Economic Outlook

Chile

Third Quarter 2011
Economic Analysis

- **Strong global growth in the outlook** with politically-driven downside risks..
- **In Chile, we have revised up our growth forecast from 6.2% to 6.5% in 2011, and from 5.1% to 4.7% in 2012.** The 2011 adjustment is the result of the stronger than expected economy in the first half of the year, as expected moderation in the second half is unchanged.
- **Inflation is expected to reach 4.1% in 2011, slightly below our previous estimate of 4.3%, but with the balance of risks in equilibrium** rather than with an upward bias, and convergence to the target towards the end of 2012.
- **The monetary policy rate will be closing its cycle of rises,** although we still expect two increases of 25 bps over the rest of the year, to take the rate to its neutral level of 5.75%.
- **The main risk is a deterioration of the situation in the European periphery,** with adverse effects on growth, although less so than in the last crisis. In this scenario, the balance of payments would also deteriorate.

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Closing date: August 3, 2011

1. Politics at the center of the global economic outlook

The global economy will continue growing strongly, after a soft patch in the first semester

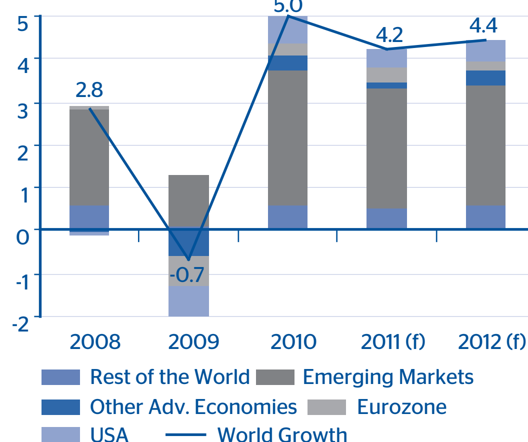
The global economy experienced a mild slowdown in the first half of the year, more pronounced in the US, but also in some emerging countries. Nevertheless, as the factors behind the slowdown are mostly temporary in nature (high oil prices, supply chain disruptions from Japan and bad weather), global growth is set to continue at a robust pace, at 4.2% in 2011 and 4.4% in 2012 (Chart 1).

However, risks to the outlook are now more tilted to the downside. Although the slowdown in activity in the US should be temporary as oil prices stop climbing and international supply chains are restored, the recovery is still weak and may be prone to relapses, as expected in the aftermath of a financial crisis with highly leveraged consumers. The recent soft patch in the US has reminded markets of that, and may dent consumer and producers sentiment going forward.

Both in Europe and the US, fiscal concerns pose big challenges for policymakers. As solvency concerns have not been fully addressed, the sovereign debt crisis in peripheral Europe intensified (Chart 2), with the risk of it becoming systemic as market pressure spreads beyond Greece, Portugal and Ireland to Spain, Italy and could eventually claim Belgium. Although its solvency is not being put in doubt, the US also faces the challenge of a large near-term fiscal adjustment, with the risk that political negotiations turn just to short-term fixes but not to a long-term consolidation plan. This would increase the chances of a sudden spike in long-term yields in the US.

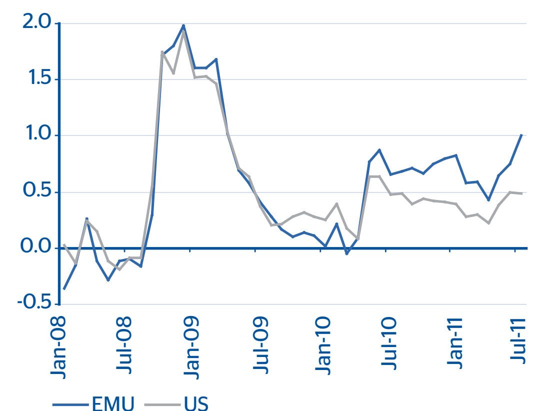
Finally, in emerging economies, overheating concerns have eased slightly as tightening measures continue to ease growth gradually in Asia and Latin America, although fiscal policies still remain mostly accommodative, thus overburdening monetary authorities, at a time when concerns over the appreciation of exchange rates in these economies remain.

Chart 1
Global GDP growth and contributions



Source: BBVA Research y FMI

Chart 2
BBVA Financial Stress Index



Source: BBVA Research

It is high time to address solvency concerns in Europe, and that requires continued bold actions from EU politicians

In recent weeks a new round of financial market stress in Europe has extended to Spain and Italy, and thus has increased the chances of the crisis becoming systemic in all Europe (with spillovers beyond the EU). This was the result of the delay in providing a second package to Greece and the insistence that private bondholders should bear part of the cost of further financial aid to that country, together with the lack of a comprehensive solution to underlying solvency concerns in Greece. This lack of resolve in Greece spilled over countries with no solvency problems such as Spain and Italy, and as a consequence to the European financial sector, which quickly saw their liquidity dry up.

In this context, with so much at stake, the Eurogroup agreed on July 21 to deal with liquidity and solvency concerns. For, the former, it decided to improve the EFSF by allowing it to lend preemptively to solvent countries in distress –much like the Flexible Credit Line from the IMF– and to buy sovereign bonds in secondary markets. Regarding solvency, it softened the conditions of official loans to Greece (also extended to other program countries) and reached an agreement with the private sector for a reduction of net present value of their holdings of Greek debt by 21%, through debt swaps and buy-backs.

These have surely been big –and, in some cases, unexpected– steps in the right direction towards solving the financial crisis in Europe. But Europe is not out of the woods, and that has been reflected in only a moderated reduction in risk premia in peripheral countries. Apart from filling in the technical details of the July 21 agreements, there are still four main lines of action. First, the EFSF should be expanded and pre-financed. Second, Europe needs to work towards a closer fiscal union, ending with the introduction of Eurobonds, together with fiscal rules and tight control of national budgets. Third, economic reforms should continue. Fourth, EU authorities should finally decide how they will bring Greece's debt to a sustainable level and end solvency concerns. Until these four steps are taken, Europe will be confronted with elevated sovereign spreads (not just for peripheral Europe) and a bigger debt restructuring down the road. In the meantime, Europe will continue to be subject to "accidents" due to reform fatigue or bailout fatigue leading to a disorderly debt restructuring, which could have a global impact.

Fiscal consolidation in the US also focuses the attention on politics

In the US, the political haggling between two opposite (and highly polarized) approaches to deficit reduction has added much noise, but so far has not increased market pressure on US rates. This reflected the belief that a solution to raising the debt ceiling would be found and default averted. But an accord to raise the debt ceiling without a plan for long term fiscal consolidation will not address long-term sustainability concerns. Here the risk also lies –as in Europe– in the temptation to kick the can down the road, postpone a solution after the 2012 elections and increase the chances of a spike in long-term interest rates.

Politics also holds the key to the outlook in many countries in Latin America

To a lesser extent, in Latin America, many countries also face uncertainty derived from the future course of politics. In some cases this is derived from perceived weakness by some governments as they are saddled by corruption charges or by massive protests. In other cases, it is the result of recent changes in governments or the uncertainty about the outcome of upcoming elections. Although it is true that the election cycle in the region has had less influence on the economic cycle in the last decade, it is crucial that this capital is not wasted by wide policy swings straying from continuing economic reforms.

Overheating concerns ease slightly in many emerging economies, but global risks and currency appreciation might turn policy tightening more cautious

Emerging economies continue to show risks of overheating, although as a whole they have receded somewhat given ongoing tightening measures and headwinds (in Asia) from higher commodity prices and the earthquake in Japan. Importantly, risks of a hard landing in China were reduced as Q2 growth showed only a slight deceleration, still on track for a soft landing. However, inflation in emerging economies remains a concern, and there is the risk of policymakers falling behind the curve, in some cases as they remain cautious about the global environment and in other cases as they worry about excessive currency appreciation.

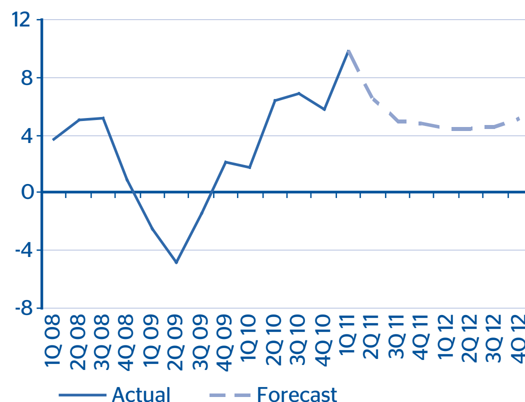
2. Chile: Continued strength with slight signs of slowdown

Economic growth has remained robust in the second quarter of the year, with an average expansion close to 8.5% y/y over the first five months. The main driver continues to be domestic demand, though it is showing signs of slackening

Growth in the second quarter continued the strong expansion of activity observed in the first quarter, although it showed signs of a slight quarterly slowdown in the last month, despite the positive effect of low basis of comparison.

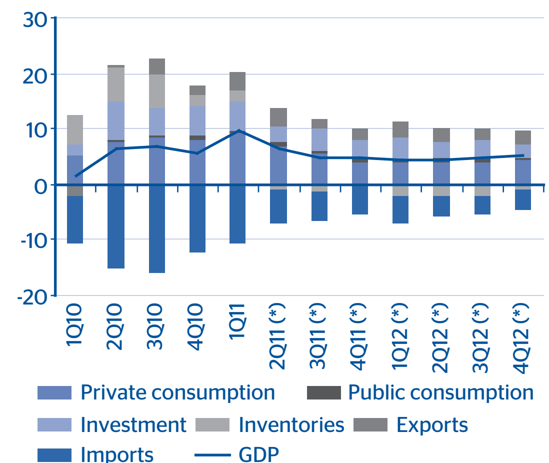
Thus with growth of 9.8% y/y in the first quarter, economic figures for the second quarter indicate that growth will be close to 8% y/y in the first half of the year. Given this greater than expected strength, we have corrected upward the forecast growth from 6.2% to 6.5% for the year. However, the expected slowdown to potential output growth and the vanishing of capacity gaps determines a downward correction in expected expansion for 2012 from 5.1% to 4.7% y/y (Chart 3).

Chart 3
GDP growth (% y/y change)



Source: BCCh and BBVA Research

Chart 4
Growth by aggregated demand components



* Forecast
Source: BCCh and BBVA Research

With respect to the economic indicators, the monthly index of economic activity (IMACEC) showed a slowdown in the second quarter of the year, which is also observed in the retail sales figures. All this reaffirms expectations of a moderation in economic activity towards the second half of the year, in line with the reduction of capacity gaps in the economy.

In terms of demand components, consumption is expected to slowdown from annual double-digit figures to 5.5% in the last quarter of the year, once the lower monetary stimulus extends across the economy and the slowdown in real wages moderates household spending decisions. As a result of the above, the projected growth in private consumption for 2011 has been corrected upwards to 8.7% from 7.1% y/y, mainly due to the surprise registered in the first quarter of the year and the maintenance of the expected buoyancy for the rest of the year. Investment is forecast to grow at 13.5% y/y in its fixed component, marginally below the previous report, and will maintain its strength over the coming quarters. Prospects for the external sector continue in line with a negative incidence on growth, with exports up 7.1% y/y and imports up 12.7% y/y.

The labor market continues strong, but shows signs of moderation in job creation

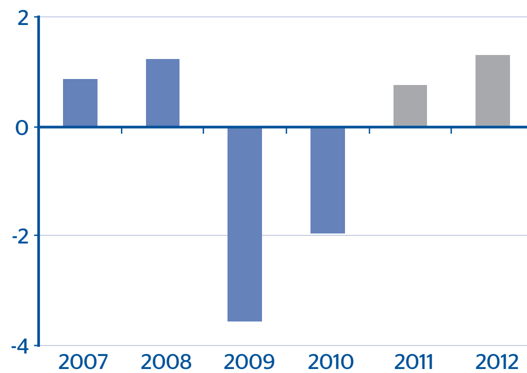
The labor market remained buoyant in recent months, with an unemployment rate of 7.2% in the moving quarter to Jun, but some signs of a slowdown, given lower job creation, though this can be largely explained by seasonal factors. Job creation is expected to continue into the second half of the year, with the average unemployment rate for the year at 7.3%, a fall of 0.8 pp on the figure for 2010, and salaried employment contributing proportionally more than self-employment.

Medium-term inflationary expectations moderate in the face of reduced pressure from international prices, a higher exchange rate and second-round effects in check

Annual inflation to June was 3.4%, and it is expected to close the year at 4.1% (4.3% in our May report). This trend implies a lower accumulated inflation for the second half of this year, which is coherent with a gradual convergence to the Central Bank's 3% long-term target.

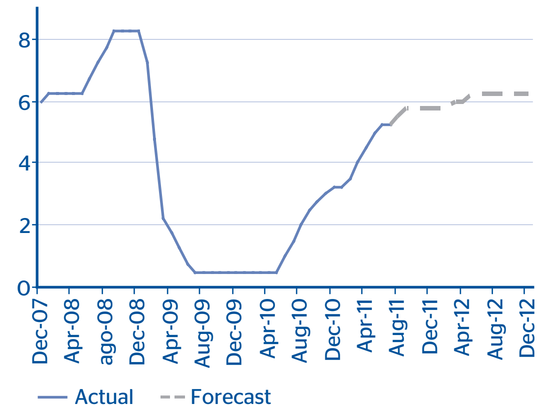
The lower rates of core inflation have helped market expectations return to the target inflation level, while the second round effects of international price increases in the first half of the year have been lower than anticipated. At the same time, the recent movements of these prices shows that although they have remained high, they have lower associated risks of an upturn than those estimated two months ago, so our balance of inflationary risks is at equilibrium in the medium term. The uncertainty regarding the recovery of developed economies, the worsening fiscal situation in Europe and the withdrawal of the monetary stimulus in emerging economies all point to lower risks. However, the output gap will close this year and in fact we estimate that it will be slightly positive in the fourth quarter.

Chart 5
Output gap (% of potential GDP)



Source: INE and BBVA Research

Chart 6
Monetary policy interest rate (%)



Source: BCCh and BBVA Research

In line with the above, both the market consensus and the Central Bank in its June Monetary Policy Report have reduced their inflation forecasts. The Central Bank decided to pause its withdrawal of the monetary stimulus at its monthly meeting in July, after discussing this option for the first time at its June meeting. Thus after five consecutive rises that increased the rate by 200 bps since the close of 2010, Central Bank reduced the increases from 50 bps to 25 bps in June, and then put it on hold. In any event, we expect two increases in the second half of the year to take the rate to its neutral estimated level of 5.75%, although we do not rule out that due to the prevailing uncertainty in external markets the cycle could end at 5.5% (Chart 6).

With respect to the exchange rate, the CLP has remained within a range between $455 and 465 per dollar, and its movements have been linked largely to news from abroad, in particular the movements in copper prices and the risk aversion of investors in developed economies.

The real exchange rate remains at relatively low levels with respect to its historical average, although there has been no significant move from its fundamentals. Thus the conditions of the international economy and the lower effective and anticipated rate of monetary adjustment in Chile have eased some of the pressure on the market. In all, the maintenance of high terms of trade means caution is needed in public expenditure, which in any event has shown low levels of execution in the first half of the year. In this sense, the Ministry of Finance adjusted down its forecast of expenditure growth to 4.6% y/y for 2011, with a fiscal surplus of 1.3% of GDP, which converges towards our base scenario for the year.

In any case, it would be a good idea if this adjustment to more moderate expenditure was announced as an explicit government measure to achieve a structural balance of the fiscal accounts in the medium term. Among other effects, this would ease pressures on the foreign-exchange market, particularly considering the successive announcements of greater resources

for educational reforms (fund for university education), health (cut in the contributions by retired people) and the labor market (extension of the post-natal benefit). The expectations that these measures will actually result in a greater permanent public expenditure is generating upward pressure on the exchange rate in the short term and feeding a downward bias in the core scenario for the peso-dollar exchange rate.

Credit has recovered its growth rate to around 13% in nominal terms to Jun. This is in line with the strength of economic activity, falling unemployment, improved economic prospects and more favorable credit conditions. This behavior is also consistent with the result of the bank credit survey to June this year. The survey shows fewer restrictions for big companies in commercial lending and a significant reduction in the case of SMEs. Conditions have also improved for personal loans, mainly due to lower portfolio risk and more competition in the banking system.

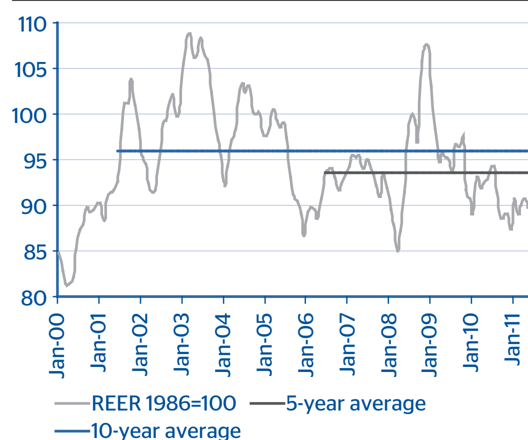
By category, the nominal growth of total lending has been fairly even, with corporate lending growing by 12.3% y/y to Jun and personal loans up 14%, with somewhat greater movement in consumer loans than mortgage loans. For 2011, the forecast points to an expansion of 14.2% for total credit with a growth of 15% in personal loans and 13.7% in corporate loans. In the case of personal loans, the somewhat higher increase in consumer finance over mortgage loans will continue.

With respect to the situation of the banking sector, the Financial Stability Report for the first half of this year prepared by the Central Bank shows that with the recovery of lending last year, the banks are in a good position with respect to provisions in the different categories of lending, and liquidity indicators continue at above their historical average. In addition, the average capital adequacy index for the sector stands at 14% and much of the base capital is made up of high-quality assets.

However, the case of La Polar in early June, after the Board admitted that there had been unilateral renegotiation of non-performing loans and that this involved a recognition of greater provisions than those in the financial statements, raised a note of caution in at least two relevant respects: i) the position of the other actors in the retail market with respect to the formulas for renegotiating loans; and, even more importantly ii) the real level of debt of households who use these kinds of instruments. With respect to the real level of debt, although different economic authorities and regulatory bodies have insisted that there is no systemic risk arising from this case, estimates suggest that close to 4% of households are in a weak credit situation with a debt ratio of 75% of annual income and expenses of 20% above their income.

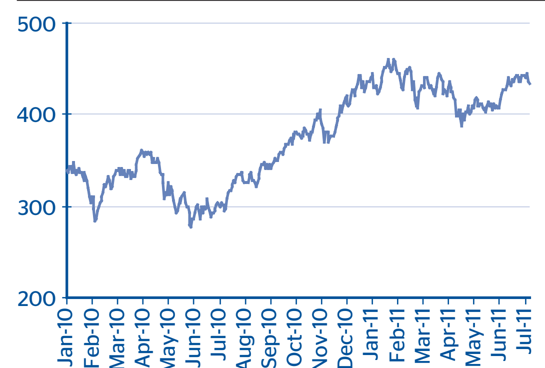
It cannot be ruled out that the case will generate a review of the current regulatory enviroment, with changes being proposed in the regulations. Among them is the idea of reactivating the system of consolidating the debt information that households have with banks and other credit institutions. In addition to this, a national consumer service for financial products (the Sernac Financiero project) is being created, with the idea that its decisions would be mandatory if it ruled against financial services suppliers and voluntary if it ruled against consumers.

Chart 7
Multilateral real exchange rate (CLP/USD)



Source: BCCh and BBVA Research

Chart 8
Copper price (USD cents/ pound)



Source: Cochilco and BBVA Research

With respect to external accounts, the greater strength of demand suggests the need to correct import forecasts to a rise of 12.7% y/y in 2011 (7.7% previous forecast), while exports would increase by 7.1% y/y (5.4% previous forecast). The forecast oil price remains the same as in the previous scenario, while the price of copper has been corrected upwards for this year to US$ 4.13 per pound. All these factors have led us to adjust the expected balance of the current account to 1.1% of GDP in 2011 and 2.0% in 2012, which compares with the forecasts of a slight surplus of 0.2% for 2011 and a deficit of 1.4% for 2012 in the previous report. In the future, a convergence of commodity prices to long-term levels, in particular in the case of copper, will be offset by an expected slowdown in demand and thus of imports. This will maintain the deficit in external accounts at sustainable levels.

On the financial accounts side, we maintain our forecast of a significant increase in foreign direct investment compared with the figure for last year. This rise would be offset by the plan for reserve accumulation announced by the Central Bank at the start of January. Following the major net outflow of portfolio investment in 2010, forecasts now point to a slight net entry, mainly due to the movement of investments abroad held by pension fund administrators. Last year's major outflows as funds took advantage of their return to the international markets will not be repeated this year.

3. Overheating and the fiscal situation as an idiosyncratic risk

Risks of overheating in the economy have moderated, while expectations of increased public expenditure provide signs of concern

Recent figures for economic activity have shown signs of slowdown in 2Q11, which would result in a convergence towards trend levels by the end of this year. However, a note of caution should be included on the labor market and its impact on domestic demand. There is a risk that the slowdown will be less pronounced or even delayed until 2012, with the resulting inflationary pressures, in particular through second-round effects.

On the fiscal side, recent public demonstrations have fed growing pressure for more resources to be spent on higher education, healthcare support and benefits in the labor market. This could generate a scenario of increased fiscal expenditure on items associated with permanent outlays. The only way to guarantee fiscal sustainability would be through reassigning resources, which success would depend on the size of the amounts committed, or on reforms that ensure greater permanent revenues for the state.

4. Financial turmoil in Europe and its impact on Chile

A deterioration in the fiscal situation of European economies would lead to greater risk aversion, lower global growth and a negative impact on commodity prices

As a risk scenario we evaluated the effect of a worsening fiscal situation in peripheral European economies, with contagion towards core European economies at the end of 2011, so its effect is felt in 2012-2013. Although the size of the shock is assumed to be lower than the event suffered at the beginning of 2009, the currencies of the different regions will lose ground against the US dollar as investors search for a safe haven.

In this scenario, the Chilean economy would grow by 3.1% in 2012 and 3.7% in 2013, 1.5 pp less on average than in the baseline scenario. Estimates suggest that private consumption would be weaker and fall by a similar extent as GDP, with an average growth of 4.2% y/y in the two-year period 2012-2013. However, investment would be affected more significantly through the postponement of projects, some of them linked to mining sector. As a result, investment would grow around 2.5% for the same period, far below the estimate in the base scenario. The external sector would be affected through a lower rate of growth in exports, with an average increase of 5.5% for 2012-2013. However, this would be offset by weaker imports, which would grow by an average of 4.5% in the same period, as a result of reduced domestic demand and a weaker local currency. Overall, the greater importance of a fall in copper price for Chile leads to a greater current account deficit in the medium and long term, given that copper price would remain persistently below the level estimated in the baseline scenario.

The exchange rate would be around 15% higher on average than in the base scenario in 2012, but we expect a limited pass-through to headline inflation, given lower domestic demand and the fall in the price of oil. Thus inflation would remain below the Central Bank target of 3.0% in 2012 and 2013.

Although the scenario shows significant effects in the main variables of economic activity and prices, there would be room for a policy reaction by the Central Bank and the government, which would mitigate its impact and reduce the time needed for recovery to the economy's trend levels. Monetary policy would continue along a similar pattern to that observed in 2009, although with a much reduced adjustment. The policy rate would fall to 3.0% in the third quarter of 2012, and remain at that level for a prolonged period. On the fiscal policy side, public expenditure would grow by around 1 pp over the base scenario, and increase by an average of 6.0% y/y in 2012-2013. This would mean a smaller surplus in the fiscal balance in 2012 and a deficit of around 1% of GDP in the following years.

5. Tables

Table 1

Macroeconomic forecast annual

	2009	2010	2011	2012
GDP (% y/y)	-1.7	5.2	6.5	4.7
Inflation (% y/y, eop)	-1.4	3.0	4.1	3.2
Exchange Rate (vs. USD, eop)	502	475	488	508
Interest Rate (%, eop)	0.5	3.3	5.8	6.3
Private Consumption (% y/y)	0.9	10.4	8.7	5.5
Government Consumption (% y/y)	7.5	3.3	4.6	4.9
Investment (% y/y)	-15.9	18.8	13.5	10.1
Fiscal Balance (% GDP)	-4.6	-0.3	0.7	0.6
Current Account (% GDP)	1.4	1.2	-1.1	-2.0

Source: BBVA Research

Table 2

Quarterly macroeconomic forecasts

	GDP (% y/y)	Inflation (% y/y, eop)	Exchange Rate (vs. USD, eop)	Interest Rate (%, eop)
Q1 10	1.7	0.3	523	0.5
Q2 10	6.4	1.2	537	1.0
Q3 10	6.8	1.9	494	2.5
Q4 10	5.8	3.0	475	3.3
Q1 11	9.8	3.4	480	4.0
Q2 11	6.5	3.5	469	5.3
Q3 11	4.9	3.7	477	5.8
Q4 11	4.9	4.1	488	5.8
Q1 12	4.4	3.6	493	6.0
Q2 12	4.5	3.3	497	6.3
Q3 12	4.6	3.0	502	6.3
Q4 12	5.1	3.2	508	6.3

Source: BBVA Research

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