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Economics Group

Special Commentary

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Chile: Better Economic Prospects

Executive Summary

For many decades, Chile was the darling of capital markets and the strongest performer in South America. However, as the years of double-digit economic growth in China are over, economic growth in Chile has slowed considerably over the past several years. As Chile has noticeably benefited in the past from the strong economic growth in China, the country needs to reinsert itself in the global economy with less reliance on China. The Chilean economy had a very good track record prior to the eruption of China as the engine of commodity-driven economies. Thus, we believe that the country's authorities need to refocus the country on what it was doing right before 2000.

It will not be easy to refocus the economy, as competition in the global economy is stronger today, but Chile has a stable political system and strong institutions. This still will be no small feat in a region that is still going through growing political pain.

The Chilean economy had a very good track record prior to the eruption of China as the engine of commodity-driven economies.

Chilean Economy Started to Improve at the End of 2017

The Chilean economy showed another disappointing performance in 2017, growing just 1.5 percent for the whole year. The only reason why this performance was an improvement compared to 2016, was that the growth number for 2016 was revised down to 1.3 percent from 1.6 percent. The manufacturing sector's growth in 2016, was revised to a decline of 2.4 percent from a previously reported decline of 0.9 percent. On the demand side, the revision was allocated fundamentally to personal consumption expenditures, which were revised to an increase of 2.2 percent in real terms in 2016 compared to a previously reported increase of 2.4 percent. There was also an upward revision to real imports of goods and services in 2016, to an increase of 0.2 percent from an originally reported decline of 1.6 percent. Recall that imports enter in the calculation for gross domestic product (GDP) with a negative sign.

Figure 1

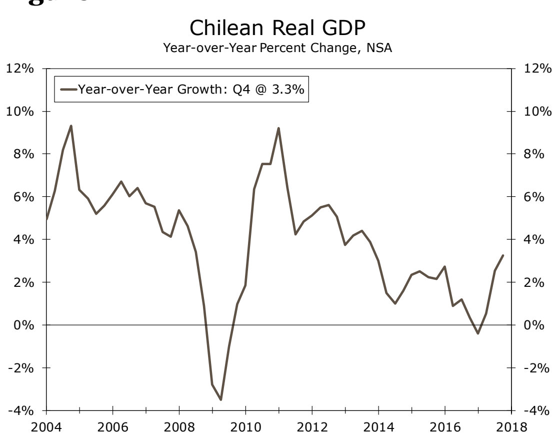
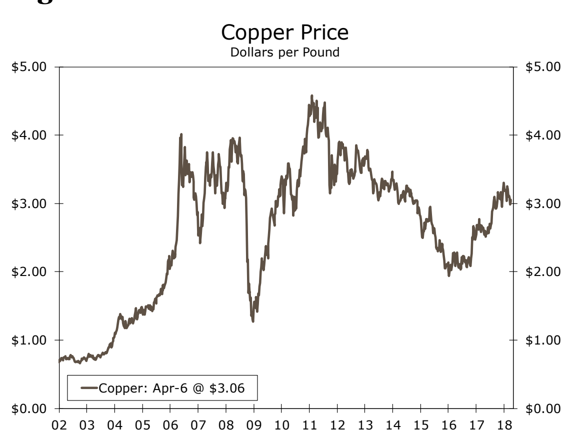


Figure 2



Source: Bloomberg LP, IHS Markit and Wells Fargo Securities

Most of the supply side weakness in GDP in 2017 was due to a weak mining sector during the first half of the year, but especially in the first quarter when mining GDP collapsed 17.4 percent on a year-over-year basis. As the year progressed, mining GDP recovered somewhat but was still down

2.0 percent for the whole year. Some of the growth in mining has probably been driven by still strong copper prices (Figure 2). On the other hand, the first half of 2017 was relatively weak for non-mining GDP, growing 1.1 percent year-over-year during the first two quarters. Non-mining GDP, however, increased 2.0 percent in Q3 and 2.9 percent in Q4, capping the year as a whole up 1.8 percent.

Almost every sector of Chilean GDP on the demand side improved as the year came to a close.

Almost every sector of Chilean GDP on the demand side improved as the year came to a close, which means that this year started on a positive note compared to previous years. In fact, according to the February Index of Economic Activity (IMACEC), which tracks the behavior of GDP on a monthly basis, the Chilean economy grew 4.0 percent in February compared to a year earlier, while growing 0.9 percent compared to January on a seasonally-adjusted basis. The strong result was due to a surge in the mining side of the economy, which had a rate of growth that jumped 19.4 percent compared to a year earlier, while the non-mining economy grew 2.8 percent, year-over-year.

New Administration to Have a Head Start

The new president, Sebastián Piñera, will have the upper hand compared to ex-President Michelle Bachelet, who served her second, non-consecutive term at the helm of the country's top office during the slowdown in commodity prices. During her first term in office, from 2006 to 2010, she saw some of the strongest (first two years) and weakest (second two years) commodity price environments in recent memory. For new president Piñera, it will also be his second non-consecutive term in office, as he served as president from 2010 to 2014, a period that saw some recovery in commodity prices.

Today, President Piñera is taking over an economy that has been struggling to grow at the strong rates experienced in the past, but expectations regarding his tenure are relatively positive. It will be interesting to see if his administration is able to identify the reasons for such a weak performance of the Chilean economy and make the appropriate policy changes needed to strengthen the rate of growth in coming years. The good news is that the global economy has continued to improve, which should help the Chilean economy. Furthermore, as we previously mentioned, economic activity had been strengthening at the end of last year and such improvement has continued for the first two months of this year.

Personal consumption expenditures (PCE) grew 2.4 percent in real terms in 2017, after posting a 2.2 percent growth rate the previous year, while real government expenditures posted a growth rate of 4.0 percent. However, real gross fixed capital formation dropped 1.1 percent during the year. This was the fourth consecutive yearly decline and will be a variable that Piñera will need to crack for the Chilean economy to return to the growth rates it achieved in the past. However, real gross capital formation increased 2.7 percent in the final quarter of the year, year over year, which means Piñera may get a head start here. Furthermore, real imports of goods and services were up 4.7 percent for the whole of 2017. Given that imports enter GDP with a negative sign, strong import growth prevented overall economic growth from being higher.

Gross capital formation has weakened considerably since about 2013.

In the recent past, one of the most important driving forces for Chilean economic growth was real gross capital formation, with growth rates of above 10 percent per year. However, as Figure 3 shows, gross capital formation has weakened considerably since about 2013. Figure 4 shows foreign direct investment in Chile, historical plus a two years' forecast, from the International Institute of Finance (IIF). The IIF expects further weakness ahead for foreign investment in Chile.

Some blame the slowdown in economic activity in Chile on the tax reforms implemented in both 2012 as well as in 2014, that is, during the presidencies of both Piñera and Bachelet. While there may be some truth to this argument, the fact of the matter is that the country will not be able to grow at a faster pace if it does not determine how to invest more in the economy, be it from domestic sources, foreign sources or a combination of both.

Figure 3

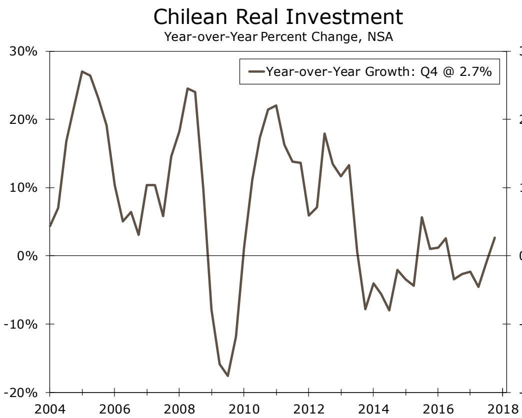
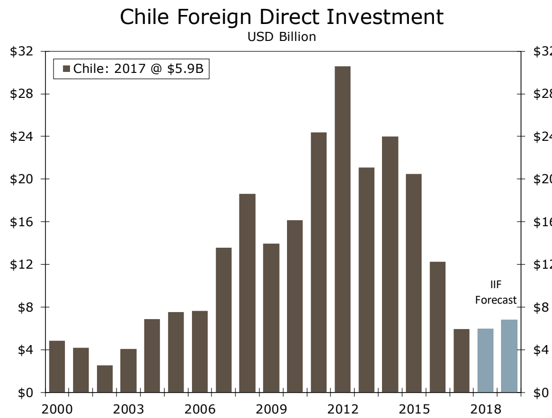


Figure 4



Source: IHS Markit, Institute of International Finance and Wells Fargo Securities

Another economic variable that should start to kick in and help the prospects for higher economic growth in the next several years is real exports of goods and services. Here also it is clear that Piñera has a head start as real exports of goods and services have been improving lately. For 2017 as a whole, real exports of goods and services declined 0.9 percent, but we saw a relatively strong recovery during the second half of the year compared to what was happening during the first half. Real exports of goods and services declined 4.4 percent during the first half of last year versus a year earlier, while increasing 2.6 percent during the second half.

Real exports of goods and services have been improving lately.

However, stronger global economic growth has helped other economies in the region, but has not yet had a significant impact on Chilean economic growth. The fact that the Chilean economy, but more specifically, its copper economy, grew so dependent on Chinese economic growth has kept Chilean growth limited. Furthermore, our expectation is for the Chinese economy to continue with its growth slowdown, so we do not see much help from this important sector of the Chilean economy in the future.

Furthermore, the good times of high copper prices, high Chinese economic growth plus fiscal reforms (increase in taxes), provided both the first Bachelet and Piñera administrations with revenues to conduct fiscal policies. However, the second Bachelet administration did not have such sources of extra revenues, and such sources will probably be absent during the second term of incoming President Piñera. That is, Piñera's administration will need to make reforms that will improve the prospects for economic growth without counting on much help from the fiscal sector.

Inflation and Interest Rates will Remain Supportive of Growth

The Chilean inflation rate should also remain supportive of economic growth over the next several quarters. Inflation in Chile increased in 2014 to 2016 but has now come down to below 2.0 percent and will allow the Chilean central bank to keep interest rates low for the near future, even as global interest rates continue to increase from very low levels (Figure 5 & Figure 6).

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Of course, at some point in time interest rates will need to start moving higher to counteract higher global interest rates. However, this is probably a ways off as our expectation is that the Federal Reserve will move slowly, while interest rates in the rest of the developing world will also slowly move higher once policymakers start tightening policy.

Furthermore, the steady recovery in the country's currency, the Chilean peso, after the depreciation experienced during the 2014 to 2016 period, will also remain supportive of lower inflation, lower interest rates as well as higher imports.

Figure 5

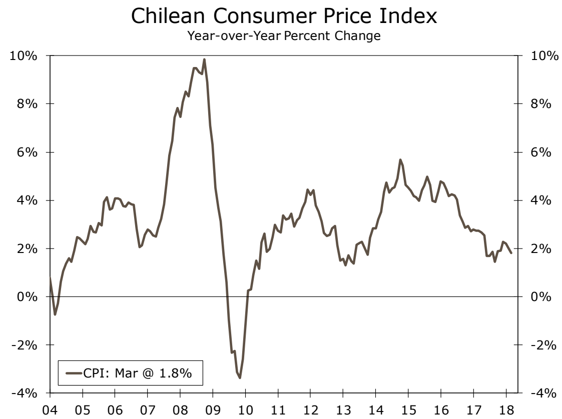
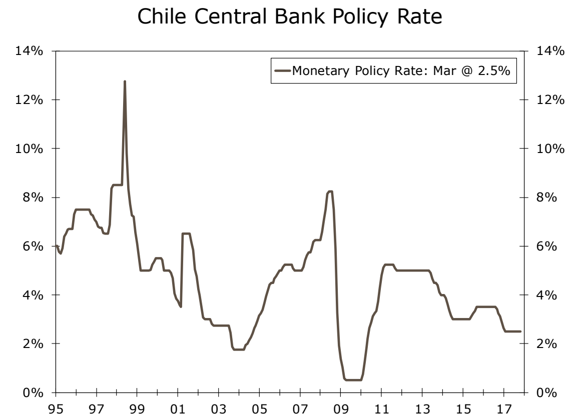


Figure 6



Source: IHS Markit and Wells Fargo Securities

Conclusion

Many economic cylinders seem to be pointing to an improved path going forward.

After several years of subpar performance by the Chilean economy, many economic cylinders seem to be pointing to an improved path going forward, just in time for the new administration of President Piñero to take advantage. Chile was the darling of foreign capital and a lightning rod in the South American region, a role that seems to have been taken by the Peruvian economy during the past several years. However, now that the Peruvian political system is going through some growing pains it is going to be an important time for Chile to reclaim its lost role in the South American region.

The road back will not be easy for the Chilean economy, as it has to offer investors advantages that they would not find elsewhere, which is not easy nowadays. However, the country has a very stable political system as well as strong institutions, which is not something to be underestimated in a region that continues to struggle with its political and economic direction.

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