Scotiabank

GLOBAL ECONOMICS

LATAM INSIGHTS

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Chile—Let's Talk about the Current Account Deficit

- **Chile's peso depreciation to date should facilitate current account adjustment to sustainable levels.**

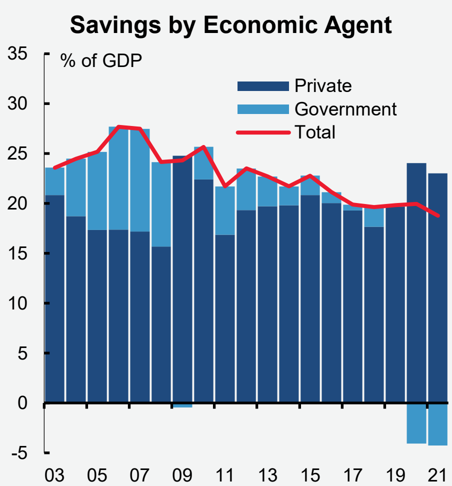
CLP DEPRECIATION SHOULD BE SUFFICIENT TO GUARANTEE EXTERNAL SUSTAINABILITY, CONDITIONAL ON NO FURTHER PENSION FUND WITHDRAWALS OR EXTRAORDINARY FISCAL EXPENSES

Recent assessments of Chile's current account deficit by international observers suffer from a vision of temporary adjustment. In particular, their focus on the high current account deficit as a percentage of GDP with respect to a broad group of countries does not represent a good basis for the depreciation of the Chilean peso (CLP). This is because the CLP may have already depreciated sufficiently to ensure the convergence of external accounts. In this Latam Flash we review relevant aspects to assess the drivers of the current account deficit, the composition of its financing, the expected dynamics during the coming quarters and the consistent adjustment of the CLP.

WHY DO WE HAVE SUCH A HIGH CURRENT ACCOUNT DEFICIT?

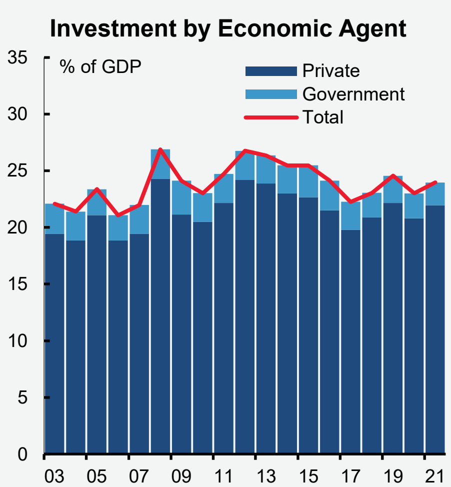
In our view, the main driver of large current account deficits is the government. Large deficits which prevailed prior to 2019 began to narrow at the start of the pandemic. But deficits quickly started to increase again as a result of a stable private investment and a decline in public savings (charts 1 and 2). In contrast, the private sector significantly increased its savings (for precautionary reasons after the social unrest in Chile), underscoring that public dissaving has been responsible for the fall in national saving. In fact, despite pension fund (PF) withdrawals, there was an increase in private national savings as a percentage of GDP. Meanwhile, the private sector maintained and even increased investment as a share of GDP. These considerations suggest that normalization of the current account would simply require that the government return to its trend savings/investment ratio, which in turn implies a curtailment of new fiscal transfers and/or divestment of sovereign wealth funds. **Aligning spending to the fiscal rule (which implies a reduction of the fiscal deficit) and the absence of extraordinary spending would facilitate convergence of the current account deficit to (close to) sustainable levels. Abstaining from new PF withdrawals (private dissaving) would likewise allow the convergence of the current account deficit. So far, we see encouraging signs in both dimensions.**

Chart 1



Sources: Scotiabank Economics, BCCh.

Chart 2



Sources: Scotiabank Economics, BCCh.

After the social unrest, there was lower reinvestment of profits (income) by foreign investors, which together with the worsening of the trade balance of goods and services generated by the strong increase in domestic demand (due to fiscal transfers and PF withdrawals), reversed the initial improvement in the current account observed at the beginning of the pandemic (chart 3).

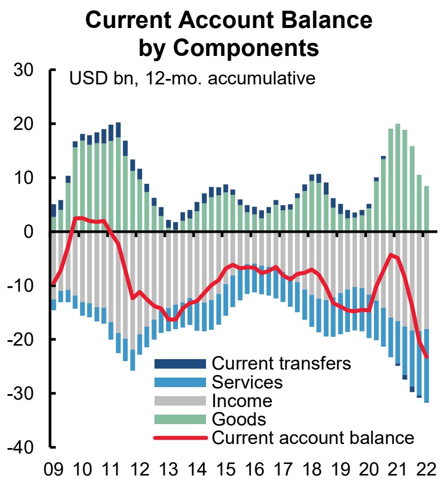
WHO HAS FINANCED THE CURRENT ACCOUNT?

Prior to 2019, foreign direct investment (FDI) was the largest source of current account financing (albeit focused on mining and the energy sector). That fact alleviated concerns about financial vulnerability. However, since the beginning of the pandemic Portfolio Investment (PF withdrawals) and, to a lesser extent, the increase in sovereign debt that has financed deficits (chart 4). In this context, financial market concerns about the ability of the economy to sustain current account deficits are justified, concerns to which we at Scotiabank subscribe.

IS THE ECONOMY MAKING THE NECESSARY ADJUSTMENTS?

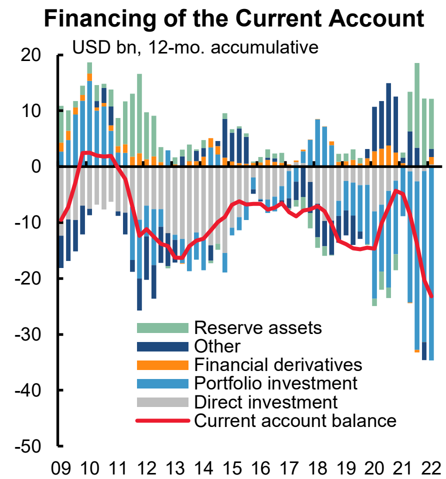
In our view, the answer to this question is in the affirmative; moreover, the adjustment process is already well advanced. As of Q2-2022, a virtuous combination between

Chart 3



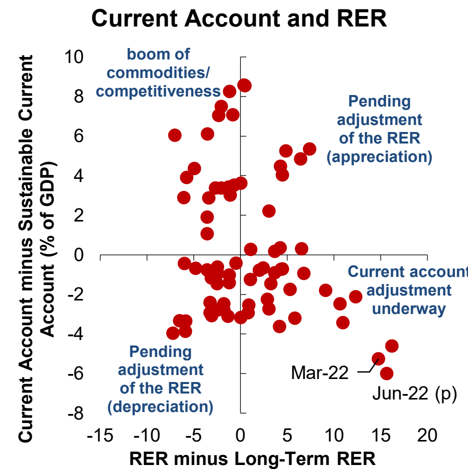
Sources: Scotiabank Economics, BCCh.

Chart 4



Sources: Scotiabank Economics, BCCh.

Chart 5



Sources: Scotiabank Economics, BCCh.

current account deficits and the real depreciation of the CLP already exists (chart 5). In that sense, the economy does not have a high current account deficit and, at the same time, an appreciated CLP with respect to its long-term equilibrium level. On the contrary, we are in the “current account adjustment in progress” quadrant, which means that the CLP is highly depreciated while the current account is also in large deficit position. Much more worrying is the quadrant “pending adjustment in the real exchange rate (RER) (depreciation)”. In this case, which the Chilean economy has already experienced in the past, the current account deficit is high while the currency is still appreciating with respect to its equilibrium.

HOW DOES THE CURRENT ACCOUNT ADJUST?

Our analysis suggests that the adjustment is already underway. Moreover, we have likely already seen the worst in terms of the current account deficit in Q2-2022. Data to be released by the central bank (balance of payments for the Q2-2022) will show that the deficit at 8% of GDP. However, in the following quarter, the smooth but persistent convergence of the current account deficit towards sustainable levels begins. This adjustment reflects a combination of CLP depreciation and a slight slowdown in domestic demand (especially private consumption). The second half of 2022 will see a more pronounced slowdown in consumption owing to the contractionary effect of the recent real and nominal depreciation of the CLP (chart 6). With this, the current account deficit would converge to 6.6% of GDP for the end of 2022 and towards 4.5% of GDP for 2023, levels even lower than those observed at the beginning of 2019.

IS FURTHER DEPRECIATION OF THE CLP NECESSARY?

For many international observers, the mere presence of a large and higher-than-sustainable current account deficit militates for CLP depreciation. However, they forget the significant CLP depreciation that followed the social unrest, which has accelerated recently. Indeed, according to our estimates, the RER for July is around 120 points (index 1986=100), which is 25% above its traditional equilibrium level (implying an undervaluation) and around 20% above a new level of equilibrium reached after the social unrest (around 100 points).

To estimate whether the recent depreciation is sufficient, we calculated the CLP depreciation needed to achieve convergence of the current account to its sustainable level (Sustainable Current Account Deficit SCAD). For this convergence to occur, the current account deficit at trend prices (TCAD) is required (chart 7). The TCAD corresponds to the current account deficit evaluated at long-term prices for copper and oil. In 2022, according to our estimates, the range of the SCAD is between 0.9% and 2.2% of GDP depending on the assumptions for the long-term GDP in Chile (chart 8). The ability to sustain the current account deficit has diminished due to the long-term fall in GDP. Given that the TCAD must adjust from 6.7% of GDP to 2.2% of GDP (lower part of the SCAD), the depreciation of the CLP is determined by the elasticities of exports and imports to the RER.

In table 1, we present the RER level needed to bring the TCAD towards the SCAD. For this exercise, it is necessary to define an initial RER. Given the uncertainty regarding the initial starting point, we carry out the exercise taking the RER level of September 2021, December 2021 and March 2022. In those scenarios, the RER necessary to bring the TCAD to the SCAD would be

Table 1: Chile—RER to Converge the Trend Current Account Deficit Towards a Sustainable Level*

Index, 1986 = 100	
Sep-21	115.9
Dec-21	123.6
Mar-22	117.8

*Estimates of import and export elasticities published by the BCCh are used.
Source: Scotiabank Economics.

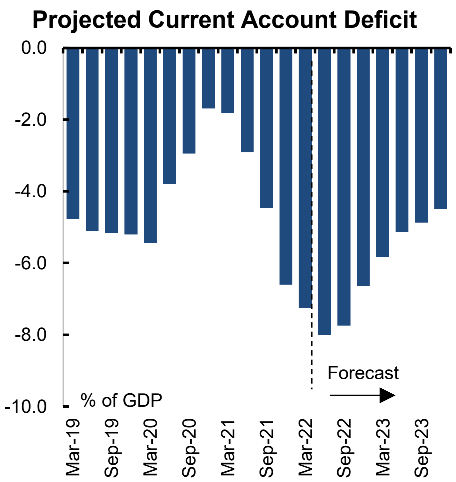
between 115.9 and 123.6 points. These values must be compared with the current RER which, as pointed out earlier, is 120 points in July 2022. Given this, there is little doubt that the needed exchange rate adjustment has already been made.

At the same time, given that a RER of between 115.9 and 123.6 points take the TCAD to a sustainable level, it seems to us that even more than enough depreciation to eliminate concerns of external convergence has been achieved. Most likely, with a deficit between 4% and 5% of GDP (similar to those observed on average in the last 10 years), the sustainability of the deficit would cease to be a concern for the market.

PUTTING THESE CONSIDERATIONS TOGETHER YIELDS THREE KEY CONCLUSIONS:

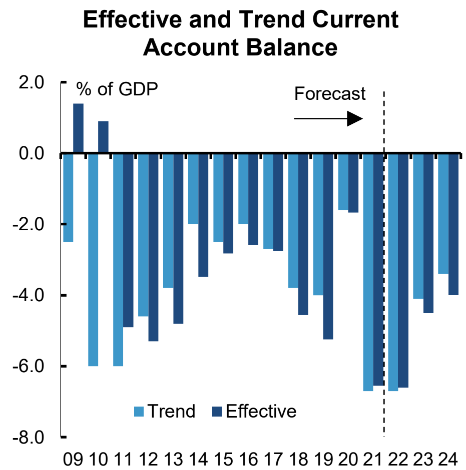
- **We do not expect a further real depreciation of the CLP in our baseline scenario in which the economy expands 2.1% in 2022 and falls into recession with a contraction of 0.9% in 2023.** In our view, the current depreciated level of the CLP, if sustained, would be enough to ensure external sustainability.
- **The effect of large current account deficits on CLP depreciation are likely to wane, although concerns about financing are valid and justifiable.**
- **Our scenario assumes no new PF withdrawals, fiscal transfers that jeopardize fiscal convergence and/or levels of public debt higher than the included in the latest *Public Finance Report* (38.0% of GDP in 2022). We have seen positive signs in these dimensions.**

Chart 6



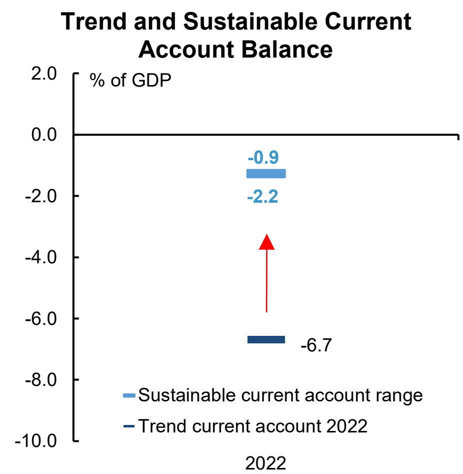
Source: Scotiabank Economics.

Chart 7



Sources: Scotiabank Economics, BCCh.

Chart 8



Assumptions: Trend GDP growth between 2.4 and 3.4%, external inflation of 2%, net international liabilities between 20 and 40% of GDP.
Sources: Scotiabank Economics, BCCh. Based on S. Edwards, "Is the US Current Account Deficit Sustainable? And If Not, How Costly is Adjustment Likely to Be?", August 2005, NBER.