BTMU Focus Latin America

Chile: macroeconomic performance

(2Q GDP and Current Monthly Indicators)

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I) Chile: Growth Momentum (1)

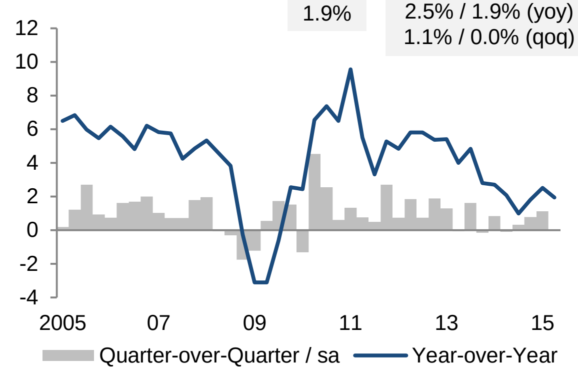
- **Weak second-quarter growth signals ongoing adjustments to soft copper prices and weak external demand.**

- Chile's yoy GDP growth slowed in 2Q 2015 after a brief rebound in 1Q, implying that the economy is still adjusting to this landscape of softening copper prices and weakening external demand. Take the example of gross fixed capital formation (GFCF), a proxy for investment. Softer copper prices are no doubt hurting mining investments by reducing the value of some projects. But they are impairing other investments as well by raising the cost of imported capital goods (fueled by a weaker peso). Thus, not surprisingly, GFCF slid further in 2Q and spending on machinery & equipment, mostly imported and a component of GFCF, fell by 15.9% yoy despite a big boost from public investment. Likewise, exports volume dipped by 4.9% yoy in 2Q after rising in the previous two quarters. This time, the setback was explained by a sharp contraction in manufacturing exports (-13.4%) rather than mining exports, which probably suggests retreating demand from Latin America and Europe. In fact, mining exports picked up by 3.5% in 2Q in real terms, with refined copper exports to China growing by about 13%.

Figure 1: GDP Growth

% real change

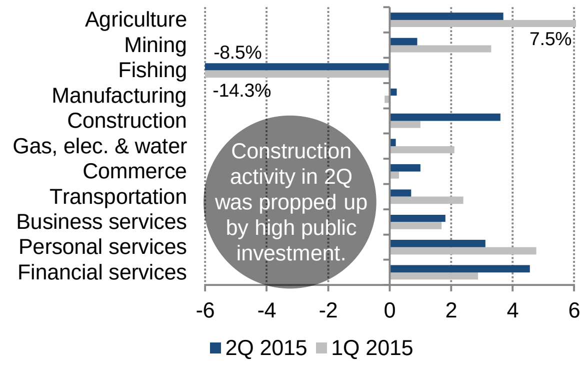
2014	1Q / 2Q 2015
1.9%	2.5% / 1.9% (yoy) 1.1% / 0.0% (qoq)



Source: Central Bank of Chile; BTMU

Figure 2: GDP by Sector

% real change yoy

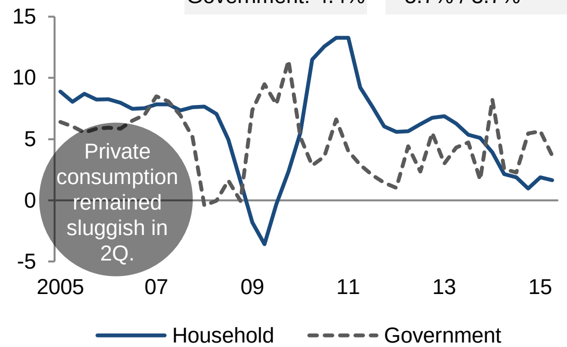


Source: Central Bank of Chile; BTMU

Figure 3: Consumption

% real change yoy

2014	1Q / 2Q 2015
Household: 2.2%	1.9% / 1.6% (yoy)
Government: 4.4%	5.7% / 3.7%

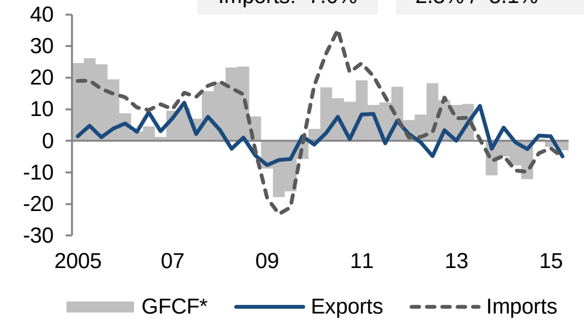


Source: Central Bank of Chile; BTMU

Figure 4: Investment, Exports and Imports

% real change yoy

2014	1Q / 2Q 2015
Investment: -6.1%	-1.9% / -3.0% (yoy)
Exports: 0.7%	1.5% / -4.9%
Imports: -7.0%	-2.3% / -5.1%



*Gross fixed capital formation

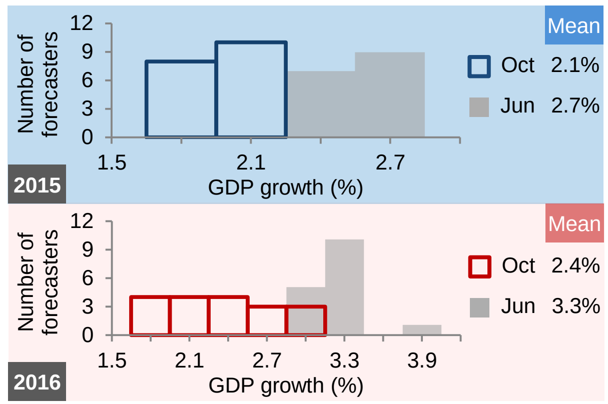
Source: Central Bank of Chile; BTMU

I) Chile: Growth Momentum (2)

▪ Economic activity will probably remain sluggish well into 2016.

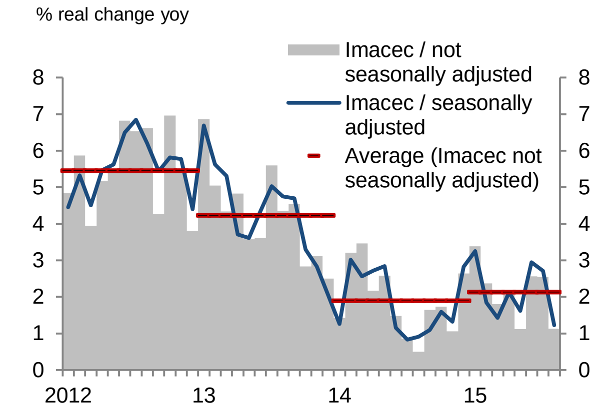
- The Chilean economy will continue to adjust to the prospects of an increasingly more difficult external environment (e.g., softer copper prices and sapping demand from some major trading partners) and, to a less extent, to the potential fallout of some reform initiatives (especially the proposed tax increases on capital income). So far this year, those ongoing adjustments have been costly in terms of growth: the Imacec index, a proxy for GDP, revealed that the economy grew on average around 2% yoy from January to August, which is similar to last year's pace but well below the 4.2% in 2013. This clearly suggests that this year's GDP growth rate will disappoint again. What about next year? We do not have a compelling reason to believe in a swift recovery. In fact, given the ongoing demand and supply-side adjustments to the weakening external conditions, and the gradual withdrawal of stimulus policies (i.e., a more austere 2016 fiscal budget and a less accommodative monetary policy), we expect the economy to remain sluggish well into 2016, in line with other private forecasts.

Figure 5: GDP Growth (private forecasts)



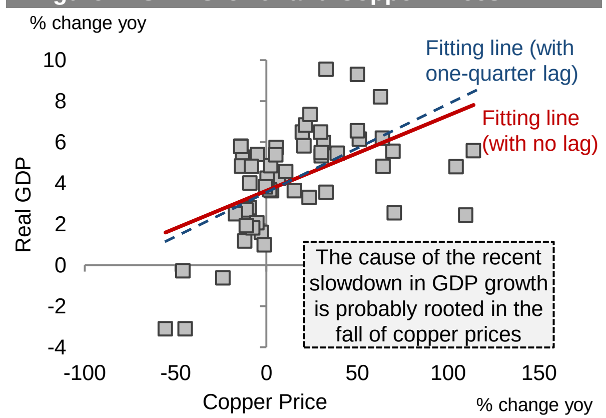
Source: Consensus Economics; BTMU

Figure 6: Index of Economic Activity (Imacec)



Source: Central Bank of Chile; BTMU

Figure 7: GDP Growth and Copper Prices



Sample: Q1 2002 – Q2 2015, Quarterly
Source: Central Bank of Chile; Thomson Reuters; BTMU

Figure 8: Government's Reform Agenda

Reform Areas	Main Measures	Status
Tax Reform	Capital income tax	Passed
	Excise and broadening of VAT base	Passed
Public Education	Repeal private co-payments and student selection	Passed
	Eliminate for-profit institutions	Passed
	Increase expenditure in schools	Announced
	Improve early education	Announced
	Universal tertiary education	Announced
Labor Market	Repeal gender-biased rules	In Congress
	Increase day care facilities	Announced
	Increase unionization	In Congress
Energy	Ease permits	Announced
	New concessions to foster PPP	Announced
	Incentive renewable energy	Announced
Telecommunication	Reduce digital divide	Announced
	Improve roads and connectivity	Announced
Transportation	New transportations lines	Announced
	New ports	Announced

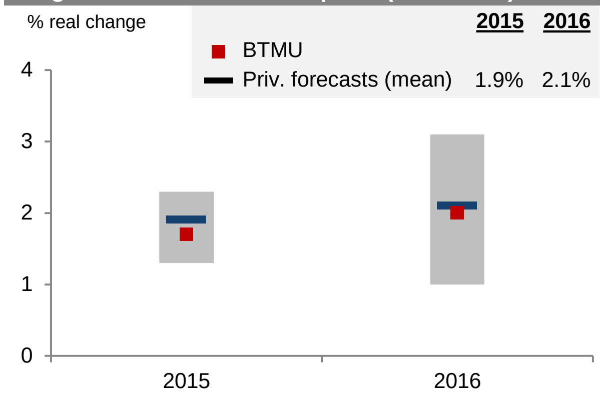
Source: IMF Country Report No. 15/228, Selected Issues; BTMU

I) Chile: Growth Momentum (3)

▪ Weakening fundamentals will probably keep consumer spending sluggish well into next year.

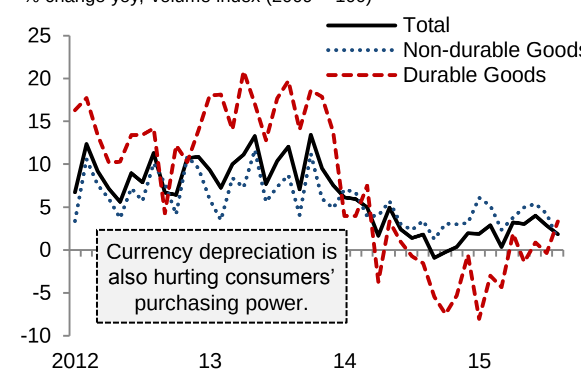
- Private consumption will likely stay sluggish in 2015 and 2016, as households continue to adjust to the bleaker growth prospects by cutting back spending on both goods and services. The slowdown in the former has been particularly dramatic over the last 2 years: consumption of non-durable goods slowed from a growth rate of 5.5% in 2013 to 1.7% yoy in first half of the year; and, worse yet, spending on durable goods swung from growing 14.3% in 2013 to shrinking 3% in 1H 2015. The good news is that purchases of durable goods may have bottomed out as observed in the most recent data. But the bad news is that consumption of non-durable goods has started to slow down in 3Q, suggesting the possibility of further cuts in the coming quarters. This gloomy outlook is hardly surprising given how weak the fundamentals for consumption are. True, the unemployment rate is still low, but the number of job vacancies has been falling since it peaked in late 2012, and nominal wages are not even keeping up with inflation. Similarly, consumer confidence has been falling again since 1Q 2015.

Figure 9: Private Consumption (Forecasts)



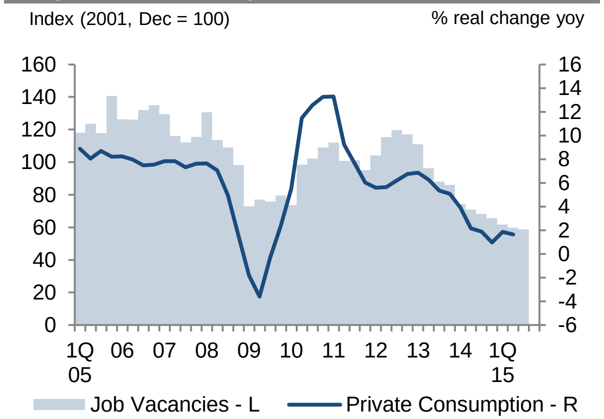
Source: Consensus Economics; BTMU

Figure 10: Domestic Sales



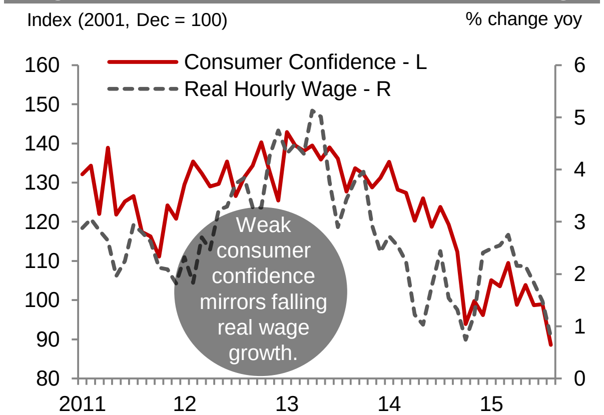
Source: Instituto Nacional de Estadísticas (INE); BTMU

Figure 11: Consumption and Job Vacancies



Source: Central Bank of Chile; BTMU

Figure 12: Consumer Confidence and Real Wage



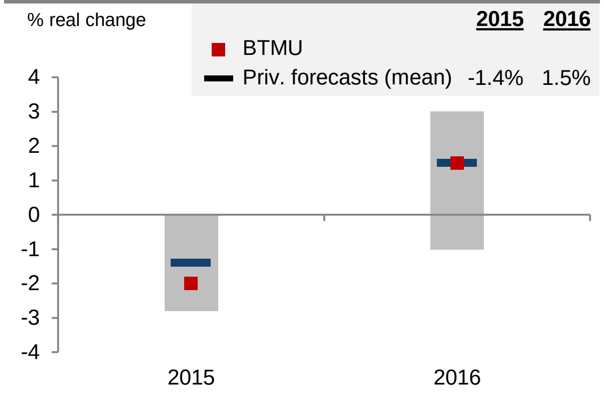
Source: INE; Universidad del Desarrollo (Chile); BTMU

I) Chile: Growth Momentum (4)

▪ Investment will sag for a second year in a row in 2015, and next year's recovery will be muted at best.

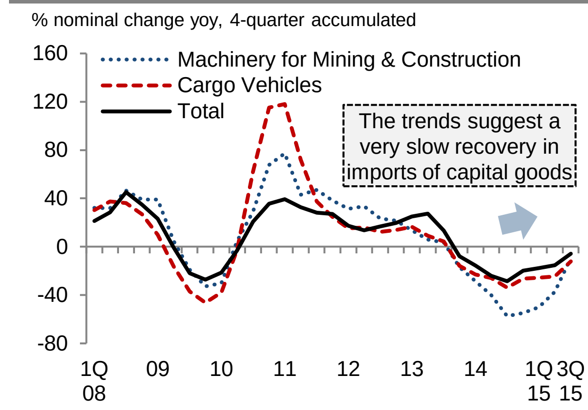
- It is no secret that Chile's investment boom during the last decade (i.e., annual growth rate of GFCF averaged 7.3%) was essentially powered by mining investments (see our previous report). Now, with copper prices already down 48% since their peak in early 2011 and expected to remain soft in the short-to-medium term (or even sap further, according to some private forecasts), the odds are that GFCF will shrink again in 2015 and next year's recovery, fueled by non-mining investments, will be gradual and muted at best. This lengthy adjustment process implies that soft copper prices hurt not only mining investment, but non-mining capital spending as well. In the former case, not only because mining projects are now less attractive as reflected in the fall in inward FDI, but also because in some cases cutting capital spending could be easier than slashing labor costs. As in non-mining sectors, investments are being undermined by higher import costs, which, along with the simmering discontent and uncertainty over the tax reform, probably explain why business confidence is so low.

Figure 13: Gross Fixed Investment (Forecasts)



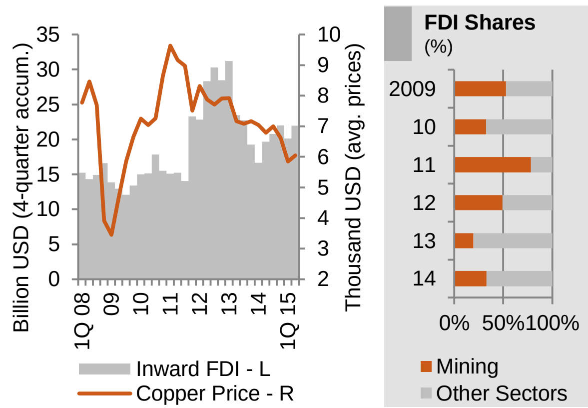
Source: Consensus Economics; BTMU

Figure 14: Imports of Capital Goods



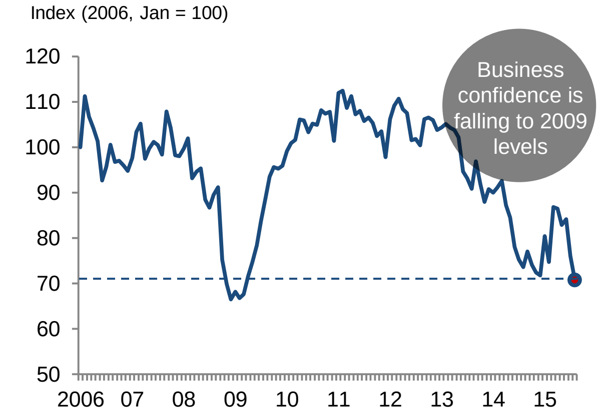
Source: Central Bank of Chile; BTMU

Figure 15: Inward FDI and Copper Price



Source: Central Bank of Chile; Thomson Reuters; BTMU

Figure 16: Business Confidence



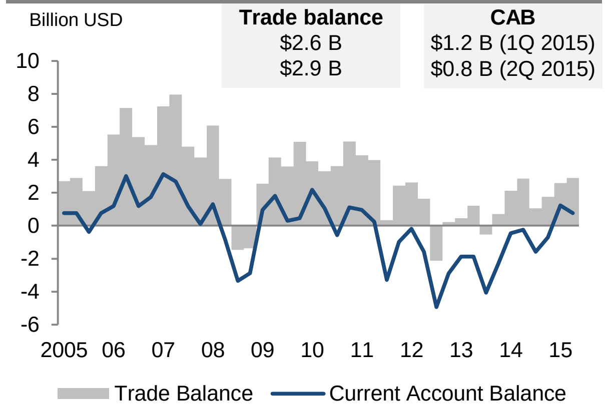
Source: ICARE; BTMU

II) Chile: External Sector

▪ The recent improvements in the country's current account are likely to be short-lived.

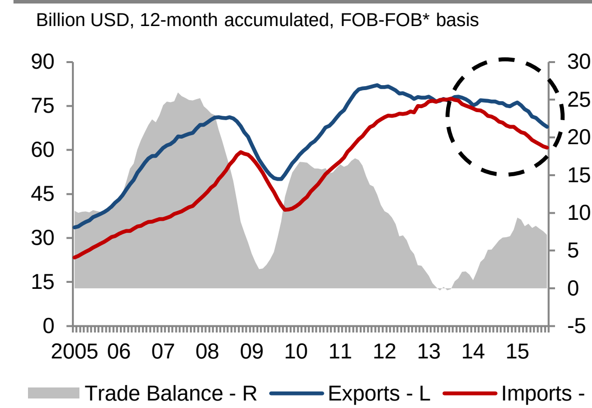
- Chile's current account recorded another surplus in 2Q 2015, chiefly on the back of rising trade surplus, which in turn hit $2.9 billion, up from $2.6 in 1Q. This is certainly a positive shift in the country's external accounts amid mounting expectations for copper prices to fall further in 2016. The bad news, however, is that this upturn will probably be short-lived for two reasons. First off, the increase in trade surplus has been mostly driven by the fall in imports (as a result of feeble domestic demand and currency depreciation), which should decelerate in the coming quarters in line with a gradually pick up in private investment. Second, the impact of softer copper prices on copper exports has been so far cushioned by higher export volume. But that strategy may not be feasible in times when several major mining companies have already announced production cutbacks. One additional concern is the contraction of manufacturing exports in 2Q 2015 despite the sharp depreciation of the peso. But to be fair, the Chilean peso has actually depreciated less than the Brazilian real or the Colombia peso.

Figure 17: Current Account Balance



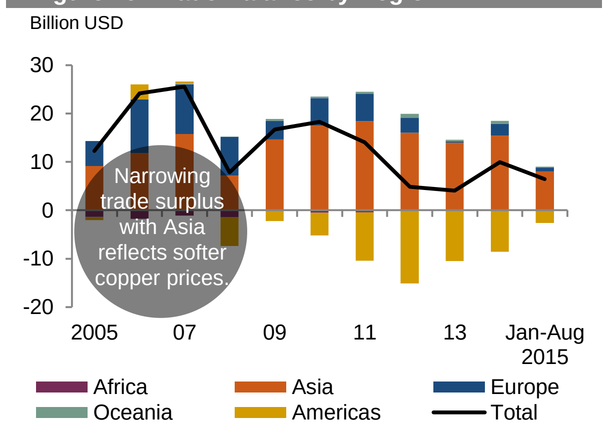
Source: Central Bank of Chile; BTMU

Figure 18: Trade Balance, Exports and Imports



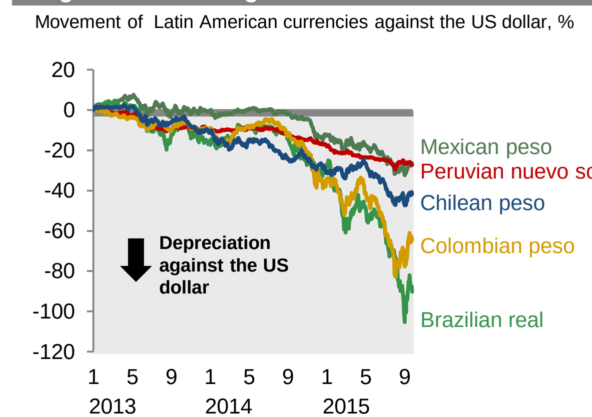
*Free On Board
Source: Central Bank of Chile; BTMU

Figure 19: Trade Balance by Region



Source: Central Bank of Chile; BTMU

Figure 20: Exchange rates



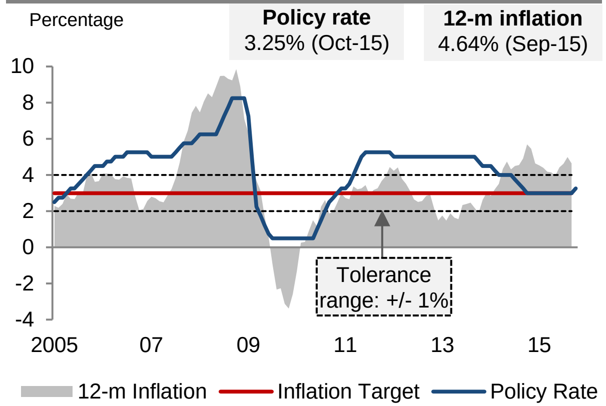
Source: Thomson Reuters; BTMU

III) Chile: Prices and Monetary Policy

▪ The depreciation of the peso will probably force inflation to stay above the central bank’s target range in 2015.

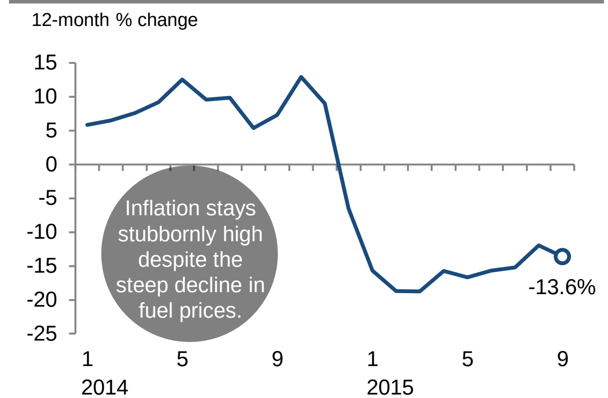
- 12-month inflation has remained stubbornly high and entrenched above the central bank’s target range of 2%-4% since early 2014. Albeit inflation eased off a bit in the first quarter of 2015, upward pressures on prices have intensified again in recent months, forcing the central bank to raise its policy rate by 25 bps in September. One thing is clear about Chile’s plight with inflation: it is mostly a result of the depreciation of the peso as pointed out by the contribution of tradable goods in inflation, even though some degree of wage indexation to past inflation is also to blame. Now, with a weak peso still weighing on prices of tradable goods and inflation expectations, the scenario for inflation to fall below 4% at the end of 2015 is far-fetched. Still, inflation should cool off steadily throughout 2016 as the pass-through effects of the weaker peso slowly wear off. The absent of inflationary pressures from the demand side will help the disinflation process too. But bear in mind that there are upside risks as well. For example, an intense El Niño weather event could raise food prices higher than expected.

Figure 21: CPI Inflation and Policy Rate



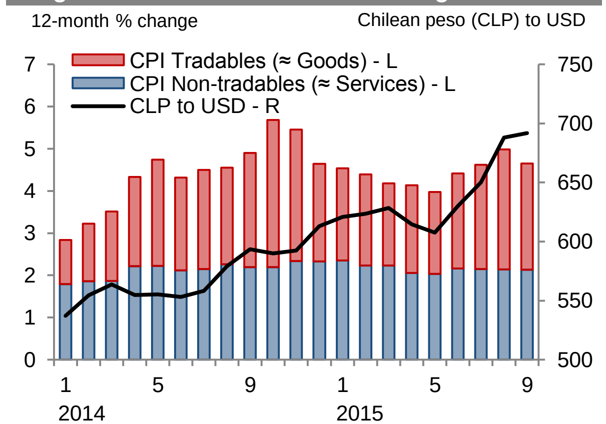
Source: INE; Central Bank of Chile; BTMU

Figure 22: CPI Fuel



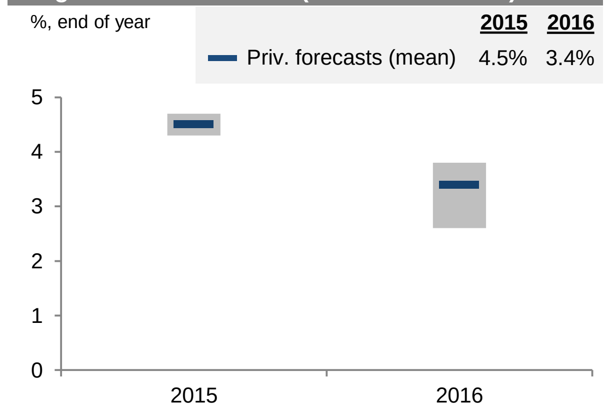
Source: Central Bank of Chile; BTMU

Figure 23: CPI Inflation and Exchange Rate



Source: own estimates using data from Central Bank of Chile; BTMU

Figure 24: CPI Inflation (Private Forecasts)



Source: Consensus Economics; BTMU

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