BTMU Focus Latin America

Chile: macroeconomic performance

(3Q GDP and Current Monthly Indicators)

MUFG UNION BANK
Economic Research (New York)

Hongrui Zhang
Latin America Economist
hozhang@us.mufg.jp | +1(212)782-5708

February 9, 2016

The Bank of Tokyo-Mitsubishi UFJ, Ltd.
A member of MUFG, a global financial group

Contents

I) Chile: Growth Momentum (1)

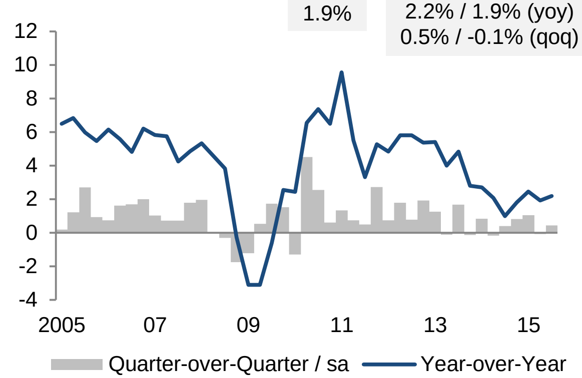
▪ The Chilean economy is showing signs of stabilizing, while adjusting to the harsh external conditions.

▪ The Chilean economy has been showing signs of stabilizing, after undergoing a harsh and lingering slowdown in GDP growth, triggered and constantly fueled by the decline in copper prices. For instance, GDP has been growing in the neighborhood of 2% yoy in the first three quarters of 2015, shored up by sectors such as construction, utilities and services that tend to hinge on domestic forces rather than on external factors. Not only does this suggest growth is stabilizing despite declining export volumes, but it also hints that the economy is gradually adjusting to the tough external conditions by relying more on domestic demand to deliver growth. Take the example of private consumption growth. It slowed down severely in 2014 but has stayed fairly stable in the range of 1.5%-2% in 2015, sustained by low unemployment and positive wage growth. Gross fixed capital formation (GFCF), a measure for investments, has been also showing early signs of recovery: it picked up by 7.1% yoy in 3Q 2015, largely on the back of solid construction activity and higher imports of machinery and equipment.

Figure 1: GDP Growth

% real change

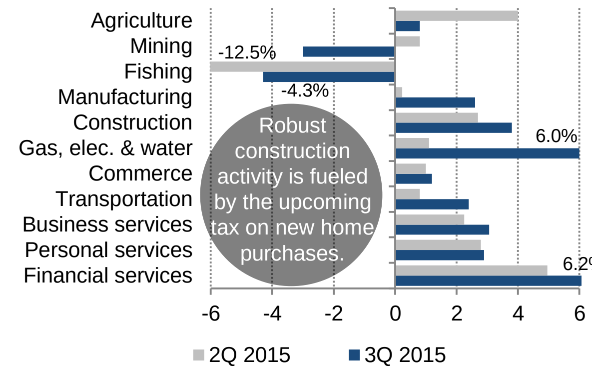
2014	3Q / 2Q 2015
1.9%	2.2% / 1.9% (yoy) 0.5% / -0.1% (qoq)



Source: Central Bank of Chile; BTMU

Figure 2: GDP by Sector

% real change yoy

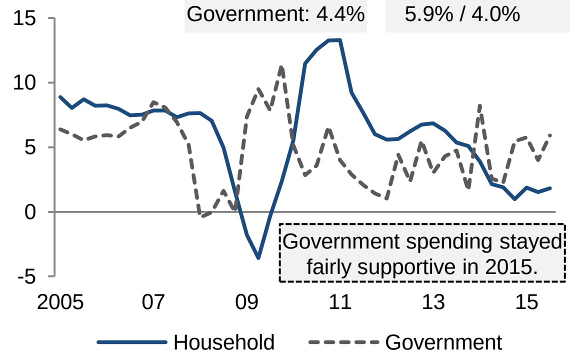


Source: Central Bank of Chile; BTMU

Figure 3: Consumption

% real change yoy

2014	3Q / 2Q 2015
Household: 2.2%	1.8% / 1.5% (yoy)
Government: 4.4%	5.9% / 4.0%

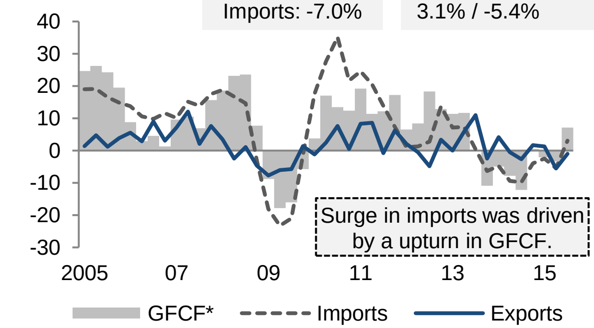


Source: Central Bank of Chile; BTMU

Figure 4: Investment, Exports and Imports

% real change yoy

2014	3Q / 2Q 2015
Investment: -6.1%	7.1% / -3.3% (yoy)
Exports: 0.7%	-1.0% / -5.5%
Imports: -7.0%	3.1% / -5.4%



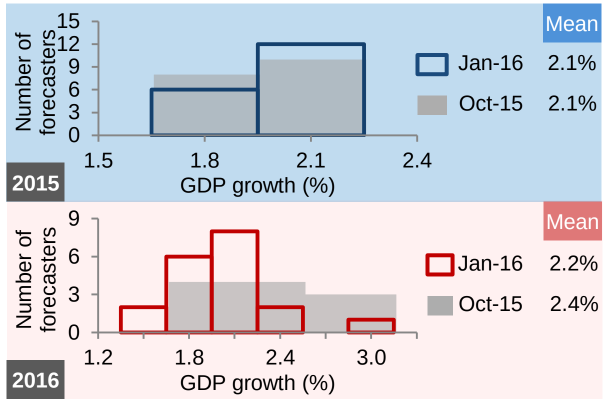
*Gross fixed capital formation
Source: Central Bank of Chile; BTMU

I) Chile: Growth Momentum (2)

- **Chile has probably weathered the end of the commodity boom, but growth is unlikely to pick up speed soon.**

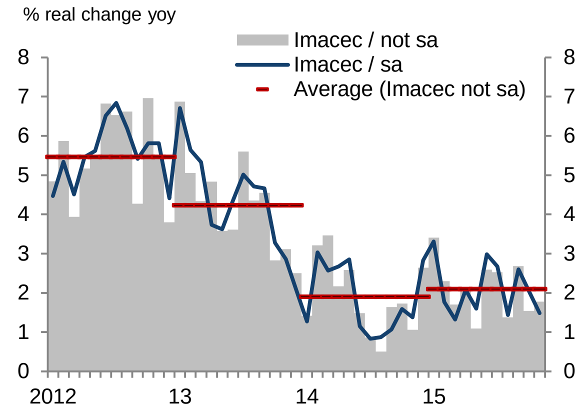
- It is quite clear that the drop in the prices of copper, Chile's main export product (~50% of total exports), couple with waning demand from its main trading partners, have hit the Andean economy hard. GDP growth abruptly slowed to 1.9% in 2014 from 4.2% a year earlier, and the Chilean peso has lost 36% of its value against the dollar since 2013. The silver lining, though, is that growth has been stabilizing in 2015: the Imacec index, a proxy for GDP, showed the economy expanded at an average rate of 2.1%, which is fairly similar to the 2014 rate. This clearly signals that the Chilean economy, one of the most commodity-dependent, has weathered the end of the commodity super cycle, and is adjusting to the new external conditions in an orderly manner. But, of course, this does not mean GDP growth will pick up speed in the near future. In fact, chances are that growth will remain sluggish (within the range of 2% to 3%), inhibited by a tougher-than-expected external backdrop (e.g., tighter financial conditions, weak external demand copper prices), increased corporate leverage, and sluggish internal demand.

Figure 5: GDP Growth (private forecasts)



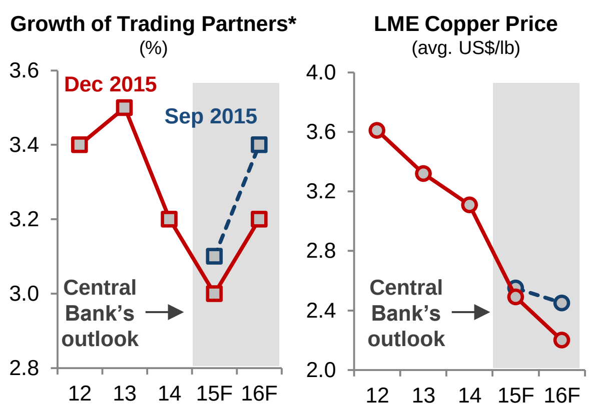
Source: Consensus Economics; BTMU

Figure 6: Index of Economic Activity (Imacec)



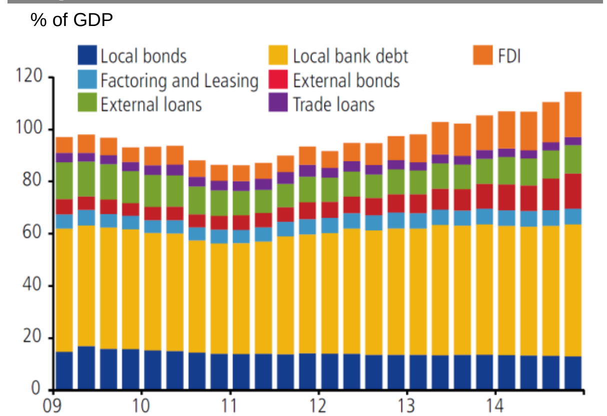
Source: Central Bank of Chile; BTMU

Figure 7: External Demand and Copper Price



*Countries included make up around 93% of Chile's total exports.
Source: Central Bank of Chile, Monetary Policy Report; BTMU

Figure 8: Total Debt of Firms*



*Financial Stability Report 1H 2015 published by Central Bank of Chile
Source: Central Bank of Chile; BTMU

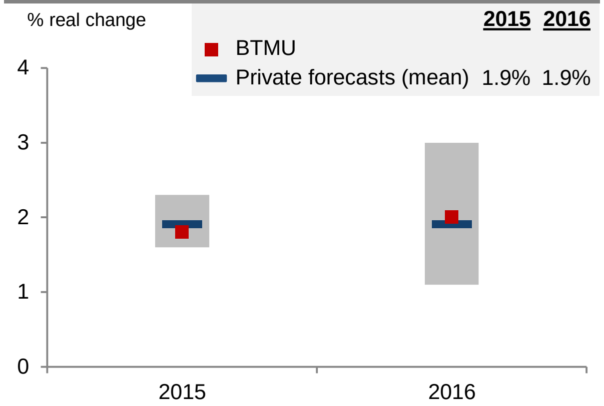
The Bank of Tokyo-Mitsubishi UFJ, Ltd.
A member of MUFG, a global financial group

I) Chile: Growth Momentum (3)

- **Domestic demand seems to have adjusted to the new environment, but will stay sluggish in the near future.**

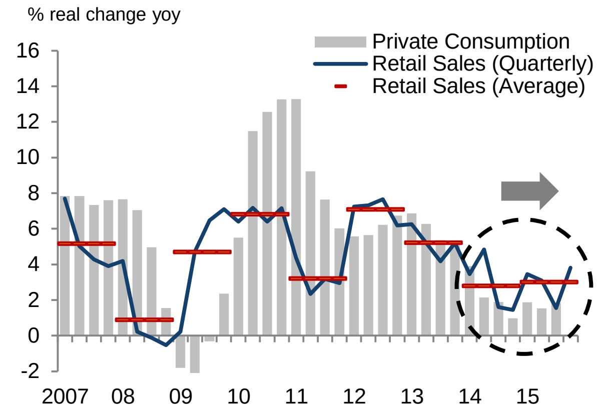
- Domestic demand appears to have adjusted to the new economic conditions in an orderly manner too. Private consumption growth decelerated sharply in 2014, and more or less stabilized last year, as retail sales data compellingly suggests. Growth in GFCF fell into negative territory since 2Q 2013, but has begun to show early signs of bottoming out during 2H 2015. In fact, imports of capital goods rose by 1.9% in 2H 2015, after falling by 12.3% in the first half. While this is encouraging, it is important to emphasize that domestic demand will likely remain sluggish this year, as some growth drivers are still anemic. First, consumer confidence, though slowly improving, is still relatively weak, which may signal that consumers are cautious about the health of the labor market. Second, while investment is likely to return to positive growth this year, buoyed by solid construction activity (caused by a forthcoming tax on purchases of new houses), and a gradual recovery in non-mining investments. Yet business sentiment is still weak, which could reflects falling profit margins and ongoing cost-control efforts.

Figure 9: Private Consumption (Forecasts)



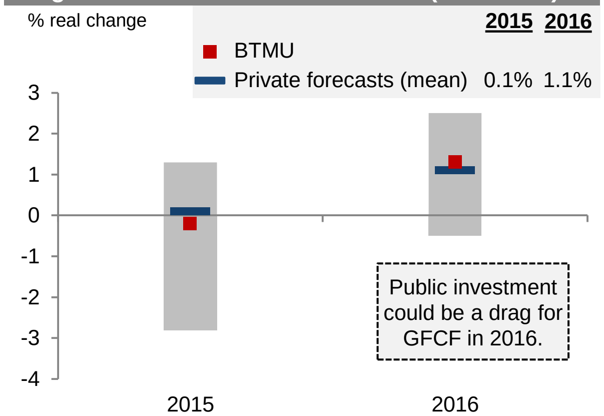
Source: Consensus Economics; BTMU

Figure 10: Private Consumption and Retail Sales



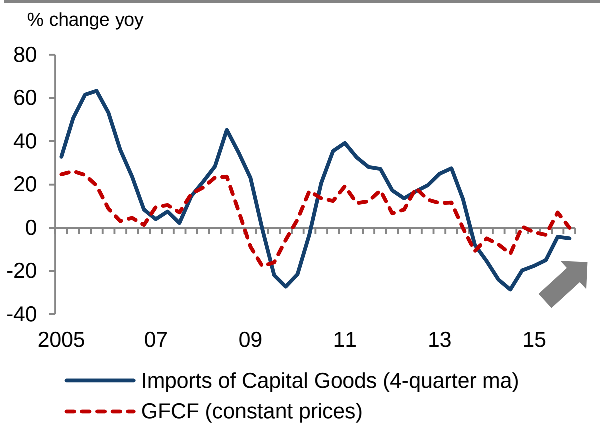
Source: Central Bank of Chile; INE; BTMU

Figure 11: Gross Fixed Investment (Forecasts)



Source: Consensus Economics; BTMU

Figure 12: GFCF and Imports of Capital Goods



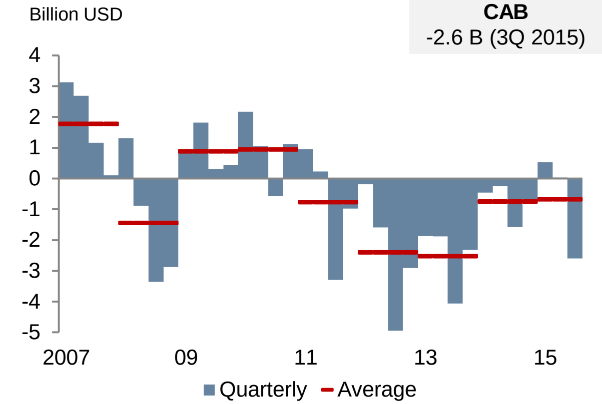
Source: Central Bank of Chile; BTMU

II) Chile: External Sector

▪ The country's current account deficit is likely to widen this year.

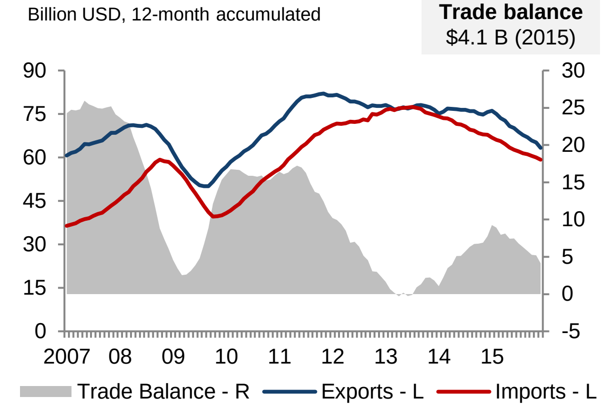
▪ In our prior report, we made the case that Chile's current account was likely to swing back into deficit in the next few quarters because its trade balance was also expected to worsen. So it is not surprising that its current account recorded a deficit of $2.6 billion in 3Q 2015, especially when the downside risks (highlighted in the report) have materialized in 2H 2015. First, the plunge in imports in the second half of 2015 (-10.1% yoy) has been smaller than in the first half (-15.6% yoy), mainly caused by a slight recovery in imports of capital goods, which in turn was explained by the third-quarter upturn in GFCF. Second, the export volume of copper has remained fairly flat last year, owing to drop in mining output (probably caused by labor disputes and production cutbacks by mining companies). Naturally, all this means the impact of falling copper prices on export revenues has not been eased by higher volume. No wonder copper exports and prices dived by a similar rate in 2015. And since copper prices are expected to fall further this year, Chile's current account deficit will probably widened as well.

Figure 13: Current Account Balance



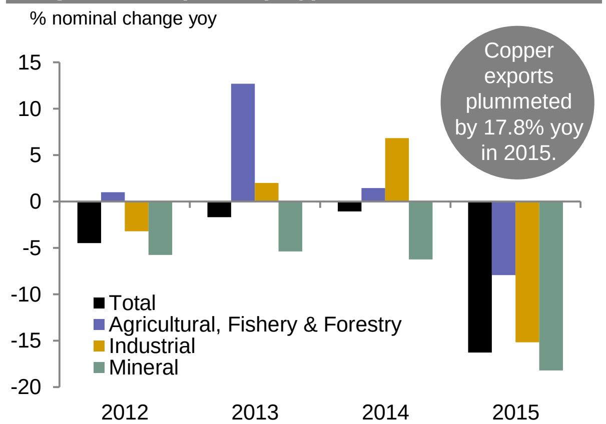
Source: Central Bank of Chile; BTMU

Figure 14: Trade Balance, Exports and Imports



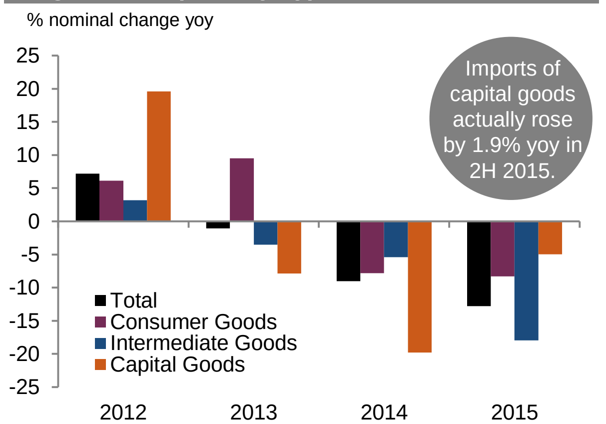
Source: Central Bank of Chile; BTMU

Figure 15: Exports by Types of Goods



Source: Central Bank of Chile; BTMU

Figure 16: Imports by Types of Goods



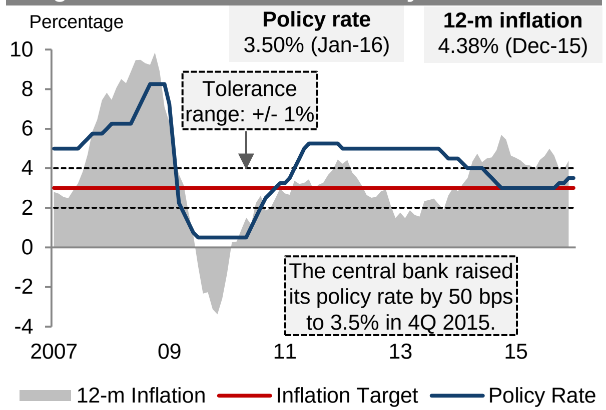
Source: Central Bank of Chile; BTMU

III) Chile: Prices and Monetary Policy

▪ Inflation will probably stay close to the upper limit of the target range of 2% to 4% throughout 2016.

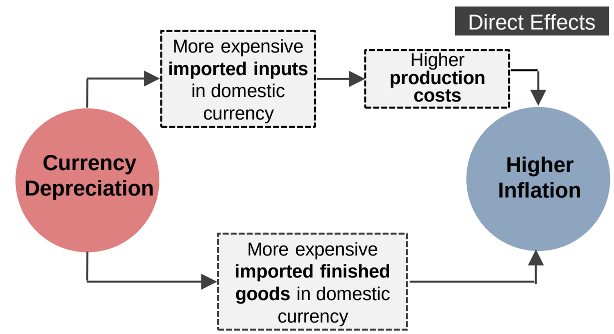
▪ Chile's 12-month inflation has been hovering above the central bank's target range of 2% to 4% for the most part of 2015, forcing the monetary authority to roll back part of the stimulus by lifting its policy rate. As we highlighted in the previous report, one major source of inflationary pressures was the so-called exchange rate pass-through, a process in which a weaker currency adds pressures on local consumer prices by making imported finished goods more expensive, as well as raising production costs (i.e., imported inputs would be more expensive). In fact, the central bank argues that the surge in inflation over the past two years has been primarily fueled by the ongoing depreciation of the peso. Of course, there are domestic factors to blame as well: core inflation (i.e., excluding food and energy prices) has stayed stubbornly high and above the target range since 3Q 2014, which suggests limited output gap, resilient labor market, robust wage growth, and the use of wage indexation to past inflation. All this naturally hints that overall inflation will likely stay close to the upper limit of the target range this year.

Figure 17: CPI Inflation and Policy Rate



Source: INE; Central Bank of Chile; BTMU

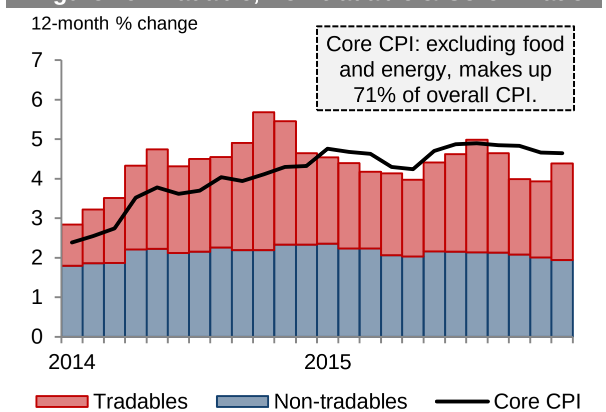
Figure 18: Exchange Rate Pass-through to Prices



According to the latest estimate, a depreciation of the Chilean peso of 10% could add 1.75 % to inflation*.

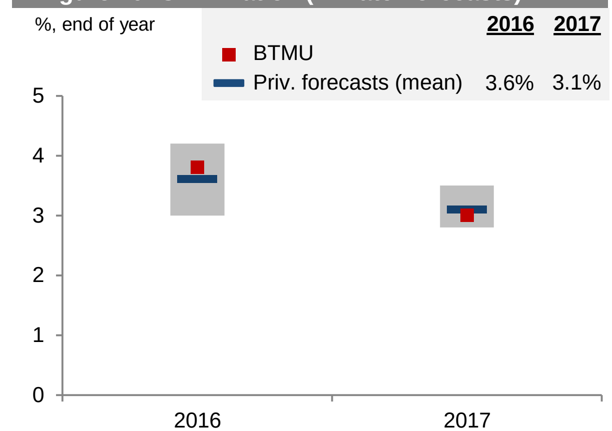
*See Quarterly Report July-September 2015 by Banxico, pages 18-20.
Source: BTMU

Figure 19: Tradable, Non-tradable & Core Inflation



*Overall prices = tradable (≈ goods) + non-tradable (≈ services)
Source: INE; BTMU

Figure 20: CPI Inflation (Private Forecasts)



Source: Consensus Economics; BTMU

- **This report is intended only for information purposes and shall not be construed as solicitation to take any action. In taking any action, readers are requested to do so on the basis of their own judgement.**

- **This report is based on information believed to be reliable, but we do not guarantee its accuracy. The contents of this report may be revised without notice.**

- **This report is a literary work protected by the copyright act. No part of this report may be reproduced in any form without express statement of its source.**