BBVA Research

Chile

Economic Outlook

Third Quarter 2010

Economic Analysis

- The unraveling of the European situation has caused a moderate and temporary contagion in Chile.
- In view of stronger economic growth in recent months, we are changing our growth forecast to 4.8% for 2010, and 5.6% and 4.8% for 2011 and 2012, respectively.
- There is a risk that the heavy increase in demand could cause inflationary pressure by the second half of the year and in 2011. We therefore insist on our prediction that the monetary policy will return to normal more quickly than the central bank anticipates.
- Better outlook for economic activity and copper prices strengthen fiscal accounts, while fall in foreign accounts is moderate.
- A worsening of the European situation would result in a risk scenario with adverse effects, although much lower than those caused by the sub prime mortgage crisis. Domestic risks are related to the danger of the economy heating up again and the currency appreciating.

Index

Closing date: 29 July 2010

1. Reassessing the outlook for the global economy

The effect from the fiscal adjustment on growth in Europe will be lower than commonly assumed. The positive impact on credibility will almost compensate the negative effect from reduced public demand. Conversely, medium-term risks from unsustainable fiscal positions in other developed regions are probably underestimated

One of the most important channels through which the fiscal crisis has affected the European economy has been the loss of confidence, and a prerequisite to restore confidence is fiscal prudence. Consolidation plans in Europe are being implemented according to schedules presented to the EC at the beginning on 2010. Fiscal consolidation in Europe needs to focus on the structural side, but a positive factor is that adjustment is fast and tilted towards reducing expenditure, which will boost confidence and almost compensate the negative effect on growth from reduced public demand. Thus, as long as the determination on fiscal consolidation is maintained, the impact on European economic activity will be limited and transitory. On the other hand, other advanced economies, where fiscal impulses have been substantial and debt levels have increased at similar pace as in Europe, are relatively slow in coming to grips with reducing deficits and –at least– stabilizing debt levels. This is a medium-term risk that is being underestimated, as experience shows that the effect of lax fiscal policy on interest rates in highly non-linear, and there is a risk of sudden increase in long-term rates and a displacement of private demand; exactly the opposite effect as intended by the fiscal stimulus packages.

The main risk to the global outlook is still coming from financial markets. Stress tests have had positive –though asymmetric– impacts throughout Europe. Although risks have been reduced, the potential fallout from renewed tensions is still sizable

Financial risks, which stemmed from sovereign debt concerns, formed a feedback loop that ended up increasing market risk and drying up liquidity, especially in Europe. Nonetheless the sharp increase in financial tensions in Europe in the second quarter is starting to abate (see Chart 1). The release of European stress test results has had positive effects on lowering tensions, although there has been a clear differentiation across countries. In particular, it may act as a powerful driver for removing uncertainty surrounding the Spanish financial system, as the implementation of the exercise looks rigorous and the outcome seems credible and is very informative. Undoubtedly the risk to Europe and the global economy coming from financial markets is still the main source of concern.

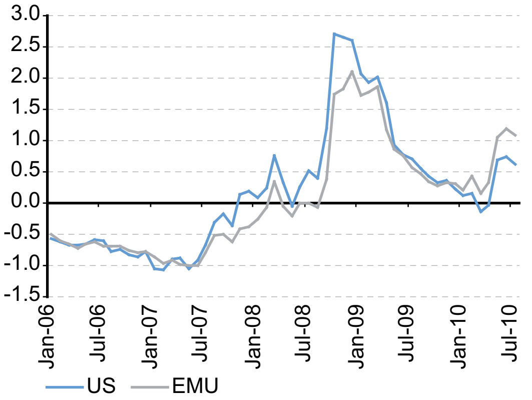
Increasing divergence in monetary policy strategies. Heightened uncertainty will prompt the Fed and ECB to postpone the exit from accommodative policies. On the contrary, tightening has resumed across much of Asia and Latin America

Financial strains in Europe and uncertainty about the pace of recovery in the US will prompt central banks in both regions to postpone their first rate rises and keep very low policy rates for an extended period. Inflationary pressures in both areas will remain subdued, allowing them to keep lax monetary policies. Nonetheless, a faster recovery in the US will mean that the monetary exit will be earlier there than in Europe, and both factors will weigh down on the euro. Although both central banks will postpone monetary tightening, communication and the assessment of risks continue to differentiate both institutions, limiting the ECB's relative capacity to react, in particular to deflationary risks. On the other hand, in emerging economies monetary tightening is resuming, after a pause (especially in Asia) as the European debt crisis unfolded. This will help reduce inflationary pressures in Asia –where they were starting to build– and prevent potential pressures from developing later in the year in South America. An important exception is Banco de México, likely to hold rates beyond the second quarter of 2011, even when inflation edges up in the last months of this year.

The global economy is on track for a mild and differentiated slowdown. It will be a healthy development for China and the rest of emerging Asia, with growth converging towards more sustainable rates. However, in the US private demand will remain weak without policy support, whereas in Europe confidence will be negatively affected by the fallout from the financial crisis

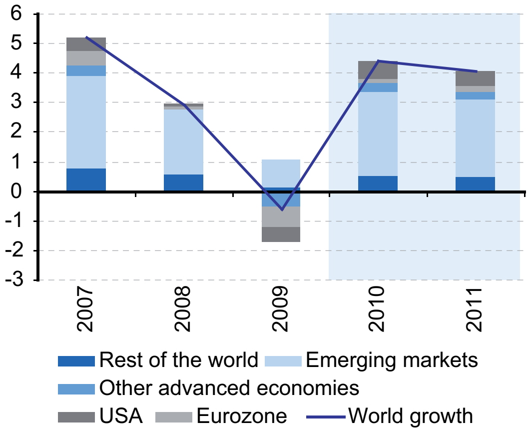
Spillovers from the European financial crisis to other geographical zones have been relatively limited. Nonetheless, the global economy will slow down going forward (see Chart 2). The severity of financial tensions in Europe will affect confidence and reduce growth in the second half of 2010 and the beginning of 2011. Moreover, external demand will not be as strong as it was in the first half of the year, although it will provide some support for economic activity. In the US, the recovery is likely to lose momentum on account of softening labor and housing markets. This shows the limits of private demand taking over as an autonomous driver of growth. In China, slowing GDP growth in the second quarter and moderating activity indicators are evidence that the authorities' tightening measures are being effective to steer the economy to more sustainable growth rates. Latin America will also slow down in 2011, but keep robust growth rates going forward. Therefore divergences with continue to widen both between advanced and emerging economies and within each of those groups.

Chart 1
Financial Stress Index*



* Composite indicator of financial tensions in 3 credit markets (sovereign, corporate and financial), liquidity strains and volatility in interest rate, foreign exchange and equity markets
Source: BBVA Research

Chart 2
Contributions to Global GDP growth



Source: Source: BBVA Research based on national accounts

Although there were some steps in the right direction, going forward the necessary global rebalancing of demand and the narrowing of global imbalances is still pending
The rebalancing of the Chinese economy towards more internal demand (particularly consumption) continues, and the recent renewal of currency flexibility should help. However, further reforms are needed to bring the weight of consumption more in line with international standards. Other advanced surplus countries also need to implement reforms to increase domestic demand, most notably in the service sector. On the other hand, the US and other countries with substantial external financing needs need to switch from a consumption-led model to investment, especially in tradable sectors. The recent financial crisis has shown the limits to foreign financing of growth. Economies with high external financing needs are highly vulnerable to an upsurge of international financial tensions, and the resulting sudden movements in exchange rates risk undermining global financial stability.

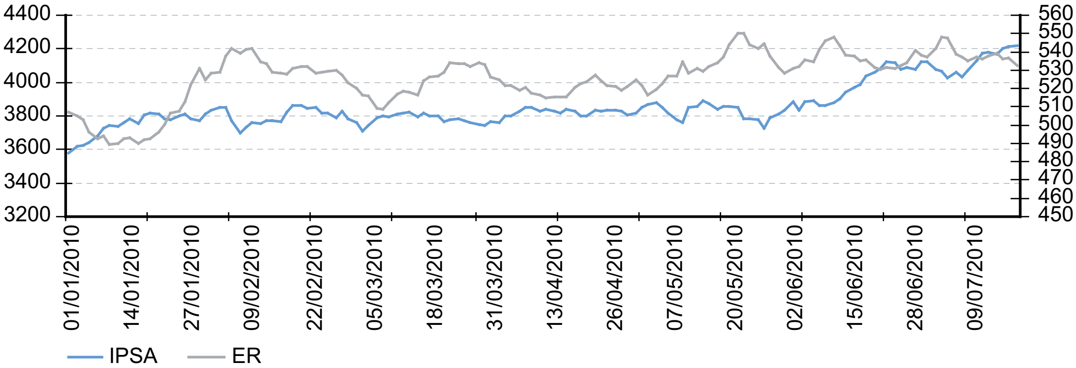
2. Recovery against wind and tide

The earthquake temporarily halted growth in economic activity, while the contagion from the European situation has been moderate
The intensity of the earthquake evoked initial concern over whether the Chilean economy would be able to take two consecutive knock backs, especially given the uncertainty regarding global recovery due to the unraveling of the European situation. The heavy tumble that economic activity took in March, the first month after the earthquake, seemed to confirm these fears. However, recovery between April and June was considerable, much quicker and intense than anticipated and it could be said that the economy resumed the dynamic growth that it experienced prior to 27F.

In the financial field, all attention has been focused on the impact from the European situation. In this regard, the test to which global economies, and the Chilean economy in particular, have been subjected, at least until now, is precisely more related to financial variables than real variables, specifically to the contagion on stock markets, exchange rates and sovereign risk indicators. In the first case, the performance of the Chilean stock market has not only escaped the contagion; last month the Santiago stock index continued to rise, reaching all-time highs, and it is expected to remain at these levels at least until the end of 2010. The exchange rate, on the other hand, following an initial adjustment of around 5 percentage points, has left behind depreciation and is forecast to stabilize at around 2% more depreciated than its level prior to the worsening of the Greece crisis, in other words, a remarkably different situation to the one following the Lehman Brothers bankruptcy (see Chart 3). As regards the sovereign risk, measured in terms of CDS performance, it has increased by around 20 points since May, which is significantly different to what it recorded during the worst times of the sub prime mortgage crisis. In any case, Chile has one of the lowest sovereign debt insurance costs in emerging countries and lower than several developed economies.

Chart 3

Stock market index (IPSA) and exchange rate



Source: Datastream

3. Poorly-balanced growth

The economy has started growing again, but there is a heavy imbalance between domestic supply and demand which leads us to anticipate inflationary pressure and a gradually less expansive monetary policy

Dynamic economic growth in recent months, with annualized Monthly Economic Activity Indicator growth of 4.6% and 7.1% in April and May respectively, and growth estimates of around 6% for the second half of the year, result in a 4.8% growth forecast for 2010[1]. This represents a 1pp increase on our previous forecast, which expected a greater negative impact from the earthquake.

One feature of the recovery that must be highlighted is the imbalance between growth in aggregate supply and demand. In the first quarter of the year, while domestic demand rose by 4.2% versus the previous quarter, the GDP fell by 1.5%.

Along these same lines, 16.4% growth is predicted for aggregate domestic demand in 2010. In particular, investment will rise by 19% and consumption by 6.5%. But what lies behind this contrast between growth in supply and demand? Although there are several factors in play, and they will continue to apply in the coming quarters, most of them are transitory and part of this imbalance will be eliminated without needing to resort to anti-cyclical policies. One of these factors is, of course, the delayed effect of the monetary policy so far that, even following the withdrawal of unconventional measures and with the monetary policy rate (TPM) upward trend underway, continues to be heavily expansive and will continue to be so until at least 2H11.

Another transitory factor has been the recovery in the consumption of durable goods and investment spending that were delayed due to uncertainty brought on by the financial crisis. This spending includes the purchase of motor vehicles, which according to our estimates will reach a record 260 thousand units during the year. Finally, another component that must be mentioned is the need to replace property destroyed by the earthquake. This will last for several quarters, giving a boost to more dynamic growth in economic activity throughout 2010 and all of 2011. By this year, leveraged on public and private investment spending, we forecast growth of 5.6%. By 2012 we think that the economy will grow by 4.8%, converging to its potential growth and with a curb in consumer spending, investment and imports.

1: It is worth noting that the impact of natural disasters on the level of activity is usually overestimated. However, the main impact is on stock wealth, with a more moderate impact on flows, especially the GDP.

Foreign demand, on the other hand, will continue to contribute negatively to growth until 2012, mainly due to the fact that imports, in line with an increase in consumption and investment, will grow more quickly than exports.

As regards the job market, it is worth noting that although employment has been recovering slowly, it has done so during months in which, due to seasonal reasons, not to mention the impact from the earthquake, what we should have expected were job losses. Although we should anticipate a fall until August, during the second half of the year and due to the reconstruction process, employment should rise substantially. We therefore expect this market to heat up again somewhat.

In terms of inflation, the change in outlook involves a moderate upward adjustment from 3.4% to 3.6% in 2010, while the 3% forecast (central bank target) for 2011 and 2012 is maintained. Nonetheless, a considerable volatility is expected in the coming months, mainly due to the effect of changes in taxes (stamp duty) and tariffs (electricity accounts and public transport rates). In fact, in recent months, the return to positive inflation has been driven by volatile components and regulated prices, such that the increase in CPI-measured inflation, being moderate, has not been joined by core inflation measures. Along these lines, and considering the dramatic growth in economic activity, we should ask ourselves what is behind these inflation figures and whether greater inflationary pressure should be anticipated. One explanation lies in the delayed and lower growth in employment, which through increases in productivity, has probably curbed cost pressure. Another explanation is a persistent excess capacity following the activity fall in 2009. On both fronts, more tension is expected in the coming quarters.

On the job market a recovery in employment is forecast due to the stepping up of the reconstruction schedule and the delayed effect of growth in recent months. As regards excess capacity, we think that this will disappear during 2011. The forecast of this situation caused the central bank to increase the MPR by 50 basic points at the June and July meetings, taking the rate to 1.5%, as we predicted in our previous report. Likewise, activity and inflation performance and expectations prompt us to confirm our closing forecast for the MPR at 3% and 6% for 2010 and 2011, respectively. Towards the end of 2012, when we think inflationary pressure will start to wane, we predict a neutral rate of around 5.75%[2].

No significant adjustment is expected in the rate structure because the market will have probably anticipated these adjustments and they are at similar levels to those which prevailed at the start of 2008. We should expect gradual rises in interest rates on short-term commercial loans, in keeping with the adjustment in the overnight interbank rate that is usually set around the MPR. Although mortgage loan rates are below historic averages, competition in this segment should keep them relatively low. Concerning credit flows, good local and external financing conditions suggest that they will remain in positive terrain, with growth of around 11% in total credit in the system during 2010, with quicker growth in the case of consumer loans than corporate lending. Mortgage loan flows, on the other hand, will increase more slowly in accordance with the forecast of a moderate fall in house sales for this year[3].

In the absence of intervention from the central bank, the multiple factors determining the exchange rate, i.e. real, financial, short- and long-term, represent considerable volatility for this variable. Recently, fundamental factors such as copper prices or the level of public spending and its financing structure, have been joined by factors related to financial turbulence caused by the European situation and the impact on risk aversion and financial flows, or PFM portfolio decisions, determined by the change in regulations regarding currency hedging and limits on foreign investment. By the second half of the year, the exchange rate is expected to appreciate slightly. This is partly due to the fact that PFMs are reaching their foreign investment limits –defined by regulations in the sector-, which suggests a fall in the demand for dollars from these agents, a factor that has been behind pressure on the peso's depreciation in recent months. This is also joined by the appreciating effect of a less-expansive monetary policy and the liquidation of dollars to fund the post-earthquake reconstruction.

By the end of 2010 and in 2011, an exchange rate of $530 per dollar is forecast, although converging with these levels in a highly-volatile climate. By the end of 2012, an exchange rate of $525 per dollar is expected. In the medium-term, fundamental factors –productivity spreads, copper prices and budget balance, mainly- will determine the strengthening of the peso.

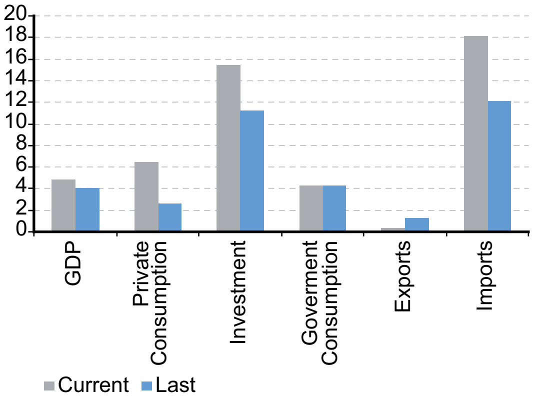
For 2010 we are raising our forecast of the central balance's fiscal balance from -2.7% to -1.6%, mainly due to the expectations of greater growth in the GDP and aggregate domestic demand, and higher copper prices. Deficits of 0.9% and 2.1% are expected for 2011 and 2012, respectively, below our previous forecast and also fostered by better copper prices than in our previous outlook.

2: In accordance with the central bank's Monetary Policy Report, the neutral level will probably be reached between the end of 2011 and the beginning of 2012.
3: See Property Watch 2010, June 2010.

The Central Government's financing needs for 2010, which as well as the deficit include servicing of debt, are around 3 percentage points of the GDP and are covered by authorized debt of up to US$7,800 million. The recent approval of the Reconstruction Financing Plan, has dispelled doubts over the method of financing this program this year and for the next two years. Out of the Government's original proposal, only the reform of the mining royalty was excluded, one of the plan's least important measures and expected to raise US$600 million (0.3% of the GDP) between 2011 and 2012. This amount can be covered by money saved in sovereign funds or by more debt[4]. Furthermore, as the Government explained, the structural balance will not be achieved until the end of the current administration in 2014.

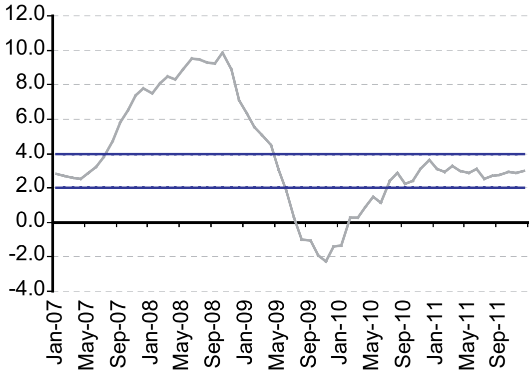
With respect to the foreign account balance, in 2010 a trade surplus of US$12,331 million is expected, with a 20% rise in exports and a 30% rise in imports. Bearing services, income and transfers in mind, a current account surplus of 0.2% is expected. This is lower than our previous forecast of a 1.3% surplus. We are holding onto our forecast of a 3.8% deficit in 2011, also caused by an increase in imports but made worse by a fall in average copper price from US$3.05/pound to US$2.75/pound.

Chart 4
Changes in forecast for 2010: Demand and GDP (yoy % change)



Source: BBVA Research

Chart 5
Recorded and forecast inflation (yoy % change)



Source: INE and BBVA Research

4. Main risks: foreign economy cools down and domestic economy heats up

The contrast between local recovery and a slowdown in growth in developed countries is the main dilemma facing the current economic polity, because the risk of heating up on the domestic front means increases in the monetary policy rate, which against a background of delays for the first increase in the main markets could cause an excessive currency appreciation

A more negative scenario in the rest of the world, for example caused by an unraveling of the European situation which has a contagion effect on countries leading the recovery and which prompts a return to restrictions on international financing and effects on prices and demand for raw materials, will probably mean a slower recovery in economic growth, some currency depreciation, a slower rise in prices and a decline of the fiscal balance in relation to the forecast made in the most likely baseline scenario.

In any case, we must point out that this scenario will not have the same dramatic effects as the recession following the sub prime mortgage crisis. In the case of economic activity, growth will only slow down by around one half of a percentage point in 2010, and by less than one point in 2011. As regards inflation, this will only mean that the rate will be at the lower end of the central bank's tolerance range, and in terms of the exchange rate it will mean a significantly more moderate increase than recorded in 2009.

The decline in the fiscal balance will not represent problems for financing given the aforementioned excess capacity in the Chilean public sector. On the other hand, this scenario will not necessary mean a decline in the balance of payments, because the fall in domestic demand will curb the growth in imports.

However, risks do not only come from abroad and, in fact, the main dilemma facing the economic policy is related to the different cycle that developed and emerging economies are experiencing. Indeed, the imbalance between supply and demand leads us to expect inflationary pressure for the second half of the year and in 2011. However, given the lag in economic policies, in particular the monetary policy, the decisions taken today will have an impact on the performance of economic activity and inflation for several quarters. The ruling out of inflationary pressure that is hatching, and maintaining a heavily expansive monetary policy, would lead to a heating up of the economy and inflationary excesses, the control of which would affect the recovery in economic activity in the coming years.

On the other hand, a rapid increase in the policy rate, against a long pause on main markets, could lead to an excessive appreciation of the peso with a negative impact on net exports and recovery in economic activity. This is the main dilemma facing the current economic policy, and a wrong solution is the main risk in the short- to medium-term.

5. Tables

Table 1

Macroeconomic Forecasts: Annual

	2009	2010	2011
GDP (% y/y)	-1.5	4.8	5.6
Inflation (% y/y, average)	0.4	1.5	2.9
Exchange Rate (vs. USD, average)	559.6	530.0	535.0
Interest Rate (%, average)	2.00	1.50	4.90
Private Consumption (% y/y)	0.9	6.8	5.5
Government Consumption (% y/y)	6.8	4.3	4.2
Investment (% y/y)	-15.3	16.4	16.0
Fiscal Balance (% GDP)	-4.6	-1.6	-0.9
Current Account (% GDP)	2.5	0.2	-3.8

Source: BBVA Research

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