BBVA Research

Chile

Economic Outlook

Second Quarter of 2010

Economic Analysis

- The earthquake damaged productive capacity but economic activity is continuing to increase, reinforced by investment in reconstruction. We have reviewed our 2010 growth forecasts downwards (4%) and increased our forecast for 2011 (5.6%).
- We expect a slight surplus in Chile's current account in 2010 (1.8% of GDP), and deficits of 3.5% and 3.1% in 2011 and 2012, respectively, as a result of lower commodity prices and strong growth in domestic demand.
- Interest is currently focused on the financial plan for reconstruction following the earthquake. We consider balanced use of a range of different sources of finance to be appropriate from the point of view of impact on the country's economic activity.

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Closing date: 17 May 2010

1. The challenges ahead for sustained recovery

In recent quarters, the economic situation has improved considerably due to the upturn in emerging economies and in the U.S. World trade is growing at a rate of 7% and our forecasts suggest there will be 4.2% growth in the world economy in 2010. However, doubts remain regarding the EMU's capacity to tackle the problem of high debt levels in some countries. These doubts have led to an increase in sovereign spreads and a new period of financial instability. This situation could affect the European economy, but it could also spill over to the rest of the world. The timing and the scope of these adverse impacts will crucially depend on the effectiveness of the announcements that the European Council made on 9 May regarding the agreed rescue packages and the ECB's special measures. Although these packages have stabilized market conditions in the short-term, uncertainties still lurk on three fronts: i) the rescue package implementation process over the coming months; ii) the credibility of the additional fiscal consolidation in some EMU countries; and iii) the medium-term obligation on central EMU countries regarding the rescue packages.

While economic recovery was widespread at the start of 2010, its intensity varies widely between countries. This is due to the varying degrees of use of fiscal and monetary policies. These policies have been particularly effective in boosting the economic cycle in China and the U.S. At the same time, emerging economies are benefiting from the growing strength of their domestic demand and from the upturn in terms of trade, in a climate of reduced risk aversion. In this region the recovery is therefore much more consolidated. On the other hand, in developed economies, as the expansionary policies ease, questions arise regarding the sustainability of the recovery beyond 2010.

The Fed is expected to push interest rates up gradually. The first rises are predicted for the start of 2011, with rates slightly above 1% by the end of that year. The differences in the economic fundamentals in the U.S. and the EMU will lead to different monetary policy exit strategies in the two regions. Although economic growth could be slow from 2010 onwards, the risk of a reversal of the current trend is limited in the U.S. and inflationary pressure is still at a very early stage. In contrast, in the EMU, as well as a much more fragile financial situation, the cyclical improvement seems to be uncertain and there are no indications of inflationary pressure. As regards monetary policies in emerging economies, there is no doubt that they need to be toughened. Given the cyclical discrepancies in this region, the exit strategies will vary from country to country. If monetary policy is not made stricter and other measures are not implemented in time, increasing imbalances could be generated in some economies.

At times of greater risk aversion, financial markets tend to be more forward-looking. Financial markets are efficient when it comes to detecting inconsistencies in macroeconomic policies that usually go unnoticed in times of economic boom. In spite of the large rescue package agreed in Europe, significant risk premiums will persist on the sovereign debt market in some European countries in the midst of uncertainties regarding fiscal consolidation processes. The growing contagion has been clear proof of the fragility of the current situation. Economic history is full of examples of "unfounded contagions" from country to country in times of crisis. In these cases, geographical proximity or cyclical similarities are more important than differences in terms of fundamentals. In fact, the current contagion situation is not completely justified by either the financial channel spurred by the breakout of the crisis in Greece or by any similarity in terms of fundamentals. Even though this may be cause for debate, there is a compelling need for some countries to increase their credibility in order to face the pressure from international investors.

There is growing concern over the long-term consequences of increases in public debt. In developed countries this will inevitably lead to upward pressure on real interest rates and high risk premiums for a long time. Even if the recent contagion gradually fades, there will be growing discrimination between countries depending on the credibility of their fiscal situation.

There are two main types of uncertainty from the financial sector. Firstly, the slow restructuring of the financial industry, especially in Europe could result in a creditless recovery. This is an increasing concern, because past experience and empirical evidence show the importance of credit in the early stages of economic recovery. There is also uncertainty over the regulatory reform that is already underway. The most likely result is a significant increase in capital and liquidity requirements, which could limit banks' capacity to grant credit over the coming years.

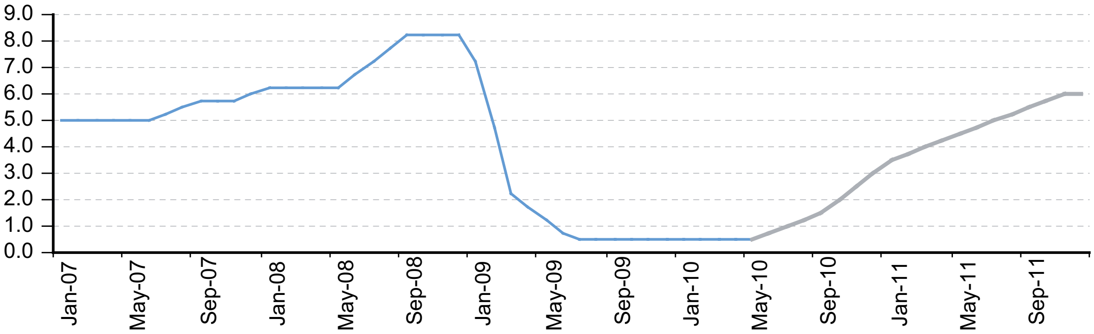
2. The earthquake: short-term production losses, greater dynamism in the future

The review of Chile's economic outlook is strongly affected by the 27 February earthquake and tidal wave. Before this disaster, the Chilean economy was showing signs of solid growth, with strong performance in domestic demand, and consumption in particular, which increased by 5.5% during the last quarter of 2009. This, together with advance indicators published at the start of the year, suggested there should be an upward review of growth forecasts for 2010. However, the earthquake then occurred, obliging us to revise our forecasts downwards to recognize transitory losses in production. It has been estimated that the earthquake destroyed approximately 3% of the country's capital stock, mostly in housing and transport infrastructure, with a consequent reduction in potential GDP and existing excess capacity. In the first quarter, the growth in output of 1% was lower than the 1.2% forecast, as a result of which the economic will grow by less than 3% in the first half of the year. However, although these figures have put a negative tinge on the outlook, we expect strong performance during the second half of 2010 and throughout 2011 as a result of reconstruction efforts. The main catalyst for this growth will be public and private sector investment, increasing by 11.2% and 13.9% respectively, which will result in growth of around 6% in the second half of 2010 and in 2011.

The earthquake had little effect on the labor market. In the first quarter, unemployment fell from 9.1% in the previous quarter to 9%. However, we expect an increase in the rate when the labor market in the regions most affected by the quake is examined in greater depth. Overall, we expect a gradual reduction in the unemployment rate to an average level around its natural rate in 2011; the Finance Ministry estimates this to be approximately 8%. There has been a slight fall in salaries so far this year (-0.1%), and we expect the real increase to be less than 1% during 2010.

Chart 1

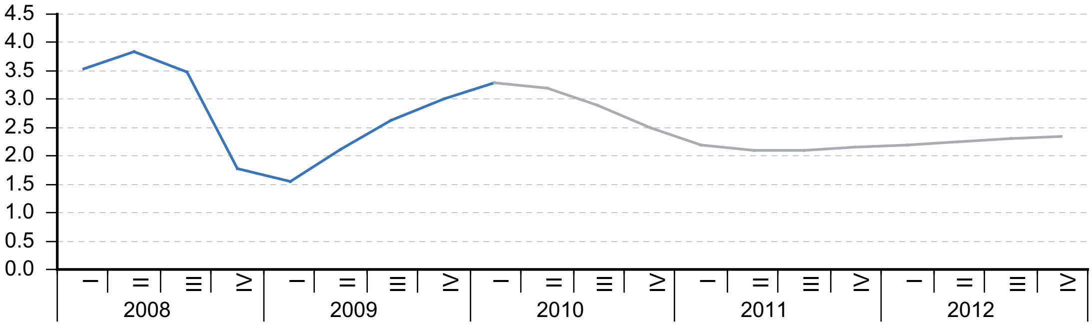
Monetary Policy Rate



Source: CBCh and BBVA Research

The closing of the output gap and the strong growth in demand over recent months will result in an increase in inflation, which will be within the Central Bank's acceptable range, reaching 3.4% at the end of 2010. In anticipation of this situation, the Central Bank signaled in the minutes of its last Monetary Policy Meeting that it would shortly start a cycle of increases in its policy rate. This option was in fact discussed at the April meeting. However, expectations of inflation were higher at the time than they are now, as a result of which it held the rate steady at its May meeting, and we expect the first increase to occur in June. We expect the rate to return to normal levels relatively rapidly, with the MPR reaching 3% in December this year and 6% by the end of 2011.

Chart 2
Cooper price projections (USD/lb)



Source: Cochilco and BBVA Research

We expect a 2.7% fiscal deficit in 2010, which will increase to 3.8% in 2011 due mainly to the fall we expect in copper prices. As a result of the earthquake, the Government will have to meet increased costs amounting to approximately USD 8.400 billion; the Government has stated its desire to carry out all the reconstruction work during the four years of its mandate. To this end, the government has proposed a financing plan for the reconstruction and its government program which will require some USD 9.000 billion over 4 years; this involves increased tax revenues in the short term. In addition to debt issues, the use of sovereign funds, reallocation of budgets and sales of non-essential fiscal assets, the public finance plan includes temporary increases in taxes on large companies and private mining which will expire in 2013; it also includes permanent reductions in tax benefits on household savings and investments.

The lower commodity prices which we anticipate, together with the major increase in imports as a result of renewed dynamism in internal demand, will have a significant –but manageable- effect on foreign trade balances; moving from a small current account surplus in 2010 (1.8% of GDP) to deficits of 3.5% and 3.1% in 2011 and 2012.

The peso appreciated by 3.1% in February and April until the beginnings of the Greek crisis resulted in increased risk aversion, which combined with a toughening of monetary policy in China to cause a major correction in copper prices (down 16%) and a 4.5% depreciation of the peso. Despite this, once calm returns to the markets, the peso will start to appreciate again to levels of around 510 pesos to the US dollar in December 2010. The authorities have signaled that this is close to long-term equilibrium levels and therefore does not justify any intervention on their part. However, as the exchange rate is currently 530 pesos to the US dollar, there is a risk that this appreciation may not take place in the event of lower copper prices or if the current high levels of risk aversion persist.

3. Money does not equal happiness

As we have stated, Chile does not have any problems in financing its public spending, even as a result of the devastation caused by the earthquake. But this does not mean that there are no problems. In fact, the main political dilemma is how to use the resources available (or which could be available) without damaging the competitiveness of exporters and companies competing with imports. If sovereign funds are used intensively, or if too much foreign debt is issued, the peso will tend to appreciate and this will affect competitiveness. Issue of domestic debt and the subsequent upwards pressure on interest rates will displace private investment and result in some exchange rate appreciation. Tax increases will also cause some displacement of private investment and will reduce the multiplier effect of public spending. In this regard, we consider the public finance plan to be in essence correct, with a balance of different sources of funding.

The most important political economy dilemma for Chile is the abundance of finance available from abroad and the upwards pressure on the currency. If we add to this that rapid expansion in domestic demand will generate a conducive environment for increased inflation, the Central Bank may need to increase interest rates more rapidly. Against this background, a financing package for increased public spending with a significant contribution from transitory tax increases will ease the Central Bank's task.

4. External risks under control

At the present time, the greatest concern internationally is the possibility that the Greek situation may infect other countries. Emerging countries are usually impacted through financial channels, particularly through increases in sovereign risks. In the case of Chile, this has had little effect, partly because the increase in risk premiums has been very small, and because its vulnerability is limited by the low levels of its public debt and the fact that the State is a creditor. The situation is also helped by the relative depth of local financial markets, which at times of the greatest stress have been able to provide the finance required by the country's businesses. However, Chile may be affected through trade, particularly if China takes domestic measures to reduce inflationary pressures, which will impact on the prices of products such as copper; this is something that we have seen over recent days and this could have an effect on expectations and on tax and foreign trade accounts. It should however be stated that the commodity price levels we are seeing at present are in line with our forecasts, which include a significant adjustment in the second half of this year (an average price of copper in the last quarter of the year of USD 2.5/pound). In the event that problems in Europe persist and worsen, and inflation increases beyond acceptable levels in Asia, we could be faced with an international situation which is much more negative than the current one, with higher risk premiums and lower raw material prices which, in the case of Chile would be reflected in much higher interest rates and lower investment activity, particularly where dependent on external finance.

Domestically, the most significant risk is inadequate handling of economic and social problems resulting from the earthquake, particularly given the high expectations created by the incoming government. A related factor is the lack of experience of a coalition which has been out of government for the last twenty years. In a more optimistic vein, the government has strong public support, and the dominant forces in Congress are basically moderate.

5. Tables

Table 1

Macroeconomic Forecasts: Quarterly

	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11
GDP (% y/y)	-2.1	-4.5	-1.4	2.1	1.0	2.7	6.2	6.0	6.9	6.6	4.8	4.0
Inflation (% y/y)	5.6	3.1	-0.6	-1.9	-0.3	1.3	2.2	2.8	2.9	2.8	2.8	2.9
Exchange Rate (vs. USD)	607	567	545	518	519	520	505	510	514	515	522	530
Interest Rate (%)	4.75	1.25	0.5	0.5	0.5	0.58	1.25	2.5	3.75	4.5	5.25	5.92

Source: BBVA Research

Table 2

Macroeconomic Forecasts: Annual

	2009	2010	2011
GDP (% y/y)	-1.5	4	5.6
Inflation (% y/y, average)	1.6	1.5	2.9
Exchange Rate (vs. USD, average)	550	513	520
Interest Rate (%, average)	1.8	1.2	4.9
Private Consumption (% y/y)	0.9	2.6	4.6
Government Consumption (% y/y)	6.8	4.3	4.2
Investment (% y/y)	-15.3	11.2	13.9
Fiscal Balance (% GDP)	-4.5	-2.7	-3.8
Current Account (% GDP)	2.5	1.3	-3.8

Source: BBVA Research

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