Facing stormy weather: Will Chile and Latin America stay afloat?

Larraín Vial: "Tercera Conferencia Anual con Inversionistas Institucionales Extranjeros"

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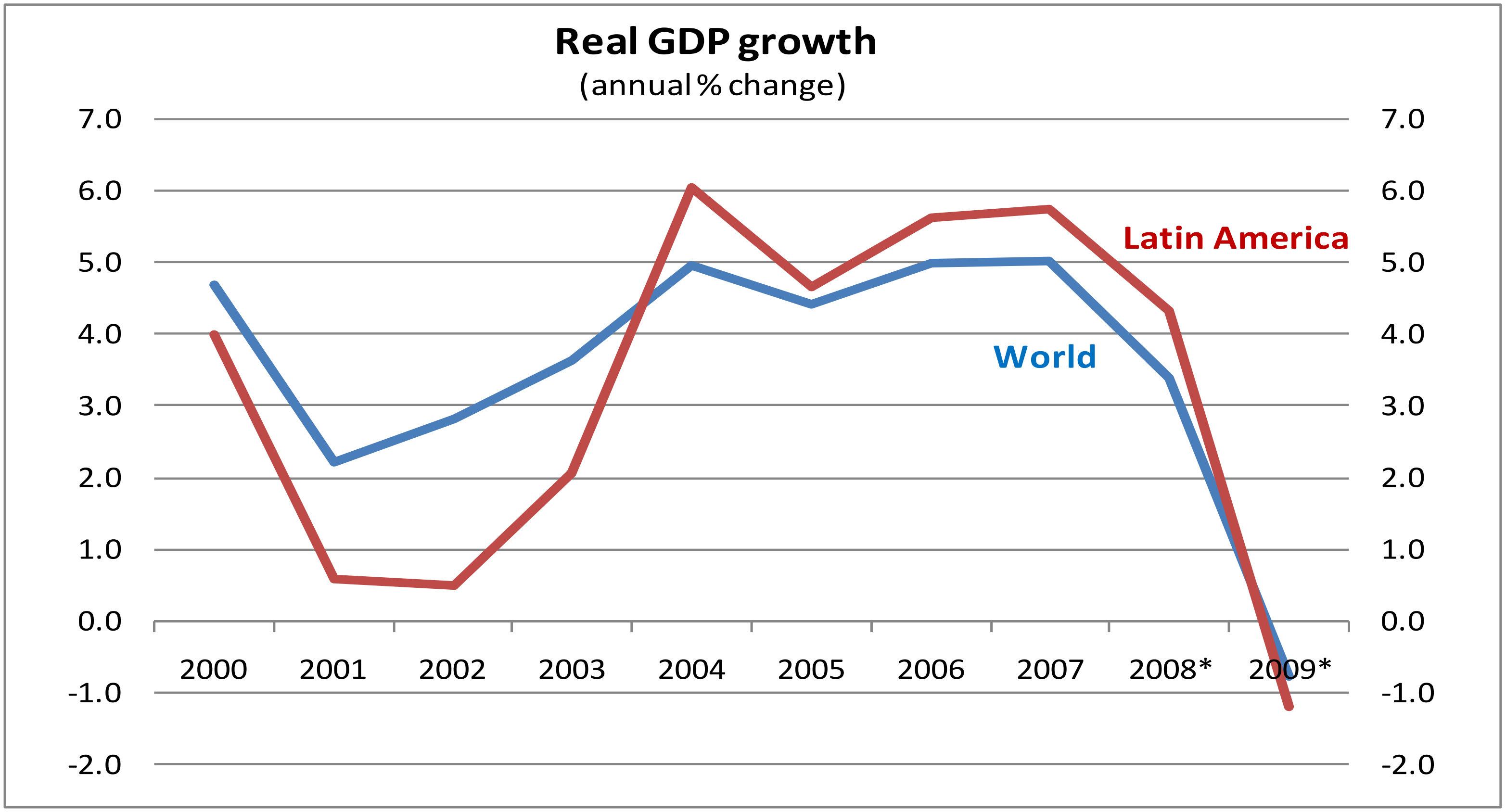
I. A NEW SCENARIO

A global economic contraction

- For the first time in 50 years the world's GDP level is posed to fall. Latin America usually amplifies the global cycle, thus a world recession this deep may be very bad news indeed.



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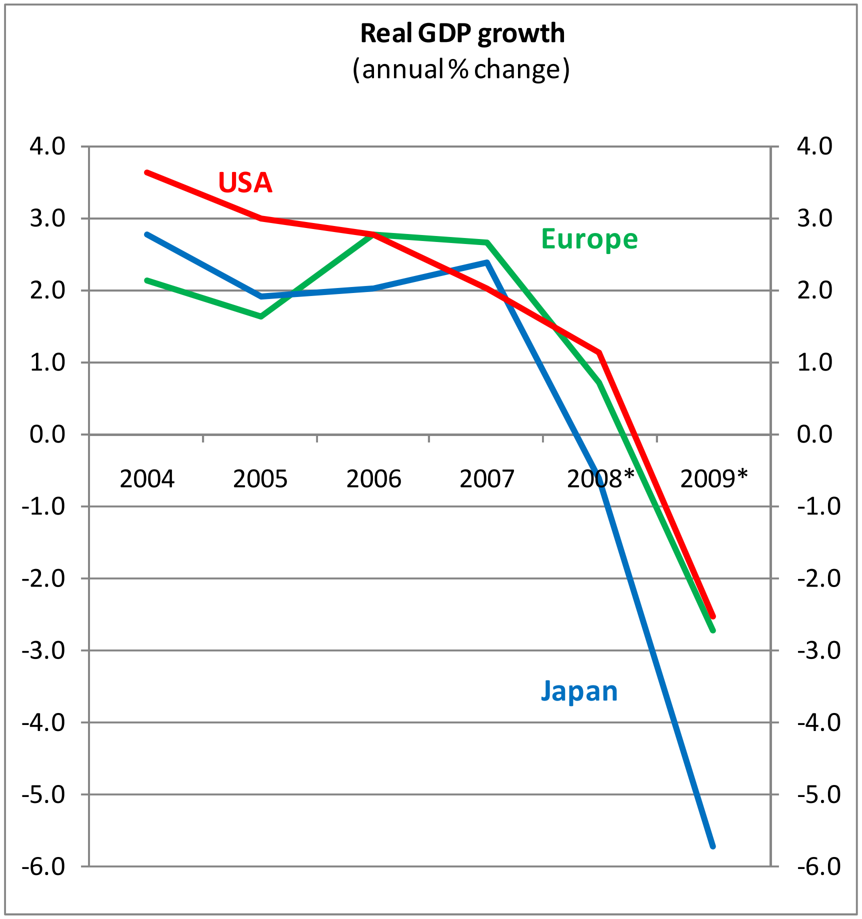
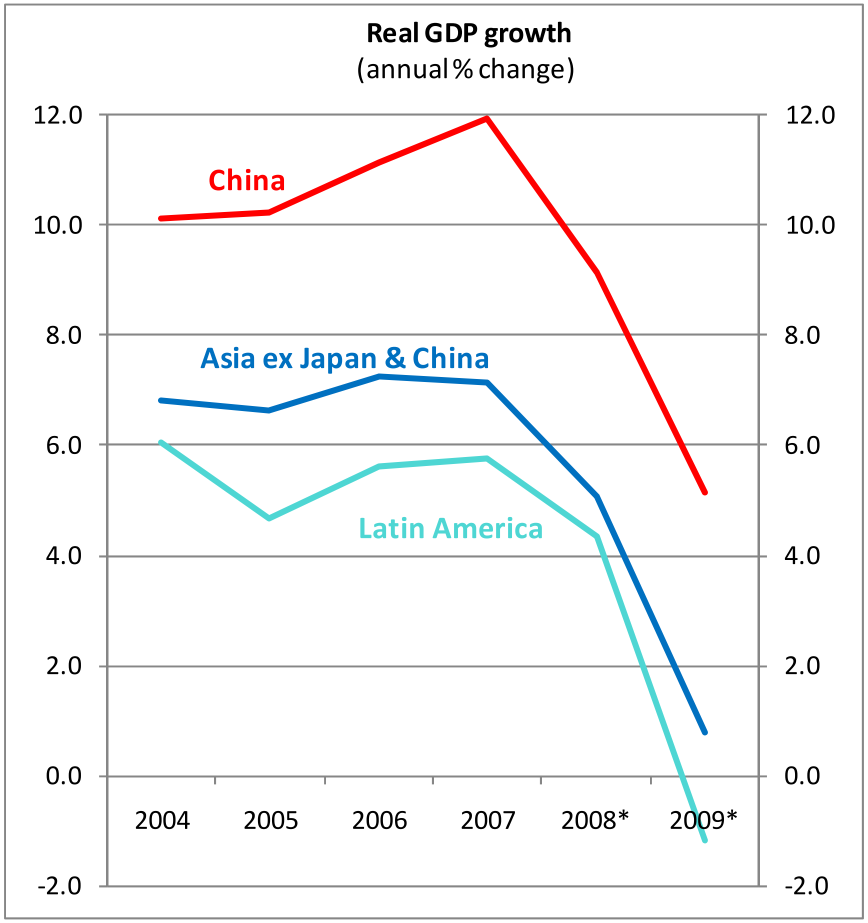
Economic performance in selected regions

- The US, Europe and Japan face steep GDP contractions. The emerging economies, led by China, fare somewhat better.

DEVELOPED ECONOMIES



EMERGING ECONOMIES



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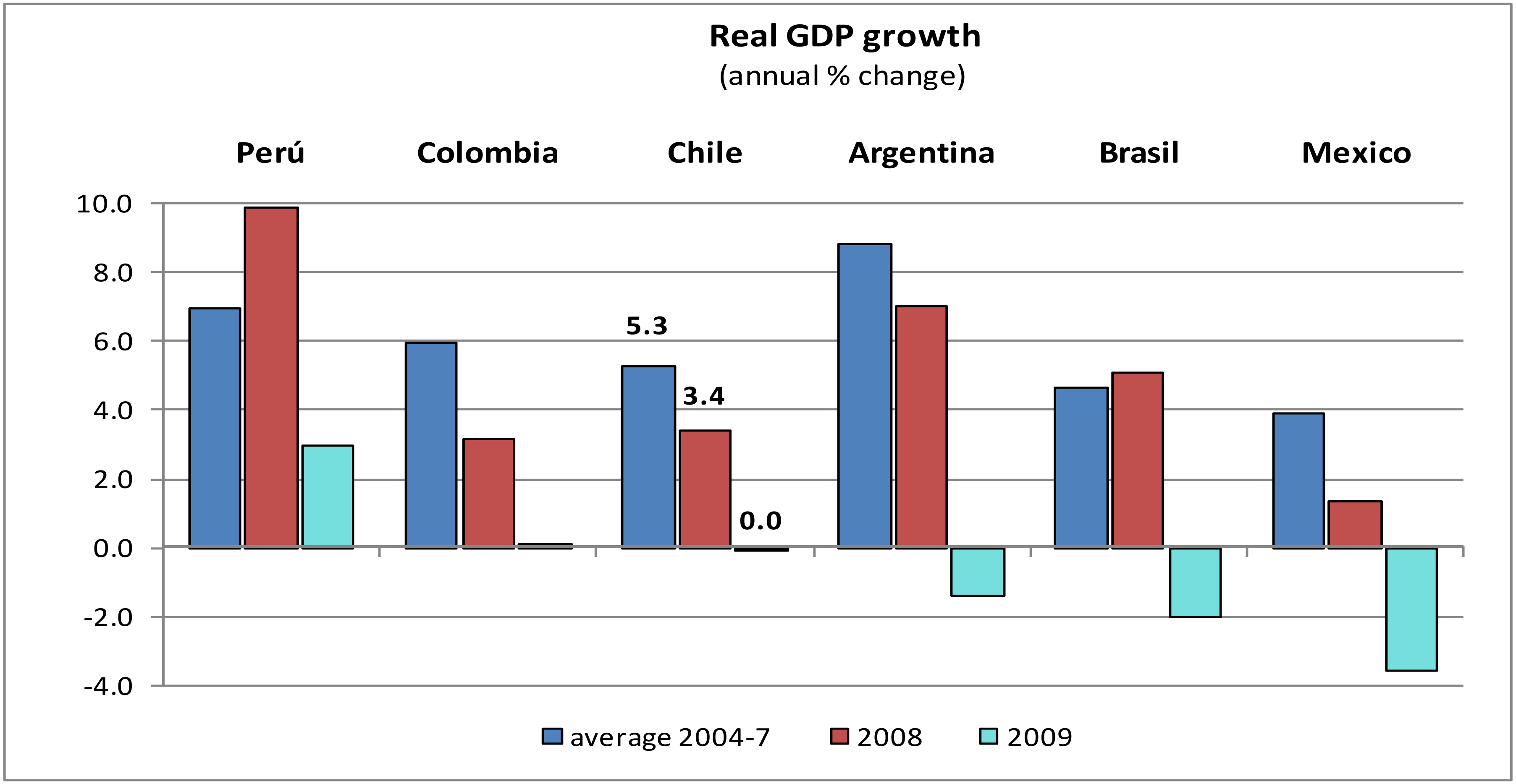
Latin America: feeling the cool weather

- All Latin America economies are expected to slow down. But none of them seem to fall into a severe recession.



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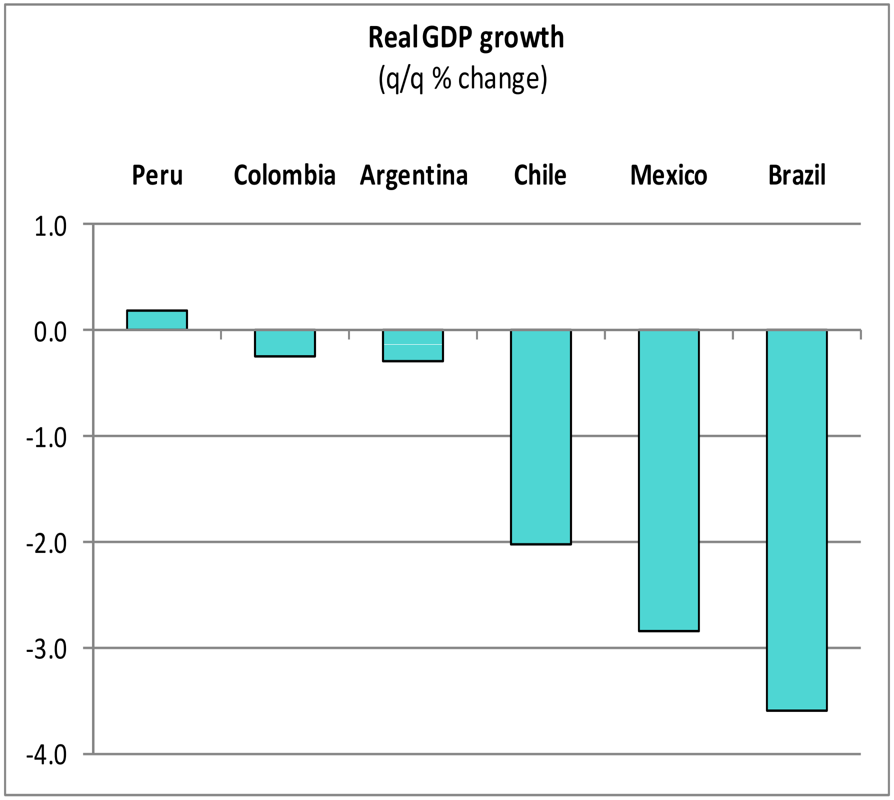
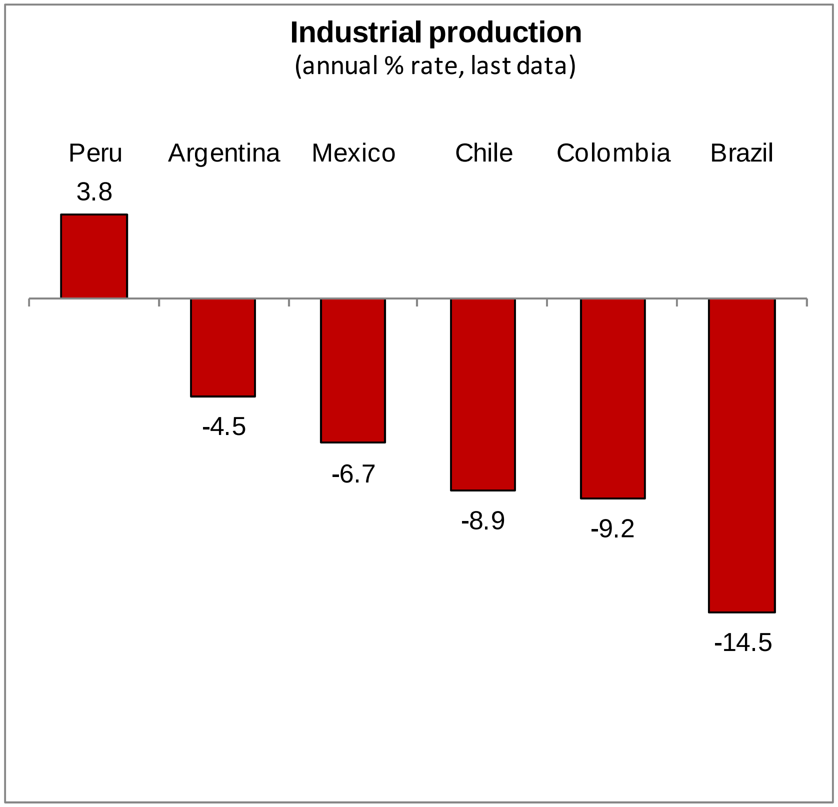
Initial impact: stronger than expected

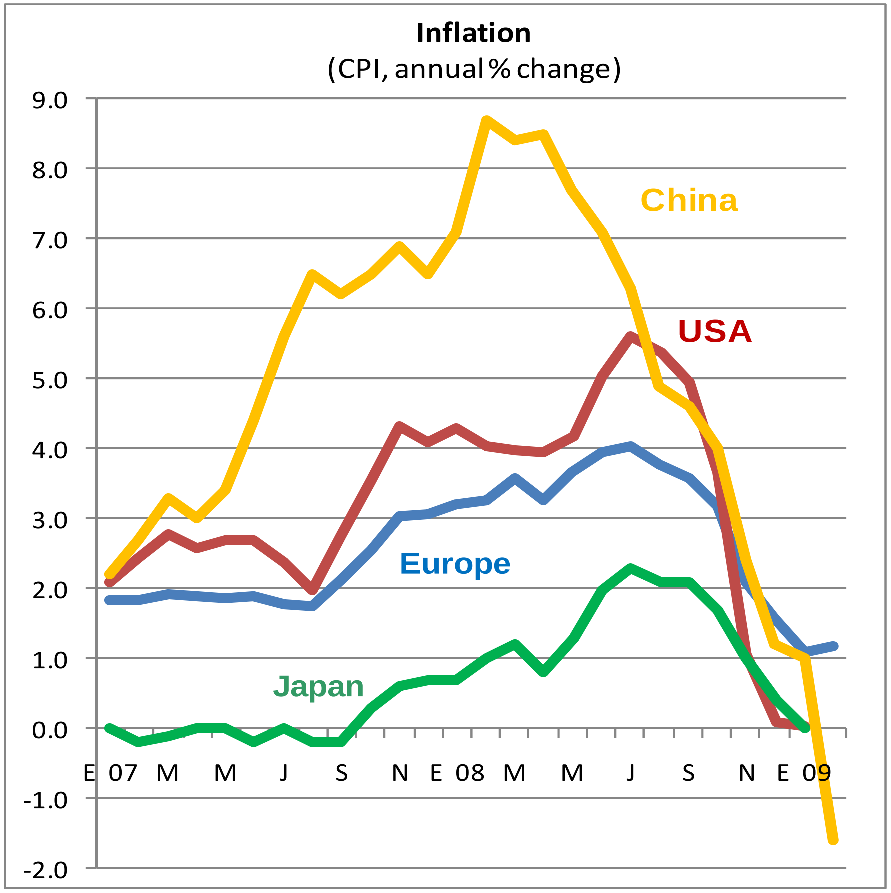
- Fourth quarter GDP signals strong initial impact of the international crisis. Steep fall in industrial production is worrysome.

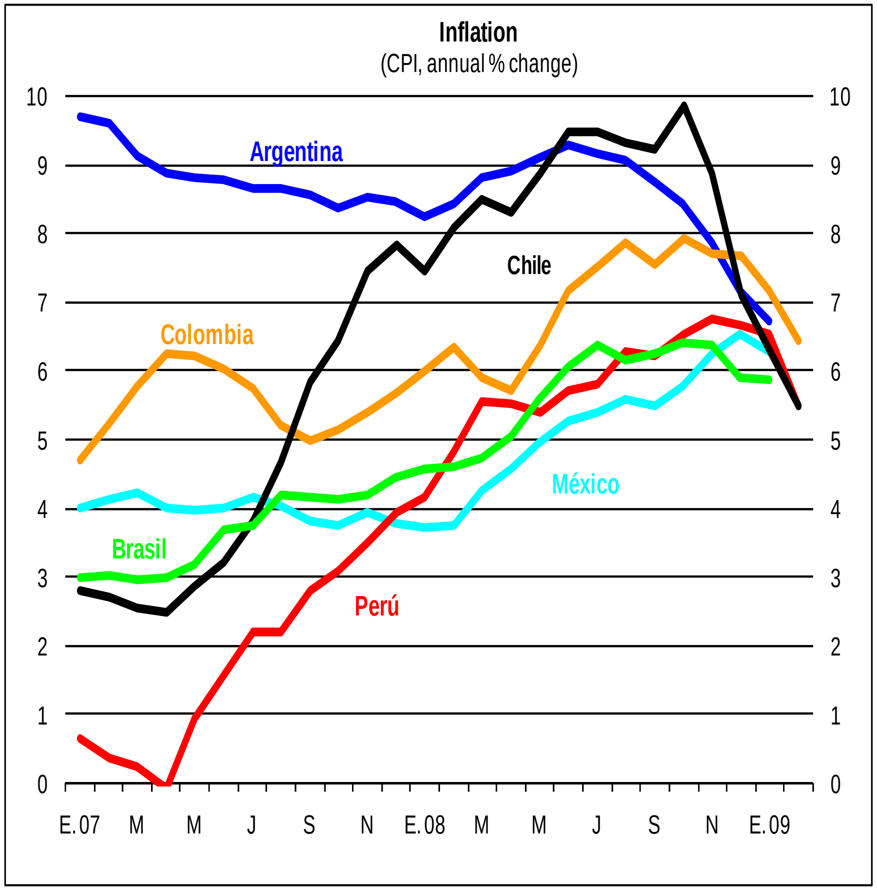




Inflation: in extinction everywhere

- World inflation is knocked down by recession. In Latin America inflation gradually heads down.





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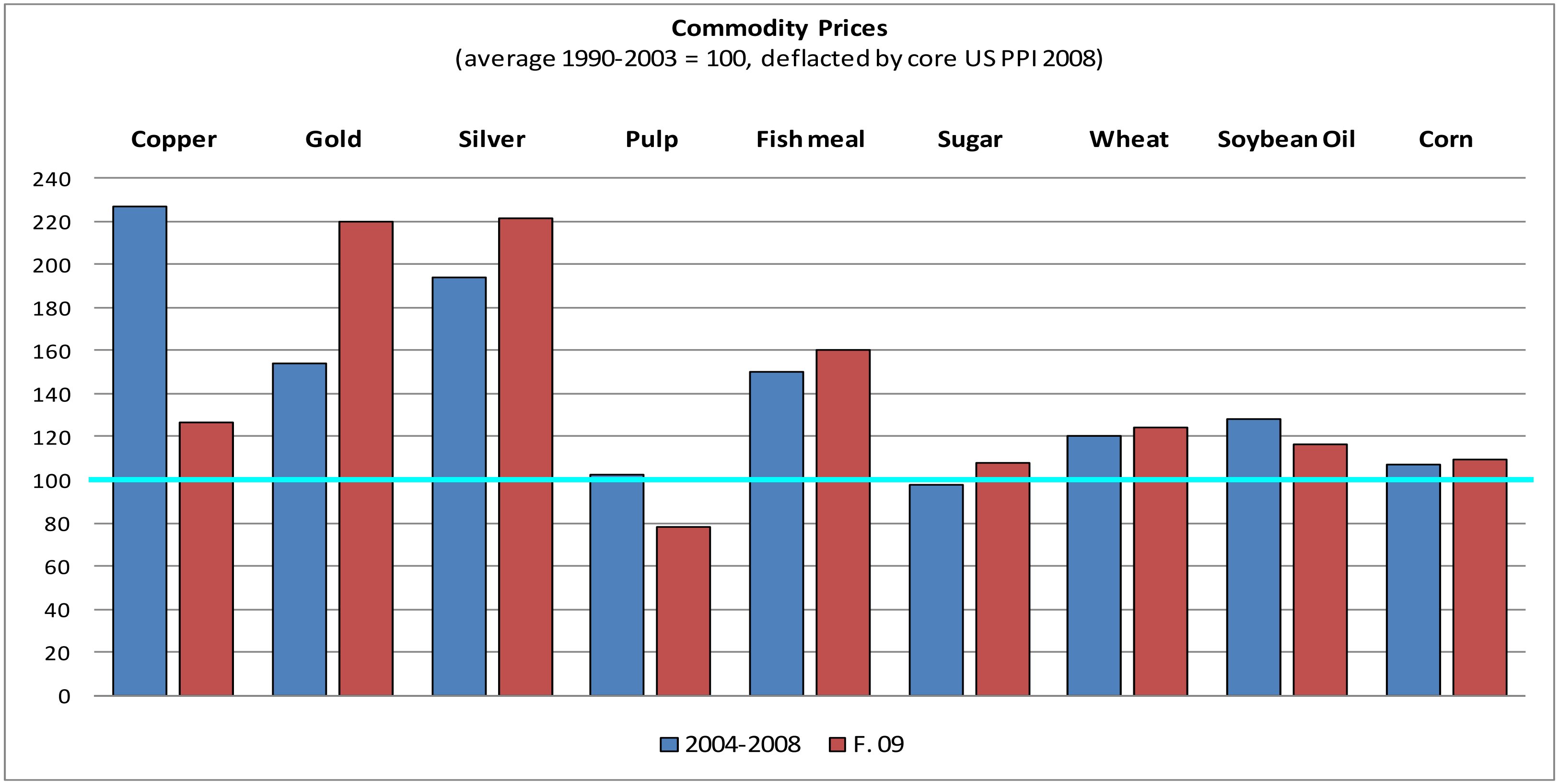
Commodities: reduced, but still high

- Economic contraction has put an end to the commodity boom. But many Latin American exports still show prices above or slightly below historic average. Metals, in particular, are still overpriced. As import prices are also dropping, Latin American terms of trade are not abnormally adverse.



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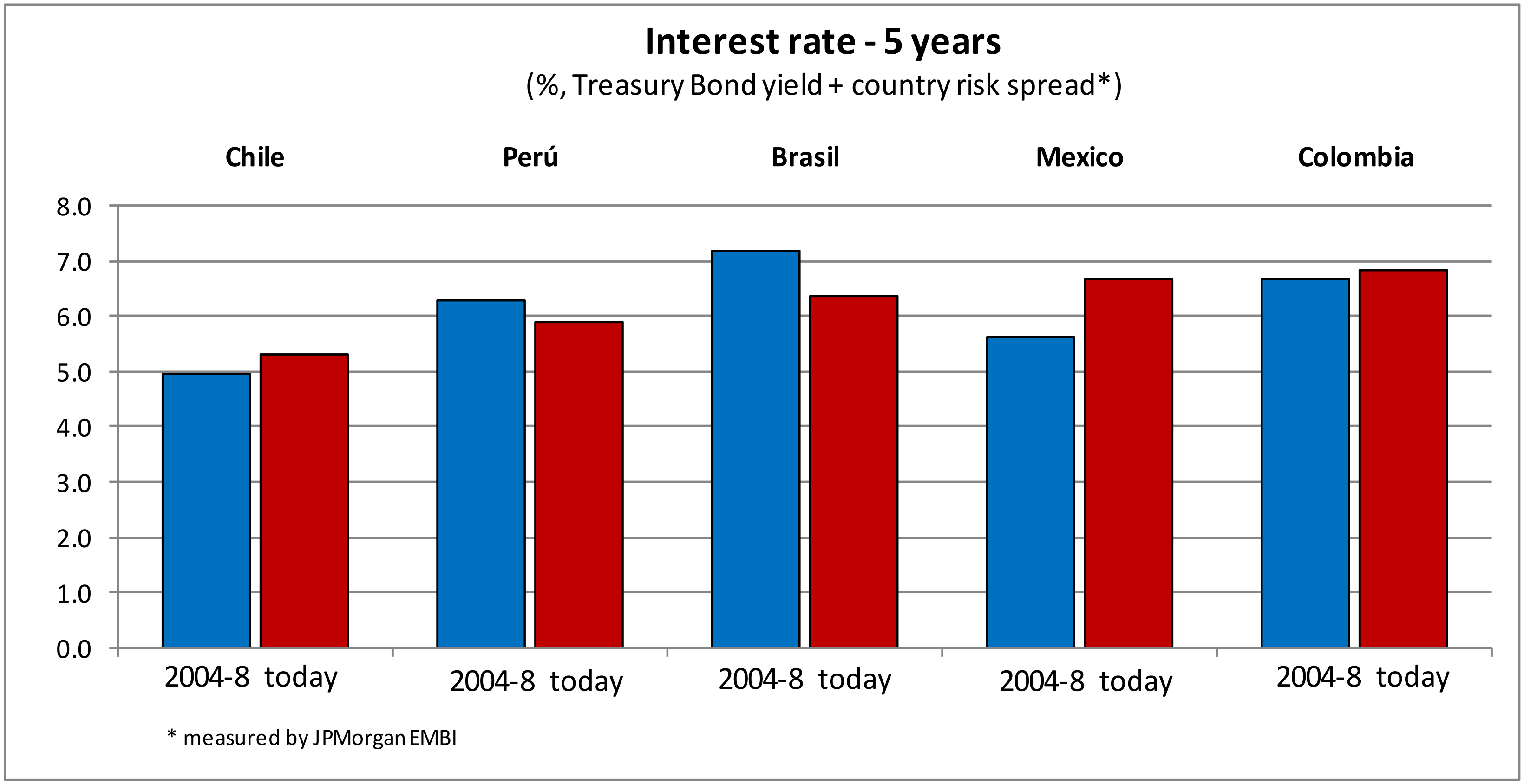
Cost of foreign finance: not much of a rise

- Following the global outburst of risk aversion, external credit spreads increased. Since base rates have come down substantially, overall real credit costs remain moderate.



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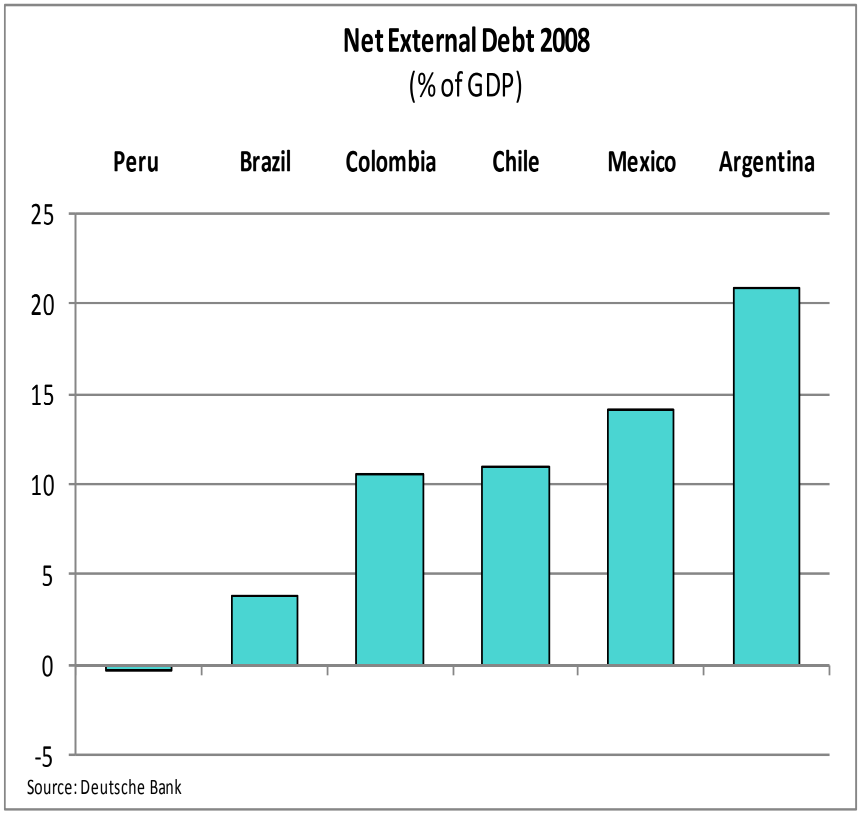
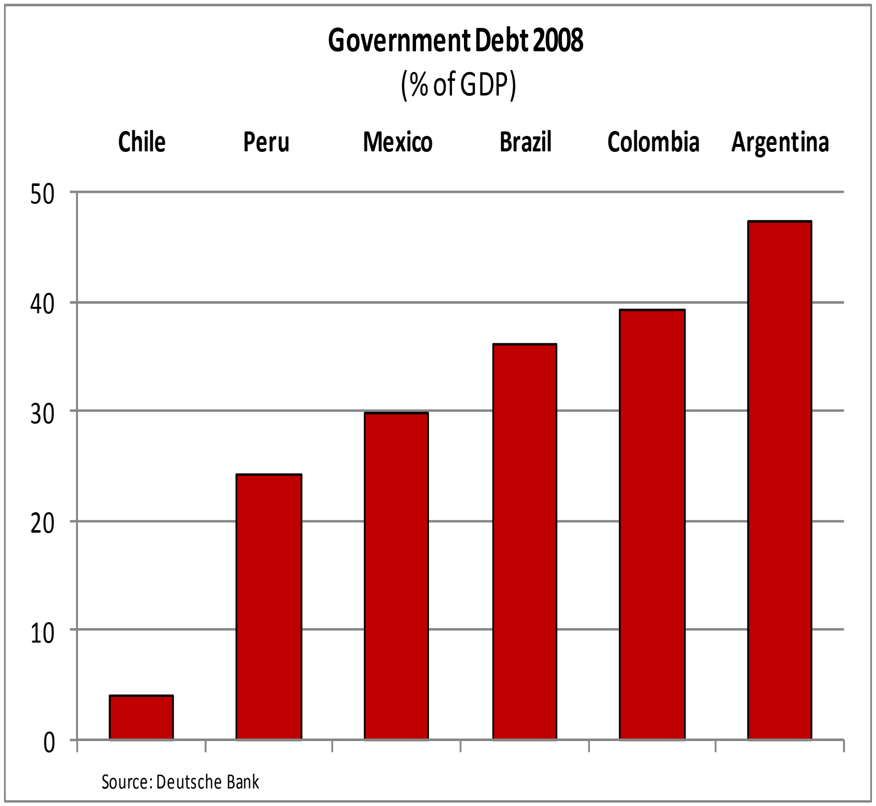
Fiscal Policy: the joys of counter-cyclical expansion

- Past macro policy discipline pays off. Foreign Debt and Public Debt ratios are unusually low for Latin America. There is room for counter-cyclical policies. But persistent fiscal expansion would be dangerous.





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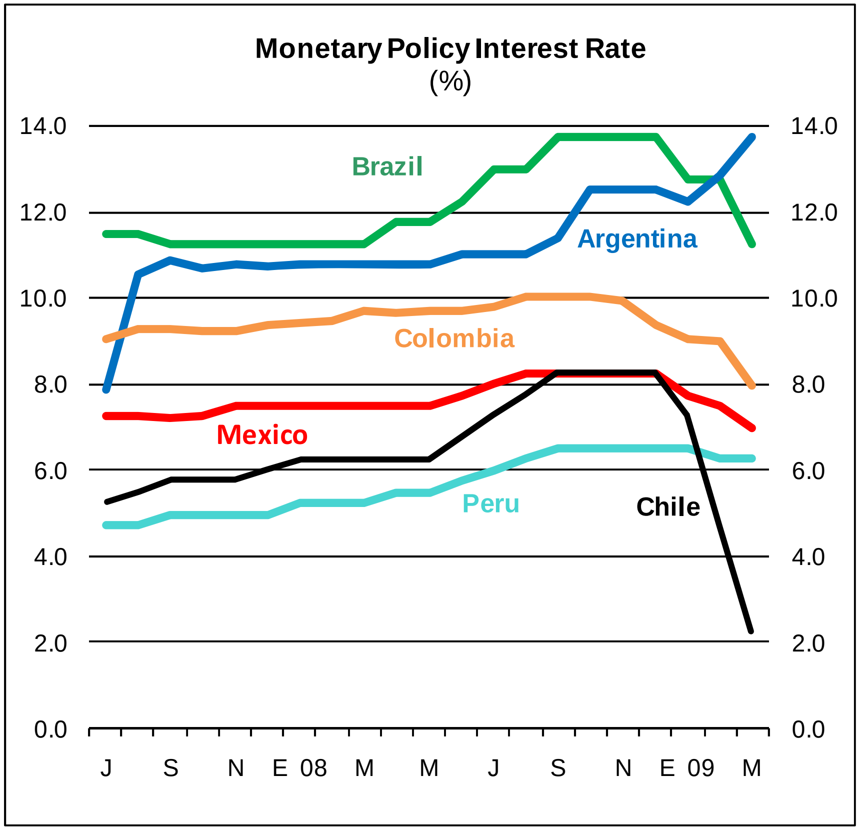
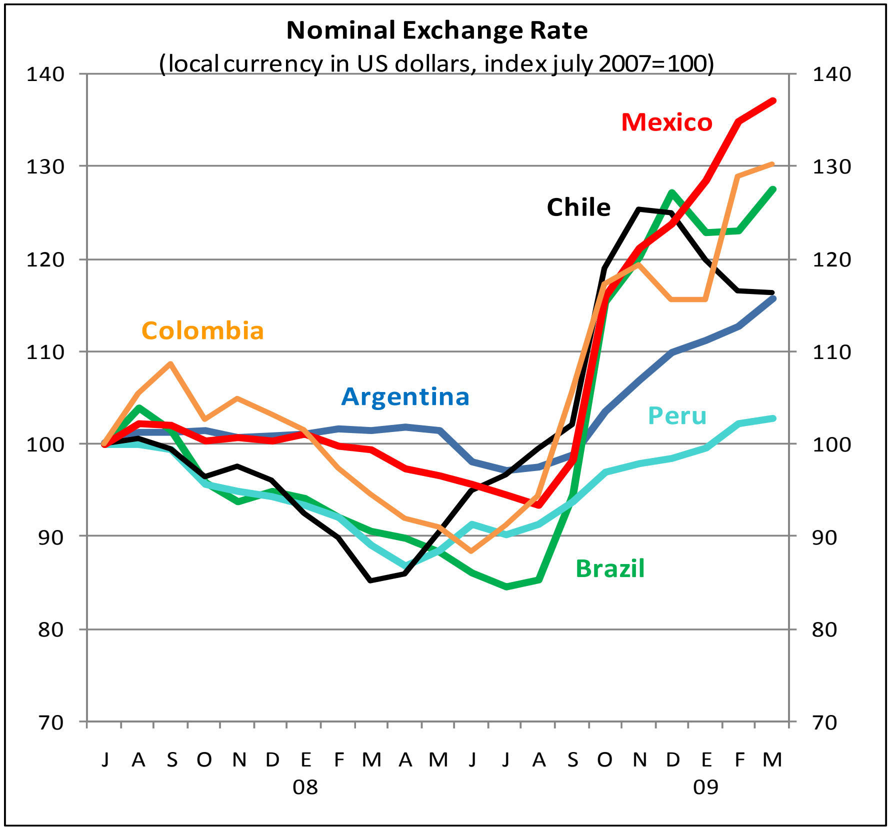
Monetary Policy: rate cuts and currency depreciation

- By far the most powerful instrument to fight recession is monetary policy. Interest rates, had been increased to control inflation. Rightly so, Central Banks are now cutting rates and allowing currencies to depreciate.





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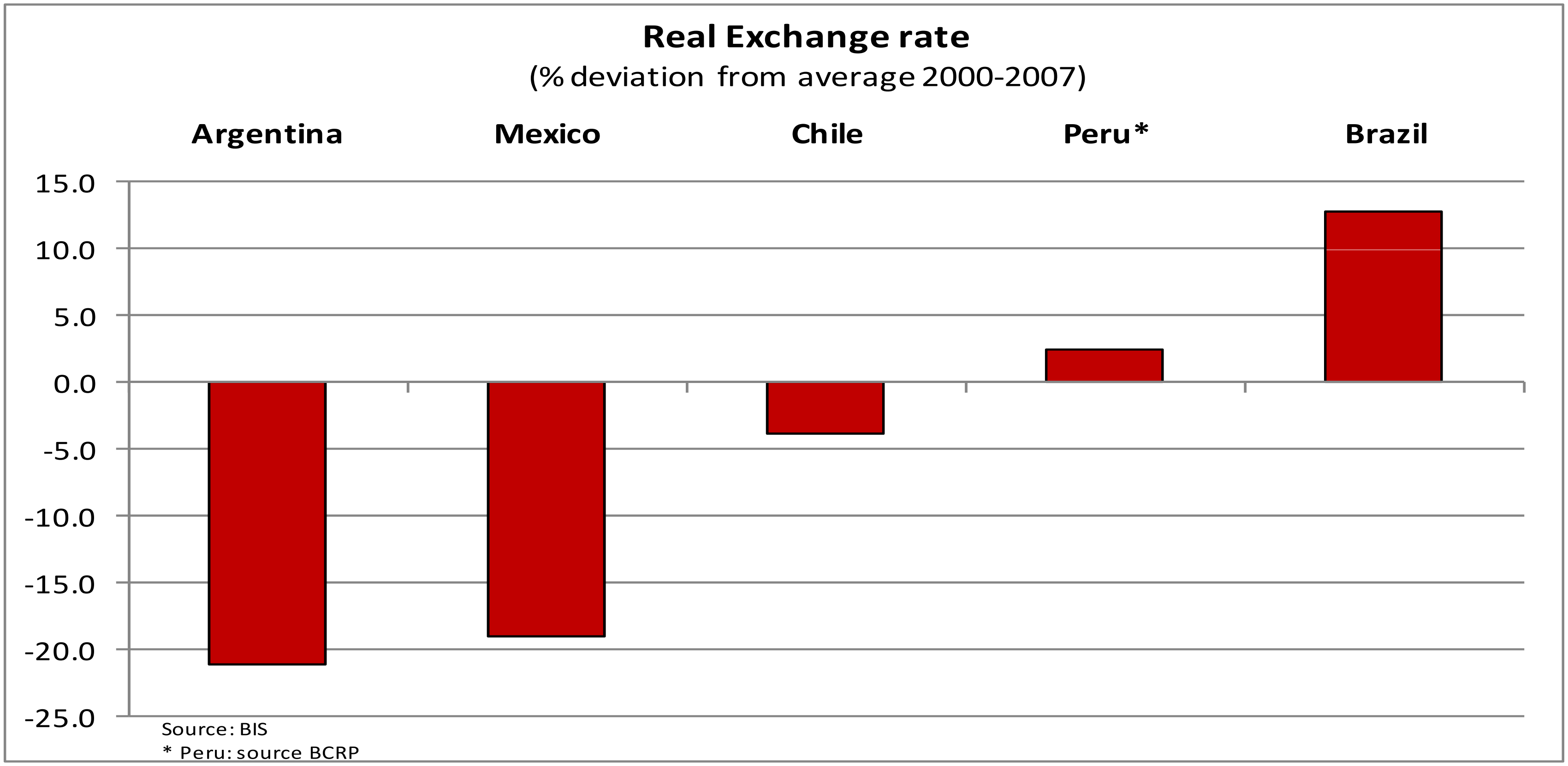
Real exchange rates: restoring competitiveness?

- While Argentina's and Mexico's currencies are below historic averages, the Brazilian Real seems to be overvalued. Under the new scenario, Latin American economies may need much more competitive real exchange rates, to promote exports and foreign investment.



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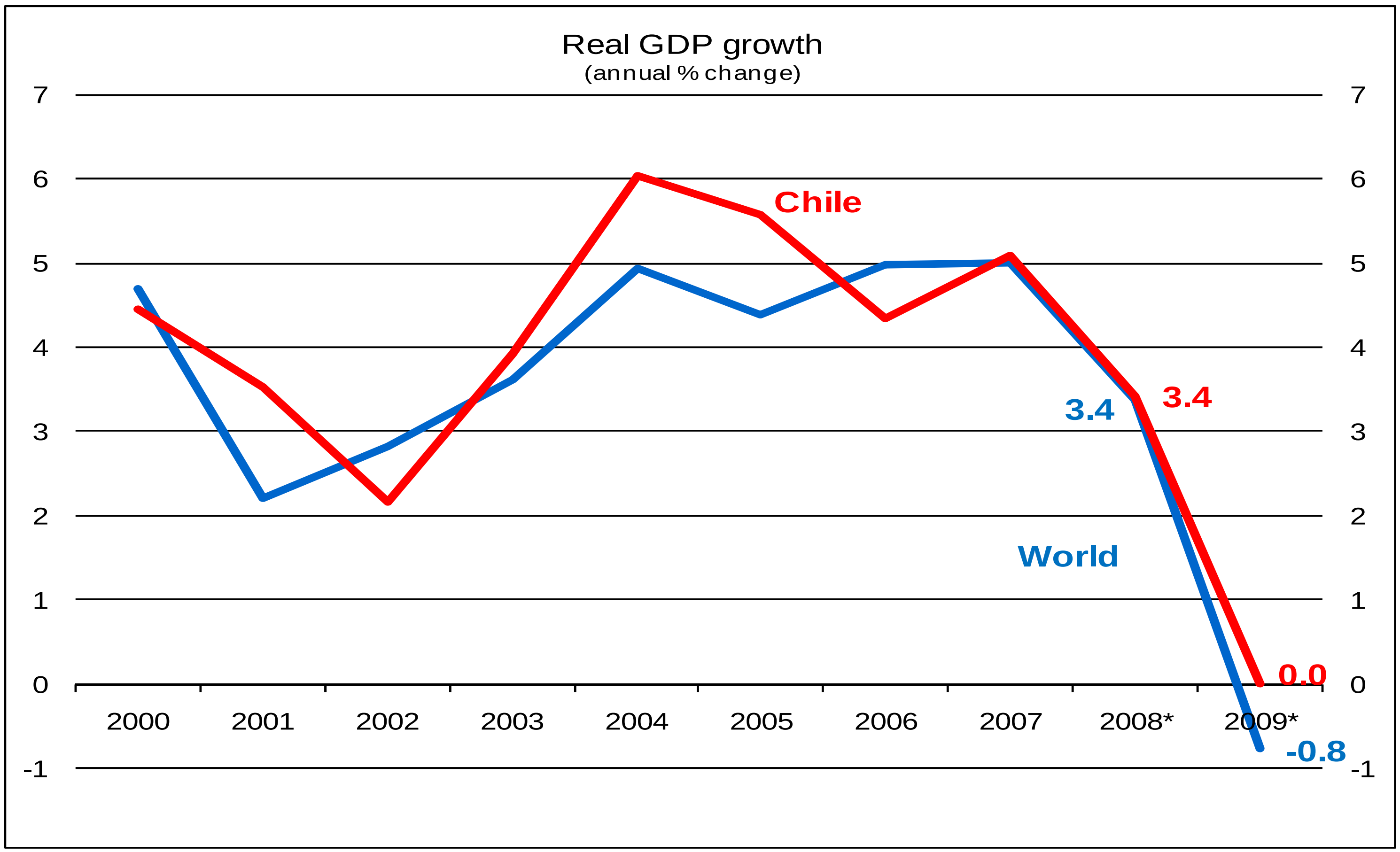
In sum: Latin America faces mild recession

- After the downfall of Lehman Brothers, worldwide panic is causing an expectations-induced recession in most of Latin America.
- But fundamentals are strong: no financial or fiscal crises are on sight.
- Moreover, past macro discipline has substantially improved fiscal and external solvency, thus creating room for cautiously countercyclical policies.
- Of course, traditional inclination towards statist and populism have to be kept at bail. Not an easy task given the current hardships.
- With the right macro stimulus and pro export-led growth policies, the current economic gloom should be soon overcome. A mild recession, followed by a gradual recovery, seems the most likely scenario.

II. CHILE: ON THE BRINK OF RECESSION

Chile rides the global cycle

- Over the last 8 years, Chile has closely followed the global business cycle. Present global contraction has knocked down confidence in Chile's capacity to grow.



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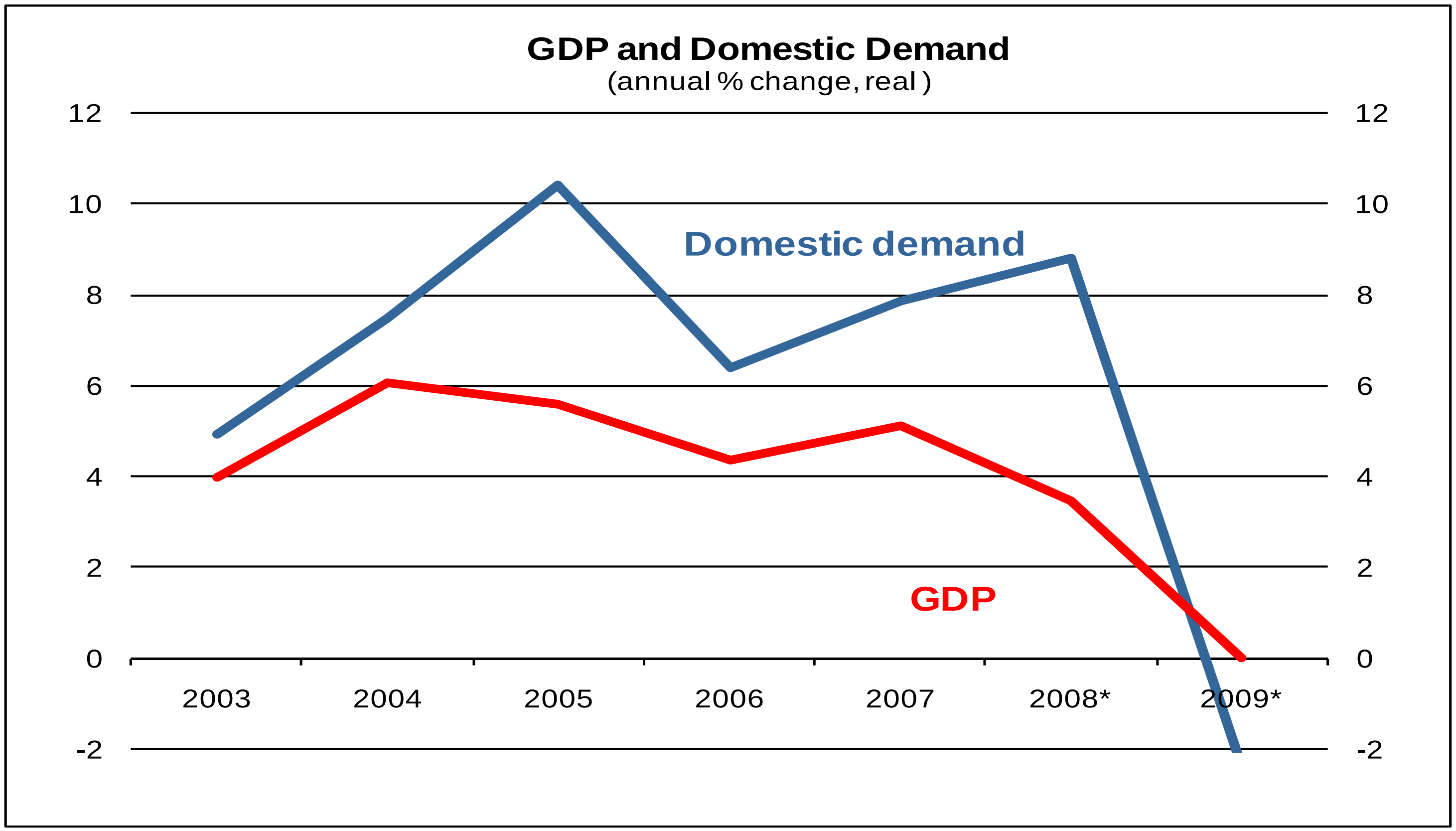
Chile's 2009 external scenario: a tough year (but tougher ones have been seen)

- Despite the extraordinary depth of the current world crisis, the objective external conditions facing Chile seem better than in our two previous recessions (1982 and 1999).

year average	1982	1999	2009*
World GDP (real annual % change)	0.6	3.5	-0.8
Copper Price (US$2008/lb)	1.2	0.9	1.5
Real Interest Rate LIBOR 180d	5.6	3.4	1.7

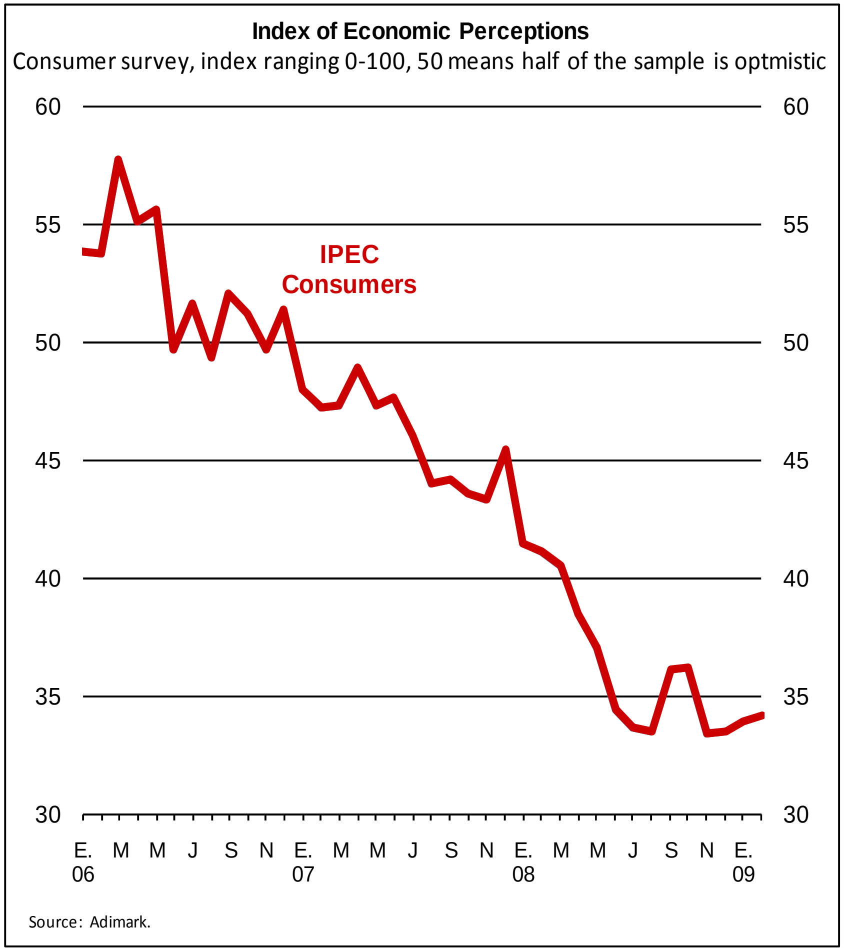
The demand boom ends, GDP stalls

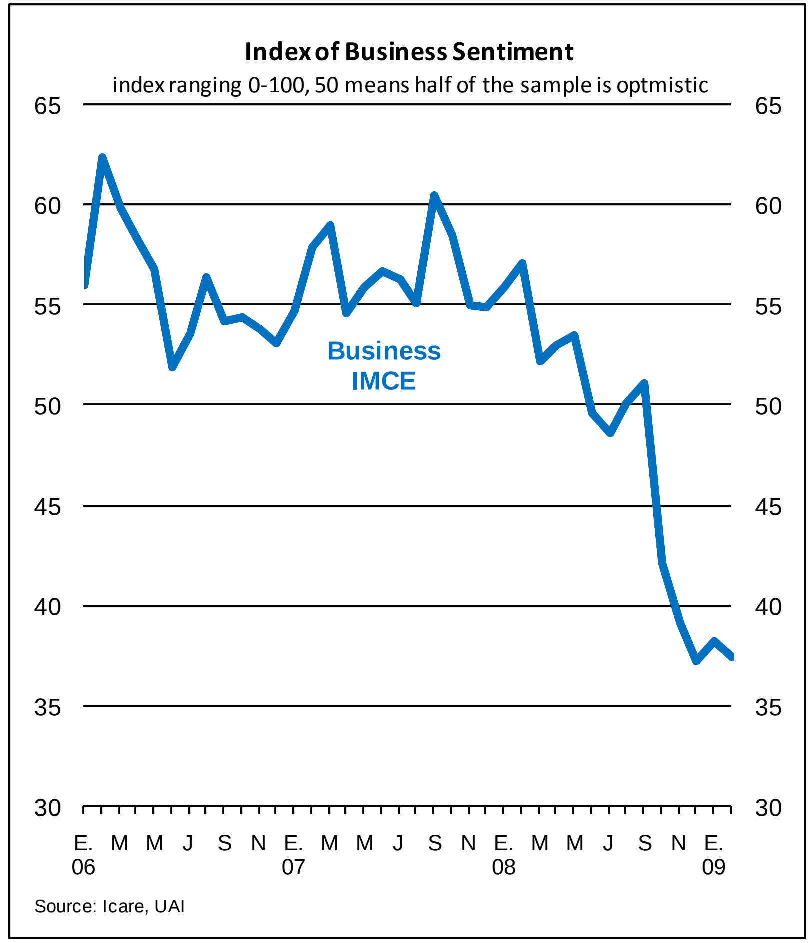
- Fuelled by high expectations, domestic demand grew strongly in 2004-08. GDP growth lagged behind due to insufficient investment and weak productivity. Under the new scenario, demand is likely to fall and output growth to stagnate.



A strong expectation shock

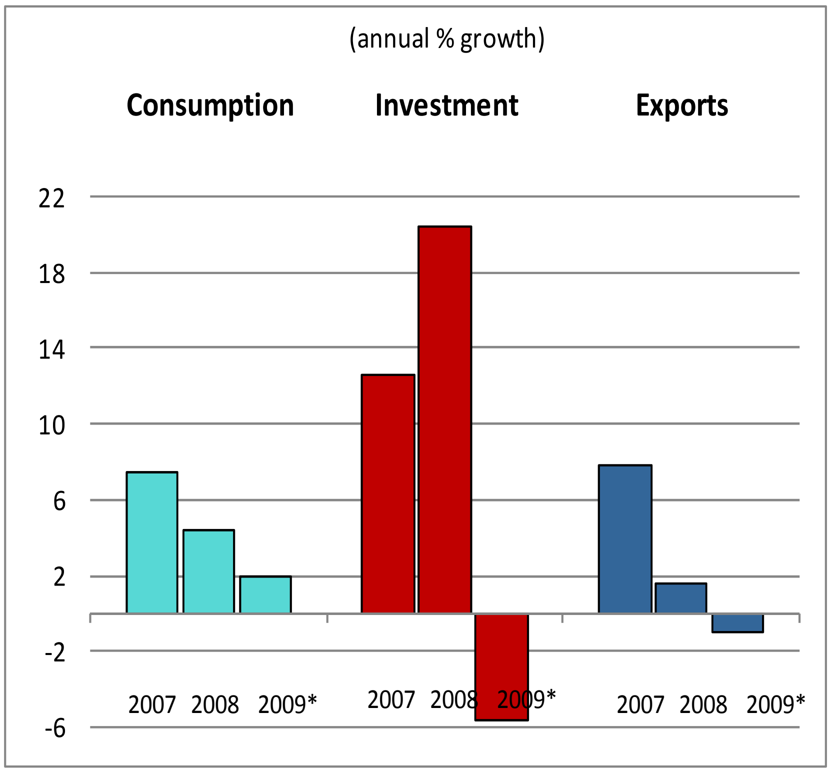
- Following the September downfall of Lehman Brothers, business and consumer sentiment plunged. A cyclical contraction in aggregate demand has started.

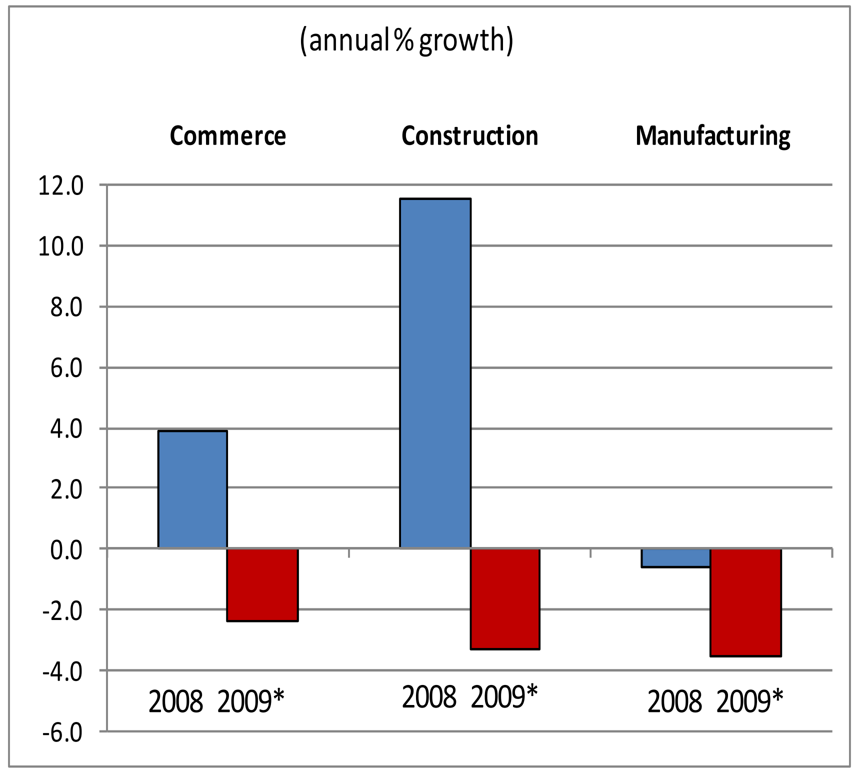




Consumption and investment are slowing down, while exports keep growing

- Domestic demand drops because of plummeting expectations, wealth losses and higher financing costs. Exports are hit by the world contraction. Construction, Manufacturing and Retail sectors are most affected.





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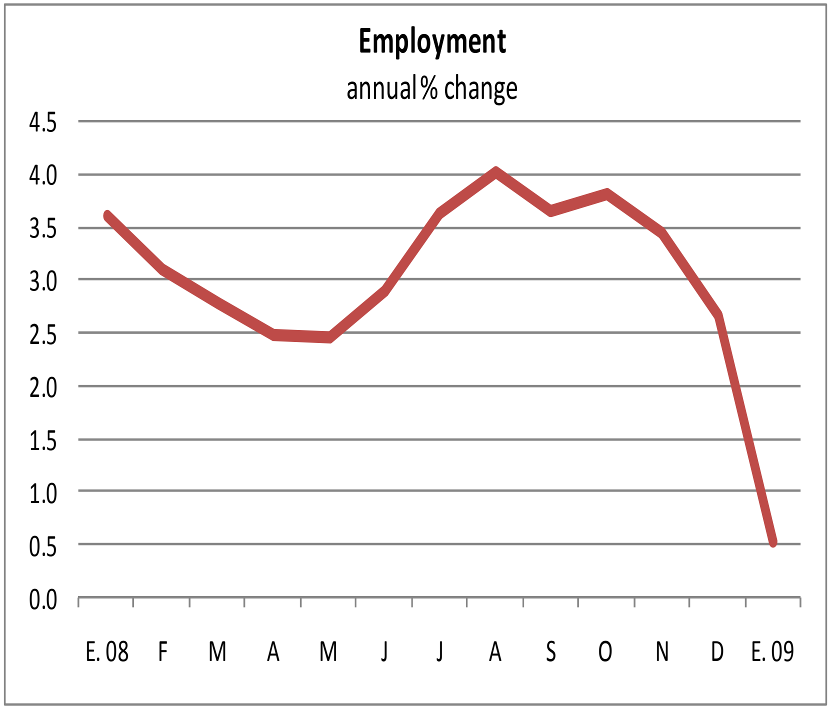
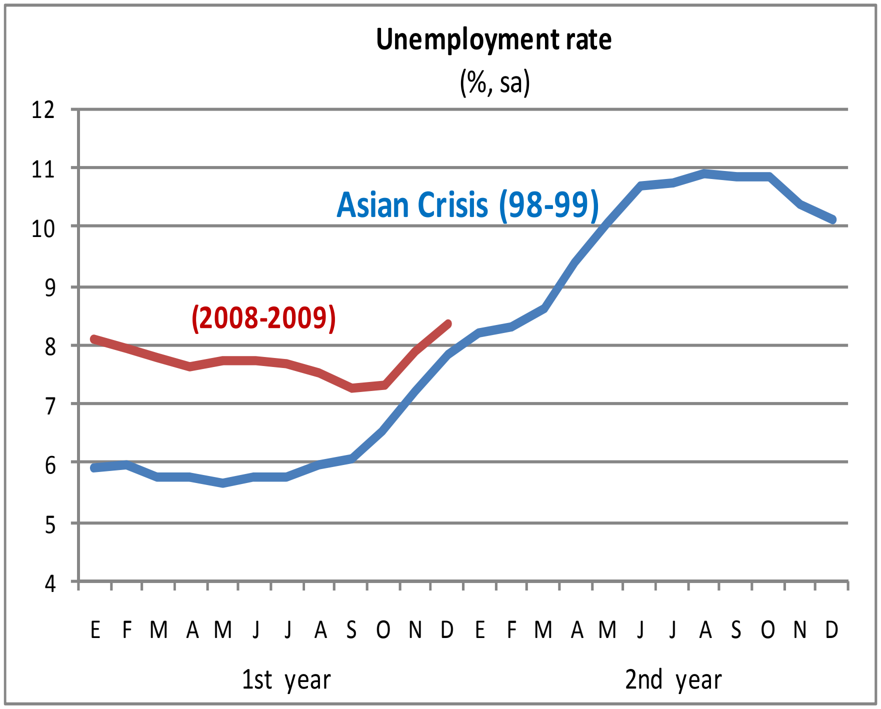
Unemployment starts rising

- Employment gets hit. Labor market regulation imposes high real wage rigidity and thus exacerbates unemployment. Social and political tensions are due to rise. Quite untimely considering the upcoming elections.





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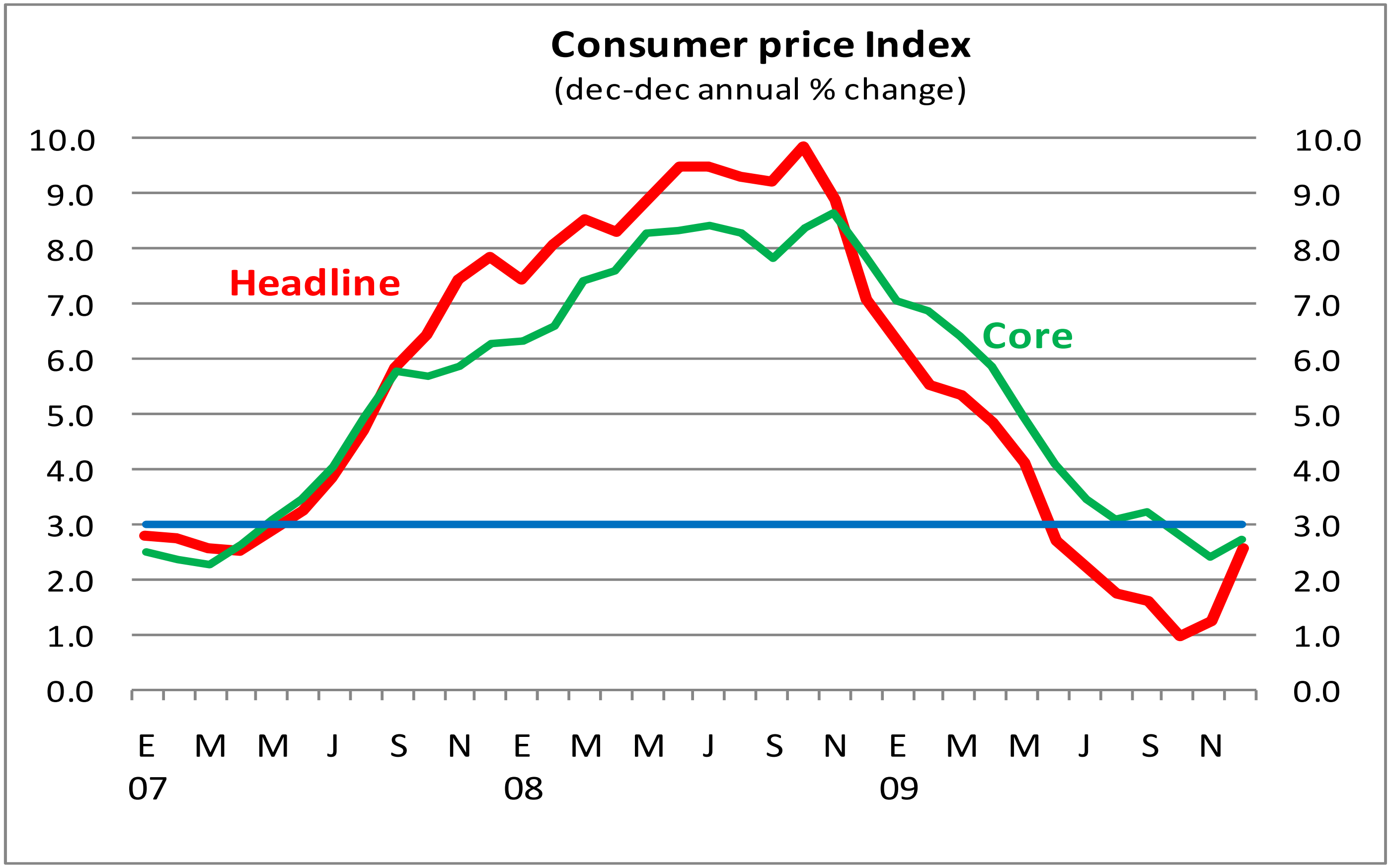
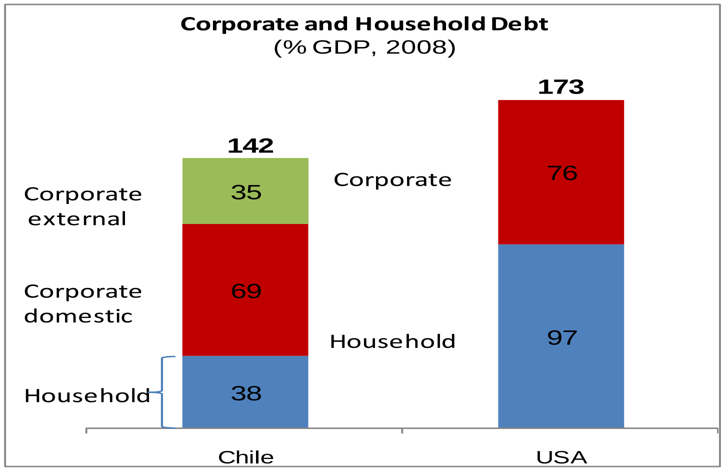
Inflation gets wiped out

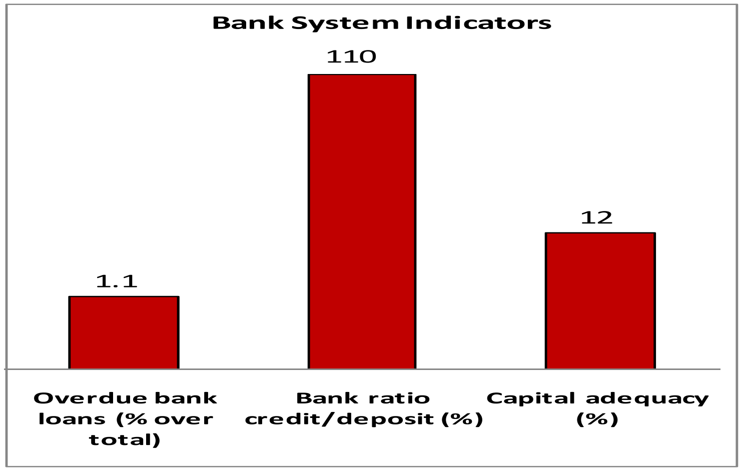
- Last year's inflation spike is over. Under the new scenario, inflation has turned negative in recent months and it is expected to be at around 2.5% target by year end.

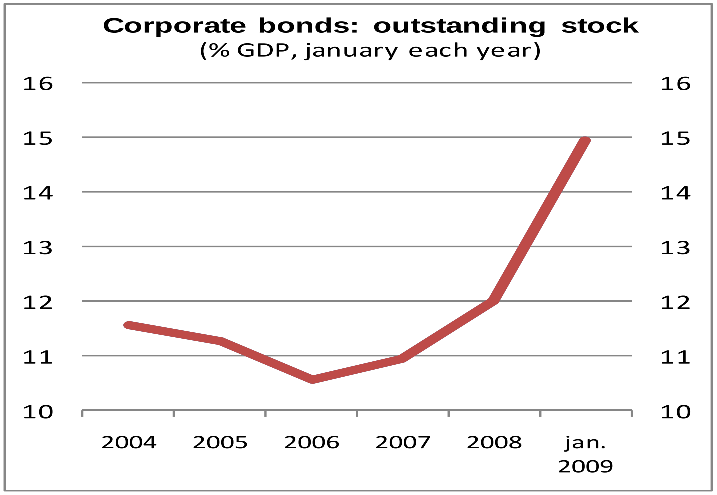


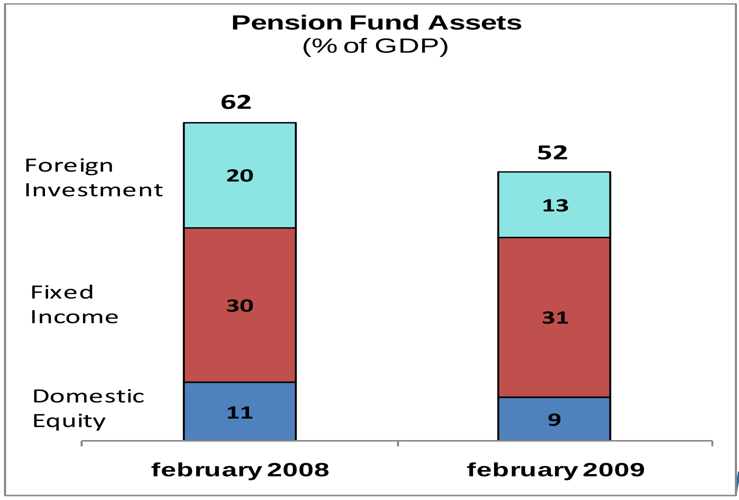
Financial markets: Caution is the name of the game

- Although bank credit policies in Chile have generally been conservative, borrowers and lenders are now rapidly curtailing debts. The Financial System is solid. Institutional investors, though battered by capital losses, remain strong and dynamic in the local financial market.









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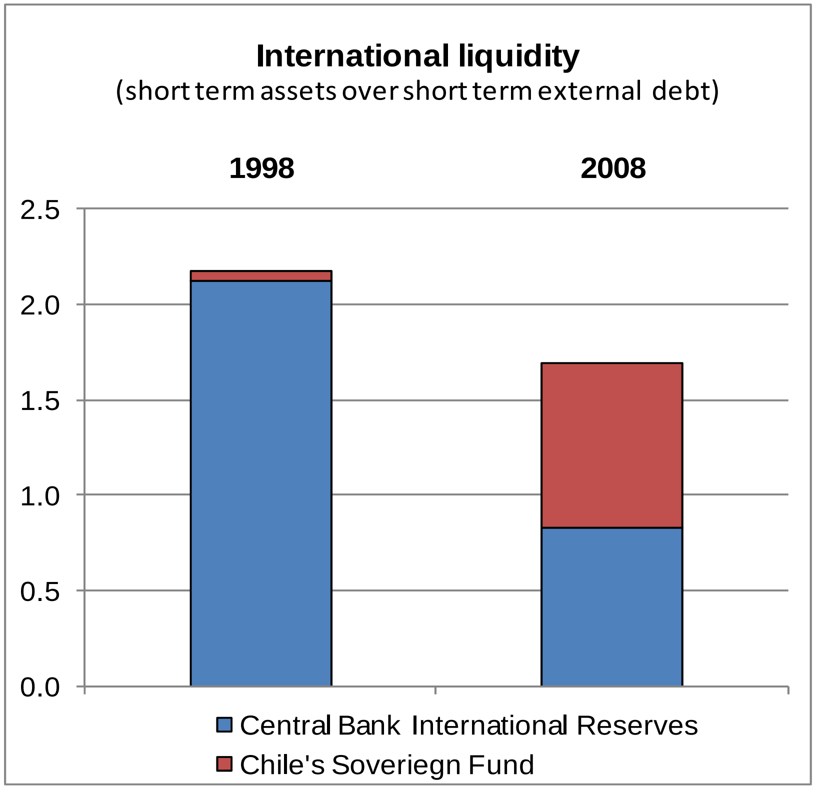
External Accounts turn red

- Gone are Chile's trade surplus and current account surplus. Under the new scenario, the trade surplus vanishes and external financing needs become significant. But Chile has a very strong external financial position and poses no serious balance of payment risk.

External Financial Needs

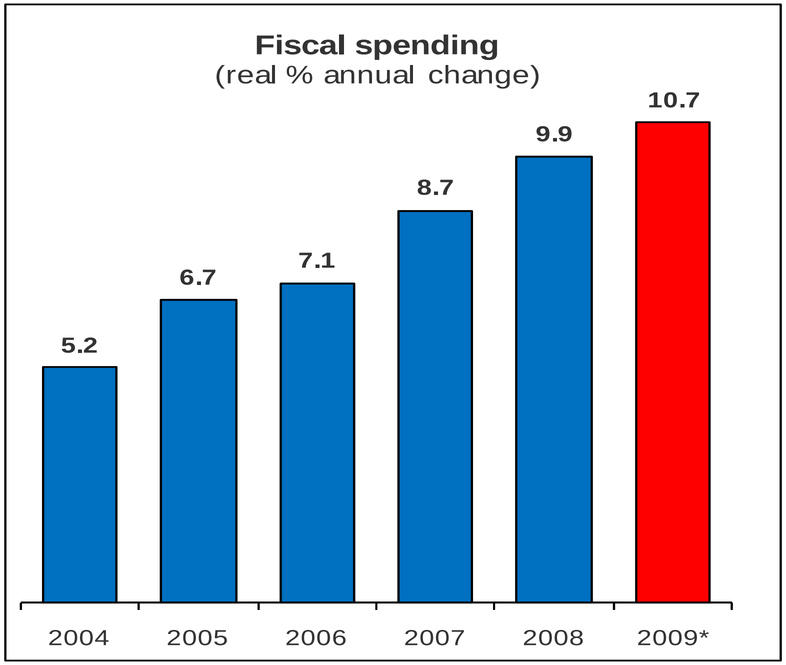
US$ billions	2007	2008	2009
Current Account Deficit	-7	5	4
MLT Debt Amortizations	8	11	14
ST Debt	9	11	15
TOTAL	**10**	**27**	**33**

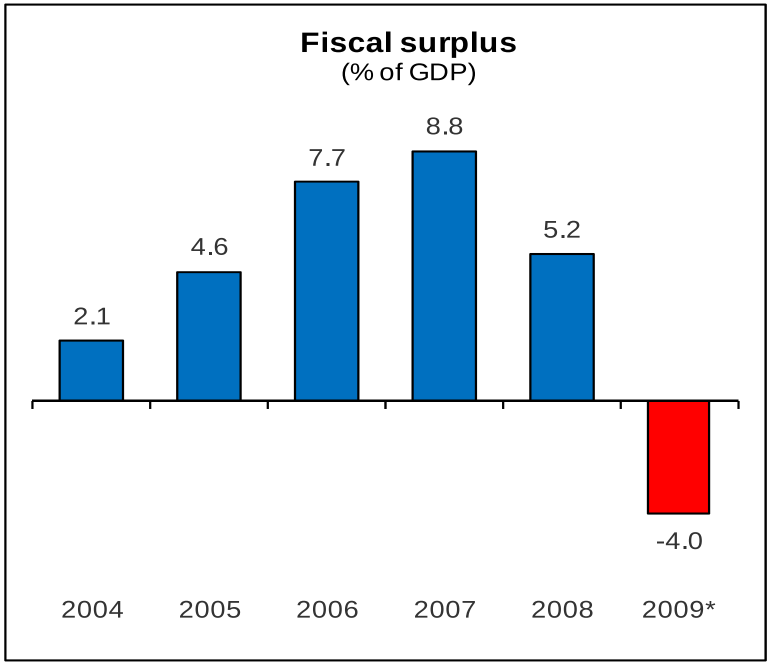


IV. MACROECONOMIC POLICY REACTION

Fiscal Policy: strongly expansionary

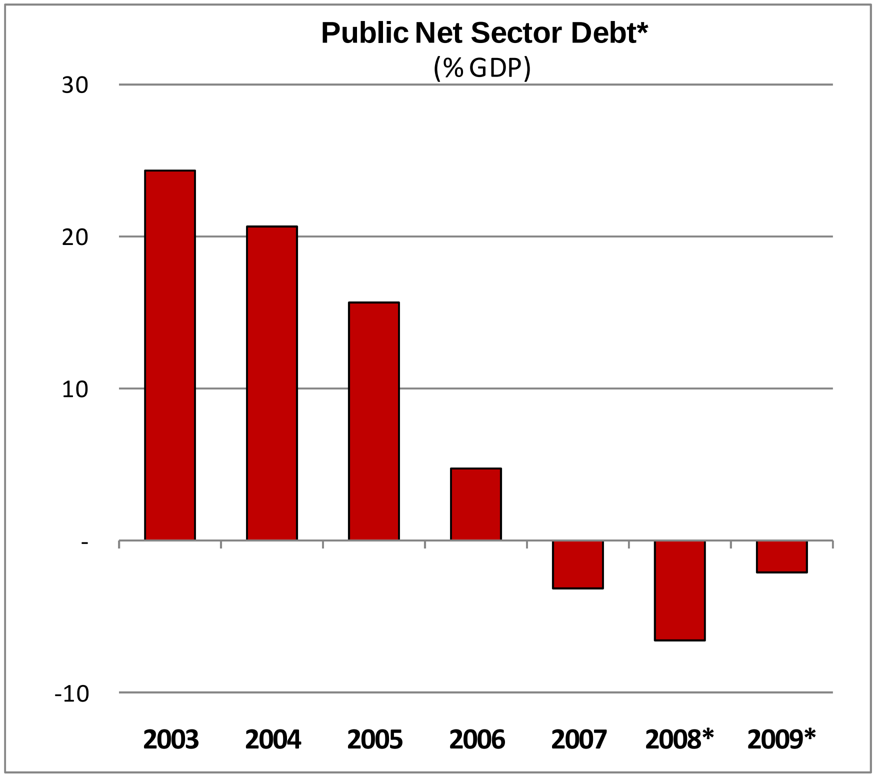
- The Crisis Fiscal Package announced last January adds a new stimulus of 2% of GDP through extra spending programs and some ultra temporary tax cuts. Spending is expected to increase by 11% in real terms, while the budget is to show a deficit of 4% of GDP. Since the Structural Surplus Rule has de facto been abandoned, additional fiscal packages may come.

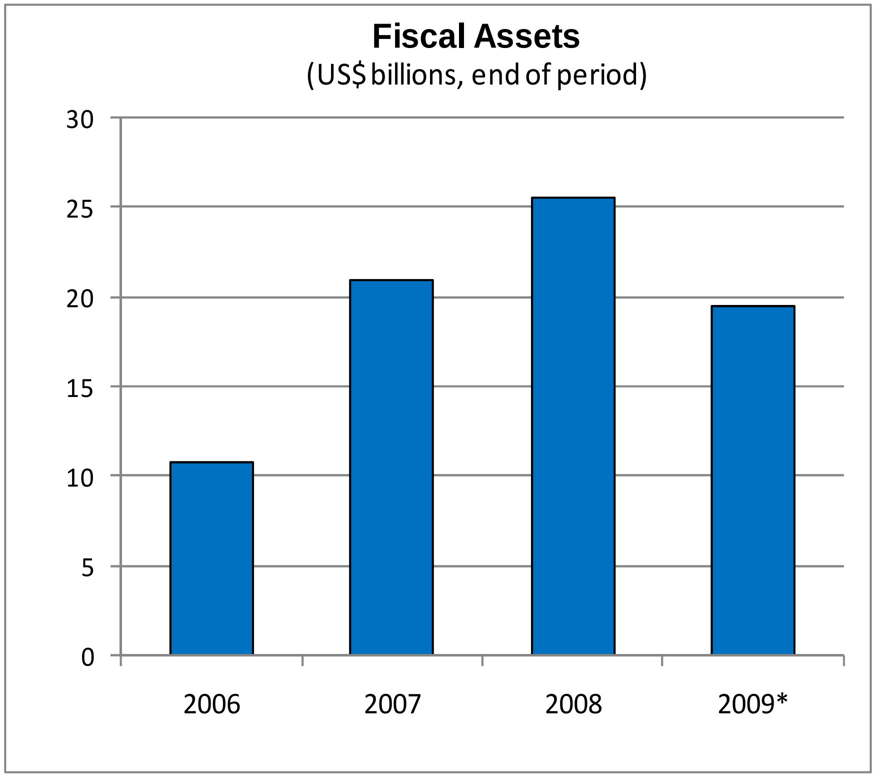




Fiscal Position: strong for how long?

- After several years of prudent fiscal policy, Chile's net public sector debt is slightly negative (the State is a creditor) and accumulated fiscal savings are large. But future fiscal deficits may gradually erode Chile's strong financial position.





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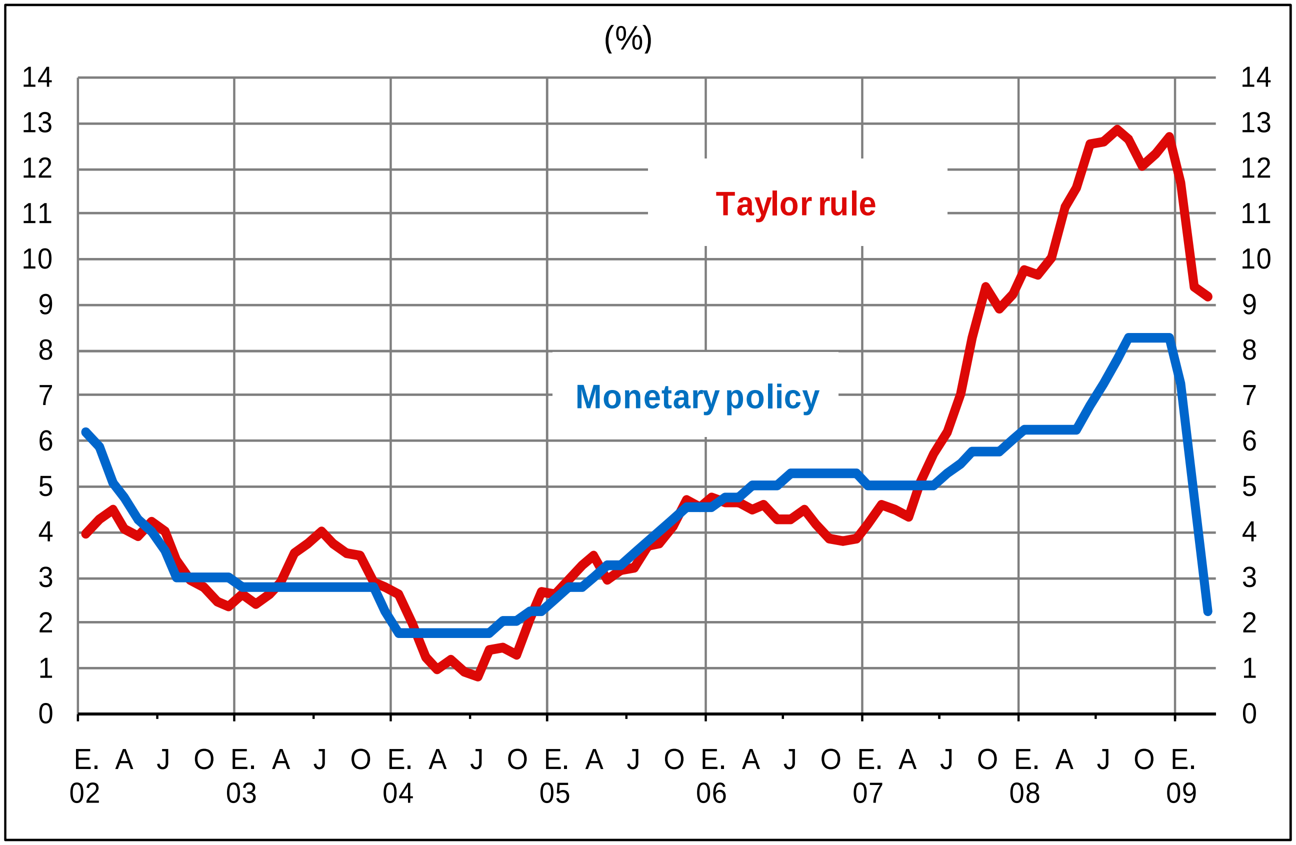
Monetary Policy: beware of shortermism …

- As in the rest of the world, the Central Bank has slashed its interest policy rate. Given the rapid drop of inflation expectations sharp cuts seem right. But we have entered a no-rules monetary world. Discretionary policies may be unavoidable in serious crises, but are dangerous in normal times.



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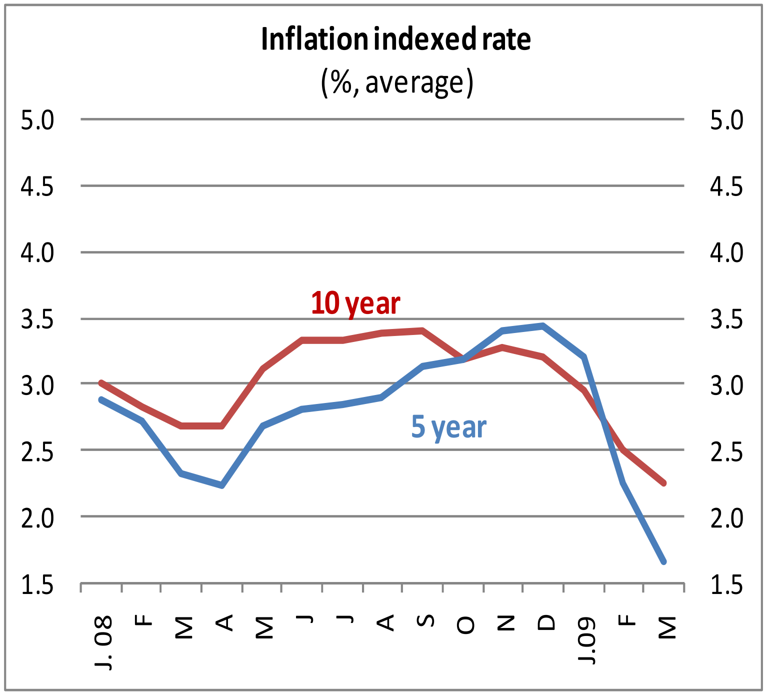
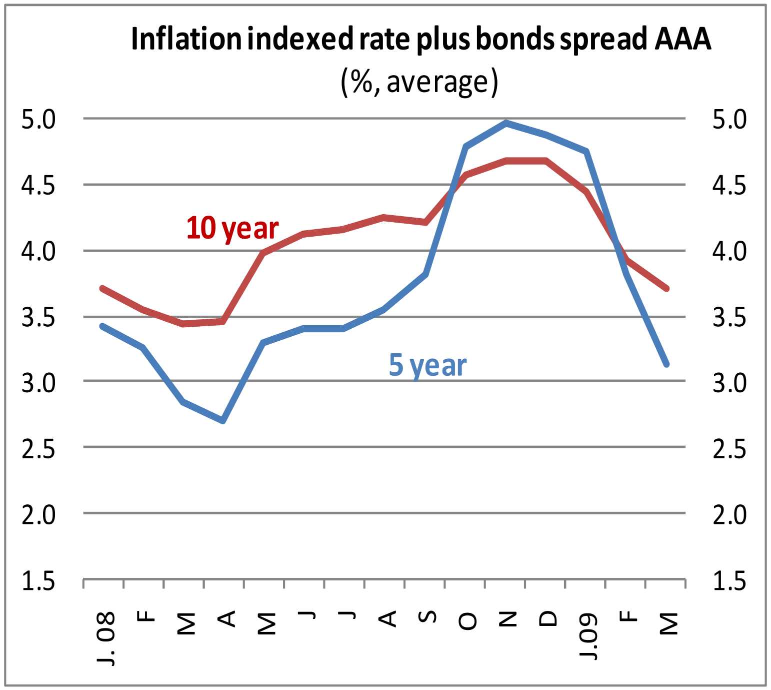
… but low rates are helping a lot

- Although credit spreads have widened, the drop in base rates is causing a healthy reduction in the cost of short and long-term credit for corporations and households.





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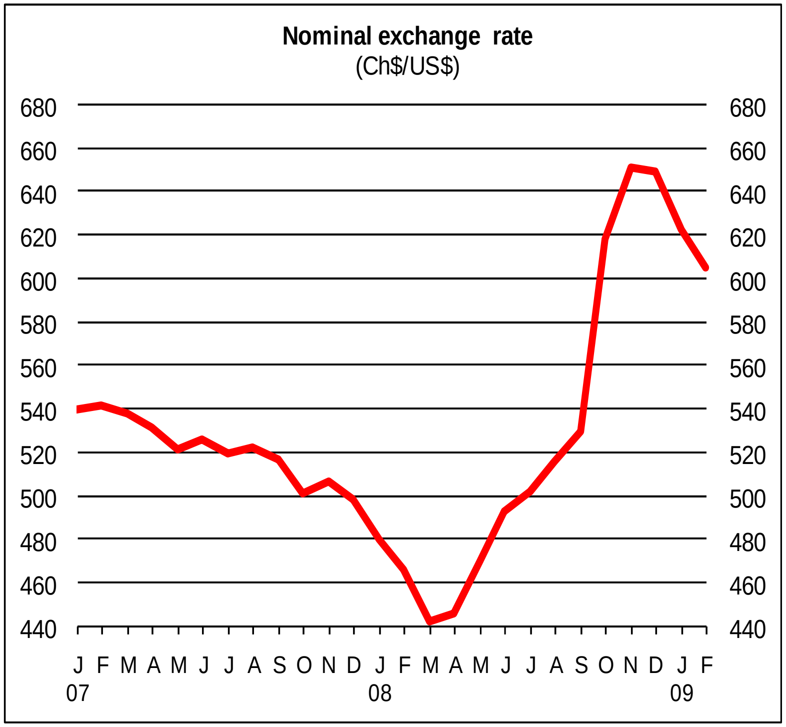
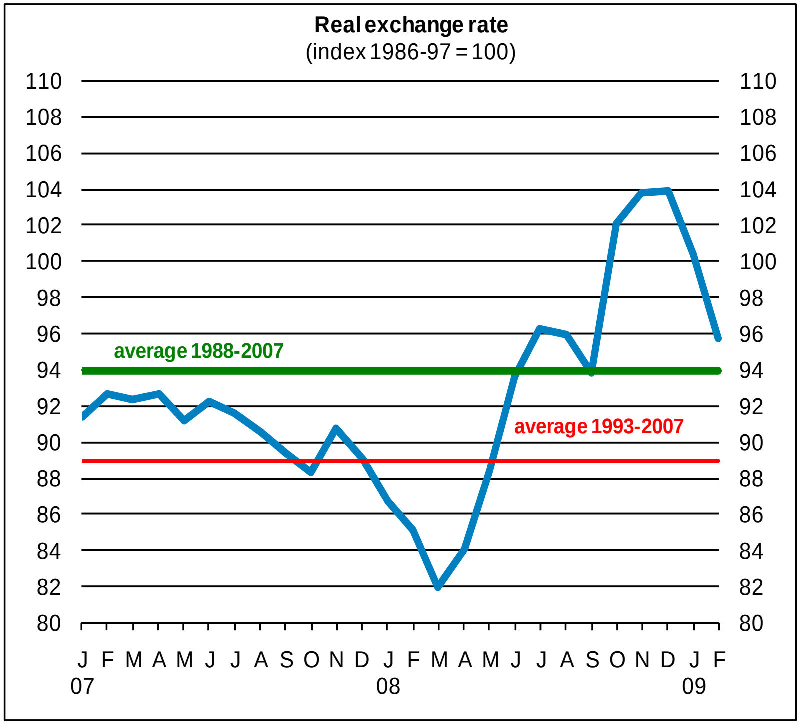
Foreign Exchange Policy: let the peso float

- The Central Bank rightly maintains the peso floating freely. Under the new scenario, the peso exchange rate should stay substantially below previous years in real effective terms. This is good for export growth. Temporarily, the Government’s decision to use its external funds to finance local currency needs is keeping the peso somewhat overvalued.





In sum: striving to avoid recession

- Somewhat unexpectedly, the world financial crisis is hitting Chile quite badly. Given the well known strengths of the Chilean economy, more resilience was to be expected.
- The source of the slowdown is an expectations shock. We got used to be pulled by world economic growth and the copper boom. Under the new gloomy world scenario, confidence on Chile's capacity to grow has faltered.
- Expansionary macro policies have a role to play to fight recessions. However, extreme caution has to be applied so as not to loose our strengths: a free floating peso, a Central Bank strongly committed to price stability and a sustainable fiscal policy.
- Since the global economy may enter a long period of slow growth, Chile has to find ways to grow by its own means. The second half of the 80s provide a good example.
- A pro-growth agenda, with market friendly reforms to stimulate investment and productivity, can quickly raise expectations and rekindle an economic recovery.

Looking ahead: main forecasts

Chile	2008*	2009*	2010*
GDP (% yoy)	3.5	0.0	3.5
Domestic Demand (% yoy)	8.8	-2.3	4.1
Current Account Surplus (% GDP)	-2.6	-2.6	-5.1
Fiscal Budget (% GDP)	5.2	-4.0	-3.0
Inflation (%)	7.1	2.6	3.7
Unemployment Rate (%)	7.8	10.2	9.5
Monetary Policy Rate (%) *	8.3	2.0	4.3
Exchange Rate (Ch$/US$) *	649	625	670

* end of period