LATAM Market Update

- **Chile: International scenario (finally) takes over the Monetary Policy Report**

Without a pessimistic diagnosis of local activity in 2Q19, CB strongly ponders external deterioration.

The Central Bank makes a new downward adjustment on its growth projection for this year to 2.5%. The year began with an increase to the MPR and a projection of GDP growth of 3.8% for 2019 with balanced risks and now we have an adjustment of 130 bp. in the projection of growth for this year, within the highest projection cuts made by a monetary authority globally and even higher than the one made by market consensus. That explains quite well the abrupt adjustment in monetary policy that goes from “normalize” mode to “stimulate” mode in a few months. The persistent deterioration of the international scenario is the main factor according to the CB, although it also seems likely that we had a somewhat exuberant diagnosis regarding the local cyclical recovery by the Council that the data finally reverted.

The Monetary Policy Report lowers the CPI inflation for 2019 from 2.8% to 2.7% and from 2.9% to 2.8% by 2020. We differ with the CB in the short-term inflationary dynamics and disinflationary pressures of 2020, which we believe will see an appreciation of the CLP toward the end of that year. According to our view, 2019 would end with CPI inflation of 3.0% while 2020 inflation would reach 2.6% despite the recovery of economic activity and due to the disinflationary effects of the appreciation of the Chilean peso towards levels of 640 by 2020.

In our view, the accumulated inflation between September and December would be at least 0.9%. In the short term, we foresee a significant impact of the update of electricity rates, which should come into effect in October, as well as the increase in prices of new cars and other imported goods, along with some fruits and vegetables. The Central Bank, on its part, estimates a low inflation of services in the third and fourth quarter of 2019, a view that we do not share completely, while we expect that the rebound in investment will press somewhat more on employment/wages.

The Central Bank estimates a 3Q19 GDP expansion of 3.6% y/y, lower than what we estimate (4.0% y/y) that would begin with an IMACEC in July approaching 4.0% y/y (0.6% m/m). The CB makes a relatively positive diagnosis of the economic activity for the second quarter, realizing that the negative surprise on its baseline scenario was explained by transitory factors referring to supply shocks (Codelco's strike and teachers’ strike, among others). The foregoing would account, as we have indicated, that the economic activity that excludes supply sectors has shown a relevant resilience that should continue solid during the rest of the year unless external tensions worsen or remain as it is reflected in CB's baseline scenario. Hence, we anticipate expansions over those expected by the CB and consensus this second part of the year, to end up with GDP growing 2.9% in 2019 and 3.2% in 2020 (Table 1). Our main differences with respect to the base scenario of the CB come from domestic demand. We estimate greater investment

CONTACTS

Eduardo Suárez, VP, Latin America Economics
52.55.9179.5174 (Mexico)
Scotiabank Economics
eduardo.suarez@scotiabank.com

Guillermo Arbe
511.211.6052 (Peru)
Scotiabank Peru
guillermo.arbe@scotiabank.com.pe

Mario Correa
52.55.5123.2683 (Mexico)
Scotiabank Mexico
mcorrea@scotiacb.com.mx

Sergio Olarte
57.1.745.6300 (Colombia)
Scotiabank Colombia
sergio.olarte@co.scotiabank.com

Jorge Selaive
56.2.2939.1092 (Chile)
Scotiabank Chile
jorge.selaive@scotiabank.cl

strength (as already seen) and a somewhat faster rebound in consumption (Table 2). The recent upward correction in the investment registers of the CB and the improvement in imports of capital goods lead us to project a second half with greater dynamism for investment (2019 S2: 7% y/y).

Table 1

Quarterly forecast comparison (percentage, annual growth, average)

	GDP growth		Annual Inflation	
	CB	Scotia	CB	Scotia
2019 Q3	3.6	4.0	2.2	2.3
2019 Q4	3.0	3.8	2.5	2.8
2019 (Dec.)	2.5	2.9	2.7	3.0
2020 (Dec.)	3.1	3.2	2.8	2.6

Sources: Banco Central de Chile, Scotiabank.

Table 2

Annual forecast (percentage, annual growth)

	2019		2020	
	CB	Scotia	CB	Scotia
GDP	2.9	3.2	3.4	3.2
Consumption	3.1	3.0	3.5	3.0
Investment	4.5	6.0	5.1	5.0
Current account (% GDP)	-2.9	-3.2	-2.8	-3.3
CPI (Dec.)	2.8	2.8	2.9	3.0
CPI core (Dec.)	2.6	2.7	2.9	3.0
MPR (Dec.)	2.5	2.5	-	3.25
Potential GDP (non-mining)	3.3	3.2	3.4	3.2
Neutral MPR (%, nominal)	3.75 - 4.25	3.75 - 4.0	-	-

Sources: Banco Central de Chile, Scotiabank.

We expect nominal swaps rates to incorporate a Monetary Policy Rate (MPR) of 1.0% or less in the short term, which, in turn, also delivers significant fuel for additional depreciation of the CLP conditional to the dynamics of copper prices. Yesterday's reaction is highly depreciative after controlling for the significant rise in the price of the red metal. If international financial tensions persist that affect the terms of trade and further weaken global activity, the CB would follow the path of other central banks by cutting the instance rate without fear of taking it even to levels similar to those observed during the subprime crisis.

We adjusted our MPR base scenario to December 2019 to 1.75% from 2.0%, while we do not expect the MPR to reach neutral levels (3.75-4.0%) in the policy horizon. Given the above, we expect the CB to make a new justified cut on the international stage rather than the domestic one at its meeting in October.

In this Report the Central Bank chooses not to deliver a forward guidance for the MPR in the medium term, revealing that the uncertain external scenario prevents it from defining an end point of this process of cuts and thus validate the expectations of Market or surveys. Regarding the real exchange rate (RER), the authority indicates that it will remain above its historical averages (average TCR 15 years: 94 pts) throughout the forecast horizon, assuming then that the CLP will remain depreciated for several more quarters.

Flexibility to reverse the stimulus after seeing an abrupt change in external conditions will be key to defining the MPR at the end of the policy horizon. Although the external scenario has persistently worsened in recent months, a sudden change that favours global risk appetite cannot be ruled out, with positive implications for portfolio flows and commodity prices. Indeed, the CB scenario assumes that copper will reach a modest US $ 2.6/lb by 2020, levels similar to the current ones. This price for the metal assumes, consequently, that external tensions will remain or even worsen, an aspect that can change depending on the negotiations between China and the US, or due to favourable surprises in activity from one of our main trading partners. In that sense, monetary policy should resume the normalization path, an aspect that for now the CB neglects.

—Carlos Muñoz, Waldo Riveras & Jorge Selaive