Macro scenario - Chile

June 10, 2024

Fine-tuning

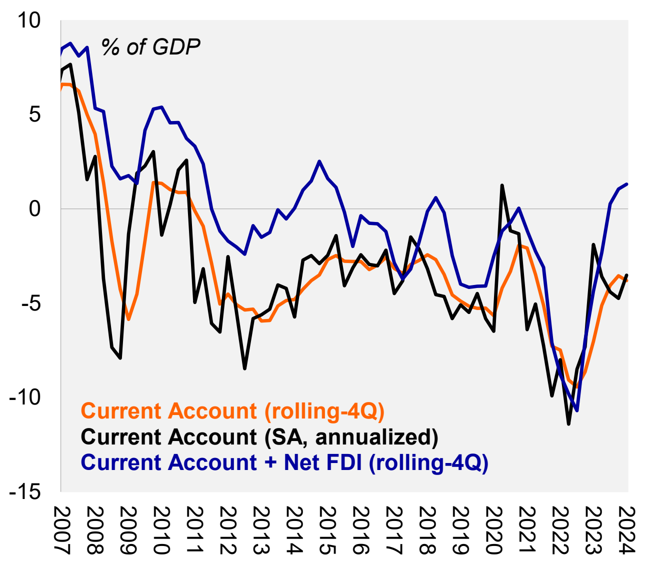
- Consumption remains a key driver of the economic recovery, but a narrow CAD indicates that the economy has rebalanced from prior overheating. Supply factors will challenge the convergence of inflation to the 3% target. Nevertheless, with medium-term inflation expectations anchored and monetary policy still restrictive, further rate cuts ahead are penciled in. The Board trimmed the size of cuts in recent meetings (to 50 bps in May), and we envisage a further reduction to 25 bps ahead, providing the BCCh with additional policy flexibility as it approaches neutral and FFR levels. We expect rates to reach 5.25% this year (currently 6%) and to resume a downward trajectory next year to 4.5%.

Upbeat consumption, narrow CAD

Activity during the first quarter of the year picked up momentum, lifted by consumption. Private consumption rose 4.4% qoq/saar), while gross fixed investment contracted 0.5% qoq/saar, reflecting the decoupling of consumption and investment. In annual terms, the economy rose 2.3% yoy in 1Q24 (0.4% in 4Q24). Overall activity at the start of 2Q24 posted a mild retreat (-0.2% mom/sa), but services continued to advance. Favorable calendar effects also contributed to annual growth of 3.5%. The seasonally adjusted unemployment rate dropped to 8.4% in the April quarter (8.5% in 1Q24; 9% cycle peak in the November quarter). Overall labor-market dynamics, recorded through surveys, point to a gradual recovery. However, complementary information such as the stabilization of job openings at low levels, rising unemployment insurance beneficiaries (up 14% YoY in March), and higher-than-normal layoffs by firms, suggest significant further improvement in the labor market is unlikely. Nevertheless, persistent sequential employment growth, along with real wage growth, has been boosting the wage bill and consolidating a consumption-led recovery.

The current account balance in 1Q24 came in at a historically mild deficit of USD 0.1 billion. The large trade surplus of goods (revised up from monthly tracking) helped keep the current account close to balance. The rolling-four-quarter CAD came in at 3.7% of GDP (3.6% in 2023). The income deficit was elevated, but narrowed from highs in the prior two quarters. The financing breakdown of the CAD remained favorable, with sufficient funding derived from long-term FDI. Improvement in Chile's balance of payments, driven by the normalization of domestic demand, lowers the CLP's vulnerability to external shocks in the context of narrowing interest-rate differentials with the U.S.

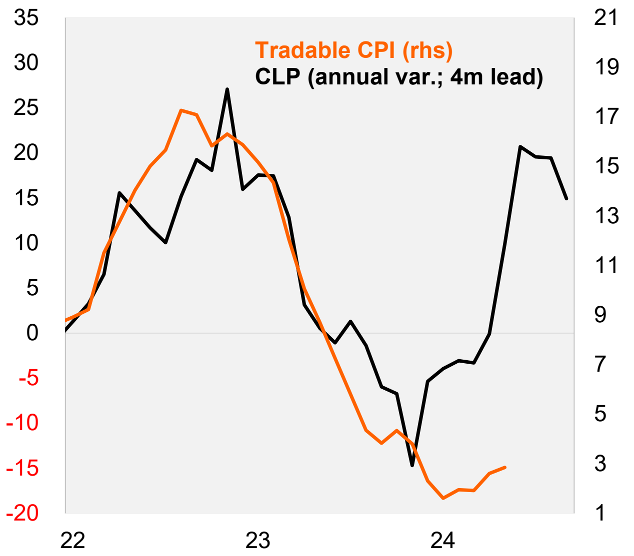
A sustainable CAD



Source: BCCh, Itaú

Tradable inflation continued to gradually tick up, while services CPI gradually edges down (in line with an output gap that is near closed). Headline inflation increased 0.3% mom in May, resulting in annual inflation dropping 0.1pp to 3.4% in the reference series. Core inflation rose 0.4% in the month, leading to a stable annual variation of 3.5% (reference series). Tradables increased 0.4% mom, corresponding to a 2.9% YoY increase in the reference series, up 0.3pp from April. Separately, energy prices rose 1.1pp from April to 8.8% YoY. Non-tradables increased by a milder 0.1% MoM, leading to a yearly rate of 4.2% (reference series; down 0.6pp from April), with services down 0.5pp to 4.2%. At the margin, we estimate that inflation accumulated in the quarter was 4.2% (SA, annualized), down from 5.2% in 1Q24 (but up from 3.2% in 4Q23). Meanwhile, core inflation reached 3.3% (SA, annualized, 4.5% in 1Q24 and 2.8% in 4Q23). While the appreciation of the CLP since April, amid higher copper prices, may provide some relief to tradable price pressures, one-off adjustments stemming from expected electricity price increases during 2H24 should keep inflation elevated.

Despite CLP appreciation, tradable inflation pressures persist



Source: INE, BCCh

In its May monetary policy meeting, the BCCh unanimously cut the policy rate by 50 bps to 6.0%, in line with our call, market pricing, and consensus. With the cut, the BCCh has lowered the policy rate by a total of 525 bps since beginning the cycle in July 2023, leading the easing cycles in the region and among EMs. The one-year real ex-ante rate fell to 2.8%, gradually edging closer to the ceiling of the BCCh's neutral real rate range (0.5%-1.5%). **The meeting statement recognized that the policy rate will continue to decline, yet maintained the data-dependent guidance, including the usual policy flexibility reference with regard to decision-making ahead.** The Board has signaled a preference to take rates to neutral. Global financial conditions will likely be the key to how fast and close to neutral rates may get this year as the nominal levels near the FFR.

The minutes of the BCCh's 1H24 Financial Policy Meeting show the Board assessed risks to be in line with or lower than in the previous meeting. As a result, the Board maintained the counter-cyclical capital buffer (CCyB) at 0.5% of RWAs (to be implemented by the end of May 2024). The bulk of the risks were seen stemming from the external scenario, considering that stable or rising short-term rates abroad could trigger an abrupt adjustment in stretched valuations, leading to rising spreads for EMs. One Board member believed Chile was more sensitive to external shocks than in the past, and thereby fiscal consolidation was key to rebuild buffers. The BCCh reaffirmed the importance of continuing to deepen the policy framework of the CCyB, including the definition of a neutral level this year.

Regarding public finance, April's fiscal data did not change our view of the short-term stress in Chile's fiscal accounts. Revenues continue to improve, yet were below the mark in the tax season, while spending growth roared back after the slowdown seen in March. Higher-than-projected copper revenues from above-budget spot prices should yield some relief ahead, while spending will have to be reeled in to meet the official forecasts. The year-to-date fiscal balance is now 0.01% of GDP (1.3% YTD as of April 2023). The MoF's 2024 nominal (structural) fiscal balance forecast is 1.9% (2.2%) of GDP, implying a moderate fiscal consolidation from the 2.4% of GDP and 2.7% of GDP nominal and structural deficits in 2023. Gross public debt had reached 40.7% of GDP by the end of 1Q24, and the MoF projects a drop to 40.6% of GDP by the end of 2024.

Data dependent cuts during the final mile

Activity data continues to reflect the divergence between investment and consumption dynamics. Lower average inflation and falling interest rates with a growing wage bill will support the consumption rebound. Mining is also projected to recover this year, following several years of operational challenges. The economy is also supported by favorable growth in major trading partners and positive terms of trade shifts. However, even though copper prices remain high, investment is unlikely to jump materially in the near term, as issues related to the length and outcome of the environmental approval processes persist. In any case, the stronger-than-expected start to the year led us to revise our GDP growth call upward by 40 bps, to 2.8% (0.2% last year).

While the gradual recovery of domestic demand should support imports ahead, the upwardly revised copper-price scenario will lead to a CAD narrowing this year. Tight monetary policy has succeeded in correcting Chile's external imbalances from prior highs of a CAD nearing 10% of GDP. We see a CAD of 3.2% of GDP this year, 0.6 pp below the prior call (3.6% in 2023). While recent CLP dynamics have been mainly driven by interest-rate differentials, the copper-price surge has boosted financial flows towards Chile. Our upwardly revised copper price still implies a decline in copper prices from current spot levels. We continue to see a year-end CLP rate of 920 per U.S. dollar.

Inflation-to-date print reaffirms the challenges of inflation convergence to the 3% target, amid significant supply shocks and indexation. Looking ahead, further supply pressures stemming from expected electricity price increases will keep inflation elevated. We expect a year-end CPI rate of 4.1%. Our scenario incorporates an accumulated electricity price increase of around 20%, but risks lean towards an increase of double the magnitude (adding a further half a percentage point to our call). The recent appreciation of the CLP, amid elevated copper prices, may provide some relief to tradable price pressures.

The BCCh has much less room left to get to neutral (around 4% nominal), and the main risk we see going forward continues to be the external scenario, especially heightened geopolitical tensions and market jitters related to Fed repricing. The May communique signals, in our view, that we cannot rule out a consecutive 50-bp cut if favorable CLP dynamics persist and global financial conditions ease ahead of the next meeting. We continue to envisage a year-end rate of 5.25%. During 2025, as the Fed embarks on policy easing, we see the BCCh resuming its cutting cycle and taking the policy rate to 4.5% (the upper bound of the 3.5%-4.5% neutral range). Overall, we believe global developments will be the key as to whether the BCCh may lower rates even further or pause above our 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**	2.4	**2.0**	2.0
Nominal GDP - USD bn	273	254	311	303	332	**316**	315	**357**	355
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	**15,740**	15,679	**17,653**	17,584
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	**4.1**	4.1	**3.1**	3.1
Interest Rate									
Monetary Policy Rate - eop - %	1.75	0.50	4.00	11.25	8.25	**5.25**	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	**18.0**	12.0	**12.0**	7.5
Current Account - % GDP	-5.3	-1.9	-7.4	-8.6	-3.6	**-3.2**	-3.8	**-3.5**	-4.0
Foreign Direct Investment - % GDP	5.0	4.5	4.9	6.0	6.6	**6.6**	5.7	**6.4**	5.1
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**	24.5	**26.0**	26.0

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

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