BBVA | RESEARCH

Economic Outlook

Chile

Second Quarter 2011
Economic Analysis

- **The global economy is continuing to grow rapidly,** driven by emerging economies.
- **Chile will grow 6.2% in 2011,** driven by a favorable external environment and internal demand, which will tend to slow over the year.
- **Inflation will be over 4% at the end of the year** due to closing of capacity gaps and the increase in commodity prices.
- **The monetary stimulus is being withdrawn faster than expected,** a reflection of the Central Bank's worries regarding an increase in inflation. There are also concerns regarding the appreciation of the peso, although we believe that capital flow controls are improbable.
- **In 2012 and the years following, the economy will grow at approximately its potential,** by nearly 5%, and inflation will remain within an acceptable range for the Central Bank.
- **Oil prices are the main risk,** as further increases may boost inflation and slowdown growth.

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Closing date: May 12, 2011

1. Global outlook: recovery, global shocks and vulnerabilities

The global economy will continue growing strongly, but risks are tilted to the downside

The global economy continues to grow at a robust pace, and is still expected to expand by 4.4% both in 2011 and 2012, supported primarily by emerging economies (Chart 1). However, the threat coming from high commodity prices (especially oil) increases the uncertainty and introduces a risk to growth and inflation in most regions, even to some of those that might benefit directly from high commodity export prices. At the same time, local risks identified in the previous issue of the Global Economic Outlook continue more or less unchanged. In particular, financial stress in Europe is likely to continue, especially for Greece, Portugal and Ireland. The political noise around proposals to finally start the process of fiscal consolidation in the US will only add to uncertainty in the markets, even as we think that some form of fiscal adjustment will take place in the end. Finally, overheating pressures in emerging markets continue, although going forward they will be more of a concern in South America, given tailwinds from commodity prices.

While high commodity prices pose risks they are unlikely to dent growth

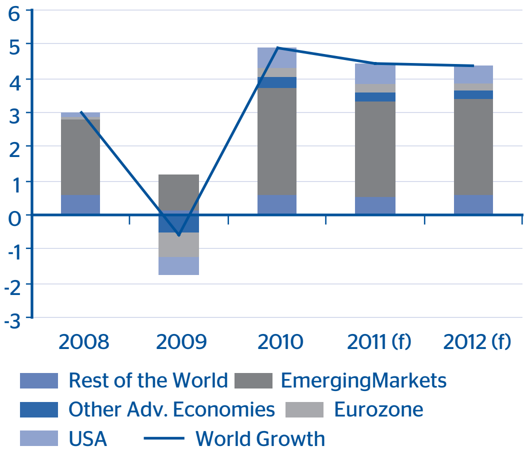
The greatest global risk stems from the rise in oil prices since the beginning of the year, caused mainly by political instability in the Middle East and North Africa (MENA). Although uncertainty is high and protests in the region are still unfolding, in our view, contagion to the point of disrupting oil production in other important oil producers beyond Libya will not occur. Thus, the geopolitical risk premia incorporated in oil prices will gradually be reduced, given ample OPEC spare capacity and OECD inventories, both above historical means. Nonetheless, oil prices may remain high at around US$110-120 per barrel during most of 2011, before receding gradually to around US$100 in 2012.

Given a rise in the price of other commodities such as food and metals as well, the main negatively affected regions will be the major developed countries and most of emerging Asia, the main importers of raw materials. On the other hand, the main beneficiaries of improved terms of trade would be the Middle East and Latin America, which will recycle part of this windfall revenue. However, a shock of this magnitude will be absorbed by the global economy without significantly affecting economic activity. This, together with relatively strong data in the first quarter of 2011, justifies relatively unchanged growth forecasts in most areas, as compared to our February Global Economic Outlook. The main exceptions are Mexico and South America, where strong data in the first quarter of 2011 and better terms of trade warrant a moderate upward revision of our growth forecasts for 2011. Core countries in Europe, as opposed to those in the periphery, will continue to grow, while risks to the U.S. forecasts shift from being biased upwards three months ago to be more balanced now because of higher oil prices.

High oil prices will push up headline inflation, necessitating earlier central bank interest rate increases in most regions

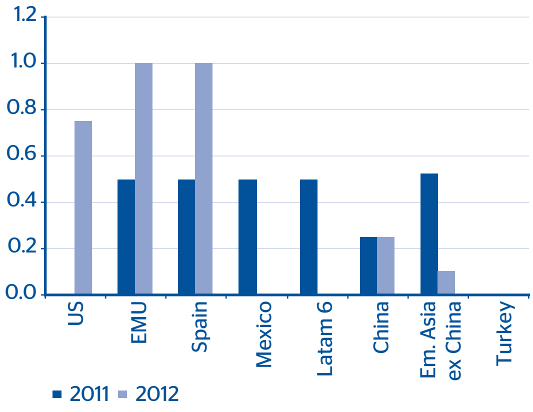
The main effect of the oil shock will be felt on prices. Higher inflation in most economies in 2011-12 will prompt monetary authorities to bring forward, and in some cases push for more aggressive, paths of interest rate increases (Chart 2). Nevertheless, there is still a wide heterogeneity in central bank approaches to the risks stemming from high oil and other commodity prices. In particular, in the US and euro zone, central banks are shifting—to varying degrees—their focus from supporting growth or preventing a tail risk scenario of very low growth and deflation, toward keeping inflation expectations well-anchored, particularly considering that the monetary policy stances are very accommodative. As a consequence, the balance of risks has tilted towards a higher probability of early hikes. The timing of the first hike depends on the perceived need to react to potential risks of second-round effects. The ECB's hawkish approach is to avoid any risk by being pre-emptive (and thus its first hike in April). On the other hand, the Fed, focusing more on the lack of sustainability in the recovery, prefers to wait and act only if risks materialize. Between these two approaches, emerging economies seem open to more front-loaded hikes if needed, but with an eye also on avoiding excessive capital inflows and exchange rate appreciation.

Chart 1
Global GDP growth and contributions



Source: BBVA Research and IMF

Chart 2
Changes in year-end expected official interest rates relative to February 2011



Source: BBVA Research

Financial tensions in the periphery of Europe will remain high

In Europe the agreements reached during the March summits are useful for the medium term both in terms of economic reforms and to help prevent future crisis. In addition, the changes introduced to the EFSF/ESM are positive to address liquidity concerns. However, financial market tensions in the three peripheral countries with international support (Greece, Ireland and Portugal) will continue as long as doubts persist about the solvency of some countries and thus the risk of debt restructurings that include private investors. These lingering doubts will continue hindering the funding to these economies and sustaining high sovereign spreads and could spread to other countries, even those with high solvency credentials. Thus, a comprehensive approach to debt resolution in case of insolvency is urgently needed, but one that takes into account that undergoing a hard debt restructuring that includes haircuts to private investors has a very high risk of contagion to the rest of Europe, so it will have to be designed carefully.

For its part, Spain has been able to differentiate itself from these three peripheral countries given advances in fiscal consolidation and economic reform including, in particular, those aimed at the financial sector and the labour market. However, continued decoupling and a meaningful reduction in spreads will depend crucially on the satisfactory completion of the recapitalization of the financial system –with a prompt entry of private capital–, on continued fulfilment of fiscal consolidation targets –including in the regional governments– and continuing advancing reforms, especially in the labour market.

In the US, fiscal consolidation will likely be achieved

In the U.S., the political process to reach a sustainable path for public debt involves difficult negotiations between two opposing approaches to deficit reduction. In the end, fiscal consolidation will have to come either from a reduction of entitlements or from higher tax revenues. In our opinion, both parties will reach an agreement that translates into lower deficits and a sustainable debt path, but the political process will be protracted.

Overheating concerns continue in emerging economies

Emerging economies continue to show risks of overheating, but with marked heterogeneity. Some countries are beginning to confront these risks through more restrictive monetary policy, for example, in the important cases of China and Brazil. We think overheating risks are manageable but, going forward, they may become more pronounced in South America, to the extent that commodity price increases are a tailwind, but act as a headwind for emerging Asia. In addition, doubts about the extent of the slowdown in Japan could weigh on economic activity in most of Asia, given extensive trade links and integrated production chains. Furthermore, current account surpluses in much of Asia provide a buffer for the region, as compared to South America.

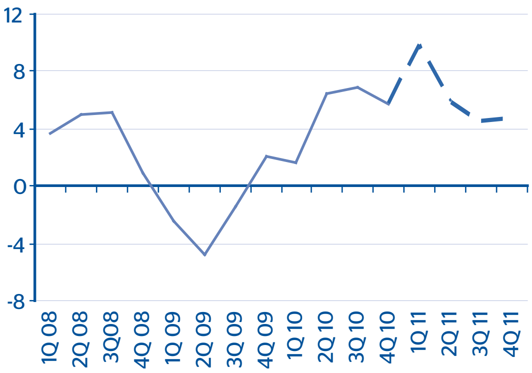
2. Chile: Demand remains dynamic

The economy grew nearly 10% y/y in the first quarter of the year thanks to dynamic internal demand and the low base of comparison caused by last year's earthquake

Although the strong increase in economic activity in March had been included in the expectations, marginal growth in the first quarter of the year was a surprise, since the data of the last quarter of 2010 indicated economic activity slowdown, especially as regards domestic demand. However, not only was this slowdown not confirmed, but sales and imports indicators show that domestic demand continues to grow faster than the GDP.

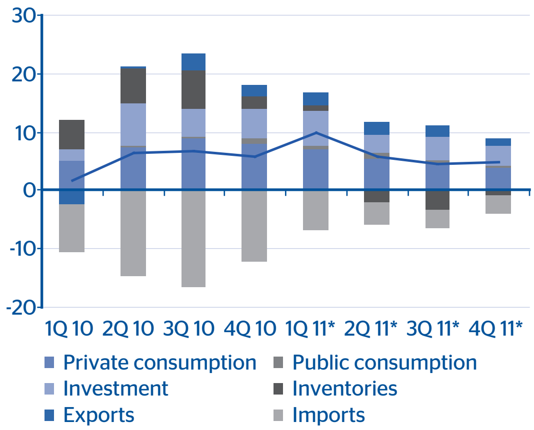
Preliminary, the first quarter showed a 9.8% GDP growth, which largely explains an increase in the growth forecast for the year from 6% to 6.2% (Chart 3).

Chart 3
GDP growth (% y/y change)



Source: BCCh and BBVA Research

Chart 4
Growth contribution by aggregated demand components (% y/y change)



Source: BCCh and BBVA Research

There are several factors that explain the strength of demand in the first part of the year. To begin with, the fiscal and monetary policies continue to be expansive. As regards fiscal policy, although the recent announcement of expense cuts between US$750 and 800 million (1.4% of the budget for 2011 and 0.4% of GDP) establishes real expense growth at 4.5%, which is lower than expected GDP growth, this includes the fiscal stimulus packages of 2009 and 2010. In any event, the expense cuts point in the right direction and we cannot rule out that the government will not spend the entire budget for this year. Secondly, business and consumer confidence indicators have remained optimistic. Specifically, business optimism has been backed up by a positive domestic and foreign environment, while the determining factor for consumers has been the performance of the job market.

We expect several of these indicators to begin to slow in the coming quarters. On one hand, materialization of the budget cuts will somewhat reduce public contribution to internal aggregated demand growth. On the other hand, as explained in detail below, the monetary policy will start to return to neutral. This adjustment in economic policies will add to mitigation in confidence, which can already be seen in consumers, due to the observed and expected increase in inflation. The points mentioned above should be understood as a decrease in the speed of growth of private consumption, which will go from an increase of 10.4% in 2010 to 7.1% in 2011, somewhat higher than our previous estimation of 6.4% (Chart 4). As regards investment, the projected increase is 14.4% in its fixed component (previously 15.2%) and a slower rhythm of inventory accumulation. On the other hand, the negative influence on growth of net foreign demand will remain, in spite of greater export growth than estimated in the previous report.

As regards sectors, growth in recent quarters has been driven by commerce, transportation and telecommunications. In contrast, the contribution of manufacturing and construction has been very low. We expect certain moderation in the contribution of commerce and transportation in 2011 due to the slowdown in internal demand. However, there will be a significant change in the manufacturing industry and construction. As regards manufacturing, those sectors that lagged behind due to the effect of the earthquake, such as the cellulose industry, refining and steel and iron industry have returned to the capacity that prevailed before the catastrophe. On the other hand, the food sector, specifically the salmon subsector, has begun to recover. As regards construction, inventory and price dynamics, as well as public housing policies will contribute to greater growth.

Employment has recovered more quickly than in previous crises

Job creation after the Asian crisis was extremely slow, and 5 years passed before full occupation employment levels were seen again. In contrast, in 2010 the unemployment rate fell from 9% in March to 7.1% in December, quickly approaching full employment levels[1].

The unemployment rate has stabilized at 7.3% during the first quarter of the year, which corresponds to normal seasonality for this part of the year. However, the lower excess capacity will have a repercussion on the speed of job creation, so the unemployment rate for the year is expected to average 7.5%, 0.6 pp below the average for 2010. The trend in the increase of wage earners is expected to continue in 2011, while self-employment is expected to increase at a lower rate or even decrease.

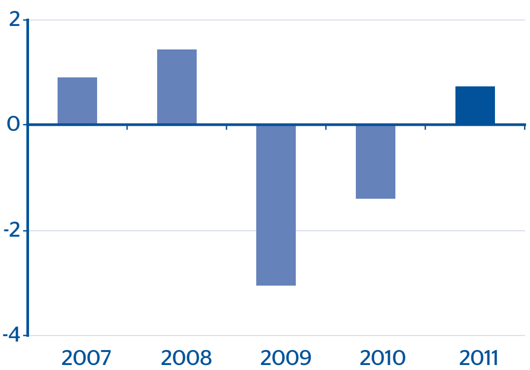
Inflation will pick up, driven by the increase in commodity prices, fuel and the closing of capacity gaps

This price increase was accompanied by a jump in inflation expectations over a one year horizon, from 3.2% in December 2010 to 4% in March 2011, after the decision of the Central Bank to increase international reserves by US$ 12 billion and postpone an increase in the policy rate in its January meeting. These decisions were interpreted by the market as greater tolerance to inflation due to a currency exchange objective. On the other hand, core inflation remains below the Central Bank's target range, while the announcement of fiscal spending cuts and the acceleration of the policy rate increases between March and May have contributed to lowering inflation expectations, now in the proximity of the range top limit (4%).

In spite of the moderation in the expectations, it is anticipated the year will close with inflation at 4.3% (previously 3.9%). Moreover, the risk balance is anticipated to be upwards, that is, there is a high probability that inflation will be over the estimation.

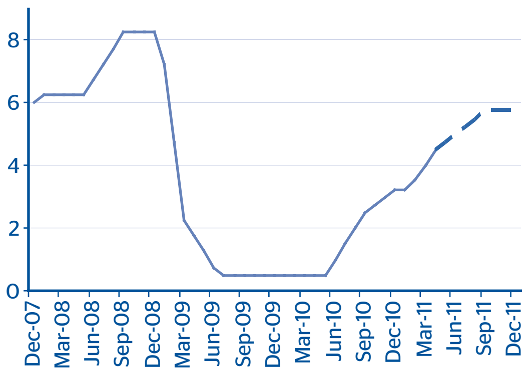
This upwards bias in the forecast is explained by the international environment, where the risks and expectations of higher inflation have increased, and the possibility that moderation in domestic demand ends up being lower than anticipated. In addition, the evolution in the inflation indicators, particularly the Production Price Index (11.7% y/y until April) and the Wage Index (6.3% y/y in March) illustrate increased price tensions.

Chart 5
Product gap (% of potential GDP)



Source: BBVA Research

Chart 6
Policy rate (%)



Source: BCCh and BBVA Research

1: The comparison is with March 2010, as this is the first month in which official figures are available using the New National Employment Survey.

In its Monetary Policy Report in March, the Central Bank recognized greater inflationary pressures and changed its inflation forecast from 3.3% to 4.3% for the end of the year, as well as a positive bias in its risk balance. Coherent with this forecast change, the Central Bank decide to accelerate the rhythm of monetary policy normalization, with increases in the policy rate of 50 bp between March and May, which placed the rate at 5% (Chart 6.).

On the other hand, although the Central Bank is required to conduct monetary policy in order to reach the inflation target in the policy horizon, renewed appreciation pressures continue to define the main dilemma of current economic policy: how to conduct the anti-inflationary policy and prevent currency appreciation implied by this policy at the same time.

The dilemma mentioned above has reopened the debate about the use of other instruments to intervene in the currency exchange market, particularly capital flow controls. However, there is opposition in the government and in the Central Bank itself to this type of policy, basically because both international and domestic experiences with these types of measures have not appeared to be very successful. Even more importantly, as mentioned further along, the net flows of capital in Chile in 2010 were negative, so controlling them does not appear to be very useful.

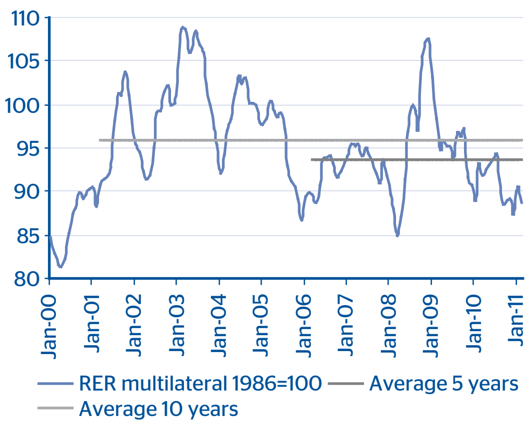
It is improbable that capital controls will be implemented. This will only occur if net influxes of capital are observed and the currency exchange rate drop below $450 per dollar.

This begs the following question: how do we explain the appreciation of the peso? The most important factor appears to be the global depreciation of the dollar. Thus, the peso would be appreciated in multilateral terms with respect to its equilibrium level in about 7% (Chart 7), a modest figure if we consider that the terms of trade exceed the historic average by more than 50%. Secondly, maintaining high copper prices favors the increase in foreign direct investment, as well as the expectations of public spending in the future (Chart 8). The first of these effects is inevitable. As regards the second, it would be desirable for the government to send a signal indicating that fiscal spending will remain restricted and will converge faster to the structural balance.

As regards macro-prudential measures, the recovery of credit growth has been moderate and total nominal credit in March reached 12.2%, while there is no evidence of a credit bubble. Likewise, banks capitalization is adequate, at least - the effective equity as a percentage of risk weighted assets reached 14.1% in December 2010.

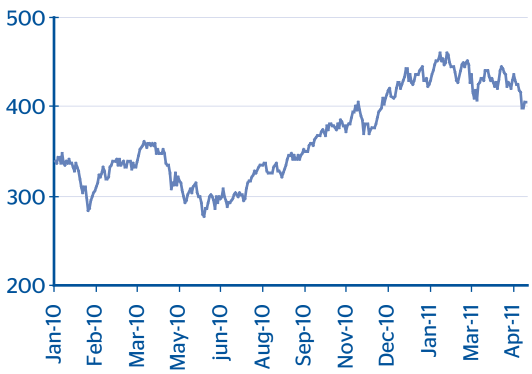
In line with economic activity, employment, confidence indicators and surveys on financing conditions, loans have continued their gradual return to normal, initiated in the last quarter of 2009, with an average growth for the first quarter of 11% y/y. For 2011, we project an average growth rate for total credit of 13.1% y/y in nominal terms. The forecast by components is 11.7% y/y in commercial loans, 16.4% y/y in consumers loans and 14.9% y/y in the case of mortgages.

Chart 7
Multilateral real exchange rate ($/US$)



Source: BCCh and BBVA Research

Chart 8
Copper price (US$ ¢/pound)



Source: Cochilco and BBVA Research

As regards the performance of the balance of payments, although the growth in demand and the higher commodity prices, especially fuel, translates into a strong increase in imports, this will be completely offset by a similar increase in exports due to the average price of copper, which is nearly 14% higher than in 2010. Therefore, the balance of goods will register a surplus of US$ 17 billion (7% of GDP). As in 2010, the trade surplus will be practically the same as the deficit in income account (mainly due to mining earnings remittances) and transfers, which leads to a forecast of moderate current account surplus (0.2% of GDP). The counterpart of the current account surplus in 2010 was a combination of net capital outflows and accumulation of international reserves, which more than compensated for the highly positive net direct investment (reinvestment of mining earnings). Again, a high amount of net direct investment is expected for 2011. This will be mainly offset by accumulation of international reserves, given the program for the purchase of $US 12 billion in reserves.

3. Nothing lasts forever

The low interest rates worldwide and the high commodity prices will return to normal levels sooner or later

As regards international monetary conditions, at the beginning of 2012 the Fed will start normalizing the lending rate, which will gradually return to its neutral level. In addition to increasing financing costs, this will have two strong implications: the dollar strengthened with respect to other currencies and the effect of a weak dollar in commodity prices will be reversed. This is one of the factors that will explain the price of copper in 2012, which will be similar to the 2010 average and 14% lower than in 2011. The prevalence of a positive output gap at the beginning of 2012 and the continuation of inflationary pressures will make monetary policy less expansionary and reduce the fiscal stimulus.

In this less expansive environment, both consumption and investment will continue to moderate, and aggregate demand will begin to converge at the rate of GDP growth. Therefore, GDP growth in 2012 is estimated at 5.1% and domestic demand at 5.4%.

The correction in commodity prices will favor moderation of inflation, which will be 3.3% at the close of 2012, although the gap between observed GDP and potential GDP levels will continue to grow, but at a lower rate. The combination of lower copper prices and the reduction in economic growth and inflation will be the main factors behind the moderation of the fiscal surplus, although this will continue to be positive at 0.2% of GDP. On the other hand, due to the fall in copper prices and the increase in imports, will increase the current account deficit (1.4% of GDP) but that will be easily financed by foreign direct investment.

Therefore, although nothing lasts forever, the changes in the global and local scenarios will essentially lead to Chile to grow around its potential from 2012 onwards.

4. Commodity prices are the main source of risk

An increase in oil prices due to higher risk premiums in the Middle East could imply lower growth and higher inflation

In this sense, we have evaluated the impact of rising oil prices, from the level assumed in the baseline scenario, approximately 20% in 2011 and 50% in 2012. In addition, the adverse effect on global growth of an increase of this magnitude would imply a fall in other commodity prices. As regards the price of copper, it would decrease 8% in 2011 and 18% in 2012.

GDP would grow 5.2% in 2011, one percentage point less than the estimated growth in the baseline scenario, while growth in 2012 would be 3.7%.

In turn, worsening term of trade would imply a depreciation of the exchange rate, which on average would be 7% higher than the baseline scenario in 2011 and 18% higher in 2012. These factors, along with the relatively fast transfer of the increase to fuel prices, would raise average inflation to 4.7% in 2011 and 6% in 2012.

Although fiscal surplus would decrease from 1% to 0.8% in 2011, this would be quite limited and there would practically be no difference in 2012. However, the current account would deteriorate with regard to the baseline scenario, reaching a deficit of 1.6% of GDP in 2011 and 4.3% in 2012.

The good news is that this scenario does not have a high level of probability. On the contrary, recent evolution of commodity prices suggests that it could be relevant to evaluate the impact of commodity prices returning to trend levels on fiscal and external balances. With a static sensitivity analysis in mind, that is, maintaining the main variable of the baseline scenario, but considering trend commodity prices, basically oil prices at approximately US$ 60 per barrel and copper at US$ 2.6 per pound, the result would be a fiscal balance of -0.4% of GDP in 2011 and -0.7% in 2012. As for the current account, the result would be -1.3% of GDP and -2.3% in these years, respectively.

These figures are quite modest and do not present serious financing problems. The existence of a structural fiscal surplus rule implies that the impact of this correction to the fiscal balance will be moderate. However, the effect on external accounts is clearly higher.

5. Tables

Table 1
Annual macroeconomic forecasts

	2009	2010	2011	2012
GDP (% y/y)	-1.7	5.2	6.2	5.1
Inflation (% y/y, average)	1.5	1.4	3.5	3.5
Exchange Rate (vs. USD, average)	560	510	472	490
Interest Rate (%, average)	1.8	1.5	5.4	6.0
Private Consumption (% y/y)	0.9	10.4	7.1	5.3
Government Consumption (% y/y)	7.5	3.3	4.1	3.9
Investment (% y/y)	-15.9	18.8	14.4	9.2
Fiscal Balance (% GDP)	-4.6	-0.4	1.0	0.2
Current Account (% GDP)	2.5	1.9	0.2	-1.4

Source: BBVA Research

Table 2
Quarterly macroeconomic forecasts

	GDP (% y/y)	Inflation (% y/y, average)	Exchange Rate (vs. USD, average)	Interest Rate (%, average)
Q1 09	-2.5	3.1	607	0.5
Q2 09	-4.8	-0.6	567	0.5
Q3 09	-1.4	-1.9	545	0.5
Q4 09	2.1	-0.3	518	0.5
Q1 10	1.7	1.2	519	0.5
Q2 10	6.4	2.2	530	0.7
Q3 10	6.8	2.5	512	2.0
Q4 10	5.8	2.9	480	3.0
Q1 11	9.5	3.4	480	3.6
Q2 11	5.3	3.5	467	4.9
Q3 11	4.7	4.2	472	5.7
Q4 11	5.3	4.0	478	5.8

Source: BBVA Research

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