MACROECONOMIC ANALYSIS

The 10 questions about fiscal policy that investors should have in mind

Jorge Selaive / Hermann González / Cristóbal Gamboni

In the middle of May, the government announced that fiscal revenues would be USD2bn lower than anticipated in the Budget Law, which was partly explained by the abrupt change that the macroeconomic scenario has suffered since the end of 2013. Economic growth and the price of copper are two key variables in determining effective fiscal revenues, so a more negative macro scenario increases funding needs. Among other considerations, the forecast presented by the government meant that this year GDP will grow by 3.4% (as opposed to 4.9% in the budget), that internal demand would expand 3.1% (instead of the budget's 5.4%) and that the price of copper would be USD3.05/lb.(USD3.25 in the budget).

However, in June's Monetary Policy Report, the central bank forecast an even much more negative scenario closer to market consensus. The economy would grow by around 3% and internal demand would only increase by 1.7% in 2014. In this paper, we review the fiscal implications of this new scenario and other questions that we consider to be essential for an investor who is following the Chilean economy.

1. By how much will the fiscal revenues shrink with a GDP growth at 3% and internal demand at 1.7%?

The reduction will be about USD370mn, in both effective and structural revenues. This fall is mainly accounted for by lower growth in internal demand, which affects indirect taxes, such as VAT, which account for the bulk of tax collection over the year.

2. Should there be an adjustment in public spending as a result of these lower revenues?

This scenario reduces the scope for expenses. Fiscal expenditure this year depends on the cyclically adjusted or structural revenues, which are not affected by changes in variables such as GDP or the copper price. However, lower growth in internal demand does impact on structural income and, as a result, reduces the scope for expenditure for a given structural balance target.

3. Where can the resources to finance expenditure be sourced? Higher debt or sovereign funds?

The government has stated its preference for liquidating assets, instead of issuing new sovereign debt, to finance the bigger effective deficit resulting from this change in the macro scenario. Furthermore, it will use resources from the Copper Reserve Law to finance expenses arising from reconstruction after the earthquake to the north of the country and the fire in Valparaíso. In our view, the option of issuing more debt should not be ruled out, given the strong appetite for sovereign instruments and market's structural needs for sovereign debt. In any event, funding the deficit will have the effect of making the CLP stronger. The use of both sovereign funds and the resources from the Copper Reserve Law imply that the Treasury has to liquidate dollars in the local market. Similarly, an increase in issues may drive interest rates upwards and, by this route, also cause the CLP to appreciate.

4. How will the effective and structural fiscal deficit be affected in this new scenario?

For the same level of spending, both the effective deficit and the structural balance will fall by between 0.1% and 0.2% of GDP because of lower revenue. However, an expenditure adjustment is possible, given that, in accordance with the spirit of the fiscal rule, expenditure must be matched to the structural revenue available to reach the pre-established goal of -1% of GDP.

5. Up to now, the depreciation of the peso has delivered higher revenues to the Treasury, helping to offset the less beneficial macro-fiscal scenario. What is the effect on revenues of a possible 4% appreciation of the Chilean peso?

A reduction in the exchange rate to levels of USD/CLP530, for example for the rest of the year, would reduce the average level from USD560 to USD540, that is, by 3.6%. This would affect the Treasury's dollar revenues negatively, particularly revenue from Codelco and taxes from private mining, by around USD200mn, for both effective and structural revenue. This would imply, at a constant level of expenditure, a higher effective and structural deficit equivalent to 0.1% of GDP.

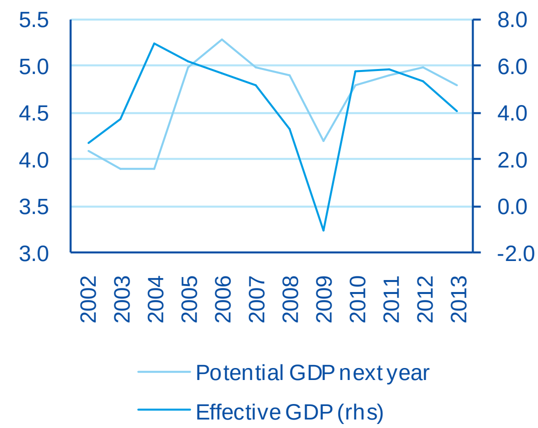
6. How will the long-term budget variables be corrected (trending GDP and the reference price of copper)?

Potential GDP has historically had a pro-cyclical behaviour and the reference price of copper has tended to stabilise around USD3.00/lb. (see figures 1 and 2). In the most likely scenario, both variables will correct downwards. In the case of GDP, there is a relative consensus that it is very difficult to sustain figures around 5% for trending growth, and some voices have moved towards estimates of around 3.5%. Although the size of the correction is not easy to anticipate, in BBVA Research we do not share these more pessimistic outlooks and we consider that the correction will most likely be from 4.8% to a figure in the 4.0-4.5% range. In the case of the reference price for copper, the correction will be to a figure close to USD3.00/lb. or just slightly below.

Figure 1
Reference price of copper (USDc/lb.)

Source: Budget Office, BBVA Research

Figure 2
Potential and effective GDP (%)



Source: Ministry of Finance, Central Bank of Chile, BBVA Research

7. What is the impact which this correction of long-term variables will have on cyclically adjusted or structural revenues, and on the scope for expenditure in 2015?

Taking 4.8% trending GDP growth for 2015 as a reference, which is the figure given after the latest Committee of independent experts meeting called by the Ministry of Finance, the table below calculates the figures by different trending growth scenarios and copper reference prices. A very negative scenario for the government would be for the experts to estimate a trending GDP of 4% and a long-term copper price of USD2.90/lb., given that it would lead to USD1.4bn less revenue, not far off the additional revenue being collected as a result of the Tax Reform.

Table 1
Lower structural revenues in 2015 at different levels of potential GDP growth and reference prices of copper (USDmn)

Copper Price* \ GDP*	4.50	4.25	4.00
3.04	-200	-330	-530
3.00	-440	-580	-775
2.90	-1,050	-1,200	-1,400

Source: BBVA Research

8. What are the expenditure and fiscal balance forecasts for 2015?

The reply depends on the long-term parameters forecast by the independent committees, and the structural balance target for the next year defined by the government. However, based on the average points of the table above (GDP = 4.25% and Copper Price* = USD3.00/lb.), together with a structural deficit goal of 0.75% of GDP, we estimate that expenditure ought to grow by 7.6% in real terms with an effective deficit of 1.7% of GDP. These results take into consideration that the Tax Reform is expected to collect about 0.8% of GDP in 2015, according to the Financial Report, which increases the Government's effective and structural revenue.*

9. To what degree will the reduction in long-term parameters offset greater revenue collection resulting from the Tax Reform (TR)?

The TR is expected to collect 0.8% of GDP (USD2.2bn) in 2015, but the lower reference parameters imply a reduction in structural revenues, in the scenario seen by BBVA Research as most probable, of USD580mn. Thus, the lower structural income as result of the change in parameters represents 26% of the additional estimated revenue from the TR. A quarter of the amount gained from the TR will be lost by the reduction in parameters.

10. How much would expenditure increase in 2015 without the TR?

We estimate that, were there no additional revenue collection resulting from the TR, public expenditure could only grow by 3.6% in real terms next year.

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