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Chile: Not a game-changer for local assets

- Last weekend's violent protests in Chile took everyone by surprise. However, given the strong institutional setup, the long-term impact is likely to be modest.
- The government has announced measures that imply some higher issuance and stimulus, which at the margin should result in higher rates at the long-end.
- BCChile, meanwhile, has been cautious and stuck to a 25bps cut, in line with our call and the consensus. We expect one additional 25bps cut in December to end the cycle at 1.5%.
- We keep our existing recommendations for Chilean assets, as described in our latest piece: a) tactically short USDCLP ; and b) paying 1Y1Y and 5Y rates as directional medium-term trades.

What does this tell us about Chile?

The scale and violent turn of the social protests in Chile last weekend took everyone by surprise. The immediate trigger was a (rather small) increase in transportation fares, but clearly they reflect deeper social and political aspects. The surprise also came since Chile is regarded as stable democracy, where social pressures are thought to be addressed through the democratic process. In fact, recent elections have seen smooth power transitions between left and right leaning administrations.

With hindsight, as the country's income expanded, the gap between Chilean's expectations and realizations (for instance in terms of the quality of social services) had been rising. We think that the events this week reflect some elements that had been largely dismissed by markets, as they focus almost solely on Chile's strong balance sheets and commodity dependence. At the same time, however, we think it is important to keep the protests in context, both as a global phenomenon taking place in countries with different income levels, and also maintaining Chile's rather strong political institutions.

With this in mind, and as local activity have started to normalize, which is positive for local assets, below we examine the impact of the government and the central bank announcements over the past few days.

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Our take is that while there effects on both directions, a) the CLP should continue to strengthen in line with the external environment; and b) rates, especially at the long-end, should increase, as inflation/growth rebounds and the central bank is likely very close to the end of its easing cycle.

Government: More social expenditure and some debt

In response to the protests and the backlash against the initial reaction, the administration has proposed a series of measures intended to tackle the social demands. In addition to rolling back the increase of transportation fares that sparked the protests, the following initiatives have been proposed, which have high chances of being implemented:

- A 20% increase in the basic pension for the poorest sectors of the population, as well as higher pension subsidies over the next few years. This is by far the largest expenditure ticket in the proposal, both in terms of the costs and the number of people affected. Politically, it also addresses one of the most contentious issues in Chile.
- Eliminating the recent increases in electricity tariffs (9% so far this year) and freezing prices for the remainder of the year. The creation of a mechanism to smooth out price increases over time has also been proposed, which should reduce the chances of this type of reaction to price adjustments in the future.
- Increasing the tax rate applied to highest earners from 35% to 40%, and guaranteeing a minimum income to those at the bottom. Establishing mechanisms to redistribute wealth between regions.
- Improving/expanding other social services, such as health care and reducing medicine prices.

Minister of Finance Larrain has provided an estimate of the costs of these expenditures as follows: total additional outlays of US$1.2bn (this is about 0.42% of GDP) for next year's budget, coming mostly from higher pensions ($500m). This would be marginally compensated with higher taxes to wealthier households, estimated to be $160m. In addition, $440m would be reassigned from other expenditures, but details on this have not provide, leaving some room for slippage as cuts could prove difficult under the current environment.

The bottom line is that about half of the proposed expenditures (call it 0.2% of GDP) will result in a higher deficit to be financed through debt issuance. In addition, and perhaps more importantly, the current plans for the pension and tax reforms have been shelved with increasingly low chances of being approved.

Chile's strong balance sheets, especially very low debt levels, allow plenty of room for this additional debt (also at very attractive yields), but it adds some pressures to the structural balance over the next year. In terms of the impact on economic activity, the medium-term impact should be modest, but given that they affect mostly the poor (basic pensions, minimum income), the fiscal multiplier should be rather high. As a whole, we think that these measures should result in slightly higher risk premia.

Central Bank: Wait-and-see, correctly

BCChile eased rates by 25bps to 1.75% yesterday, in line with our call and the consensus. This removed a key risk for the peso, given the possibility that the committee could have taken a more dovish turn following the protests. Our take had been that the committee would be reluctant to make too much of the recent events, given the effects going in different directions, as well as its institutional independence.

Indeed, the statement took a very appropriate tone, in our view. It acknowledges that in the short-term economic activity could be affected, but also that more time is needed to assess the medium-term impact of the policy proposals presented by the government. This will be addressed in the December inflation report, when the negative short-term impact of the disruptions of economic activity could be seen as moderate.

Importantly, the text does not mention the downside pressure to inflation from the lowering of electricity tariffs, which implies a 15bps reduction in this month's print, if it is implemented as a one off. The board leaves open the possibility of additional easing, as we anticipated, given the risks to global growth. Clearly, there is a strong reason to keep the option open for now.

We thus pencil in another 25bps cut in the policy rate to 1.50% at the December 6th meeting, mostly on the back of the deterioration of the global growth outlook.

Chart 1: Real rates (ex-post and ex-ante) have decreased significantly as the easing gets going

Source: Bloomberg, NWM Strategy

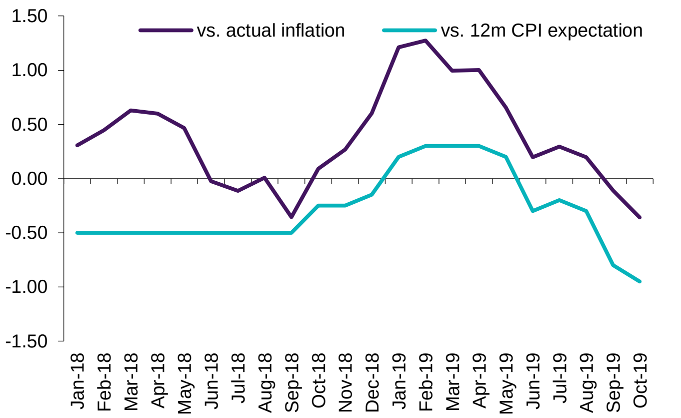
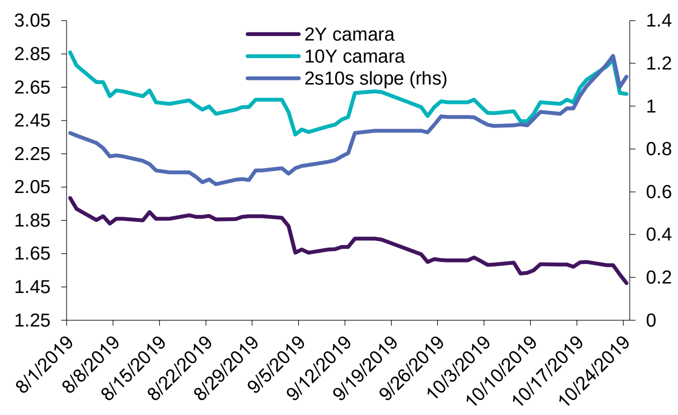


Chart 2: We expect further steepening of the local curve with higher rates at the longer-end

Source: Bloomberg, NWM Strategy



What's there to do?

Our take over the past few weeks has been that Chile presents a good opportunity for a reflation trade through short USDCLP positions and higher rates – see here for details. We keep those recommendations: we still expect the peso to head towards 690 also as the external environment is more supportive.

In terms of rates, our view is that the central bank has been correct in carrying out an early easing cycle, but that current nominal and real rates are too low compared to domestic conditions. In particular, we sense some recent reluctance (albeit before last weekend's events) from central bank officials in making too much of lower structural rates due to the immigration shock. In particular, the estimates of its effects are hard to calculate, so far the results have not been particularly strong. We think this is part of the reason behind the move towards a cut of 25bps at yesterday's meeting.

More broadly, we think that current rates at the front-end of the curve are pricing in too pessimistic a scenario for the evolution of the Chilean economy over the medium-term. Policy rates are currently about 35bps negative in real terms, which could increase towards 100bps until year-end as policy rates are cut to 1.50% and inflation can easily head towards the 2.5% range. We think any additional push beyond those levels would be unwarranted, given some of the positive economic signs: August retail sales were significantly higher than expected (at 2.3% YoY vs 1.2% expectations), nominal wage increases have picked up a bit, and copper prices are about 5% from the recent bottom. Against this, we keep our approach to local rates: paying 1Y1 as well as 5Y rates as a medium-term reflation trade.

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