Macro scenario - Chile

July 12, 2024

Approaching a pause

- As noted in our earlier reports, we believe that the bulk of the BCCh's easing cycle has already unfolded. The latest forward guidance has led us to change our call to one additional 25-bp cut, to 5.5%, followed by a prolonged pause (previously we saw the policy rate reaching 5.25% before the cycle interruption). An upcoming supply-side price shock, outlined below, and the subsequent spillover should keep inflation well above the 3% target during the forecast horizon. Expectations of a loosening of global financial conditions ahead, once the Fed initiates the easing cycle, suggest a likely resumption of rate cuts during the latter part of 2025 (to 4.5%, the upper bound of the BCCh's nominal neutral range). That said, risks are tilted toward a higher rate path.

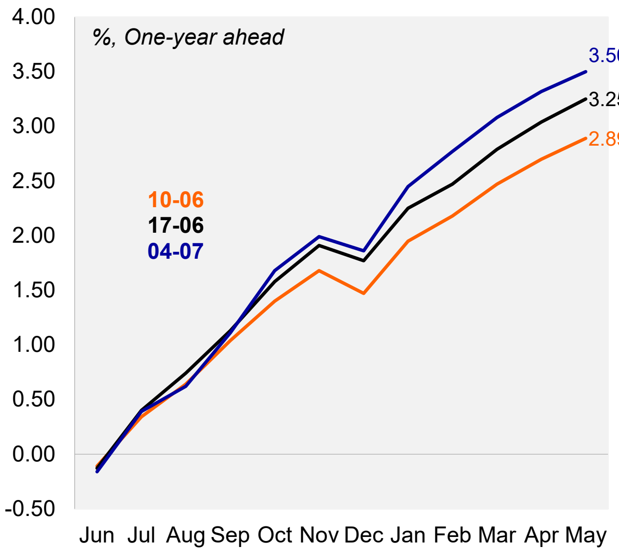
Political pressure from electricity tariffs…

The government plans to expand the coverage of its electricity subsidy. With double-digit increases in electricity tariffs, which had been frozen since 2019, in the pipeline, the Ministry of Energy announced that it will present a bill to Congress to broaden the coverage of subsidies for all vulnerable households. The price stabilization law, approved by Congress in April, includes a temporary subsidy for 40% of the most vulnerable households (15% of the population), with an estimated annual cost of USD 120 million: USD 20 million to be funded by the Treasury and the remainder to be financed through cross subsidies. The new bill is expected to include a proposal to raise the subsidy coverage to all vulnerable households (10 million individuals, around half the population). Financing for the additional subsidies would come from three sources: a green tax surcharge (coal), a public service charge that currently applies only to large-scale electricity consumers, and greater fiscal contribution from VAT resources. The bill should be presented to Congress no later than August 15. The government's new bill follows political and public concerns about the magnitude of the hike in electricity tariffs ahead and may also be a rebuttal of calls for yet another pension fund withdrawal, with the upcoming municipal elections in October.

…and higher inflation

Given the news flow from May (law approval) and June (electricity regulator report), we expect an even bigger increase in electricity tariffs. Earlier this year we incorporated the estimated risks from the adjustment of electricity tariffs, indicating an accumulated CPI effect of 70 bps over our forecast horizon. We now project that the effect will be 50 bps higher. We expect the bulk of the increase to be implemented during 2H24. Because the current subsidy program is targeted and does not directly modify the rate on electricity consumption it will not be considered by INE.

Rising inflation expectations

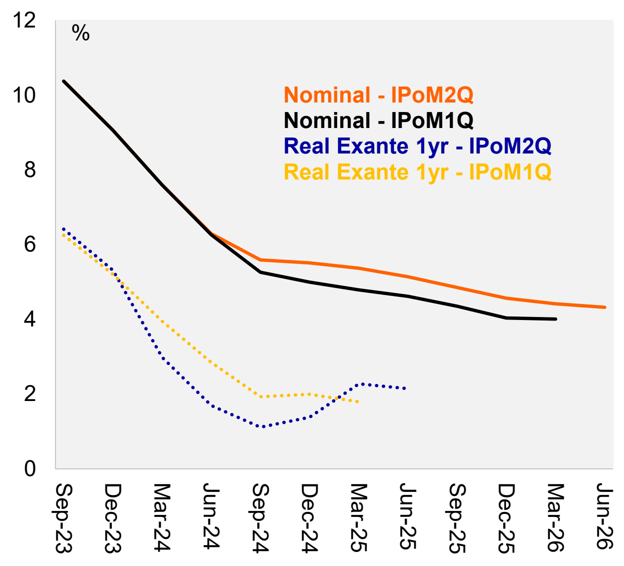


Source: ICAP.

Higher inflation loosens restrictive monetary policy

Signaling a higher nominal policy rate path. The BCCh's updated baseline scenario indicates a nominal rate path somewhat above the March forecast. However, in real terms, the path is less restrictive in the short term (due to higher inflation expectations), but similar in the medium term. The less restrictive monetary policy in the short term supports our view that there is room for the board to be more cautious and pause at a higher nominal rate than previously suggested. The 33% confidence interval now shows an average rate of 5.5% in 4Q24 (from 5% previously) and 4.6% in 4Q25 (vs. 4% previously). Still, the ex-ante one-year rate outlined for 4Q24 now stands at 1.4% (vs. 2% in March), near the upper bound of the real neutral range (0.5%-1.5%), and down by nearly 6pp since it peaked in mid-23. At the June monetary policy meeting, the BCCh's board decided to cut the monetary policy rate by 25 bps to 5.75%, in line with market consensus and our call. The board was split, with Stephanie Griffith-Jones favoring another 50-bp cut. The last divided decision was in January, again arguing for a bigger cut. The minutes signaled the Board will likely cut once more this year.

Higher nominal rate path, but lower real rates



Source: BCCh

Third consecutive sequential activity contraction. After a surprisingly strong 1Q24, activity data for the second quarter was underwhelming. At the margin, the monthly decline of 0.4% (MoM/SA) in May (-0.3% in April) was led by manufacturing, services and commerce. Several indicators support weaker activity dynamics. Commercial loans contracted again in May (by 3.4% YoY in real terms) and capital goods imports fell by 12.1% YoY in 2Q24, suggesting weak short-term investment prospects. In parallel, business confidence as measured by the IMCE fell to 43.78 in June, below the peak of 46.31 in March of this year and beneath neutral (50) since February 2022. Employment growth has moderated at the margin, while the share of informal salaried jobs in new jobs has increased. Softening activity dynamics at the margin pose a downside risk to our call of 2.8% growth for 2024.

Electricity prices start to lift services. Consumer prices fell by 0.1% MoM in June, as Cyber Day sales dragged goods inflation down. Meanwhile, rising electricity prices (from the distribution front) led to an expected 7.2% monthly rise (+16bps). Annual inflation in the reference series rose to 3.8% (3.4% previously). Core inflation fell 0.2% in the month (IPoM: +0.1%), leading to an annual variation of 3.2% (reference series; 3.5% in May). Tradable prices fell 0.2% MoM in June, but the annual tradable variation rose by 0.4pp to 3.2% YoY. The CLP remains roughly 13% weaker than one year ago, supporting upside tradable inflation pressures during 2024. Non-tradables increased 0.3pp to 4.5% (reference series), with services at 4.8% (4.2% previously). At the margin, we estimate that inflation accumulated in the quarter was 4.2% (SA, annualized), down from 5.4% in 1Q24 (but up from 3.3% in 4Q23). Meanwhile, core inflation reached a lower 3.0% (SA, annualized, 4.5% in 1Q24 and 2.6% in 4Q23).

Greater inflation, earlier rate pause

Activity in May, coupled with the performance in recent months, suggests a loss of momentum after a particularly strong start of the year. Holding activity constant at May levels would yield growth of 1.4% this year, down from the estimated 2.4% based on February levels. The intense rainfall in June is likely to boost electricity output (measured in value-added terms) in the month, but the consequent suspension of classes in certain regions is likely to weigh on services activity. We expect the economy to grow by 2.8% this year and 2% in 2025, but the risks are tilted downward. A higher inflation path will also diminish disposable income.

Significant supply shocks, indexation, and passthrough of prior CLP depreciation reaffirm the challenges for the inflation convergence path. Our updated electricity view led to the upward revision of our year-end CPI rate forecasts, to 4.5% for 2024 (up 40 bps) and 3.3% for 2025 (up 20 bps).

With the Fed expected to cut rates later this year, and still elevated copper prices, we continue to expect an exchange rate of CLP 920/USD for YE24. Soft domestic demand (particularly related to investment) and sustained export growth have led to a larger-than-expected trade surplus (3.5% of GDP accumulated during 1H24). We expect the CAD to come in at a smaller 2.7% of GDP this year (vs. 3.6% in 2023).

The rising inflationary pressures suggest that the rate cycle is close to a prolonged pause. We believe that in the context of higher projected inflation, the board will tread carefully, ensuring that inflation expectations for the two-year horizon remain anchored. After bringing the ex-ante real rate closer to neutral, the board has gained more flexibility in future decisions. Our scenario now calls for a pause at a rate of 5.5% this year (+25bps from our June scenario), before resuming a downtrend to 4.5% in 2025. We expect the rate cuts in 2025 to begin later in the year, raising our average rate path in an effort to ensure the inflation convergence path.

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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	**2.8**	2.8	**2.0**	2.0
Nominal GDP - USD bn	273	254	311	303	332	**317**	316	**359**	357
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	**15,786**	15,740	**17,773**	17,653
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**	4.1	**3.3**	3.1
Interest Rate									
Monetary Policy Rate - eop - %	1.75	0.50	4.00	11.25	8.25	**5.50**	5.25	**4.50**	4.50
Balance of Payments									
CLP / USD - eop	753	711	851	851	879	**920**	920	**850**	850
Trade Balance - USD bn	3.0	18.9	10.3	3.7	15.3	**20.0**	18.0	**15.0**	12.0
Current Account - % GDP	-5.3	-1.9	-7.4	-8.6	-3.6	**-2.7**	-3.2	**-2.9**	-3.5
Foreign Direct Investment - % GDP	5.0	4.5	4.9	6.0	6.6	**6.6**	6.6	**6.4**	6.4
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

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