Macro scenario - Chile

September 13, 2024

The cuts must go on

- With Chile facing large electricity price hikes, one-year inflation expectations have risen, yet they remain anchored at the 3.0% target in the relevant two-year outlook. In this context and considering the weakness in domestic economic activity and an imminent Fed easing cycle, we now expect 25-bp rate cuts at the remaining two meetings of the year, which would take the policy rate to 5% (5.5% previously). We see rates reaching 4.5%, the upper bound of the neutral range, during 1H25, with the risks tilted toward additional cuts next year.

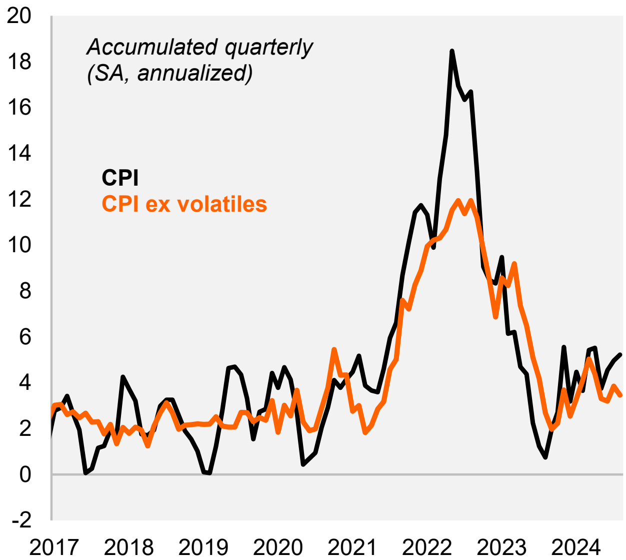
Inflation is up temporarily…

Activity softened more than expected in 2Q24, largely due to weaker private consumption… In contrast, investment stabilized after a notable drop in 2H23. The transmission of monetary policy through the bank lending channel has unfolded as expected, yet credit demand remains weak (particularly the commercial component, which is consistent with weak investment in non-mining sectors). After the weak second quarter, the monthly GDP proxy surprised with a 1% sequential rise from June to July, primarily reflecting a stronger reversion of several transitory factors, resulting in an annual increase of 4.2% YoY.

… as leading indicators suggest that the improvement in economic activity is likely to be limited. The banking system's stock of outstanding real loans fell by 0.56% YoY in July, dropping back into negative territory after being flat in annual terms in June. The fiscal scenario (accumulated nominal deficit of 1.8% of GDP as of July) suggests that spending cuts will be needed through year-end to meet fiscal targets. Imports of capital goods and consumer goods contracted in August by 7.3% and 10.8%, respectively. Non-mining business confidence as measured by the IMCE remained low in August, at 41.9 (50 = neutral). The labor market is showing greater slack, while the global impulse is easing as concerns grow over the strength of the Chinese economy.

Headline inflation rose by 1 pp, to 4.7% YoY, between March and August, largely due to higher energy costs. Electricity prices were adjusted by 7.2% MoM in June and a further 12% in July. We forecast another 15% monthly increase in October. Core inflation (excluding volatiles), however, has been lower, sitting at 3.7%. The prior CLP depreciation and evidence from manufacturing producer prices signal that tradable inflation still has room to rise, currently at 4.3% YoY. At the margin, we estimate that cumulative inflation in the quarter was 5.2% (SA, annualized), up from 4.5% in 2Q24. Meanwhile, core inflation rose by a milder 3.5% (SA, annualized, 3.2% in 2Q24). Soft domestic demand and lower global oil prices support a transitory surge in headline inflation before the resumption of a gradual convergence to the 3% target during 2025. Medium-term inflation expectations have remained anchored to the target, reflecting the incorporation into market expectations of the transitory nature of the shock.

Sequential core pressures are stable



Source: INE, Itaú

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… so rate cuts can continue

The September IPoM considers slightly weaker domestic demand, but with higher short-term inflationary pressures. The transitory nature of the supply shock and a softer activity allow for a more rapid decline in inflation over the two-year policy horizon, which in turn would allow for a somewhat faster policy-rate path toward neutral. The updated policy rate corridor points to additional cuts during 4Q24 (from the current 5.5%) and the neutral range (3.5%-4.5%) being reached during 2Q25. The central bank expects total inflation to rise in the short term, mainly due to volatile components. In the medium term, inflation is now expected to decline more rapidly than was anticipated in June, given the lower inflationary pressures from weaker domestic demand, and the IPoM estimates the convergence to the 3% target occurring during the initial months of 2026.

Regarding the monetary policy strategy, the reduced risk of inflation persisting in the medium term allows for the easing cycle to continue. In the baseline scenario, the path to neutral is swifter than the one outlined in the June IPoM. The average of the 33% confidence interval in the rate corridor is a 4Q24 average rate of 5.27% (vs. 5.51% in June), 4.49% in 2Q25 (5.14% in June) and 4.13% in 4Q25 (4.57% in June). The main risks to the current scenario are in the external environment, in line with geopolitical and financial shocks.

Swifter rate cutting path signaled *(%)*

	IPoM Sep24	IPoM Jun24	Difference
24.II	6.29	6.29	0.00
24.III	5.68	5.59	0.09
24.IV	**5.27**	**5.51**	**-0.24**
25.I	4.82	5.37	-0.55
25.II	4.49	5.14	-0.64
25.III	4.25	4.86	-0.61
25.IV	**4.13**	**4.57**	**-0.44**
26.I	4.04	4.42	-0.38
26.II	4.00	4.32	-0.32
26.III	3.97		

**Average of the 33% Confidence Interval*

Source: BCCh

Fiscal tightening expected

The cumulative fiscal balance fell further in July, stoking the headwinds against the MoF meeting its annual deficit target. The monthly fiscal balance in July reached a deficit of 0.4% of GDP, similar to July 2023. The year-to-date fiscal balance as of the end of July reached -1.8% of GDP (vs. -0.5% YTD as of July 2023), edging closer to the MoF's full-2024 nominal deficit target of 1.9% of GDP. The fiscal balance tends to deteriorate during the fourth quarter of every year – 4Q23 saw a whopping cumulative deficit of 1.2% of GDP – which suggests the MoF would have to implement a massive spending adjustment toward year-end to comply with the deficit target this year.

Current account deficit continues to narrow

The current account balance in 2Q24 came in at a deficit of USD 1.8 billion (2.3% of GDP). The deficit was below the USD 3.5 billion deficit of 2Q23 (but larger than the small surplus in 1Q24), resulting in the rolling-four-quarter CAD falling to 3.1% of GDP (from 3.6%). The narrow CAD in the quarter was supported by a large USD 5.7 billion trade surplus for goods (vs. USD 3.3 billion one year earlier). The CAD was favorably financed, with net FDI coming in at USD 3.6 billion, exceeding the USD 1.8 billion CAD. Overall, the normalization of domestic demand has contributed to a sustainable balance-of-payments scenario.

Forecasts

The surprisingly large July rebound in the monthly GDP proxy refutes the downside bias we had held on our 2.5% GDP growth call for the year. We still see growth slowing to a near-potential 2.1% for next year, as lower borrowing rates partly offset the drags of high average inflation and softening global growth.

We maintain our 4.5% year-end inflation call, but the risks remain tilted to the upside. Lower global oil prices offset upside risks stemming from a larger expected electricity price hike in October. Our forecast for an appreciation of the CLP through 2025 (to 850 pesos per dollar) along with lower oil prices and soft domestic demand support convergence to a 3.3% rate by the end of 2025. A lower oil price scenario supports a larger trade surplus and a narrow CAD next year (from 3.0% to 2.8% of GDP).

The transitory nature of the supply shock is key to permitting the continuation of the rate-cutting cycle. We had expected the board to initiate an evaluation period, holding the policy rate at 5.5% for some time to ensure that the inflation convergence path consolidated before resuming the easing cycle as global financial conditions eased and the domestic shock faded. However, weak domestic demand, well-behaved inflation expectations and more clarity regarding the Fed's imminent easing cycle have prompted us to revise our expectations for the BCCh's policy rate path. Barring significant surprises to the scenario, we believe that the BCCh will continue cutting at a 25-bp pace at each of its remaining meetings this year, taking the policy rate to 5.0% by year-end (we previously expected 5.5%). Pauses could take place if a scenario of global risk aversion is reflected in excess exchange-rate volatility. We see rates reaching 4.5% during 2Q25, with the risks tilted toward further easing. Low interest-rate differentials with the U.S. set a high bar for the BCCh to implement a large reserve accumulation program in the near term (reserves are at roughly 13% of GDP).

Andrés Pérez M.
Vittorio Peretti
Andrea Tellechea Garcia

Chile | Forecasts and Data

	2019	2020	2021	2022	2023	2024F		2025F	
						Current	Previous	Current	Previous
Economic Activity									
Real GDP growth - %	0.6	-6.1	11.3	2.1	0.2	**2.5**	2.5	**2.1**	2.1
Nominal GDP - USD bn	273	254	311	303	332	**314**	314	**356**	356
Population (millions)	19.1	19.5	19.7	19.8	20.0	**20.1**	20.1	**20.2**	20.2
Per Capita GDP - USD	14,312	13,068	15,810	15,294	16,617	**15,657**	15,657	**17,639**	17,639
Unemployment Rate - year avg	7.2	10.8	8.9	7.9	8.7	**8.6**	8.6	**8.4**	8.4
Inflation									
CPI - %	3.0	3.0	7.2	12.8	3.9	**4.5**	4.5	**3.3**	3.3
Interest Rate									
Monetary Policy Rate - eop - %	1.75	0.50	4.00	11.25	8.25	**5.00**	5.50	**4.50**	4.50
Balance of Payments									
CLP / USD - eop	753	711	851	851	879	**930**	930	**850**	850
Trade Balance - USD bn	3.0	18.9	10.3	3.7	15.3	**21.0**	20.0	**17.0**	14.0
Current Account - % GDP	-5.3	-1.9	-7.4	-8.6	-3.6	**-2.5**	-2.7	**-2.8**	-3.0
Foreign Direct Investment - % GDP	5.0	4.5	4.9	6.0	6.6	**6.7**	6.7	**6.5**	6.5
International Reserves - USD bn	40.7	39.2	51.3	39.2	46.3	**46.0**	46.0	**50.0**	50.0
Public Finances									
Primary Balance - % GDP	-1.9	-6.3	-6.9	-1.6	-1.2	**-1.6**	-1.6	**-1.2**	-1.2
Nominal Balance - % GDP	-2.9	-7.3	-7.7	1.1	-2.4	**-2.3**	-2.3	**-2.0**	-2.0
Net Public Debt - % GDP	7.9	13.4	20.2	20.4	23.1	**24.4**	24.4	**26.0**	26.0

Source: IMF, Bloomberg, BCCh, INE, Haver and Itaú

Macro Research – Itaú
Mario Mesquita – Chief Economist

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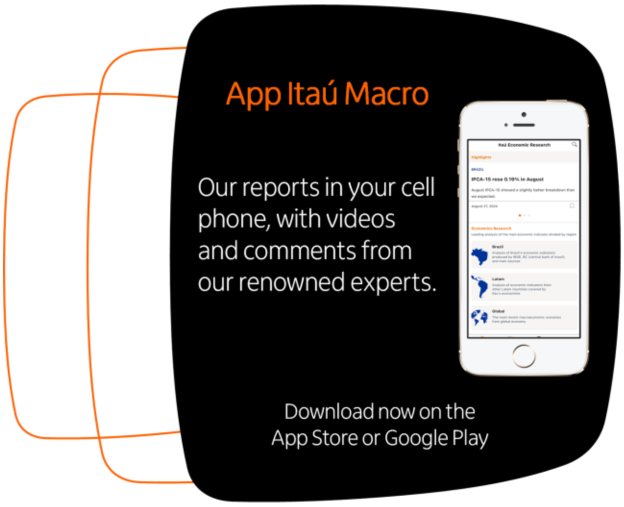

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