LATIN AMERICA ECONOMICS FOCUS

Chile's recovery is set to surprise on the upside

- **The large macroeconomic imbalances that built up during Chile's post-pandemic recovery have eased substantially, which is likely to prompt the central bank to deliver more rate cuts than almost any other EM central bank over the next couple of years. We expect this, alongside looser fiscal policy and high copper prices, to pave the way for a stronger recovery than most expect.**
- Chile's economy was one of the emerging world's post-pandemic growth stars. GDP expanded by close to 12% in 2021 on the back of very loose policy and three rounds of pension withdrawals. These lifted output well above its pre-pandemic *trend*. **But the rapid recovery came at the expense of an accumulation of large macroeconomic imbalances**. The budget and current account deficits widened to multi-year highs, of 7.5% and 10% of GDP respectively, the household savings rate plunged and inflation surged.
- This was unsustainable and the economy has been going through a rebalancing process over the past year amid a sharp tightening of fiscal and monetary policy. GDP contracted in three of the four quarters last year and the unemployment rate rose. **We estimate that, having been running above potential at the end of 2021, the economy is now running a little *below* potential.**
- Accompanying this period of weak growth has been a sharp improvement in the current account position – on a seasonally adjusted basis, the current account position flipped back into surplus at the start of the year. At the same time, wage growth has started to ease and inflation fell to an 18-month low of 7.6% y/y in June – a drop of close to 7%-pts from its recent peak.
- **With the economy now operating on a more sustainable footing, we think that there's scope for the brakes on growth from tight policy to be lifted.** Fiscal policy has already tilted in a looser direction while the central bank is likely to kick off its monetary easing cycle this month with a 50bp rate cut. We expect a cumulative 600bp of cuts, to 5.25%, by the end of next year (from 11.25% currently). This will be a more aggressive easing cycle than in most other EMs, although the policy rate will remain above its neutral level.
- **Looser policy alongside external tailwinds from high copper prices should pave the way for a stronger rebound in Chile's economy than most expect over the next couple of years**. Our forecast for Chile's economy to grow by 2.5% next year and 2.8% in 2025 are above the consensus (2.0% and 2.2%) and mean that output will converge to its pre-pandemic trend.
- This recovery will look very different to the one following the pandemic. We expect consumer spending to remain sluggish. Instead, we think that the recovery will be driven by public consumption and investment, with the latter set to be supported by lower interest rates and easing political risks (given that Chile's constitutional re-write no longer threatens to introduce a more radical charter).
- **A rebound in growth, diminishing macro imbalances and easing political risks are also good news for Chilean financial assets**. While we think the currency will struggle over the course of this year, there's scope for the peso to strengthen next year. Our end-2024 forecast is 775/$, from 814/$ now. Falling inflation, lower interest rates and falling risk premia mean that Chilean local currency bond yields are set to fall over the next couple of years while Chilean equities should continue to perform well in 2024.

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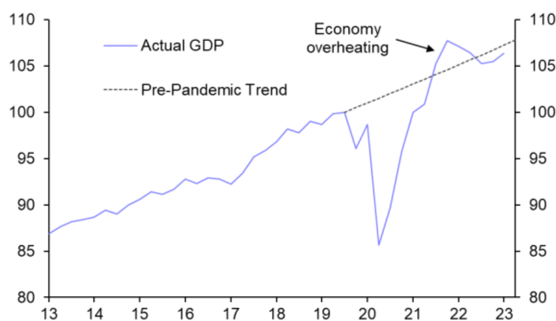
Chile's recovery is set to surprise on the upside

In this *Focus* we argue that Chile's economy is through the worst of its rebalancing process, which will provide room for looser policy and a stronger-than-expected rebound in the economy, all of which should support Chilean financial assets.

Economy on steroids goes cold turkey

Chile's economy recorded one of the strongest recoveries from the pandemic of any emerging market. A rapid vaccine rollout allowed the country to re-open more quickly than many others. At the same time, very loose fiscal policy – Chile had an extremely generous Covid-support programme – and three rounds of pension withdrawals drove a boom in private consumption. GDP rose by 11.7% in 2021, lifting output well above its pre-pandemic *trend* in 2021. (See Chart 1.) **But the flipside of this strong recovery was an accumulation of large macroeconomic imbalances, in particular a surge in inflation and a rapidly widening current account deficit, which hit 10% of GDP last year.**

Chart 1: Real GDP (SA, Q3 2019 = 100)

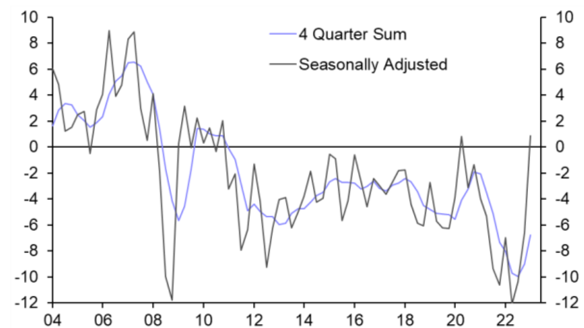


Source: Refinitiv, BCCh, Capital Economics

The strength of Chile's recovery was not sustainable and, last year, the economy started going through a sharp, but necessary adjustment process. Fiscal and monetary policy were tightened aggressively. **We estimate that, having been running above potential at the end of 2021 (by around 3%), the economy is now running a little below potential.**

Alongside this, the unemployment rate rose, inflation started to fall and import demand plunged, causing the current account deficit to narrow sharply. On a seasonally adjusted basis, we estimate that the current account position flipped back into a surplus last quarter. (See Chart 2.)

Chart 2: Current Account Balance (% of GDP)



Source: Refinitiv, BCCh, Capital Economics

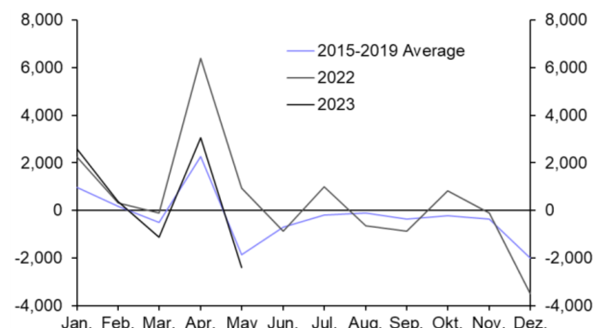
In short, imbalances have been reduced and the economy is operating on a more sustainable footing. **As a result, there's now scope for the brakes on the economy from tight policy to be lifted.**

Easing off the brakes

One of the main drags on growth last year came from fiscal policy. Following excessively loose policy in the aftermath of the pandemic when the economy was already on a clear path to recovery, government spending contracted by more than 20% in real terms last year, causing the general government budget position to flip from a deficit of 7.7% of GDP in 2021 into a surplus of 1.1% in 2022. **But the fiscal drag has now happened and policy this year has tilted in a looser direction.**

Chart 3 shows that the central government's primary budget balance, while roughly in line with historical norms, is substantially larger this year than last.

Chart 3: Monthly Central Government Primary Budget Balance (CLP bn)



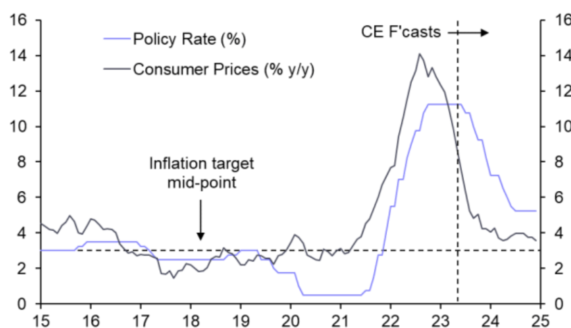
Source: Refinitiv, BCCh, Capital Economics

And we expect fiscal policy to remain relatively loose over the next few years, not least due to the shift towards a larger role of the state in the provision of services to the public which was triggered by the protests in 2019 (more on this later). We expect the budget balance to swing back to a deficit over the coming years, although we don't expect anything reckless. Our forecast is for the government to run primary deficits of 1.5-2.0% of GDP.

Meanwhile, **with inflation now on a clear downward path – the headline rate has declined from a peak of 14.1% last August to 7.6% in June – and external risks easing, the door to monetary easing is opening.** Indeed, there has been a dovish shift at the central bank recently, with two of the five board members voting for a rate cut at the last meeting in June. And the accompanying communications revealed that policymakers' inflation concerns are clearly fading. The board now sees inflationary risks "balancing out" while one member even stated that the risks of inflation falling below target "seemed to be quite high".

The larger-than-expected fall in inflation in June means that the central bank is all but certain to commence its easing cycle at its meeting later this month. We expect the central bank to deliver a 50bp cut, to 10.75%, with rates set to be lowered to 8.25% by the end of this year and 5.25% in 2024. (See Chart 4.) This implies that interest rates in Chile will come down more quickly than in almost any other EM.

Chart 4: Consumer Prices & Policy Rate



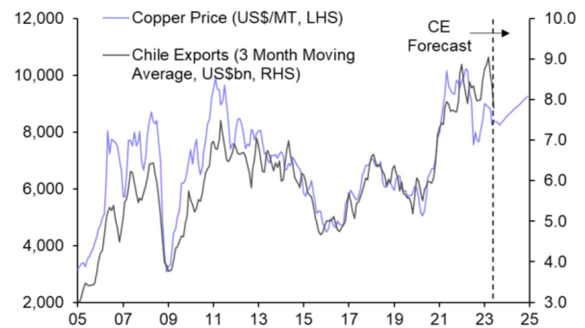
Source: Refinitiv, Capital Economics

External tailwind from high copper prices

In addition to looser policy, the external environment is set to become more favourable over the next couple of years. Chile is the world's largest copper producer – copper and copper-related products account for roughly half of total exports, equal to around 15% of GDP. So the country stands to benefit if, as we expect, the copper price gradually rises over the next couple of years on the back of a recovery in China's property sector, improved global economic prospects and the shift to renewable energy and electric vehicles. **We estimate that this will boost Chile's exports by around 15% over the next couple of years.** (See Chart 5.)

To be clear, the recently declared El Niño event poses a downside risk to our forecast as it could trigger flooding, which could impact copper production, and by extension, exports. But even if that's the case, history suggests that production rebounds quickly once rainfall subsides.

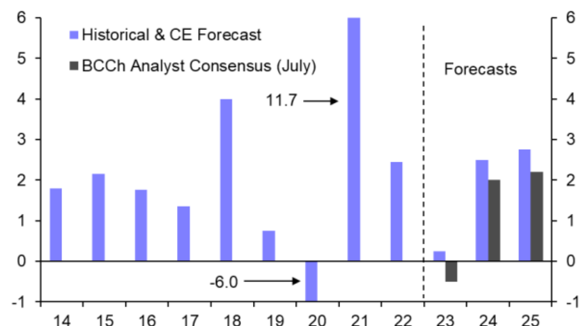
Chart 5: Copper Prices & Chile's Exports



Source: Refinitiv, Capital Economics

All told, we expect looser policy and high copper prices to pave the way for a rebound in growth over the next few years. While growth this year is likely to be sluggish at 0.0-0.3%, this mainly reflects the weak statistical carryover from 2022. And there's scope for a stronger rebound than most expect in 2024-25 as this drag fades. (See Chart 6.)

Chart 6: GDP (% y/y)



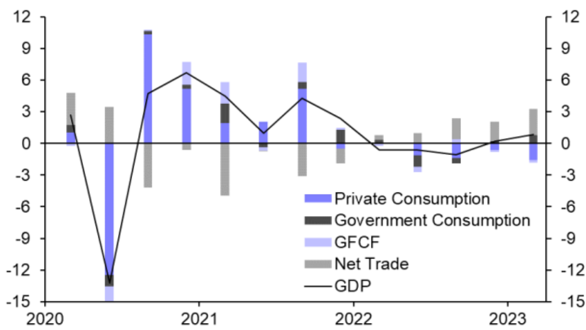
Source: Refinitiv, BCCh, Capital Economics

Our GDP growth forecasts of 2.5% and 2.8% for 2024 and 2025 respectively also imply that Chile's economy will outperform most other major economies in Latin America over the next few years.

Consumption set to be the weak spot

That said, the recovery this time round will look very different from the one that followed the pandemic. As mentioned above, the recovery in 2021 was driven by a boom in consumer spending. Private consumption, having slumped following the outbreak of Covid, contributed around 3%-pts to q/q GDP growth on average between mid-2020 and end-2021 – far more than any other component of GDP. (See Chart 7.) **In contrast, we expect consumption to be the weak spot this time round, for two key reasons.**

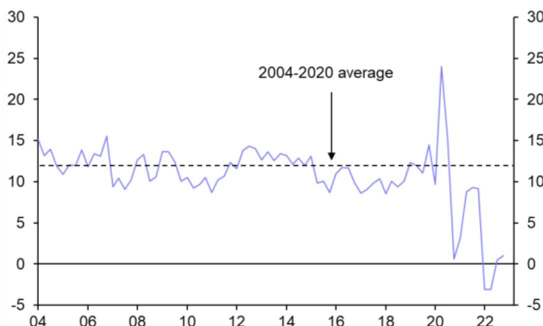
Chart 7: Contribution to q/q Growth (%-pts)



Source: Refinitiv, BCCh, Capital Economics

First, households still need to rebuild their balance sheets. The boom in consumption following the pandemic came at the expense of a rapid decline in household savings rates – the rate dropped from 12% before the pandemic to -3% last year (i.e. households were dissaving to sustain consumption – mainly a result of the pension withdrawals). (See Chart 8.)

Chart 8: Household Savings Rate (SA, %)



Source: Refinitiv, Capital Economics

And while the savings rate has risen slightly in the last couple of quarters, it remains well below its pre-pandemic average. As a result, we think that households will save a sizable share of their disposable income over the coming quarters.

Offsetting some of this weakness should be a gradual recovery in the labour market. Admittedly, timely data, such as firms' hiring prospects and internet job vacancies' suggest that labour market conditions may loosen a bit further over the coming months. But our GDP growth forecast points to a recovery in the labour market in 2024. (See Chart 9.)

Chart 9: GDP & Unemployment Rate

Source: Refinitiv, Capital Economics

This, alongside positive real wage growth as inflation falls back should offset some of the blow to consumption from households rebuilding their balance sheets, although overall, we think that consumer spending will remain sluggish over the next couple of years. We expect consumption to contract over 2023 as a whole and to grow by just over 1% next year. **This is a key reason why the overall pace of the recovery will be significantly weaker than the one following the pandemic.**

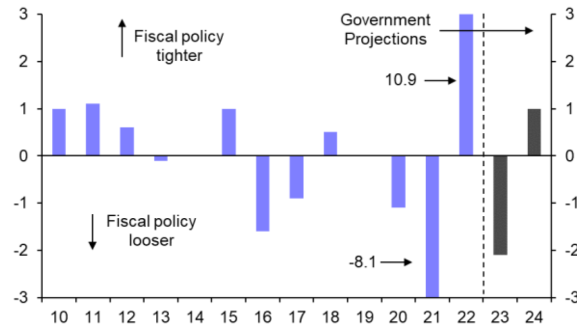
Public spending & investment to drive the rebound

Instead, we think that public consumption and in particular investment will drive growth over the next couple of years.

As mentioned in the previous section, following a very austere 2022, fiscal policy over the coming years is likely to be a lot less restrictive. In fact, the government's structural budget balance projection points to substantial fiscal loosening this year. (See Chart 10.) And even as fiscal policy is set to be tightened again in 2024, the scale of tightening is set

to be relatively modest – it won't be anywhere near the same magnitude as it was in 2022, which caused such a large drag on GDP.

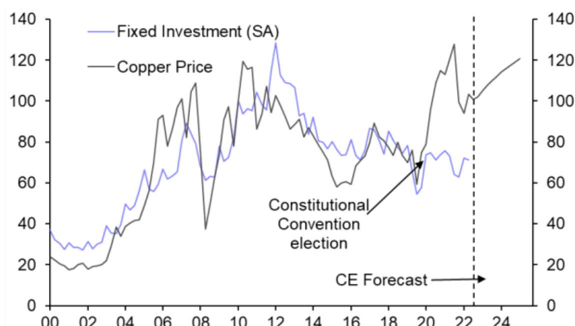
Chart 10: Change in Structural Budget Balance (%-pts of GDP)



Source: Dipres, Capital Economics

Investment should recover well too, for a couple of reasons. **For one thing, lower interest rates should favourably influence investment by reducing firms' debt servicing costs and making new investments more affordable.** And, perhaps more importantly, **the drag on investment from political uncertainty should ease.** Chart 11 shows that, historically, fixed investment took its cue from the price of copper given the outsized role of copper in Chile's economy. But this relationship has broken down since the Constitutional Convention election in 2021 and the substantial changes to Chile's market-friendly business environment (for more on Chile's constitutional process see Box). Fixed investment (as a share of GDP) has stagnated since early 2021 despite the rise in copper prices. But we expect this relationship to reassert itself going forward, at least partly, given that Chile's constitutional rewrite no longer threatens to introduce a more radical charter.

Chart 11: Copper Prices & Fixed Investment (US$ Terms, Q4 2019 = 100)



Source: Refinitiv, Capital Economics

Box: Chile's constitutional re-write

The process of re-writing Chile's constitution has its origins in the large scale protests that swept the country in 2019, when people took to the street to demonstrate against inequality and for greater public welfare provisions. The country's constitution quickly became a key target for protesters and, in an attempt to appease protesters, former President Sebastian Piñera agreed to hold a referendum on whether the current constitution should be replaced – close to 80% of Chileans voted in favour.

The first attempt at re-writing the constitution was led by a citizen-appointed, left-leaning body and resulted in a charter that would've ushered in sweeping changes to Chile's current economic model. This charter was overwhelmingly rejected in a referendum in September 2022. But there was broad-based consensus from across the political spectrum that the constitutional process should continue, albeit with modifications.

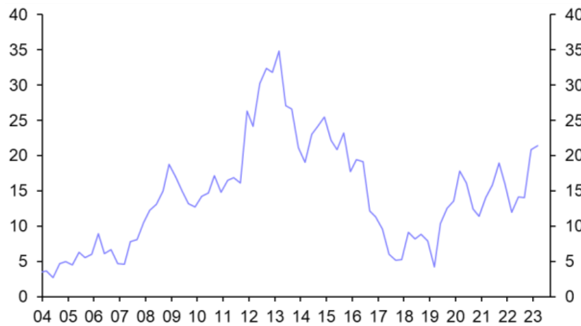
Clearer boundaries have been set. The new charter will enshrine key principles such as the central bank's independence, property rights and maintain congress in its current form. And the process this time round is being led by a mixed body, comprised of a congressionally-appointed committee of experts and a citizen-appointed Constitutional Council. And unlike in 2021, right-wing parties performed well in the vote for the Constitutional Council, securing the necessary majority to pass and/or reject articles.

We think that it's still likely that a new charter will enshrine a larger role for the state in the economy, especially when it comes to the provision of services to the public. But the clearer boundaries and the strong showing for right-wing parties have reduced the likelihood of a radical shake up of Chile's economic model. If anything, there's a risk that the strong performance of conservative parties tilts the new charter too far right for the liking of many Chileans, which could increase the likelihood of another rejection in December's exit plebiscite.

There are some tentative signs that this has already contributed to a rise in foreign direct investment.

Foreigners' direct investment into Chile has surged since Q3 2022 (which is when the charter was rejected in a referendum), with FDI inflows now at their highest level since 2015. (See Chart 12.)

Chart 12: Foreign Direct Investment Inflows Into Chile (4Q Sum, $bn)



Source: Refinitiv, BCCh, Capital Economics

If the pick-up in foreign investment is anything to go by and we're right in assuming that political risks will continue to ease, fixed investment should start to rebound over the coming quarters.

What does this mean for financial markets?

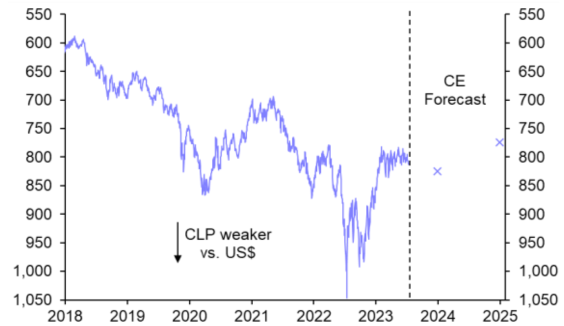
A rebound in growth, easing imbalances and fading political risks are also good news for Chile's financial markets.

Admittedly, Chilean assets are likely to struggle over the remainder of the year amid a deterioration in risk sentiment as the US economy falls into recession. But we expect them to recover next year as the global economy starts recovering and appetite for risk returns, the central bank continues to ease monetary policy and copper prices rise.

We think that these factors, alongside falling risk premia, will cause yields on Chilean 10-year local currency bonds to fall by more than in most other parts of the region, to 4.75% and 4.00% by the end of this year and next, respectively (from 5.28% currently) while Chile's benchmark IPSA is likely to rise to 7,000 by end-2024 (from ~6,100 currently).

These returns will be further bolstered by an appreciation of the Chilean peso, which is set to benefit from many of the above mentioned factors as well as the drastic improvement in the external position. We see scope for the peso to strengthen to 775/$ by end-2024 (from 814/$ currently). (See Chart 13.)

Chart 13: Chilean Peso (vs. $, Inverted)



Source: Refinitiv, Capital Economics

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