Scotiabank

GLOBAL ECONOMICS

LATAM DAILY

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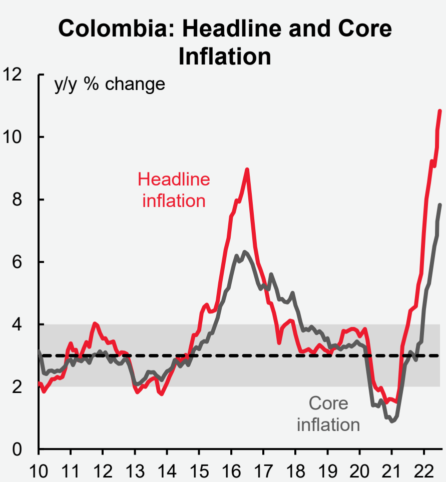
Chart 1



Sources: Scotiabank Economics, DANE.

Latam Daily: Chile's Referendum; Colombia's Inflation, Exports and Current Account

- **Chile: Market friendly result of the referendum**
- **Colombia: Inflation surprises on the upside, while exports rise and signs of current account stabilization emerge**

CHILE: MARKET FRIENDLY RESULT OF THE REFERENDUM

On Sunday, September 4, the proposal for a new constitutional text was rejected by 62% of voters, compared to 38% who voted in favour. The result was similar across the country, with the rejection option prevailing in all regions, including the Metropolitan Region (55% against 45%). In addition, the approve option won in only 8 of 346 municipalities, 5 of them in the Metropolitan Region. The plebiscite saw a high turnout (85%; 13 mn voters), since the election was mandatory.

Likely political changes in the coming days. The government is now in a weaker position than before the plebiscite, which will probably lead to moderating the structural reforms announced in recent months (Tax and Pension Reforms). In addition, the first cabinet change is coming, as President Boric said that government adjustments will be made soon. Overall, the 24 ppts margin of victory (larger than reflected in polls before the plebiscite) could (should?) see the rise of new political leaders, with a more moderate view of political and economic issues. Ahead of the debate on structural reforms in Congress, the centre-right parties will likely earn greater negotiating power, while the far-left parties lose power and influence.

Market-friendly result. As expected, the Chilean peso (CLP) appreciated, the stock market showed gains and we observed a drop in sovereign rates. Looking ahead, we will need a new national agreement to decide how the constitutional process continues. We present some alternatives in our Latam Insights: ***Latam Insights: Chile—A Preliminary Post-Plebiscite Political Roadmap***.

The design of the new constitutional review mechanism could have an additional positive impact on Chilean asset prices. We expect additional disinflationary pressures, appreciation of the currency and less headwinds from structural reforms if a national agreement is reached for a bounded constitutional assembly or if a selective group of Congresspeople is tasked with writing a new proposal.

—Jorge Selaive, Anibal Alarcón, & Waldo Riveras

COLOMBIA: INFLATION SURPRISES ON THE UPSIDE, WHILE EXPORTS RISE AND SIGNS OF CURRENT ACCOUNT STABILIZATION EMERGE

I. Inflation remains under upward pressure and reaches record highs

Monthly CPI inflation was 1.02% m/m in August 2022, according to DANE data published on Monday, September 5. The result was well above the BanRep survey (0.54% m/m) and above the Scotiabank Economics projection (0.54% m/m). Inflation in August was more than 13 times the average monthly inflation observed since 2016 (0.08% m/m). Annual headline inflation stood at 10.84% y/y, compared to 10.21% last month, and five times higher than the average since 2016 (chart 1), the highest since the inflation targeting regime was implemented. In m/m terms, food inflation accelerated again, rising by 1.85% m/m from 0.65% m/m previously.

Core inflation rose again, from 7.29% y/y to 7.83% y/y, and ex-food and regulated goods inflation stood at 7% y/y (compared to 6.44% in the previous month), the highest level since 2009. While food inflation was the main contributor to inflation in

August, core measures showed that there are other important sources of upward pressure, such as rental fees, some services and tradable goods.

The August CPI figure, in our opinion, adds pressure on BanRep ahead of its September meeting. Our latest official projection sees an increase of 50 bps at the September 30 meeting, but we now acknowledge a strong bias towards an increase of 100–150 bps that should now be the base case, with a terminal rate likely higher that 10%. It is possible that inflation will continue with an upward trend that by year-end would again trigger strong indexation forces before 2023, coming amid minimum wage negotiations. As the central bank mentioned, uncertainty is high, but stronger-than-anticipated indexation pressures would motivate BanRep to go further than expected in its hiking cycle.

Looking at August's numbers in detail, all 12 components of the CPI index contributed to higher inflation (charts 2 and 3), this time food products were again the main contributor.

The highlights are:

- **Foodstuffs inflation accelerated again showing an increase of 1.85% m/m, implying a contribution of 0.35 ppts to total inflation.** In August, rice (+2.25% m/m), eggs (+3.33% m/m), onion (+11.70% m/m) and wheat-related products (+4.78% m/m), were the main contributors, still showing a high influence of international price dynamics. According to DANE, it is difficult to anticipate a moderation as fertilizers and import prices for food production continue to show upward pressures. That said, upside risks in food prices are challenging our projection for the end of 2022, and would lead to inflation closing in double digits if see upward pressures similar to those seen in August continue.
- **The second main contribution (+0.24 ppts) came from the accommodation and utilities group (+0.76% m/m).** In this group, utility rates show the effect of higher indexation, electricity (+3.33% m/m) and gas (+3.21% m/m) are also the result of exchange rate depreciation. In the same vein, rental rates (+0.33% m/m) are also contributing to inflation, but indexation in rental prices is normalizing.
- **Exchange rate depreciation and bottlenecks in international logistics channels are also reflected in Colombia's inflation.** Vehicle prices (+1.76% m/m) were a significant contributor to prices. On the other hand, health care and cleaning products are reflecting higher production costs amid increases in international input prices.

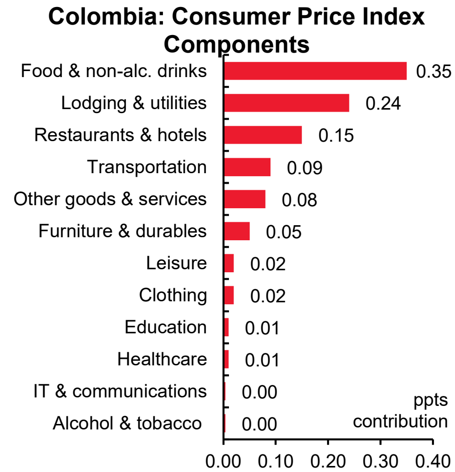
As for annual inflation in the main categories, goods inflation increased from 9.52% y/y to 10.60% y/y amid higher international prices, while services increased from 5.26% y/y to 5.48% y/y, a strong increase that reflects that demand remains strong. Regulated price inflation rose 0.86 ppts to 11.35% y/y.

All in all, August inflation again surprised to the upside, as a result of higher than expected food inflation, but also as a result of higher utility prices. Furthermore, the acceleration of services inflation shows that economic activity remains strong. Overall, August's result continues to put high pressure on the central bank, as it reached the highest level since the inflation targeting regime began, and still there are no signs of easing. Our official scenario is for a rise of 50 bps in September to reach a rate of 9.50%. However, we think that after the August CPI data the new base case should be a 100–150 bps increment in the policy rate at the September meeting—with a higher terminal rate if inflation continues to deteriorate.

II. Exports reach a new historical high in July

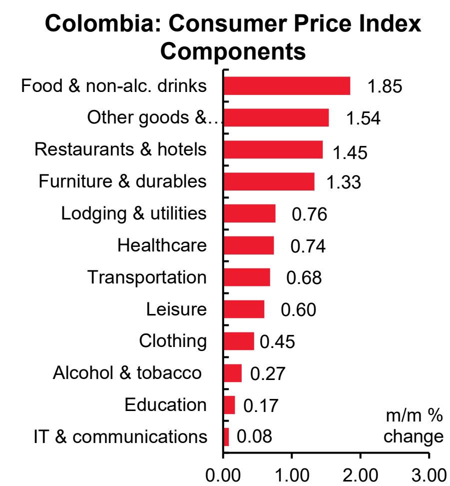
According to data published by the DANE statistical agency on Friday, September 2, July's monthly exports stood at USD 5.9 bn (71.7% y/y), up from June's figure of USD 5.56 bn, establishing a new historical high (chart 4). In annual terms, traditional exports (related to

Chart 2



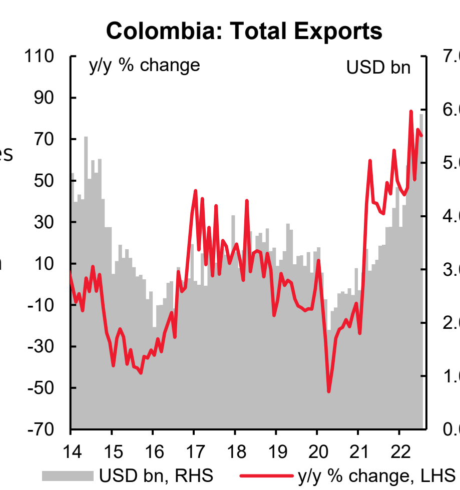
Sources: Scotiabank Economics, DANE.

Chart 3



Sources: Scotiabank Economics, DANE.

Chart 4

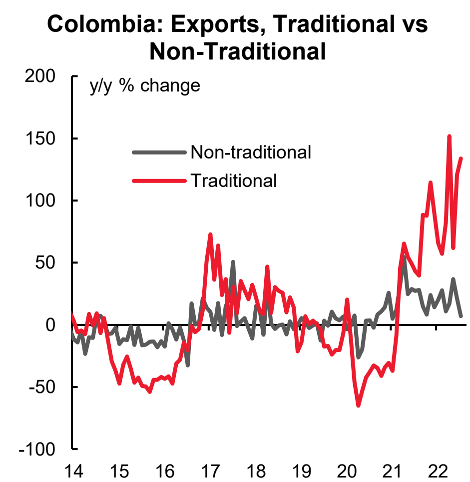


Sources: Scotiabank Economics, DANE.

mining and coffee) contributed the most to the expansion amid higher commodity prices, higher external demand, and increased domestic production. Non-traditional exports also expanded at a robust pace, growing 7% y/y (USD 1.8 bn), approaching the record levels seen in May 2022.

- **Traditional exports were up 133.7% y/y in July (chart 5), again showing the effects of higher international commodity prices and a lower statistical base.** Coffee exports increased 26.6% y/y, erasing the statistical effects of the national strike in the middle of last year. Oil expanded by 84.36% y/y, with an expansion of 19.8% y/y in metric tons, while coal sales increased 333.3% y/y, with a significant contribution from export volumes (69% y/y). In m/m terms, exports grew (19.8 % m/m), showing a normalization in activity.
- **The value of non-traditional exports was USD 1.80 bn (7% y/y) in July, a lower annual expansion than the previous month but still close to historic highs.** Manufacturing exports were the least dynamic sub-sector, growing 10.1% y/y. Machinery and transport equipment exports fell -3.5% y/y, while chemicals increased 19.7% y/y. In the case of agricultural products (17.9% y/y), the main contribution came from palm oil exports (173.1% y/y) and roasted coffee (73% y/y). This also points to the effect of higher international prices.

Chart 5



Sources: Scotiabank Economics, DANE.

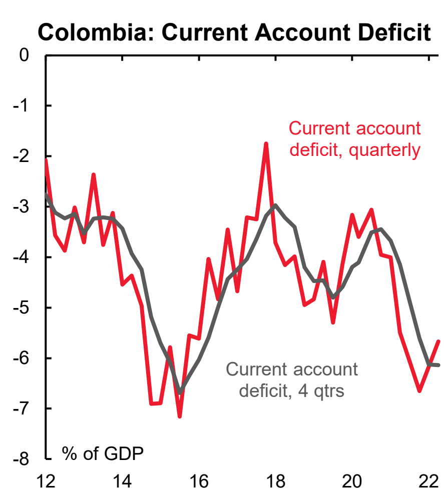
Overall, July's exports provide a positive outlook. The y/y expansion was a bit less dynamic owing to the elimination of statistical base effects from one year ago, though coal and oil exports showed a strong recovery stemming from both higher international prices and increased production. Non-traditional exports expanded by less than the y/y expansion observed the previous month as exports of machinery and equipment continued to decline. We estimate that the current account deficit in 2022 will be around USD 17 billion, similar to 2021. As a percentage of GDP, however, the deficit would represent around 5% (or less) amid the expected best economic activity. That said, a still-high external deficit would limit the potential of the Colombian peso to appreciate strongly.

III. Signs of current account deficit stabilization, while FDI remains the main financing source

On Thursday, September 1, the central bank (BanRep) released Q2-2022 current account data showing a quarterly deficit of USD 5.04 bn, equivalent to 5.7% of GDP (chart 6), slightly smaller than the Q1-2022 figure but still close to the highest level observed since 2015. Exports received a boost from higher commodity prices, but also increased services exports from tourism, while imports remained high, although increasing at a more moderate pace than the previous quarter; remittances helped to shrink the deficit, as income account outflows weighed against further correction. As a percentage of GDP, the deficit fell from 6.2% in Q1-2022 to 5.7% in Q2-2022. In the year to date, the deficit was USD 10.2 bn equivalent to 5.9% of GDP.

On the financing side, FDI net inflows in Q2-2022 stood at (USD 4.77 bn), while international credit contributed USD 2.67 bn and portfolio investment was USD 1.42 bn. FDI remains the main source of financing, consistent with economic growth supported by long-term investments. That said, capital inflows (USD 1.42 bn) increased from the previous quarter's figure (USD 800 mn), as a result of increased offshore appetite for local debt.

Chart 6



Sources: Scotiabank Economics, BanRep.

All in all, the current account deficit shows signs of stabilization, which would be a positive development and is consistent with an easing of structural pressures on the FX. Exports reflect higher commodity prices, but also increased service activity. Meanwhile, FDI was broadly stable. Going forward, it will be important to monitor how inflows are affected by fiscal reforms. Nevertheless, the external deficit remains high, which could increase the likelihood of an additional rate hike from BanRep in September's meeting, particularly as Governor Villar has emphasized that larger external deficit increases the vulnerability of Colombia to international shocks.

For 2022, we affirm our expectation of a current account deficit of around 5% of GDP given the positive effect of economic growth on the denominator. However, the current account deficit will continue having a fundamental influence on the currency, and is likely to impede the return of the FX to pre-pandemic levels.

Additional information in the balance of payments by line item:

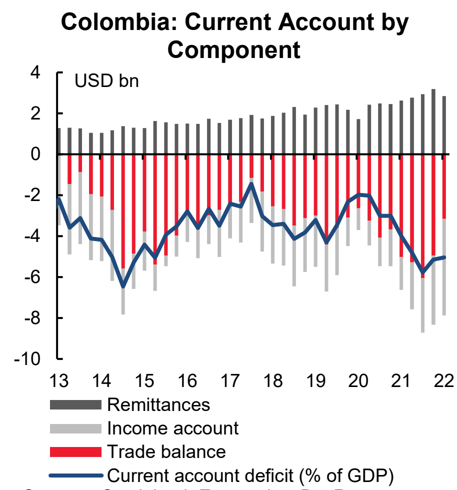
- **Current account: In Q2-2022 the current account deficit stood at USD 5.04 bn.** The income account contributed the most to the total deficit, with USD 4.72 bn outflows due to higher payments to companies in the mining-related sector (chart 7). Inflows from transfers (mainly remittances), partially offset these effects, reaching USD 2.85 bn. It is worth noting that remittances showed a new historically high with inflows of USD 2.42 bn.

- **Trade balance: Exports expanded by 12.4% q/q reflecting higher commodity prices, which offset the contraction of export volumes in some mining-related items.** Imports expanded by 9.6% q/q, reflecting higher capital goods and raw material imports for the industry. On the services side, imports were related to transport services, which also points to a still-strong economic activity.

- **Income account: Net outflows stood at USD 3.15 bn, above the USD 1.8 bn of the previous quarter.** YTD net outflows were USD 8.1 bn as profits rebounded across Colombia's main economic sectors, especially those sectors with high FDI, such as oil and mining, financial services, commerce-related activities, and transport and communications.

- **Net current transfer inflows stood at USD 2.84 bn, decreasing 10% from the previous quarter.** In the YTD, net current transfers were USD 6.02 bn, up 18.1% y/y. Remittances continued to set new historical highs (USD 4.5 bn in the YTD), explaining why households' consumption remain high despite employment that is not as strong.

Chart 7



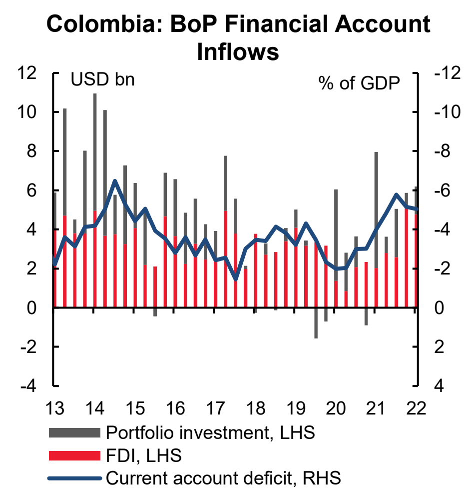
Sources: Scotiabank Economics, BanRep.

Financing side:

- **Net FDI inflows were USD 3.27 bn in Q2-2022, and USD 9.85 bn in the YTD (5.7% of GDP) (chart 8).** According to BanRep's report, 41% of total FDI was allocated to the financial sector, 30% to the oil and mining sector, and 12% to transport and communications. Roughly 51% of FDI was on new capital investments, while 36% represented reinvestment and 13% of the debt with parent companies.

- **It will be key to see how the FDI behaves for the rest of the year,** especially in the mining sector after the announcement of potentially higher taxes for oil and coal exports in the Tax Reform. For now, we expect FDI to remain strong, showing that economic activity is backed by long-term investment.

Chart 8



Sources: Scotiabank Economics, BanRep.

- **Net portfolio investments totaled inflows of USD 604 million.** Total inflows were USD 1.4 bn, higher than the mark in the previous quarter (USD 800 mn). In the YTD, total inflows totaled USD 2.2 bn, below the level a year ago of USD 2.81 bn, which is mostly explained by a more moderate appetite in the FI market but also a reduction of offshore demand in the equity market. In terms of outflows, the YTD figure is USD 7.1 bn compared to USD 4.2 bn registered the previous year. Most of those outflows were from private agents such as Pension Funds increasing their offshore positioning, but also reflect outflows from individuals associated with a pre-electoral strategy.

In the YTD, inflows from debt issuance have been concentrated in the private sector (+USD 3.1 bn) in long-term debt, as the public sector has accounted for only USD 121 million in inflows. We expect public debt issues in international markets to remain modest given that Minister Ocampo has said he does not see conditions that would lead the government to seek financing from international markets.

—Sergio Olarte, Maria (Tatiana) Mejía & Jackeline Piraján