Recent developments and perspectives for LATAM: How has Chile done in the last year?

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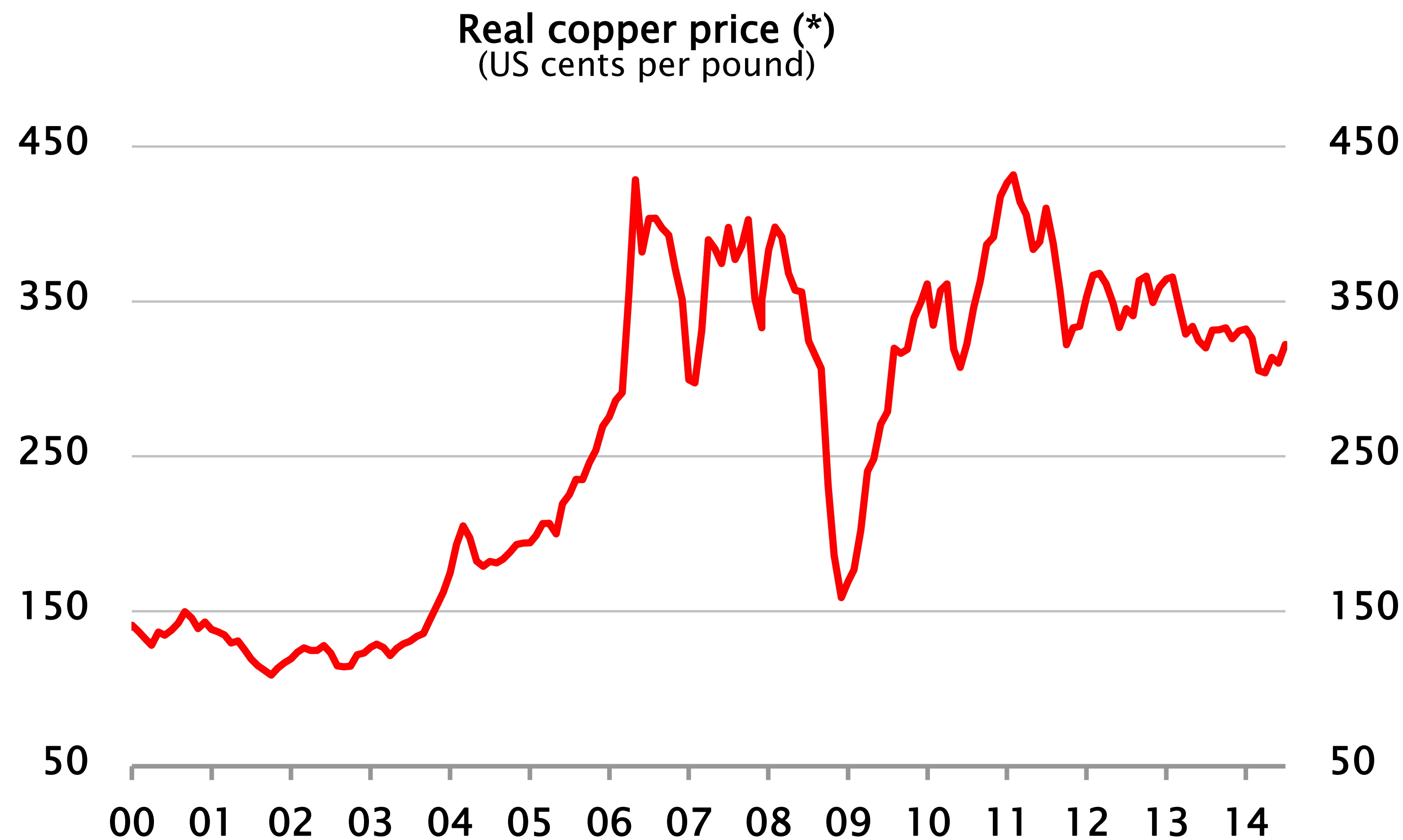
Contents

Three main issues:

- The Chilean Economic Cycle has been driven by the Investment boom associated to the long period of high commodity prices.
- The direct effect of the beginning of “The Tapering” has been different in the case of Chile than in most of the region.
- The slowdown has been deeper than what we expected.

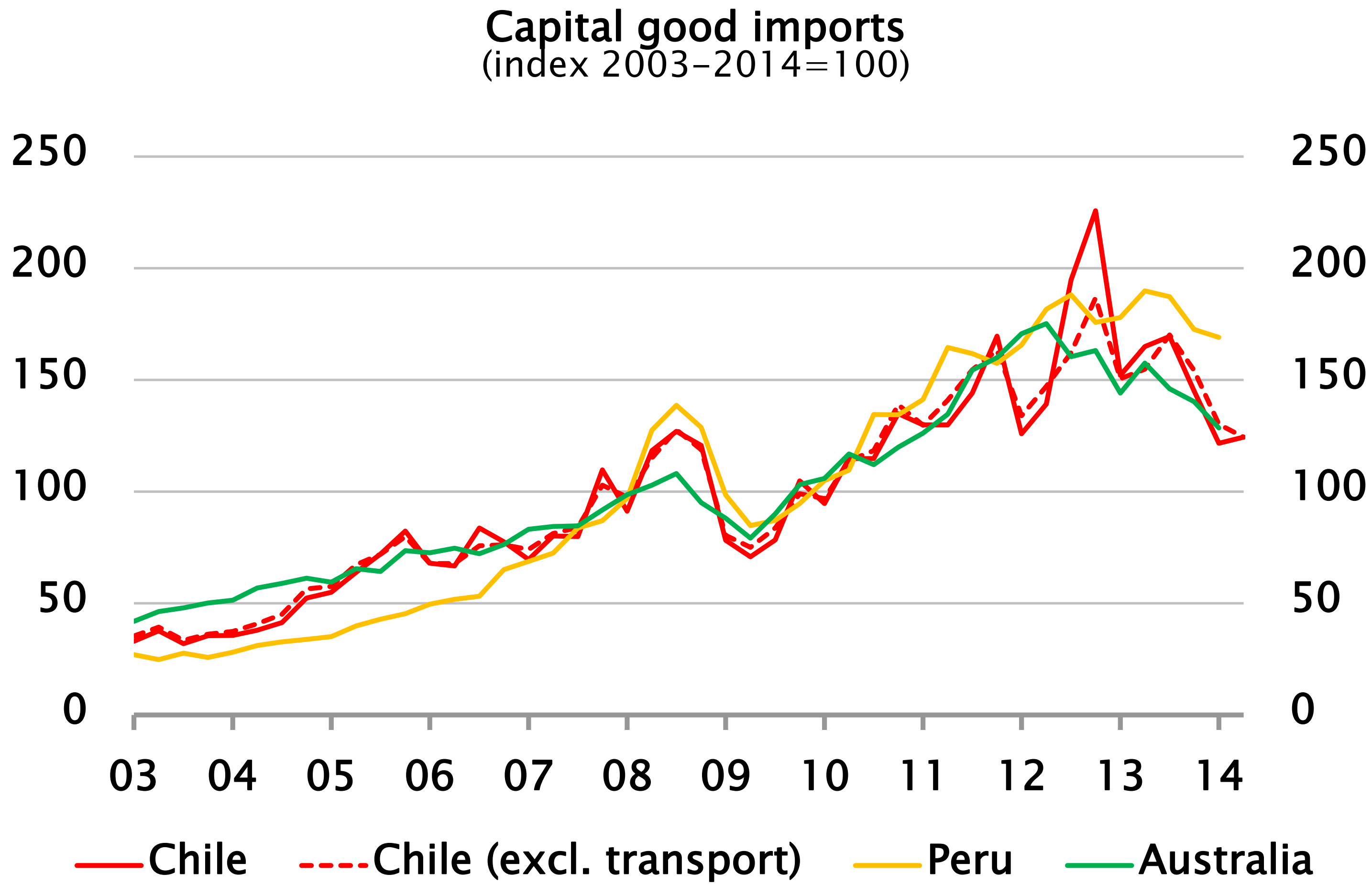
The copper price cycle and the Chilean Economy

The recent high copper price cycle has been the longest in a century (if we disregard the short – lived adjustment in 2009)



(*) London Metal Exchange price deflated by the US metal PPI.
Sources: Bloomberg and Cochilco.

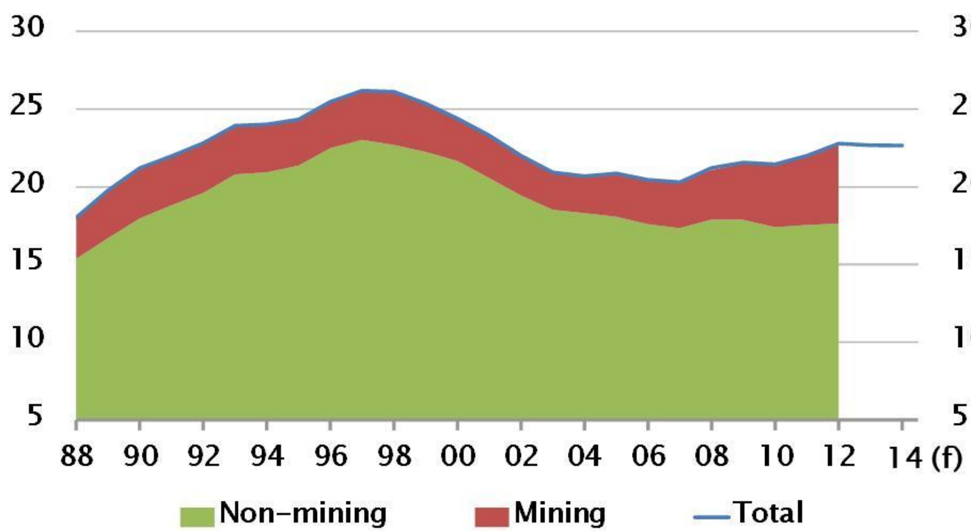
As consequence investment (specially FDI boomed) as in most mineral exporting countries, boosting capital imports…



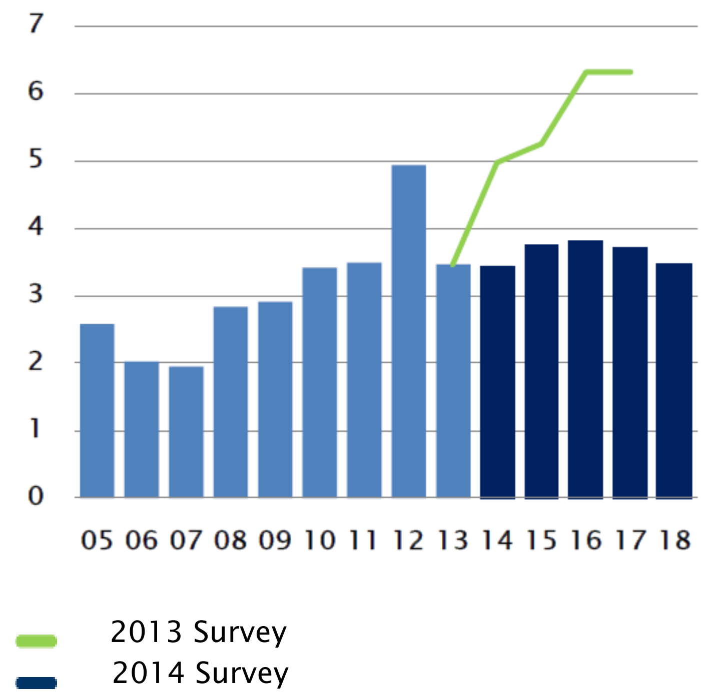
Source: Central Bank of each countries.

As prices began to adjust, while production costs climbed (in Chile and other producers as well) investment has came down affecting investment.

Gross Fixed Capital Formation
(percent of GDP, accumulated in 5 years)



Actual and Projected Investment in Mining
(percent of GDP)

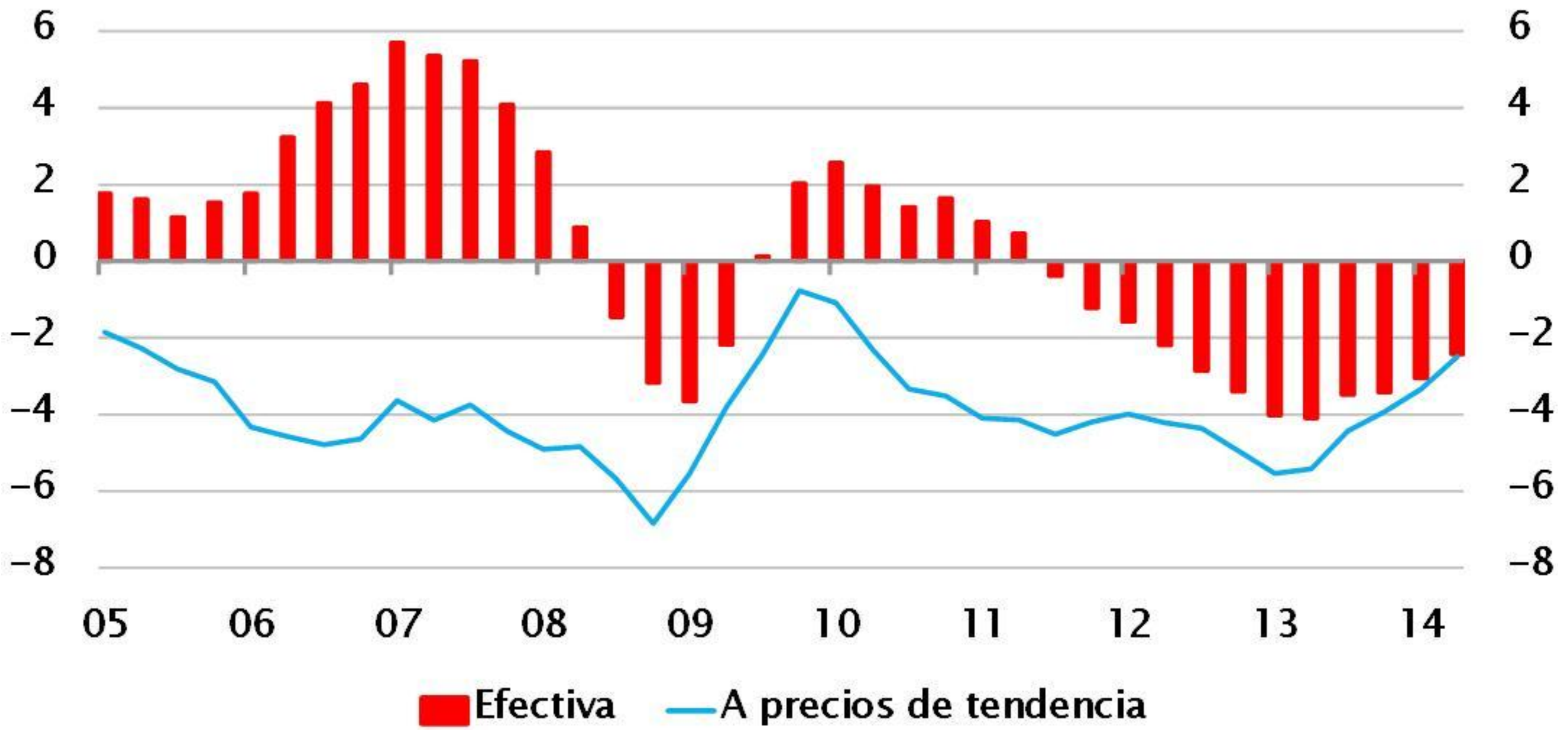


Source: Central Bank of Chile.

Source: Cochilco

As the copper price comes down, the Current Account deficit computed at trend prices and the nominal one have converged

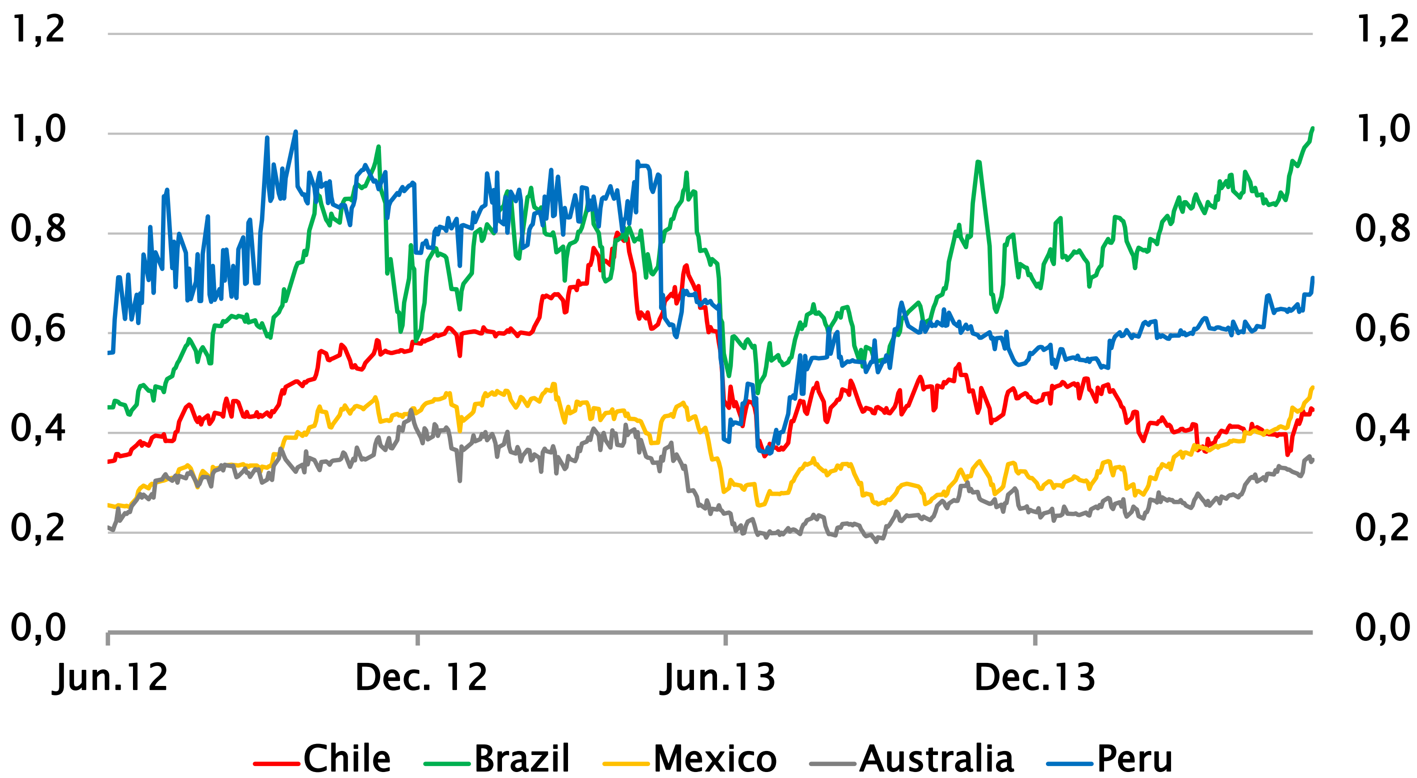
Current account
(percent of GDP)



(*) Considers long-term prices of US$2.85 per pound of copper and US$85 per barrel of oil are assumed.
Source: Central Bank of Chile.

Free floating and FX volatility has helped reduce incentives for arbitrage in Chile during this cycle

Carry to risk ratio for selected countries



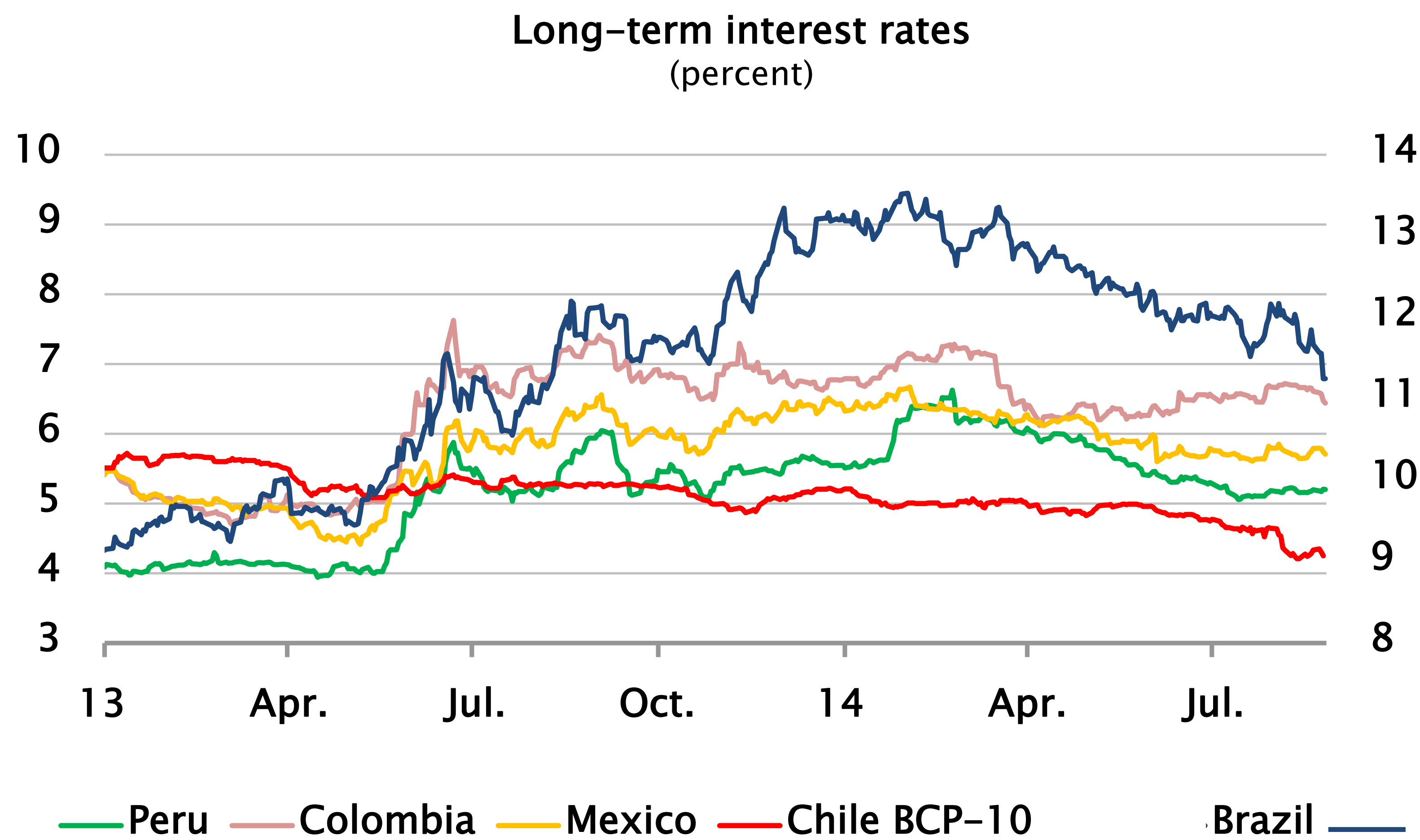
$$Carry\ to\ risk\ ratio = \frac{i^{active}_{3\ months} - i^{passive}_{3\ months}}{options\_implicit\_volatility\_3months\ active/passive}$$

i_{active}: 3 month deposit rate in local currency.
$i_{passive}$: 3 month deposit rate in USD.

Source: Bloomberg.

The impact of “The Tapering”

At the beginning of the US tapering and in the first months of 2014 emerging markets were particularly stressed. Long-term interest rates rose, but the impact on Chile's interest rates has been negligible.

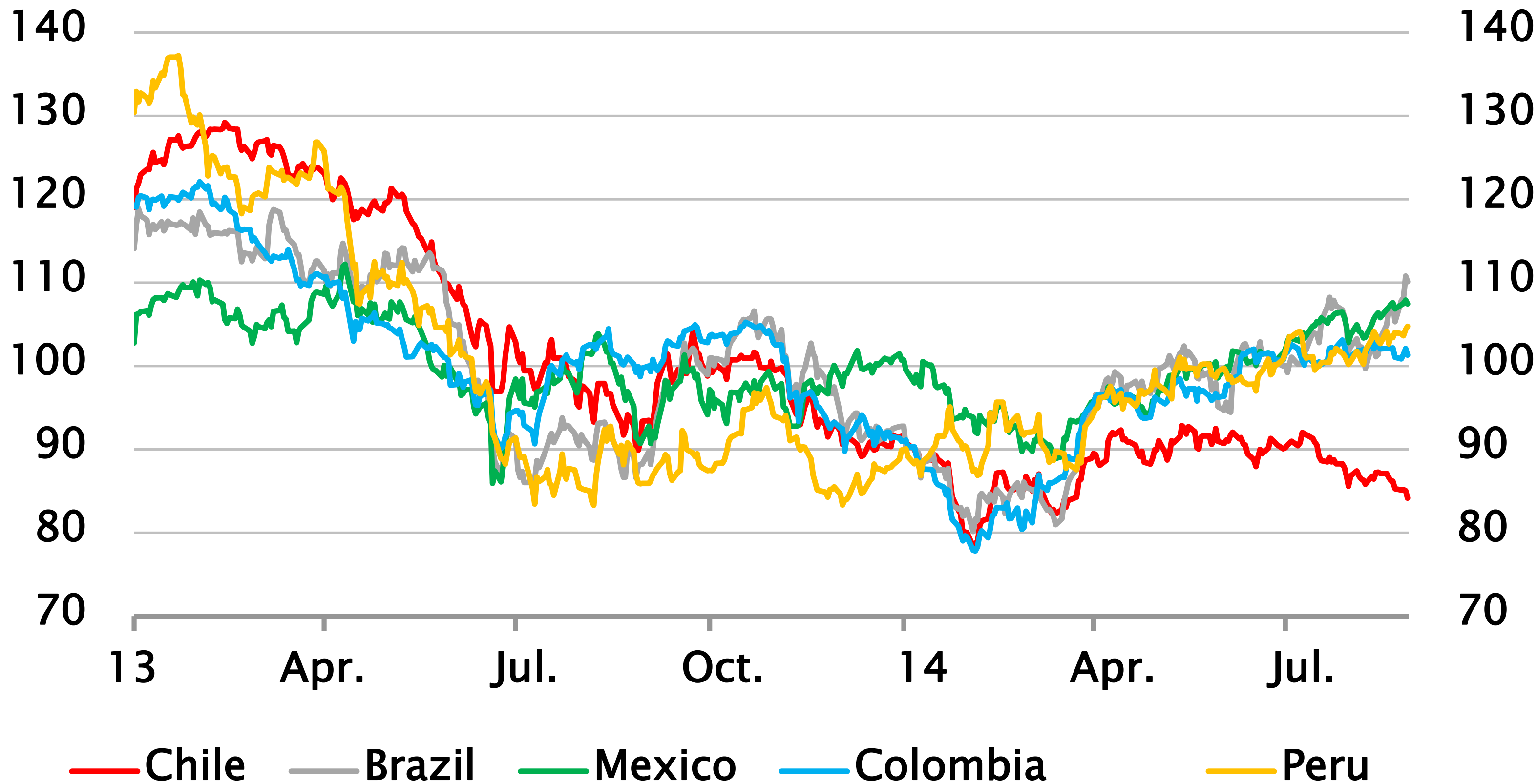


Sources: Bloomberg and Central Bank of Chile.

The initial impact of the “Tapering” shock on stock prices was not different from the rest of the region. However, Chile’s stock prices missed most of the recovery this year.

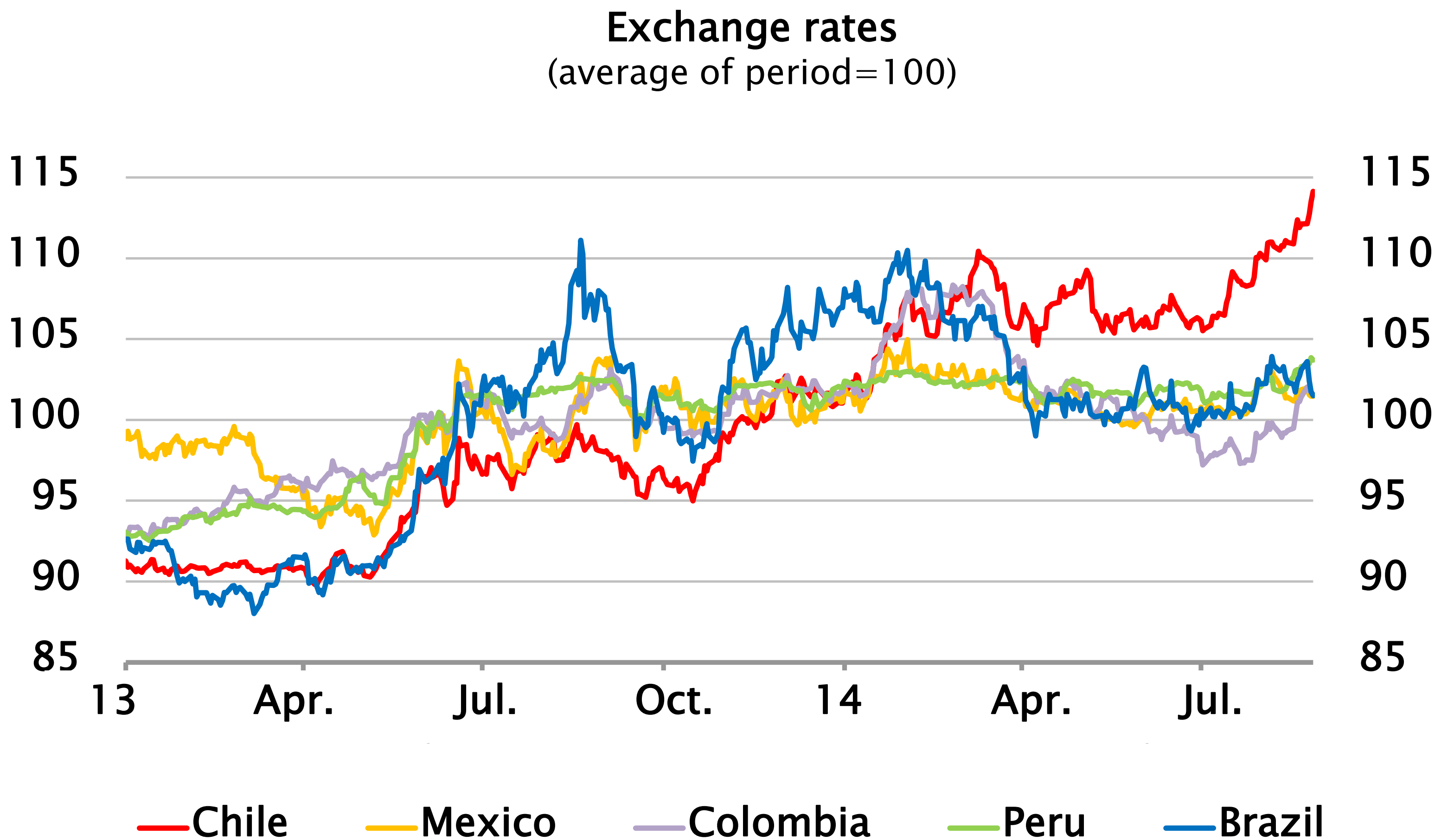
Stock markets (*)

(index 02/01/2013 – 28/08/2014 = 100)



(*) Considers MSCI index in US dollars.
Source: Bloomberg.

And the impact on the Exchange Rate has been the largest in the region. But this is also due in part to the reductions in interest rate by the Central Bank (MPR).

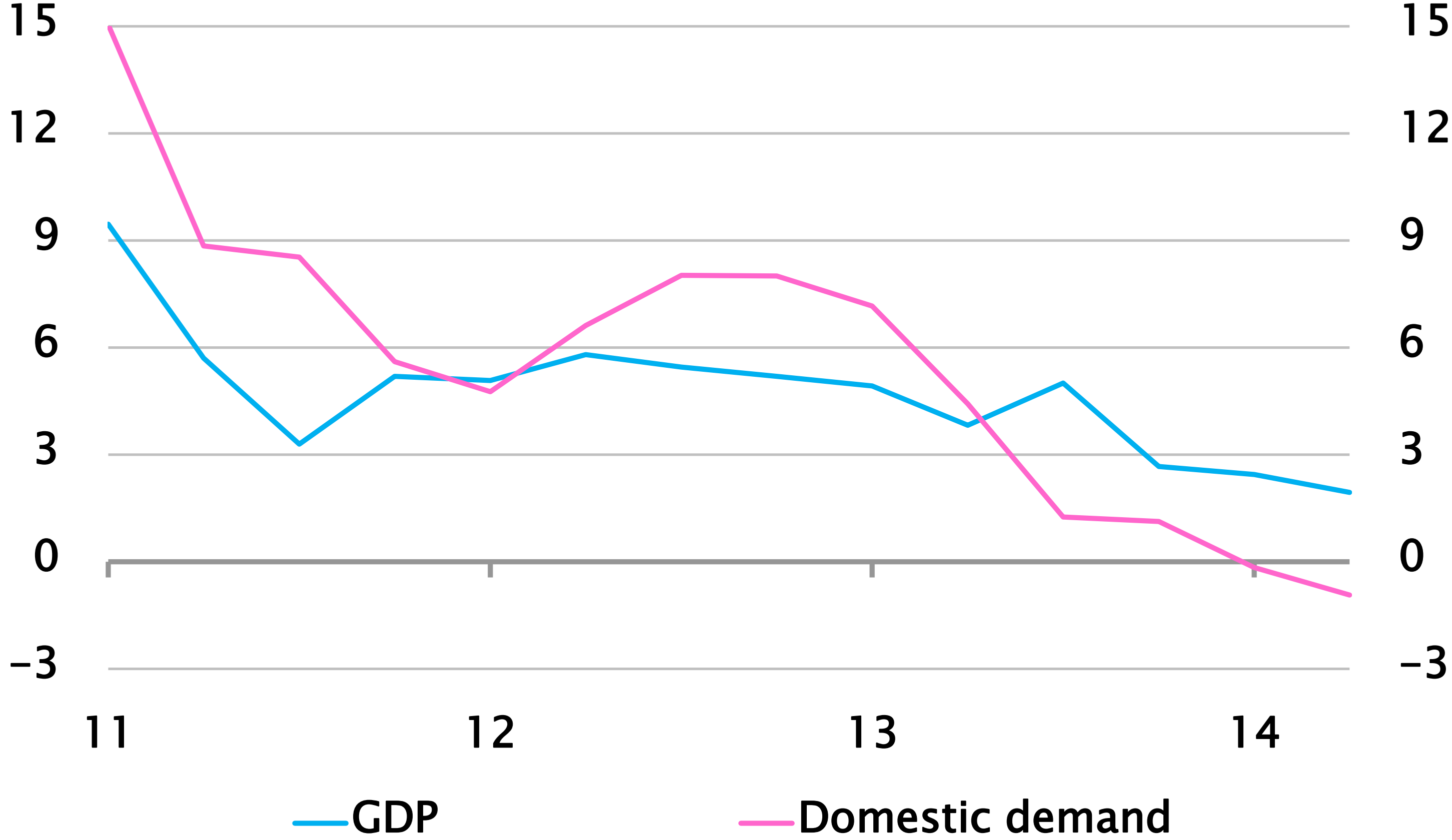


Source:Bloomberg.

The slowdown has been deeper than expected

The adjustment in investment and private consumption has gone farther than expected, and beyond what was expected on the basis of the commodity cycle and the "tapering" shock

Economic activity
(annual change, percent)



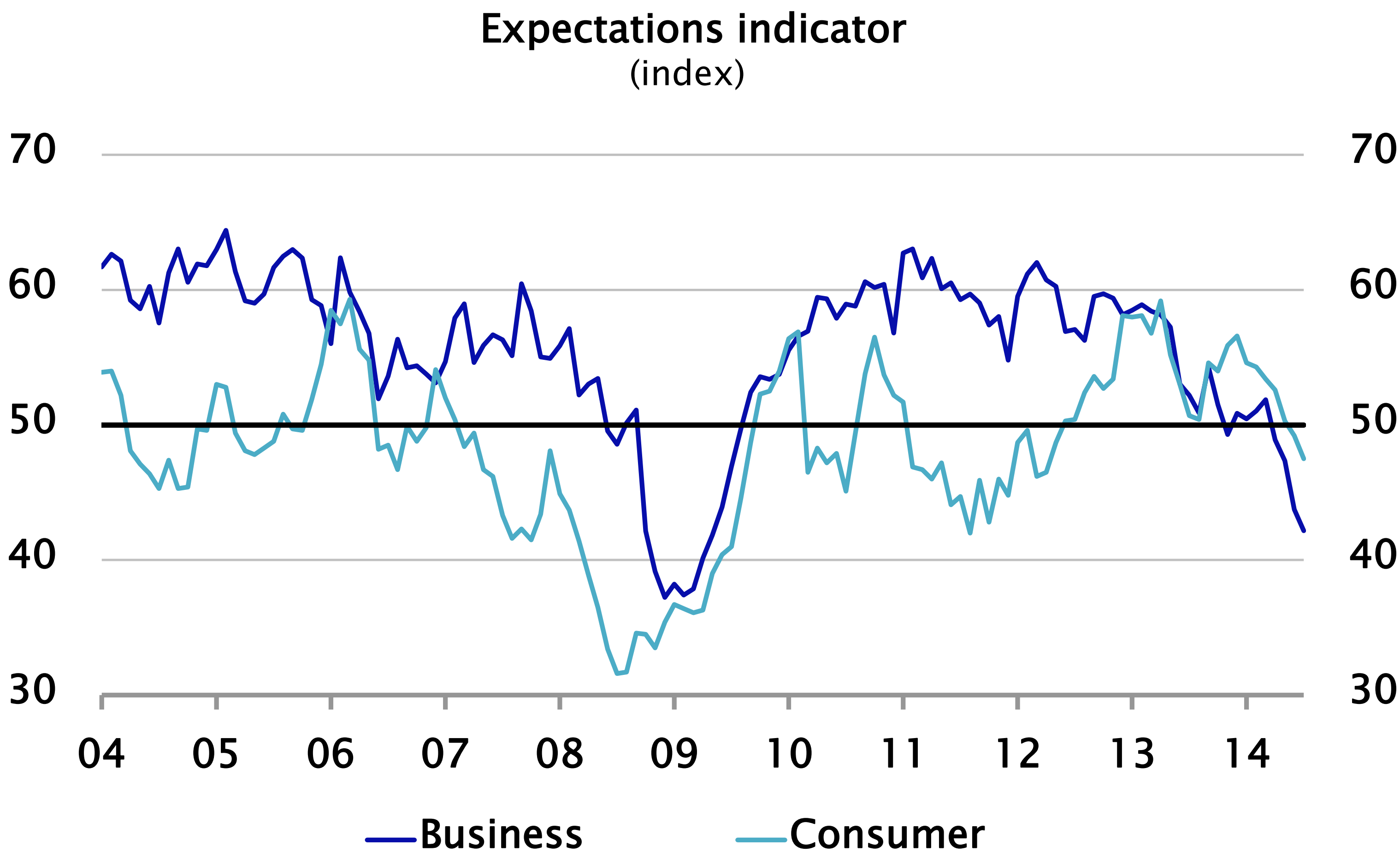
Source: Central Bank of Chile.

Despite the economic slowdown, unemployment remains low and nominal wages have accelerated somewhat, partially in response to high inflation.

Labor market
(quarterly data, percent)

Source: National Statistics Bureau.

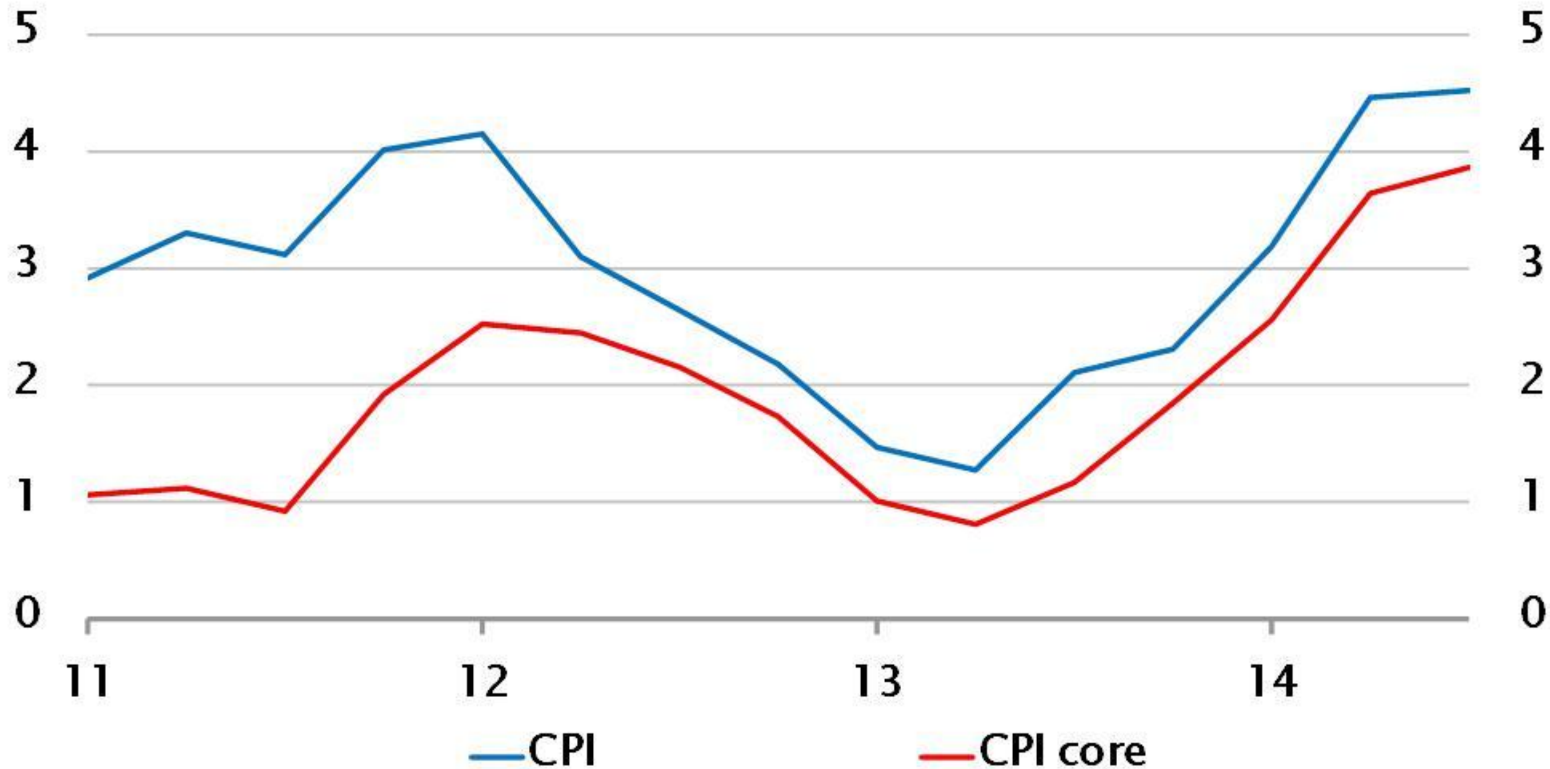
Business confidence has shown a steady decline in the last year, whereas consumer expectations dropped more visibly in the last several months



(*) A figure above (below) 50 points indicates optimism (pessimism).
Sources:Adimark and Icare/Universidad Adolfo Ibáñez.

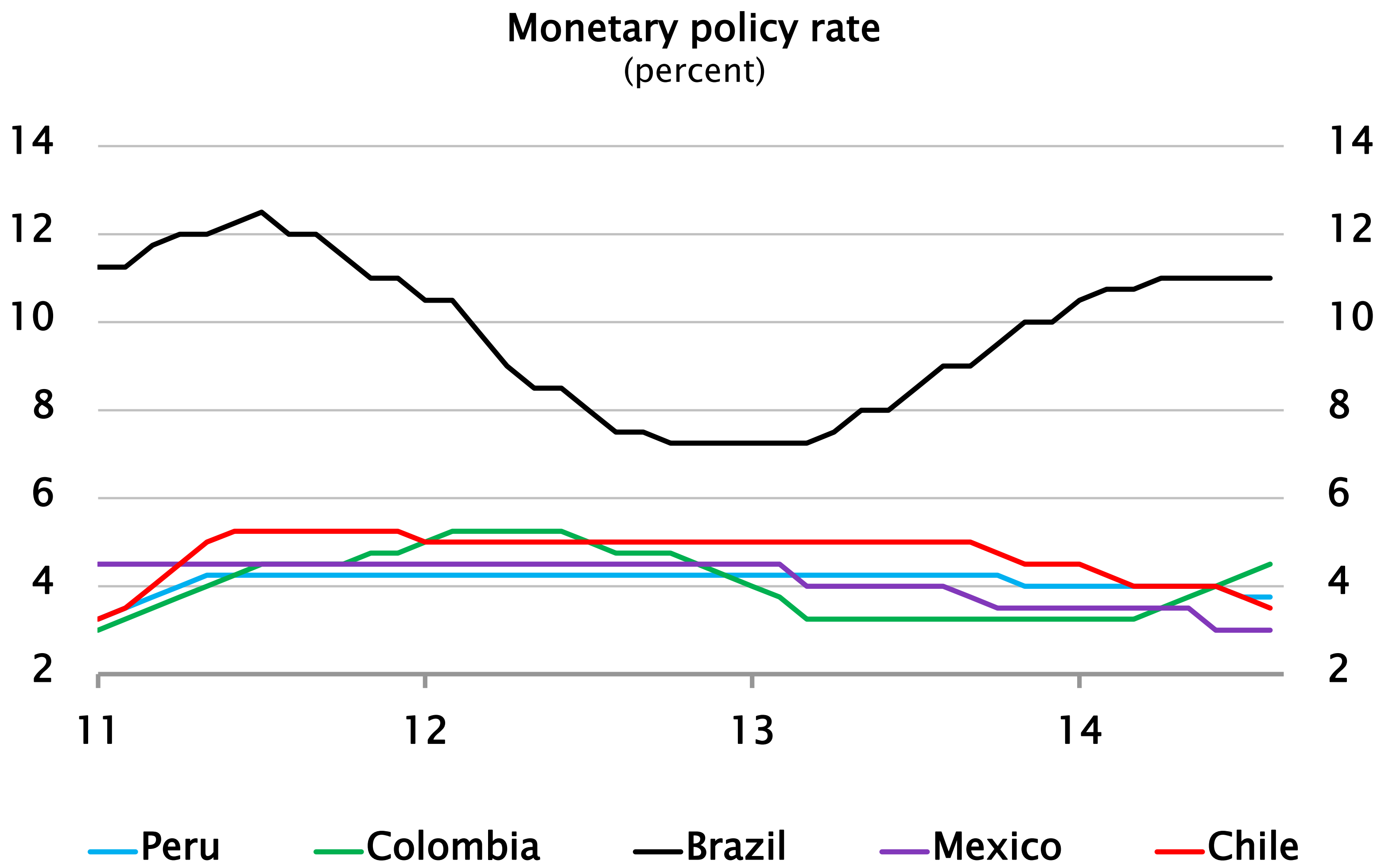
Annual inflation rates increased in reaction to the depreciation and relatively tight labor market conditions. We expect to come down next year due to a widening output gap. Expectations remain anchored at 3%.

Inflation indicators
(annual change, percent)



Sources: Central Bank of Chile and National Statistics Bureau.

As from mid-2013, the Board began to communicate that monetary policy would be more expansionary. Since October, the MPR has been lowered by 150bp to 3.50%.



Sources: Central Bank of Chile and Bloomberg.

For this year, the Chilean economy is foreseen to grow between 1.75 and 2.25% and next year between 3 and 4%.

Economic outlook

(annual change, percent)

	2012	2013	2014 (f)	2015 (f)
GDP	5.4	4.1	1.75–2.25	3.0–4.0
Domestic demand	6.9	3.4	0.1	3.4
Domestic demand (w/o inventory change)	7.1	4.2	1,0	3.2
Gross fixed capital formation	12.2	0.4	–4.1	1.8
Total consumption	5.6	5.4	2.6	3.6
Goods and services exports	1.1	4.3	2.4	3.8
Goods and services imports	5,0	2.2	–3.9	4,0
Current account (% of GDP)	–3.4	–3.4	–1.8	–2.2
Gross national saving (% of GDP)	21.7	20.5	19.8	19.7
December CPI inflation	1.5	3,0	4.1	2.8
December CPIEFE inflation	1.5	2.1	3.4	2.5

(f) Forecast, Monetary Policy Report, September 2014.
Source: Central Bank of Chile

The recovery, though moderate, is grounded on..

- The stronger monetary stimulus and lower market rates;
- Greater fiscal stimulus
- A stronger impulse from the growth of trading partners and the real depreciation of the peso;
- Improved private expectations.

Final remarks

- A long-lived commodity price boom has real effects beyond the short-term fiscal and monetary ones. Our Fiscal and Monetary frameworks are well equipped to deal with the short ones. The long cycle put to test our institutions to deal with labor market and energy constraints, revealing significant shortcomings.

- A deep domestic financial market, with significant long-term domestic savings has helped a lot to cushion the impact of "The Tapering" on local financial conditions.

- We have to go back to our old macroeconomic books to revisit the literature on short-term effects of depreciations on the price level and domestic demand. However, TX flexibility has been very helpful during this cycle, and must be preserved.

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