BBVA | RESEARCH

Economic Outlook

Chile

First Quarter 2012
Economic Analysis

- **Slowdown in the world economy.** Economic growth will recover in the second half of 2012, led by emerging economies.
- **We have reduced our forecast for economic growth in Chile in 2012 from 4.5% to 4%,** mainly because of worse external conditions.
- **Inflation will reach 3.1% by the end of 2012;** however, it will converge slowly to the target rate and will only do so towards year end.
- **We do not see much room for significant cuts to the monetary policy rate,** and only expect a 25 bp cut in the first quarter of the year.
- **In the event of a risk scenario arising, Chile is on a sound footing,** with the capacity to conduct expansionary (mainly) monetary and fiscal policies, lessening any impact compared to the preceding recession.

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Closing date: February 10, 2012

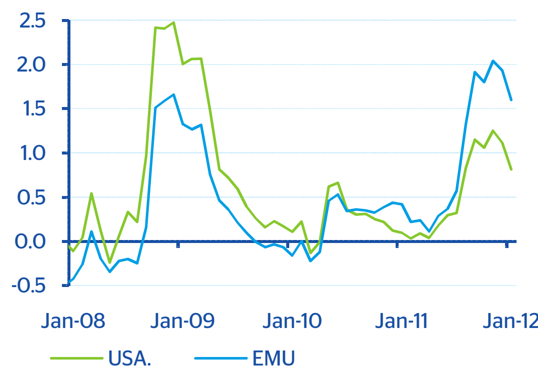
1. Global slowdown and a recession in Europe

The global economy slowed down at the end of 2011, but should rebound in the second half of 2012, led by emerging economies

The global economy decelerated markedly in the last quarters of 2011. This was the result of weaker growth in Europe (already negative in Q4) and a deceleration in emerging economies, to around 1% quarter-on-quarter at the end of 2011, their lowest growth rate since the 2008 crisis. However, the drivers of this deceleration differed. Europe has been feeling the effects of persistently high financial tensions since September (see Chart 1), owing to the lack of major advances to solve the sovereign and financial crisis. On the other hand, the slowdown in emerging economies, in addition to the headwinds from developed economies, is partly the result of previous policy tightening through the first half of 2011 to avoid overheating.

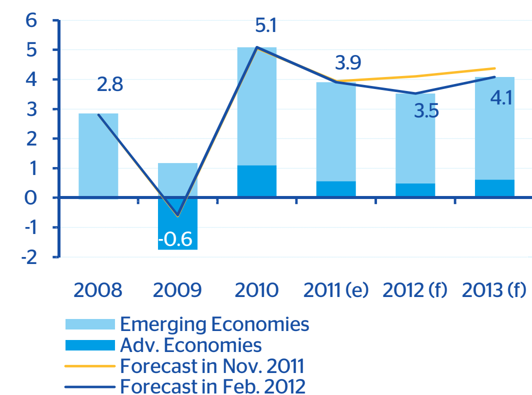
Going forward, decisive action expected by the European authorities should slowly reduce financial tensions and global risk aversion, facilitating a global rebound in the second half of 2012. The biggest contribution to that rebound will nonetheless come from emerging economies, as their policies turn more growth-supportive. At the same time, even though the US will grow more slowly than in previous recoveries, it will decouple from the recession in Europe in the first half of the year. Thus, relative to our previous Global Economic Outlook published in November, we are revising down our forecasts for global growth by 0.6pp in 2012 and 0.3pp in 2013, to 3.5% and 4.1%, respectively (Chart 2).

Gráfico 1
BBVA Financial Stress Index



Source: BBVA Research

Gráfico 2
Global GDP growth (%yoy)



Source: BBVA Research and IMF

The euro area is still the main risk to the global outlook

Even after the downward revision of growth rates in Europe and emerging economies, risks remain titled to the downside. These risks hinge on the evolution of the sovereign-financial crisis in Europe, which continues unabated and can potentially deepen the recession there and spill to other regions through trade links, financial exposures and an increase in risk aversion.

Although there have been some advances since October –mainly the provision of long-term liquidity by the ECB and some agreement towards more fiscal discipline– there needs to be more decisive action on three main lines. First, on the sovereign debt front, concerns about the solvency of Greece need to be addressed by completing the deal with private sector bondholders. At the same time, sizable and credible sovereign firewalls should be erected to

prevent contagion to less liquid countries. Second, macroeconomic reforms should be pushed forward to raise growth prospects, including those aimed at repairing financial institutions' balance sheets, while taking care to avoid a sudden a reduction in credit to the private sector. Finally, further advances in euro area governance are needed to strengthen the monetary union, including a clear roadmap to a fiscal union.

In line to these three points, European economic prospects would be greatly improved if the agreed fiscal compact were approved at the national level and convincingly implemented after the March EU summit, together with reforms proposed for peripheral countries to reduce their vulnerabilities and increase long-term growth prospects.

Sustained financial tensions have pushed Europe into recession

Financial tensions in Europe continue at levels higher than after the fall of Lehman Brothers in 2008 (Chart 1). Given this, and together with the effect of fiscal adjustment in peripheral countries, we have revised down our growth projections for Europe, incorporating negative growth at least through the first half of 2012, and -0.5% for the year as a whole, with a slow rebound in 2013. It is important to note that these projections depend on a fast resolution of the crisis and a notable reduction of financial stress. The divergence in performance between the core and the periphery in Europe will continue to be wide, partly because of the large fiscal adjustment in the latter.

Contrary to Europe, the US will show resilience in 2012, as in the second half of 2011. Our forecast remains unchanged from 3 months ago, at 2.3% in 2012 and 2.2% in 2013. However, the recovery is weaker than typical post-recession cycles, and is influenced by the risks from Europe as well as the domestic risk of policy uncertainty, including a possible fiscal tightening in 2013 (as tax cuts expire and automatic spending cuts are implemented). In addition, weak housing conditions, tight credit markets and ongoing deleveraging will create headwinds to consumption spending.

Emerging economies are heading for a soft landing

In contrast to the aftermath of the fall of Lehman Brothers in 2008, confidence has remained resilient in emerging economies, including in Asia as described below. This has allowed domestic demand in emerging economies to hold up well, even as some of the effects of increased global risk aversion are felt in financial markets through lower capital inflows, tighter trade finance, and reduced asset prices.

The slowdown in emerging economies during 2011 meant that their growth gap relative to advanced economies was close to 3 percentage points at the end of 2011, somewhat below the historical 4 percentage points since the beginning of the 2000's. We expect global risk aversion to remain high, but ease slowly in the second half of 2012, in line with the expected gradual reduction of tensions in Europe. In addition, economic policies will turn more growth supportive, in contrast with the tightening experienced in the first part of 2011. This will sustain domestic demand in the face of external headwinds from weakness in demand from developed countries. In this context, emerging economies are expected to recover growth rates close to 2% quarter-on-quarter at the end of 2012 (from 1% at end-2011), and grow 6.2% for the year as a whole. The main exception to this good performance will be in emerging markets in Europe, due to their closer trade and financial links to the euro area.

2. Chile: continuing slowdown towards sustainable growth

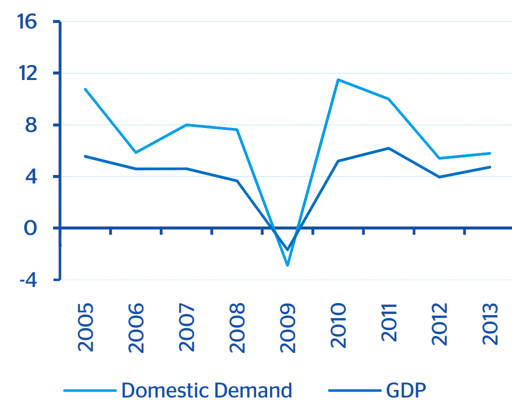
Growth will slow as a result of the deterioration in the external scenario

As we anticipated, due to the weak basis for comparison in 2010 and the withdrawal of the monetary and fiscal stimuli, the rate of economic growth declined throughout 2011. Growth peaked in the first quarter (9.9% y/y), having fallen to just 4.3% y/y in the last quarter, with the average growth rate for 2011 as a whole being 6.3% y/y. However, despite these marked differences in annual comparisons, when we look at quarter-on-quarter changes we can appreciate a slight slowdown in growth and a convergence of GDP growth towards the potential growth rate of Chile's economy, which we estimate to be around 4.8% y/y.

Nevertheless, this convergence masks some important aspects of the form that growth has taken recently. Firstly, there is an imbalance between GDP and domestic demand; this is a relatively recent phenomena, as before the international financial turmoil these two elements were in relative balance. Over recent years, we have seen a major difference in the speed of growth of GDP and domestic demand, and this has resulted in a gap between the two (Chart 3). In 2011, despite a decrease in the difference between these two growth rates, growth in domestic demand at 10% was still substantially higher than the estimated 6.3% growth in GDP. In line with this, we have noted a gradual deterioration in the balance of payments current account; this can only be partly explained by the lower price of copper over the last year.

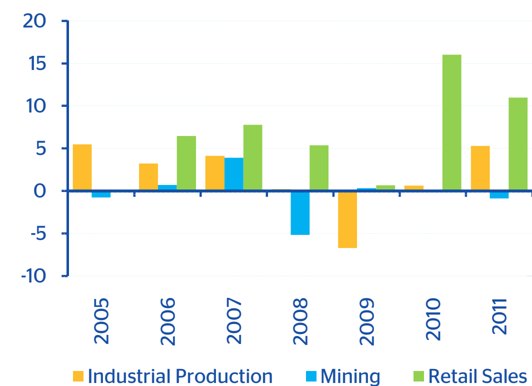
This growth in production has mainly been due to retail sales sector, whilst sectors more linked to the supply side, such as mining and industry have lagged; this was particularly true for mining throughout the whole of 2011, and for industry in the last quarter (Chart 4).

Gráfico 3
GDP and domestic demand (% y/y change)



Source: Central Bank of Chile (CBC) and BBVA Research

Gráfico 4
Economic sectors (% y/y change)



Source: National Institute of Statistics (NIS)

We have reduced our forecast for 2012 growth from the 4.5% we forecast in our previous Economic Outlook in November to 4.0%. This adjustment is mainly due to less promising external conditions, and is similar to the estimated slowdown for Chile's main trading partners. We are also forecasting a more rapid slowdown in domestic demand than previously estimated, with growth reducing to 4.5% compared to our 4Q11 forecast of 5.2%. In terms of the components of domestic demand, we expect some slowdown in consumption due to stabilization in labor market conditions and a degree of worsening in consumer confidence indicators. Information on major investment projects also supports this view of a reduced pace of gross capital formation, whilst it is expected that government spending will continue at its current rate of growth. On the other hand, the negative impact of foreign demand will reduce due to a greater deceleration in imports than in exports.

At the sector level, we expect retail sector to continue to be the one with the biggest impact on growth. We also expect a rebound in construction, mainly in the residential sector, and consolidation of the recovery in the industrial sector; this will affect the food and drink subsector (particularly the salmon industry), the pulp industry and construction materials.

The almost full employment levels seen at the end of 2011 will be a determining factor in the slowdown in the creation of jobs expected in 2012. We expect an average growth rate of 1.8% in employment -mainly in salaried jobs- which is very similar to the increase in the workforce, resulting in the average unemployment rate remaining at 7.2% in 2012.

Credit will continue to grow at the same rate as a result of domestic demand and the labor market

We forecast nominal credit growth of 14% for total credit in 2012, similar to growth of 13.9% reached in 2011. By components, we expect an increase in corporate lending of 13.8% in average this year, whilst consumer loans will keep its pace, to grow at 16% in average. There will be a rebound in mortgage lending, in accordance with the favorable outlook for residential investment.

3. Inflation will converge on the target rate only towards the end of 2012

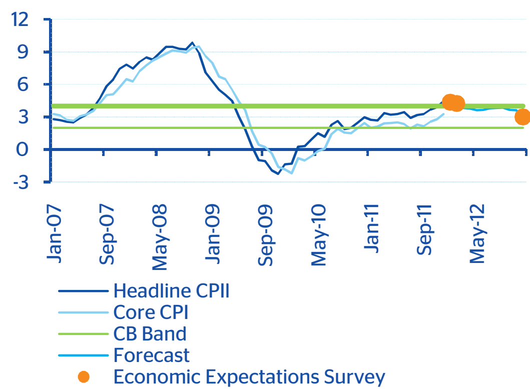
Inflation stood at 4.4% at the end of 2011, substantially above our October forecast of 3.6%, and even more in excess of market forecasts, the consensus of analysts and even the Central Bank's predictions. There were significant one-off factors behind this surprise. In particular, there were important seasonal effects on agricultural goods as a result of the drought caused by La Niña; there was also unexpected depreciation of the exchange rate, which had an impact on the performance of tradable goods, particularly fuel. However, we should not minimize the amplifying effect that could have been caused by lack of spare capacity and the continuing gap between domestic demand and supply.

On this issue, we are not as optimistic as the majority of our peers about rapid convergence towards the target inflation rate. We forecast that even by the end of the year, the 12-month rate will still be slightly above 3%, and that even in the third quarter it will still be around the ceiling of the Central Bank's target band. Inflationary pressures will persist due to tightness in both the market for goods and the labor market, and due to knock-on effects from higher inflation over recent months (Chart 5).

The labor market saw a high rate of job creation in 2011, bringing the unemployment rate down to 6.6% at the year end, which is equivalent to an annual average rate of 7.2%, close to our estimate of full employment for the economy. Against this background, wages reached an annual growth of 6.3% in nominal terms, 1.8% in real terms. The tight labor market therefore continues to be a risk factor for inflation, both at the level of costs and due to its impact on private consumption (Chart 6).

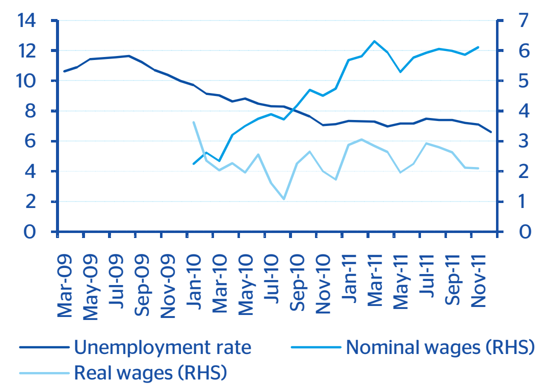
With regard to the output gap, it is important to note that an increase in economic activity at around the potential level will result in the gap not becoming negative as some expect; neither will this result in rapid elimination of the gap between GDP and domestic demand. In order for inflation to converge on its target rate, the moderation in the growth of demand needs to be consolidated; the exchange rate should remain below $500 per dollar; and there needs to be a degree of stability in fuel prices on the international markets. As a result, convergence is likely to take place around the end of the year, and this will be helped by the very high basis for comparison of figures for the last quarter of 2011.

Gráfico 5
Headline and core inflation (y/y % change)



Source: CBC, NIS and BBVA Research

Gráfico 6
Labor market indicators (y/y % change)



Source: NIS

4. Room for monetary adjustment will be constrained by dynamic demand and a closing of gaps

The deterioration in the external economic outlook resulting from uncertainty over the European debt crisis, together with lower growth forecasts for the various regions, and the impact that these will have on the local economy, resulted in the Central Bank correcting its 2012 growth forecast downward in its December Monetary Policy Report by ½ percentage point to a range of 3.75-4.75%, with downside bias. Likewise, it has also adjusted its inflation forecast downwards from 2.9% to 2.7%, with balanced risk bias, and it has defined an expansionary path for monetary policy in the short term.

As a result, there were two alternatives for monetary policy: to implement preventive cuts or wait and see. The risk of a preventive cuts strategy was that conditions would turn out to be less negative than expected, meaning that the Bank would have to reverse the direction of monetary policy in the very short term. The second option, whilst appearing less risky, would mean more drastic cuts to the policy rate. In the end, the Central Bank opted for a "middle-way" alternative, with a preventive reduction of 25 bp in January, but without explicitly mentioning the expansionary bias, as had previously occurred before the start of an easing cycle.

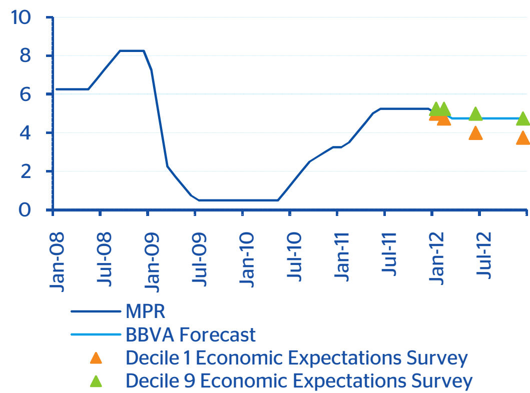
However, whilst the external situation has deteriorated and the domestic economy has slowed down-in line with the high basis for comparison and the withdrawal of fiscal and monetary stimuli- domestic demand indicators continue to be robust. This means that, against a background of growth at around potential levels, the gap between this and GDP will gradually reduce, reducing the scope for reductions in the policy rate.

As a result, we expect a further preventive cut in the monetary policy rate in the first quarter of the year to 4.75%, followed by a return to more normal levels once more developed economies return to the path of recovery and emerging economies pick up speed (Chart 7).

Whilst we do not see any room for significant cuts in the policy rate, the market has been subject to liquidity problems which have led the Central Bank to intervene in the money markets. The tightness of liquidity at the end of December was an example of how market expectations can lead to situations of stress that require a rapid response from the monetary authorities. In

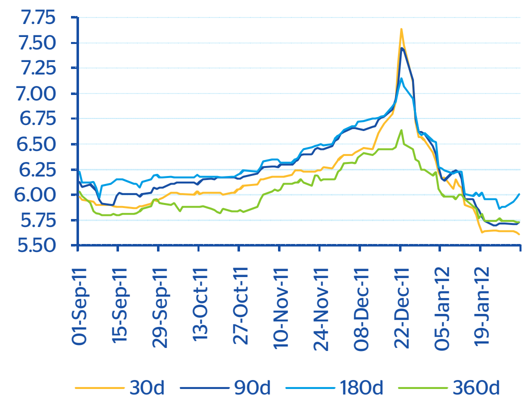
the most likely scenario, these events will not recur; however, it is clear that the Central Bank has additional tools available for reestablishing normality in local markets (Chart 8).

Gráfico 7
Monetary Policy Rate (%)



Source: CBC and BBVA Research

Gráfico 8
Money market interest rates (%)



Source: Banking and Financial Institutions Association

With regard to its exchange rate policy, the Central Bank ended its program of accumulating reserves in December, having purchased US$12,000 million since January 2011. As a result of the turbulence in foreign markets, this did not have the impact on the peso-dollar exchange rate that might have been expected. However, the recent rally in commodities markets -particularly copper, which is currently trading at around US$3.8 per pound- has taken the exchange rate to levels close to $480 per dollar. This level is not a turnaround point for exchange rate policy, as the real exchange rate remains above levels that have triggered intervention in the past. Although we cannot rule out copper prices remaining high, we estimate that long-term fundamentals point to a lower level; this would reverse the appreciation pressures on the exchange rate.

5. The fiscal situation still has room for improvement in 2012

In 2011, the actual fiscal balance was in surplus by 1.4% of GDP, whilst the structural balance was in deficit by 1.0% of GDP. Both of these figures are somewhat more positive than our previous forecasts; this is mainly explained by government underspending by 1% (compared to the adjusted budget at the start of the year) and higher revenues generated by economic activity in the year. Government spending increased at a real annual rate of 3.2%, which is lower than the government itself forecast in October. However, the overall better budget performance last year is mainly explained by the 11.5% real increase in revenues.

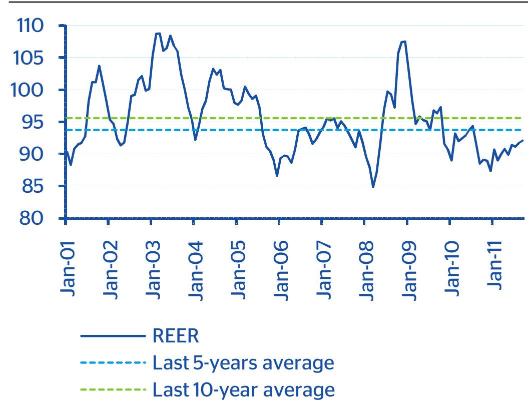
If there is a similar underspend in 2012 to that in 2011, there will be a real increase in public expenditure of 6%, bringing the budget very closely to balance (-0.1% of GDP), whilst the structural deficit would increase again to 1.4% of GDP. We consider that an underspend of 2-3% of the budget would achieve two objectives: it would keep the ratio of public expenditure to GDP within current levels and the structural deficit at around 1%, as in 2011. This would appear to be somewhat unambitious, as before the 2009 financial turmoil the ratio of public spending to GDP was around 20%, and the structural budget was more or less in balance.

However, one noteworthy aspect is that sovereign wealth funds have recovered as a result of the high copper price and the high levels of activity: at the end of 2011, the Economic and Social Stabilization Fund had accumulated around US$13,200 million, whilst the funds available to the

Treasury were around US$10,600 million. Leaving aside the Reserve Pension Fund (US$4,400 million), the amounts available to address any further turmoil amount to US$23,800 million, around US$800 million more than in 2008. Nevertheless, as a large part of the fiscal stimulus applied during the 2009 crisis has not been withdrawn, this should lead to a more cautious fiscal policy response to any further external shocks.

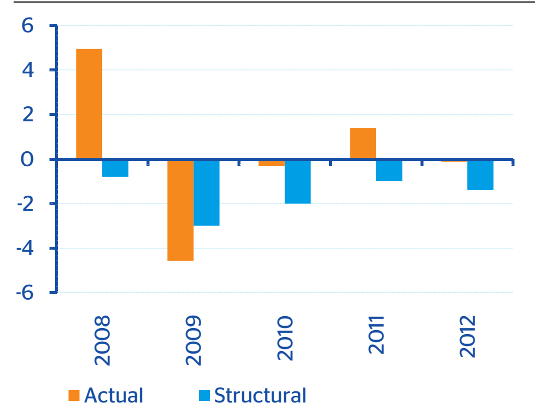
The government has maintained its objective of achieving a structural deficit of 1% of GDP by 2014, which means that real expenditure should converge at a growth rate relatively lower than that of GDP. However, in such a scenario, expenditure would still account for around 24% of nominal GDP (28% in real terms); a more ambitious fiscal target would be to reduce the combined effects of the 2009 fiscal stimulus plan and maintain the structural deficit of recent years. This would lead to lower pressure on exchange rates -where such pressure continues to be latent- and longer-term interest rates, as a result of the lower debt requirements that such adjustments would entail (charts 9 and 10).

Gráfico 9
Real effective exchange rate (1986=100)



Source: CBC

Gráfico 10
Fiscal balance (% of GDP)



Source: Budget Department and BBVA Research

6. There is downside bias in external risks, and latent internal risks remain

There continues to be downside risks due to the continuing debt crisis in Europe and its effects on global growth and on Chile

The risk scenario continues to be one of a disorderly outcome to the European debt crisis, with effects on growth and contagion of other economies in both the developed and emerging regions, as a result of commercial links, financial risks and an increase in global risk aversion.

Against such a background, there would be falls in the prices of the main commodities; copper would fall to around US$2.3 per pound in the short and medium term. This would result in a major adjustment to the terms of trade, having a contractionary effect on domestic demand, resulting in lower economic growth of, on average, 2.8% over 2012 and 2013 (1.6 percentage points below our base case scenario). Whilst foreign trade accounts would improve due to reduced expansion of demand in the short term, the current account deficit would increase in future as a result of the persistence of lower copper prices. In terms of inflation, lower demand pressures would more than offset the depreciation in the exchange rate that we would expect in this scenario, which would peak at $650 per dollar. Inflation would average 2.3% over 2012 and 2013 (1 percentage point lower than our base case scenario).

Unlike 2008-2009, an increase in global risk aversion would have a more limited effect on the economy, which would be better prepared due to the slower development of the crisis and what has been learnt from the previous episode. In addition to this, the monetary policy rate is close to its neutral level, and there are available public sector funds amounting to US$23,800 million (10% of GDP) together with US$40,000 million (17% of GDP) in international reserves; this means that the government would have tools available to offset the effects of any external deterioration. In this context, the monetary policy response would take the policy rate to a level of around 3%, resulting in the real rate falling, despite lower inflation. Whilst still being expansionary, the fiscal policy response would be more limited than in 2009, with a stimulus plan of around 1% of GDP. This would accord with the assessment that even if such resources are available, they should be preserved to comply with the fiscal rule over the medium and longer term.

Inflationary risk remains latent

In a scenario where there is an orderly exit from the European debt crisis, the deterioration in external conditions -resulting from trade links, financial risks and increased global risk aversion- should gradually improve. In such a context, with higher commodity prices and better financial conditions, domestic expectations could result in a scenario in which domestic demand does not slow down, creating additional inflationary pressures; this would result in a need for a contractionary adjustments to monetary policy.

Moreover, we cannot discount the risk of increased pressure on public expenditure, in the midst of increasing social demands as we saw in 2011, in the context of low approval ratings for the government. This could result in the government spending a higher proportion of the 2012 budget and commitments to higher future expenditure. Whilst such a scenario would not have a significant effect on growth, it could incubate additional inflationary pressures and delay convergence towards a balanced structural budget.

7. Tables

Table 1
Previsiones macroeconómicas anuales

	2009	2010	2011	2012	2013
GDP (% y/y)	-1.7	5.2	6.3	4.0	4.7
Inflation (% y/y, eop)	-1.4	3.0	4.4	3.1	3.0
Exchange Rate (vs. USD, eop)	502	475	517	489	508
Interest Rate (%, eop)	0.5	3.3	5.3	4.8	5.3
Private Consumption (% y/y)	0.9	10.4	9.0	4.5	4.9
Government Consumption (% y/y)	7.5	3.3	4.0	4.9	4.7
Investment (% y/y)	-15.9	18.8	15.7	8.0	8.3
Fiscal Balance (% GDP)	-4.6	-0.3	1.4	-0.1	-0.5
Current Account (% GDP)	1.6	1.9	-1.9	-2.3	-2.6

Source: BBVA Research

Table 2
Macroeconomic forecast annual

	GDP (% y/y)	Inflation (% y/y, eop)	Exchange Rate (vs. USD, eop)	Interest Rate (%, eop)
Q1 10	1.7	0.3	523	0.50
Q2 10	6.4	1.2	537	1.00
Q3 10	6.8	1.9	494	2.50
Q4 10	5.9	3.0	475	3.25
Q1 11	9.9	3.4	480	4.00
Q2 11	6.6	3.4	469	5.25
Q3 11	4.7	3.3	484	5.25
Q4 11	4.3	4.4	517	5.25
Q1 12	4.1	3.8	473	4.75
Q2 12	3.8	3.7	482	4.75
Q3 12	4.0	3.9	485	4.75
Q4 12	4.1	3.1	489	4.75
Q1 13	4.6	3.0	494	4.75
Q2 13	4.6	2.9	499	4.75
Q3 13	4.8	2.8	504	5.00
Q4 13	4.9	3.0	508	5.25

Source: BBVA Research

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