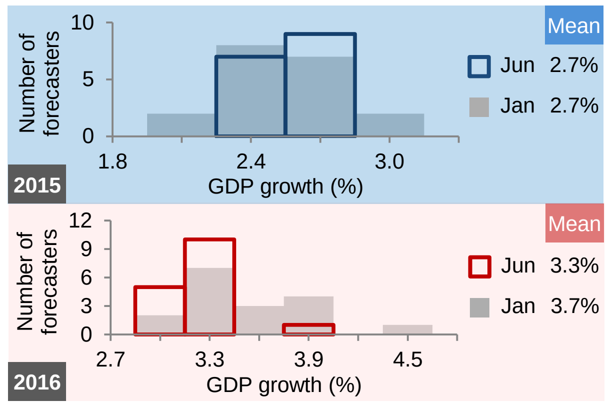
*Gross fixed capital formation
Source: Central Bank of Chile; BTMU

I) Chile: Growth Momentum (2)

▪ Hopes for strong recovery in 2015 are fading away as the rebound in 1Q turned out to be short-lived.

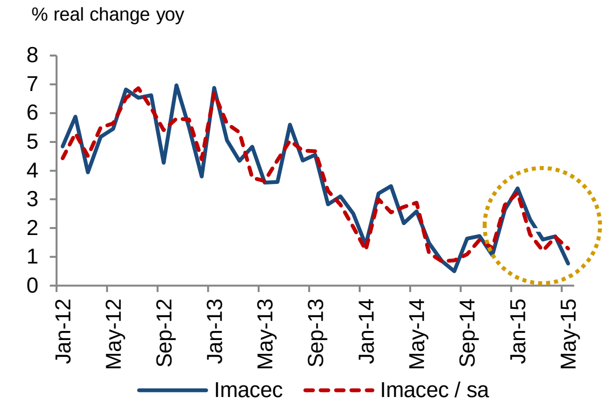
- **Overall Outlook:** Now there is little doubt that the solid recovery in 1Q was a mirage. The economy has already lost momentum in 2Q: the Imacec index, a proxy for GDP published by the Central Bank, only rose by 0.8% yoy in May following a solid gain of 2.4% yoy in 1Q. Sluggish household spending and depressed private investment only reinforce the idea that the economy is losing steam. Perhaps not surprisingly, the market is now bearish on Chile's economic prospects and many analysts have revised down their forecasts. We believe GDP should grow around 2.5% in 2015, before gradually picking up to above 3% next year on the back of stronger domestic demand and higher exports.
- **Private Consumption** will likely remain sluggish in 2015. The still-high consumption of non-durable goods will fairly cushion the effect of falling demand for durable goods. Yet the fundamentals are still fragile: i) consumer confidence is subdued with no clear signs of recovery; ii) the labor market appears to start softening; and iii) growth in consumer credit is still low despite low borrowing costs.

Figure 5: GDP Growth (private forecasts)



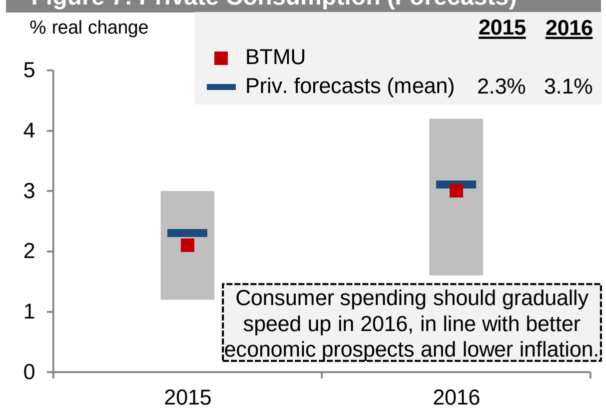
Source: Consensus Economics; BTMU

Figure 6: Index of Economic Activity (Imacec)



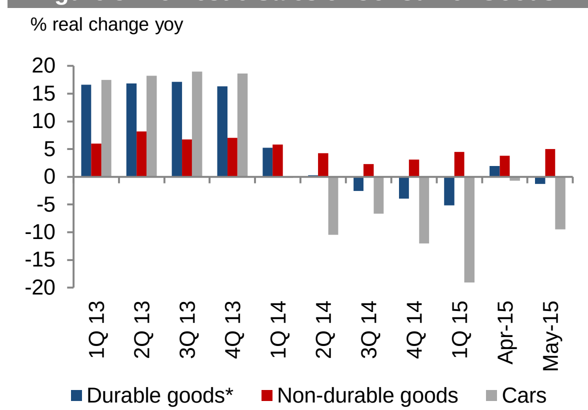
Source: Central Bank of Chile; BTMU

Figure 7: Private Consumption (Forecasts)



Source: Consensus Economics; BTMU

Figure 8: Domestic Sales of Consumer Goods



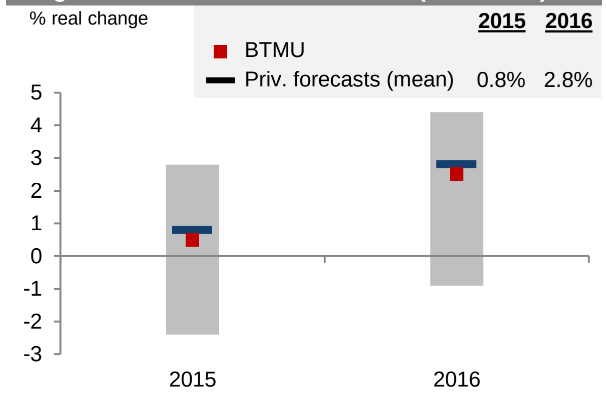
*Including cars
Source: National Institute of Statistics (INE); BTMU

I) Chile: Growth Momentum (3)

▪ GFCF will remain weak in 2015 as the government failed to spur private investment.

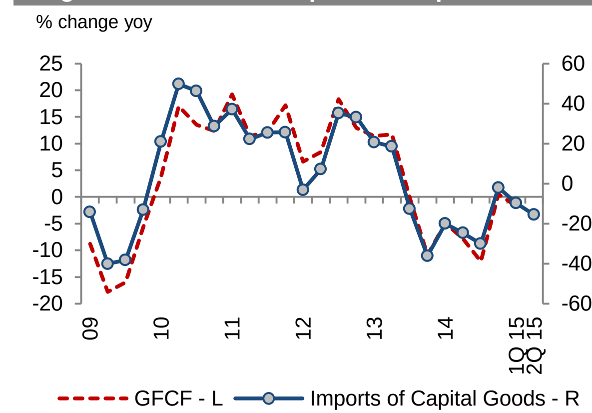
- The fall in **GFCF** in 1Q was visibly a setback for President Bachelet, as it made clear that the latest investment-friendly measures rolled out by the government have failed to shore up business confidence. The plunge in imports of capital goods in 2Q (-15.5% yoy), a indicator that tends to point the trend of GFCF, does not bode well either for the recent cabinet shuffle, a move triggered by a number of corruption scandals that have rapidly undermined President Bachelet's approval rating, and aimed to regain public trust and lure private investment. Thus, we expect GFCF to stay weak this year despite the government's efforts to hasten public investment. Capital spending should slowly pick up in 2016 as the business community begins to build up confidence; but make no mistake, should copper prices remain soft, it is unlikely to see investment growing at a similar pace as in the past (*Figure 11*). Meanwhile, government spending will continue to support economic growth, and higher copper production and a weaker currency should play in favor of exports.

Figure 9: Gross Fixed Investment (Forecasts)



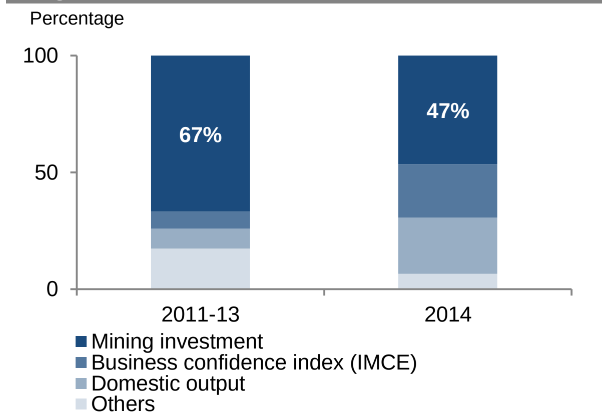
Source: Consensus Economics; BTMU

Figure 10: GFCF and Imports of Capital Goods



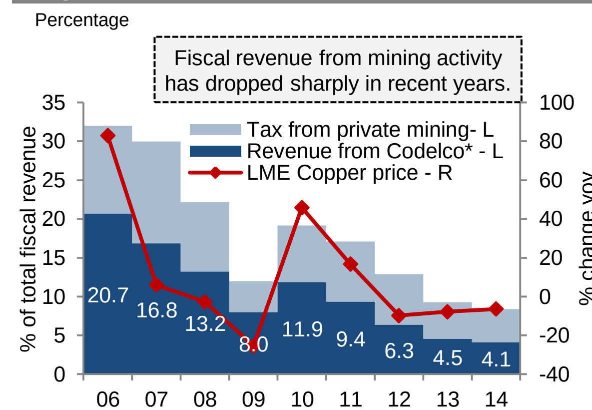
Source: Central Bank of Chile; BTMU

Figure 11: Drivers of Investment*



*For details see Monetary Policy Report (June 2015), p. 35-37.
Source: Central Bank of Chile, BTMU

Figure 12: Government's Revenue



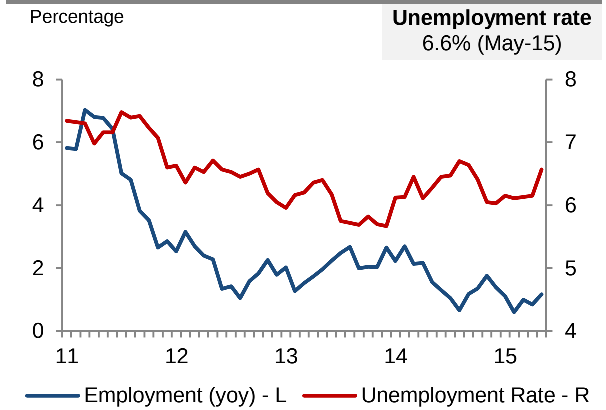
*Chile's state owned copper mining company.
Source: DIPRES; LME; BTMU

II) Chile: Labor Market and Prices

▪ Currency depreciation pushes inflation above the Central Bank's target range.

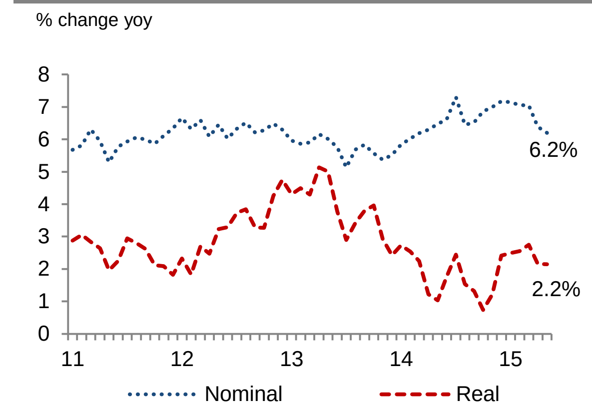
- **Labor Market:** After several straight quarters of slowing economic growth, labor market conditions have worsened noticeably. Job creation fell by half in 2014, while unemployment rate started to rise. There were signs of improvements in 1Q 2015, but they were short-lived: unemployment rate returned to 6.6% in May; and about 92,000 new jobs were added to the economy in the 12 months to May, of which only 3,000 were created by the private sector. Softer conditions have not put major pressure on nominal wages yet (growth rate stayed high at 6.2% in May), which could be owing to the effect of indexation to past inflation.
- **Inflation**: Annual inflation picked up to 4.4% in June, again exceeding the target range of 2% to 4%. The rise was partly fueled by a partial reversal in oil prices between March and June that has pumped energy prices up; but the underlying cause of high inflation continues to lie in the depreciation of the peso (higher import costs). The Central Bank expects inflation to end the year at 3.4% due to favorable base effect and slow recovery.

Figure 13: Employment and Unemployment rate



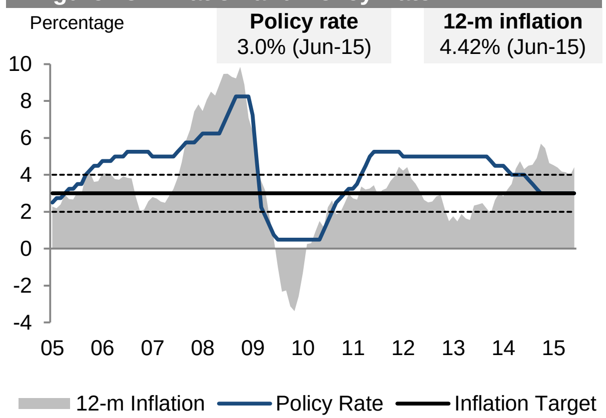
Source: INE; Central Bank of Chile; BTMU

Figure 14: Wages



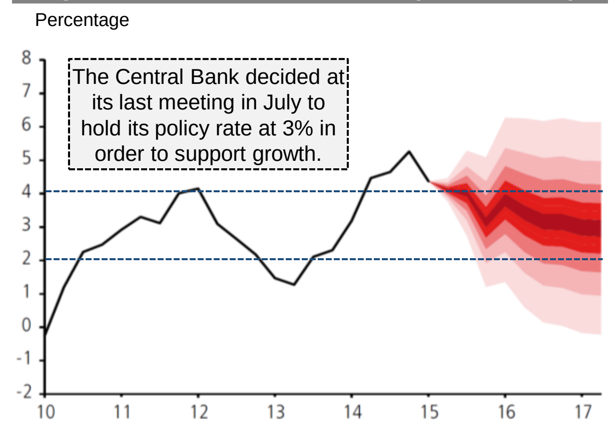
Source: INE; BTMU

Figure 15: Inflation and Policy Rate



Source: INE; Central Bank of Chile; BTMU

Figure 16: CPI Inflation Forecast (Central Bank)



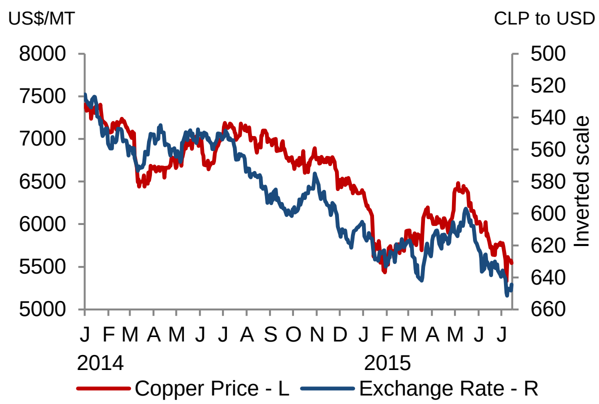
Source: Central Bank of Chile, Monetary Policy Report (June 2015); BTMU

III) Chile: Exchange Rate and Current Account

- **Falling copper prices add more downward pressure on the peso.**

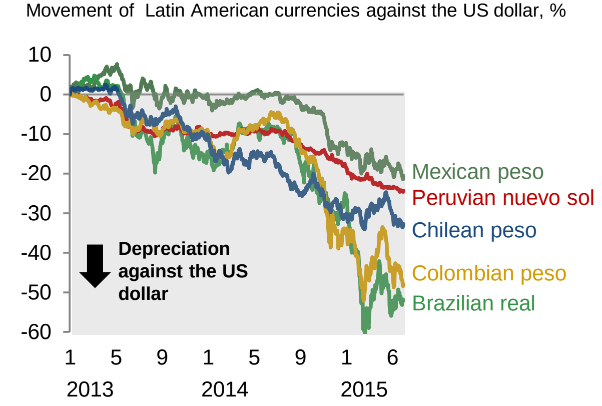
- **Exchange rate**: The Chilean peso resumed its path of steadily depreciation against the US dollar in late May, after strengthening in April due to a temporary rally in copper prices. The peso has already depreciated about 16% over the last 12 months; and mounting expectations for the Fed to lifts interest rates from zero, couple with falling copper prices, will only add more downward pressure on the peso in the coming months, further inflaming inflation. Yet an interest rate hike by the Central Bank this year is unlikely and could be delayed until mid-2016 if output and investment remain weak in 2H 2015.
- **Current Account**: Chile's current account swung back to surplus in 1Q 2015 for the first time in more than 3 years, as trade surplus hit $2.7 billion, around 56% higher than in the prior quarter. This improvement was possible even with exports plunging by 7.8% qoq in 1Q because the drop in total imports (-14.3%), caused by lower oil bill as well as declining imports of capital and consumer goods, far outstripped the fall in exports.

Figure 17: Exchange Rate and Copper Price



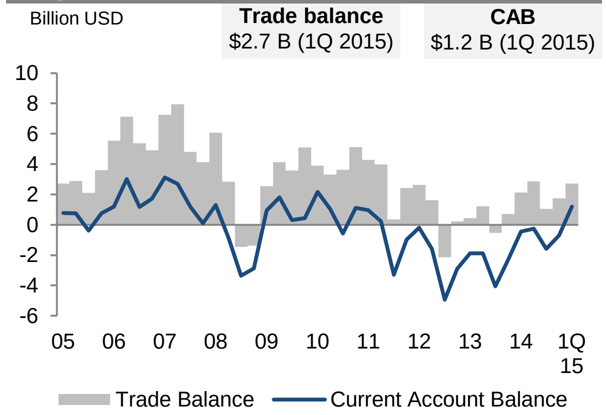
Source: Thomson Reuters; LME; BTMU

Figure 18: Exchange rates



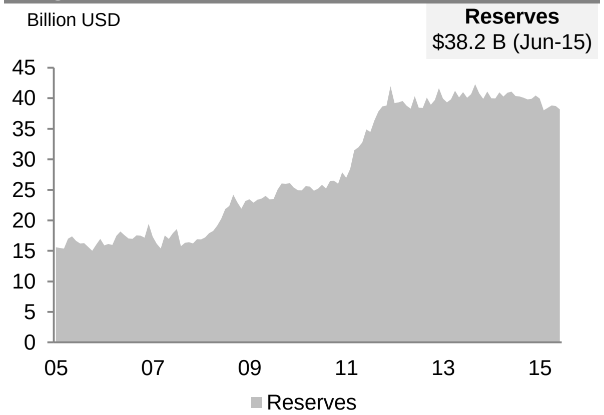
Source: Thomson Reuters; BTMU

Figure 19: Current Account Balance



Source: Central Bank of Chile; BTMU

Figure 20: International Reserves



Source: Central Bank of Chile; BTMU