BBVA | RESEARCH

Chile Economic Outlook

Third Quarter 2014
Chile Unit

- The pace of global recovery has slowed, but will gather momentum in the second half of 2014.
- We have revised downwards our growth forecast for Chile to 2.9% in 2014, with downward bias. This adjustment is due to the materialisation of idiosyncratic risks. Our forecast for 4Q14 of around 4% YoY will be a key factor for compliance with the annual projection and is not exempt from risks.
- Inflation will start to ease in 2H14, closing at around 3.6% YoY at the end of the year. The greater impact from exchange rate depreciation has already materialised and the generation of surplus excess capacity allows us to anticipate that annual inflation peaked in the middle of this year.
- After cutting the Monetary Policy Rate (MPR) by 25bp, the central bank will continue delivering stimulus of "at least" another 50bp by the end of the year. In this scenario, recently incorporated into the market's forecasts, additional peso depreciation would remain contained.
- Public expenditure will have significant room to expand in 2015 in view of the additional revenues generated by the Tax Reform.

Index

Closing date: 21July 2014

1 Summary

The slowdown of world growth during the first half of 2014 seems to have ended. The most recent confidence and volatility indicators are consistent with a gradual improvement, allowing world growth to reach 3.3% in 2014. On the back of favourable global financing conditions and support for demand-led economic policies, growth should improvefurther in 2015, up to 3.8% with an increase in the contribution made by the more developed economies. However, the uncertainty of this baseline scenario is still subject to a downward bias due to the emergence of geopolitical risks and doubts regarding the global impact on capital flows and financial assets prices as a result of the rate hikes in the US. Although China has moved away from the risk of a sharp economic slowdown, its performance should be monitored due to the huge impact that its economy has on the emerging countries and, in particular, over Chile.

In Chile, the materialisation of idiosyncratic risks mentioned in our previous report has led us to revise our GDP forecast for this year down to 2.9%. In view of the available information for the first half of the year, this growth is based on a significant upturnduring 4Q14, which is subject to considerable risks, particularly those of a local nature. In 2015, we expect economic growth to reach 3.8%, again below its potential.

The main risk to our forecasts for GDP growth in Chile lies in that it is linked to a further deterioration in confidence and a temporary impact on the recovery of investment which could harm private consumption even more. Additionally, our baseline scenario contemplates a significant increase inpublic current and capital expenditure. Such increase has the embedded risk of the difficulties which the authorities may face to execute expenditure, particularly regarding investments. Externally, the risk of the sustainability of China's growth is the main concern, followed by potential financial impacts from the withdrawal of monetary stimulus in US.

In its turn, the labour market remains resilient at least in terms of the unemployment rate which remains low from a historical perspective. However, the decline injob openings, the number of jobs destroyed,the increase in self-employed workers (more fragile employment) and the hiring momentum in the construction sector all urge caution as to the perspectives for the labour market and we anticipate a rise in the unemployment rate in the coming months.

In terms of fiscal policy, we expect public expenditure to grow in real terms at around 7% this year. In 2015, growth in spending will basically depend on how the reference parameters of the National Budget are affected and on the additionalrevenues obtained from the tax reform. We have conducted a sensitivity exercise to measure the impact of revenuesby different scenarios for the parameters in this report, showing how corrections to the reference variables could bring revenues down by as much as USD1.4bn.

When it comes to prices, although the exchange rate adjustment has had a greater impact than expected, we consider that high inflation is not here to stay. In this context, we anticipate that inflation will recede in 2H14, posting a 3.6% YoY figure at the end of the year. The greatest impact from exchange-rate depreciation has already materialised and the exchange rate is now on a path of contained depreciation, while the generation of excesscapacity leads us to conclude that annual inflation peaked in the middle of 2014. We do not foresee inflationary risks for 2015, on the contrary, we consider that upward pressure from prices is unlikely. The foregoing leads us to dismiss a stagflation scenario for the coming quarters(see Box 3 for more details).

We project "at least" two further cuts in the Monetary Policy Rate (MPR) during the second half of this year, down to 3.25%. In 2015, if the economy picks up as we anticipate, we should see a gradual process of monetary normalisation in the second half of the year, which will be influenced by the speed at which interest rates rise in the US. This latter factor reduces the central bank’s room for manoeuvre and makes it necessary to introducemore monetary stimulus sooner rather than later.

The exchange rate will return to levels of USDCLP 565 at the close of the year, but the depreciation trend will continue in 2015, with the exchange rate ranging betweenUSDCLP 570and585.

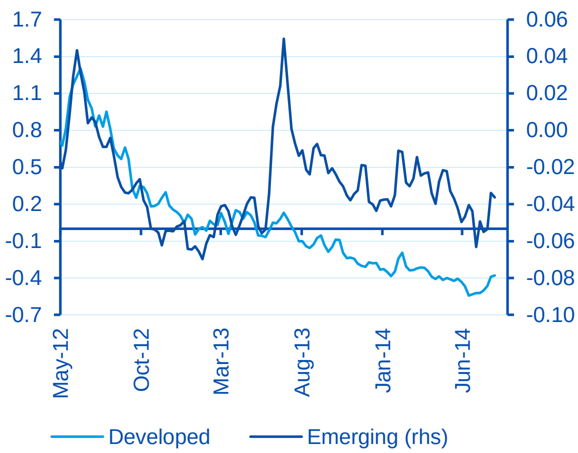
Finally, our models to determine sovereign long-term interest rates are unable to explain the reason behind such low rates. This discrepancy may be due to a number of factors, among them, certain frictions regarding interest-rate arbitrage, the relative absence of non-resident investors and the shortage of benchmark bonds available in the secondary marketsas a result of the buy-and-hold strategies by institutional investors. All in all, potential future upward adjustments of interest rates cannot be ruled out.

2 Global scenario: a slower global recovery in a complex environment

Low financial tensions, dominated by the Fed, support a scenario favourable to growth

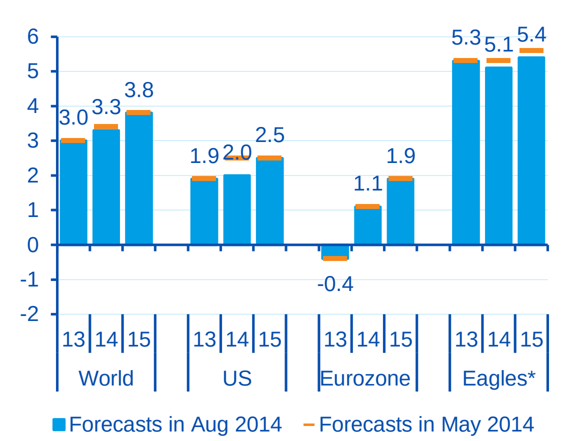
The global leading indicators are consistent with a favourable scenario for growth. First, tensions in financial markets remain low, according to our indicators, in both emerging and developed markets (Figure 2.1) – the recent uptick is due specifically to Russia. Second, industrial activity and global trade are keeping up a good momentum. All of this is taking place in a global environment in which geopolitical risk events, while not causing outright disruption to economic activity, are cropping up everywhere, and as such increasing uncertainty. For the moment, financial volatility is at historically low levels, since the factor dominating the behaviour of global financial markets is the Fed, and this institution is carefully managing a very gradual exit from the exceptional monetary measures implemented in the last few years.

Figure2.1
BBVA Research's Financial Stress Index



Source: BBVA Research

Figure2.2
GDP growth forecasts (%)



EAGLEs is the emerging markets group which will contribute most to world GDP in the next 10 years. The group consists of China, India, Indonesia, Brazil, Russia, Turkey and Mexico.
Source: BBVA Research

In China, the risk of a hard landing is receding and growth will remain above 7%

The risk of a hard landing in China, predicted by some a few months ago, is receding, thanks to the improvement in exports and in fiscal and monetary support measures. Increased external demand and the brake put on the appreciation of the yuan have helped exports to recover, while monetary policy has been relaxed by cutting the bank reserve ratios, thus favouring credit. Shadow banking controls and plans to liberalise the more regulated part of the banking sector are enabling most of this new financing to be provided by the latter segment. This combination of supervisory measures and simultaneous liberalisation to help traditional banking entities compete (freedom to set interest rates, easing the entry of private investment, promoting lending to private companies over those in the public sector) should enable the deleveraging process to take place in an orderly manner, without any sharp corrections. Finally, more focused fiscal policy measures than on other occasions have also been introduced, above all in relation to the increase in infrastructure spending.

All in all, our outlook is for a very controlled deceleration, with growth easing to 7% in 2015, from 7.7% in 2013. Furthermore, this movement is linked to a long-term trend of an increase in household consumption over business investment, while at the same time the Chinese currency returns to its previous appreciation trend against the dollar. In short, an economic rebalancing, with a moderate increase in debt, for which the authorities have the room for manoeuvre provided by their high level of reserves and control of their current account, together with high levels of private savings and relatively low public-sector debt.

Transitory hiccup in US growth. The Fed's communication policy will be key in lowering market volatility

The fall in US GDP during the first quarter of 2014 was mainly due to transitory factors, but the intensity of the correction made us revise our growth forecast downward for 2014 from 2.5% to 2% (Figure 2.2). The 2.1% quarterly drop, in annual terms, of US GDP is the sharpest of the historical series in a cyclical growth phase. The most recent information on the situation (Figure 2.3) shows that the US economy has recovered from the intense, but transitory, effect of the bad weather and from the steep fall in the accumulation of stocks.

There is greater uncertainty about the perspective of monetary tightening by the Fed and, in particular, about the global impact this will have on financial markets. The Fed will stop expanding its balance sheet in October, starting a phase in which rates and monetary measures will be determined based on the incoming information about the strength of the economic cycle and the anchoring of inflationary outlooks. In our most likely scenario, the first rise in the Fed funds rate will be in 3Q15, with a bias towards this happening closer to the middle of that year. In this scenario, the US central bank's communication policy on its view of the economic situation will become more important; as such, an increase in global financial market uncertainty is also a possibility.

The outlook in the eurozone is improving thanks to supportive domestic demand policies and progress in banking union

Leading indicators in the eurozone are consistent with a slight recovery in GDP, in line with our forecast of 1.1% for the year as a whole, the first annual growth since 2011. Sustained improvement in access to financial markets, particularly for more stressed economies on the periphery of the eurozone, is the main factor supporting the area's growth, together with the relaxation in public deficit targets in the short term and a more positive external environment. Ultimately, there are essentially two reasons for this virtuous circle. First, the confidence gained as a result of the decisions taken by the euro area authorities to strengthen the single market in the financial sector, and the ECB's reinforcement of monetary policy, which goes beyond what might have been foreseen just a few quarters ago. Second is the anchoring of global financial tensions at minimum levels. In addition, the reforms undertaken in the markets of productive factors in some economies, designed to improve competitiveness, are another positive factor.

All in all, although we are sticking to our growth forecasts of 1.1% in 2014 and 1.9% for 2015 (Figure 2.2), the bias for these is to the upside if the potential impact of the measures announced by the ECB is taken into account. All this does not, however, rule out the existence of risk to the downside which could be triggered by the worsening crisis in Ukraine and the knock-on effects of economic sanctions imposed on Russia, to which the eurozone would be far from immune.

In summary, global growth which will strengthen from the second half of 2014 onwards

In our central scenario, the slowdown in global growth in the first part of 2014 has already ended. The most recent indicators of cyclical confidence and financial volatility are consistent with a gradual improvement, which should enable worldwide growth to reach 3.3% in 2014, 30bp higher than in 2013 (Figure 2.2).

Maintaining favourable global financing conditions and supporting economic demand policies will help growth to accelerate faster in 2015 at rates close to 3.8%, with an increase in the contribution made by the more developed economies, which could gradually start positioning themselves for the withdrawal of the exceptional stimulus of the last few years.

The uncertainty within this baseline scenario continues to the downside because of the re-emergence of geopolitical risks and the doubts about the global impact on capital flows and asset prices caused by the proximity of interest-rate hikes in the US.

3 Long-term rates below fundamental levels

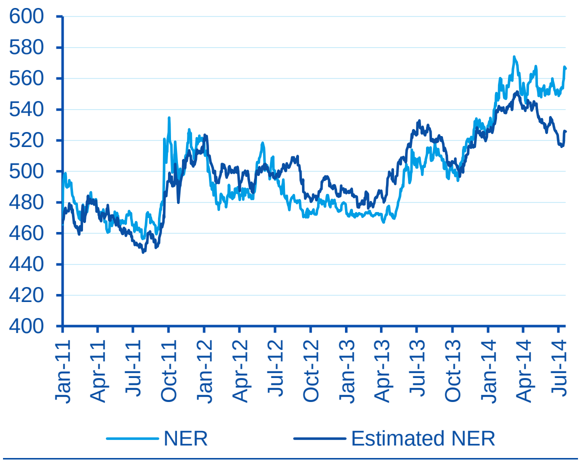
Local financial assets have gradually absorbed the withdrawal of US monetary stimulus. However, we detect long-term local rates below fundamental levels, a situation which could be due to both cyclical and structural factors

The exchange rate strengthened persistently,toppingUSDCPL 570 at the beginning of March, before depreciating after the MPR cut in July. The exchange rate is higher than the level suggested by standard parity determination models which take into account, among other variables, both the terms of trade performance and of the dollar (Figure3.1.).

As a preliminary explanation, part of this difference could be accounted for by the negative surprises in activity data, combined with a certain scepticism about a recovery in growth in the coming quarters and the uncertainty surrounding the impact of the tax reform on activity in the short term. In spite of this misalignment, which could be interpreted as short-term appreciation pressures, the peso will be subject to fundamental depreciation pressure in the mid-term at around USDCLP565 in December 2014 and around USDCLP 570-585 in 2015. However, this misalignment in the short term should be taken as a warning of potential volatility in the coming months.

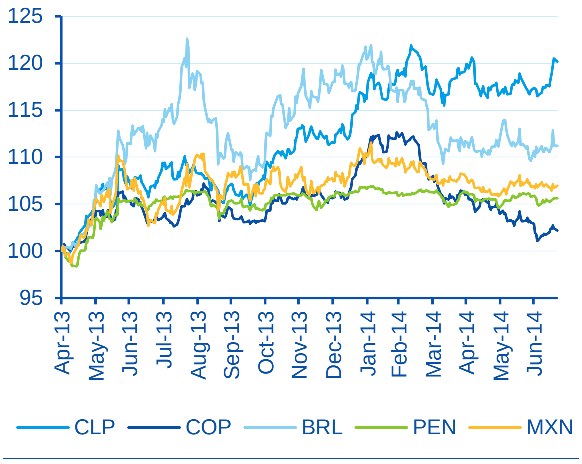
Most other currencies in the region haven fallen back fromthese highs, but not so in the case of the Chilean peso (Figure 3.2).

Figure 3.1
Effective and estimated exchange rate*



(*) Model for determining the short-term exchange rate CLP/USD in line with Cowan et al (2007).
Source: Central bankand BBVA Research

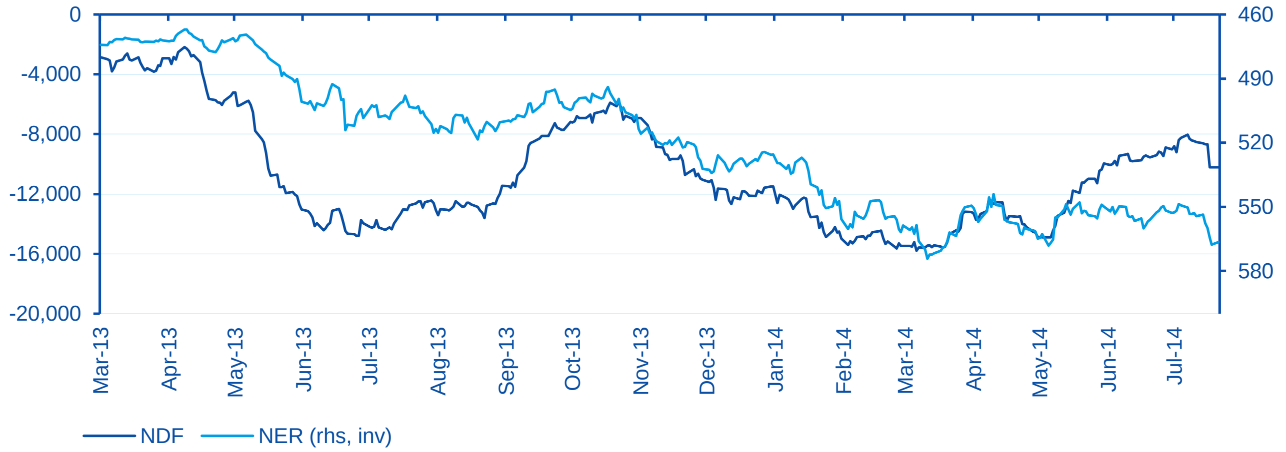
Figure 3.2
Parity against the US dollar (Indexes at 30 April 2013=100)



Source: Bloomberg and BBVA Research

Furthermore, the return to exchange rates at around USDCLP565 has coincided with a slight drop in the price of copper,increased geopolitical risks and dismantling of carrytrade operations in derivatives by non-residents after the MPR cut in the July meeting (Figure 3.3). In this context, we believe that the exchange rate might be subject to short-term depreciation,reaching USDCLP570-580, but returning to around USDCLP565 at the end of the year as long as our projection of the policy rate at"at least" 3.25% becomes a reality, and a moderate appreciation of the dollar on the back of an ongoing withdrawal of stimulus by the Federal Reserve.

Figure 3.3
Net position in the external derivatives market and nominal exchange rate (USDmn, USDCLP)

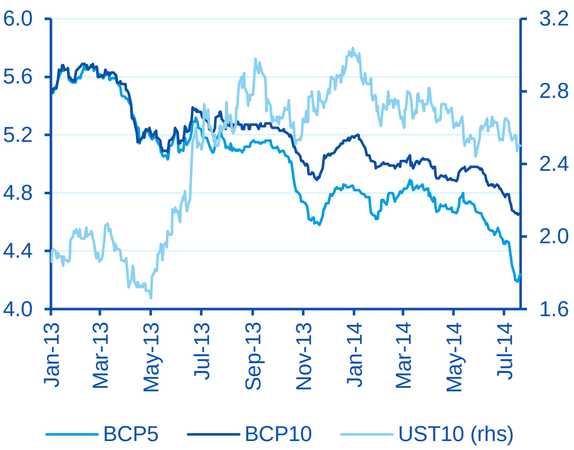


Source: Central bank and BBVA Research

Medium- and long-term sovereign yields have fallen since our previous Economic Outlook. The BCP-10 (Chilean Central Bank 10-year bond in pesos) trade at around 4.7% and the BCP-5 (Chilean Central Bank 5-year bond in pesos) has also fallen, to 4.2%. At the same time, US Treasury 10-year yields remained at levels under 2.5%, with mixed news from China and increased risk aversion because of the crises in Ukraine and Iraq (Figure 3.4).

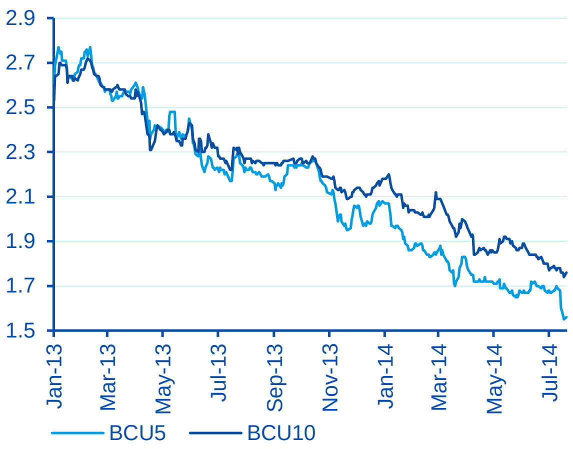
On the other hand, the yields on 5 and 10-year inflation-indexed instruments (BCU) continued their downward trend due to inflationarysurprises, registering a cumulative decrease of 51bp and 42bp respectively since the beginning of the year (Figure 3.5). Therefore, the implicit average inflation offset for these instruments comes in at under 3% at the close of this report.

Figure 3.4
BCP 5Y and 10Y yields and UST 10Y yields (%)



Source: ABIF, Federal Reserve Bank of St. Louis and BBVA Research

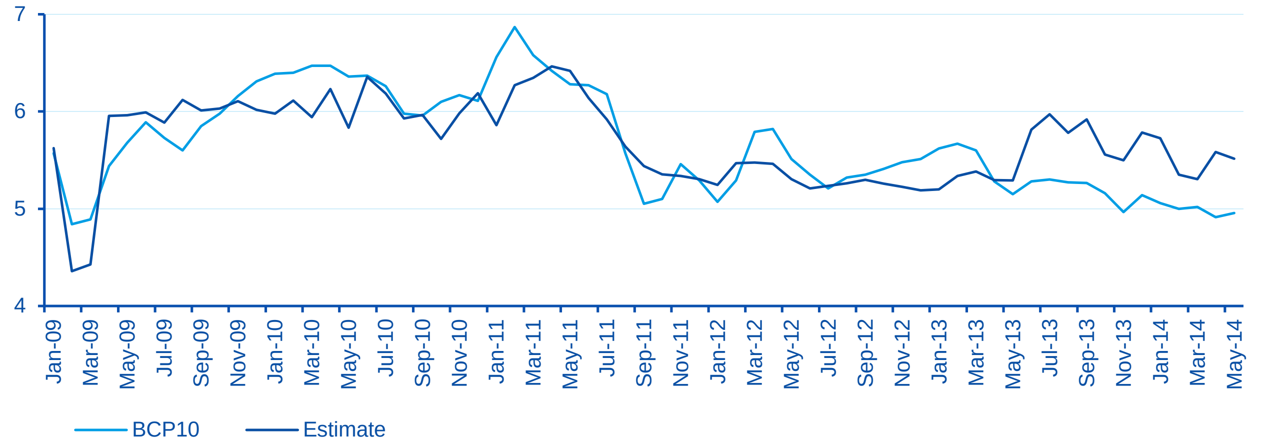
Figure 3.5
BCU 5Y and 10Yyields (%)



Source: ABIF and BBVA Research

Our models for determining long-term sovereign yieldsdo not account for their current levels (Figure 3.6). This discrepancy may be due to a number of factors, among them, certain frictions regarding interest-rate arbitrage, the relative absence of non-resident investors and the shortage of paper due to buy-and-hold strategies by institutional agents. All in all, we cannot rule out potential upward adjustments of interest rates in the future.

Figure 3.6
Long-term sovereign yield, estimate* (%)

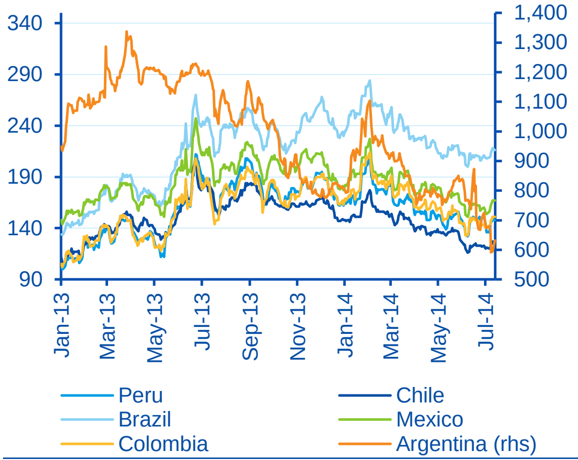


(*) Estimates based on an uncovered parity model.
Source: Central bankand BBVA Research

In its turn, the sovereign risk premium measured by the EMBI has remained unchanged since our last Economic Outlook, that is, 46bp below its peak at the beginning of February. This trend is similar to that seen in other LatAm countries (Figure 3.7).

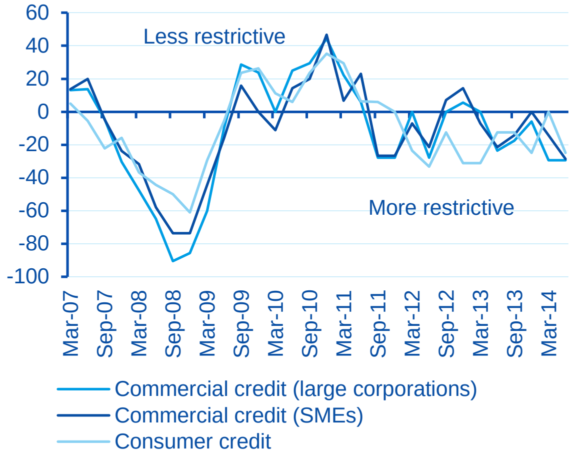
In terms of domestic borrowing conditions, in our last report we already flagged up a slowdown at some point, bearing in mind that the Credit Survey conducted by the central bank showed certain supply restrictions and a fall in demand. This situation has now materialised. In the case of consumer credit, although the conditions for granting credits are maintainedat the margin, demand is weaker, which has led to a lower momentum in the small loans segment (Figure 3.8). However, we have also detected that the reduction of the Conventional Maximum Interest Rate has continued, which may have contributed to the slowdown in the flow of personal loans.

Figure 3.7
Chile and LatAm EMBI (bp)



Source: Central bankand BBVA Research

Figure 3.8
Change in the credit supply*
(% of total replies)



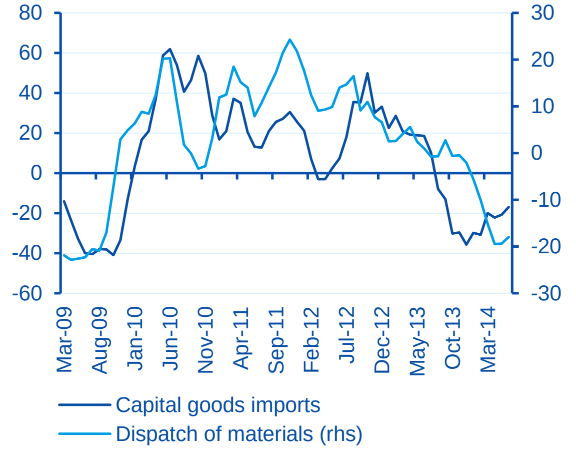
(*) Corresponds to the difference between the number of banks surveyed which found the standards for credit approval less restrictive and the numberof respondents who considered these standards were more restrictive, as a percentage of total replies.
Source: Central bank Banking Credit Survey

4 Downward adjustment of activity and demand projections due to materialisation of idiosyncratic risks

2.9% growth in 2014 with downward bias sustained by a significant recovery during 4Q14. In 2015, the economy will continue to grow below its potential, at 3.8%

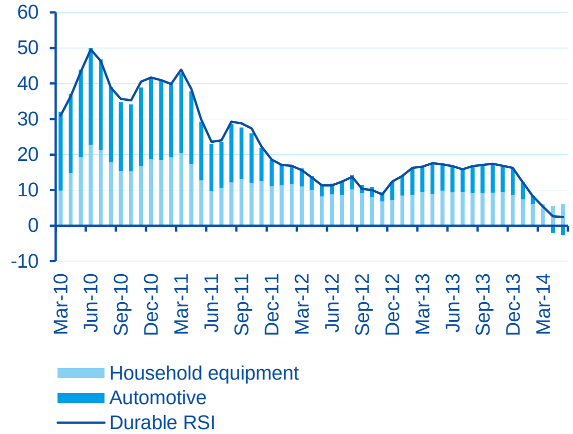
During 1Q14, GDP grew 2.6%, not far off our estimate in the previous Outlook, although its composition showed that the decelerationis more marked in private consumption, in addition to the adjustment in investments from the second half of 2013. 2Q14 figures available to date show that the quarter was weaker than the first in terms of growth, while the annual decline of investment persists and the private consumption signals of slowdown intensifies, especially in the durable component (Figures 4.1 and 4.2)

Figure 4.1
Dispatchof materials and capital goods imports (quarterly moving average, % var.YoY)



Source: Central bank, Chilean Construction Chamber and BBVA Research

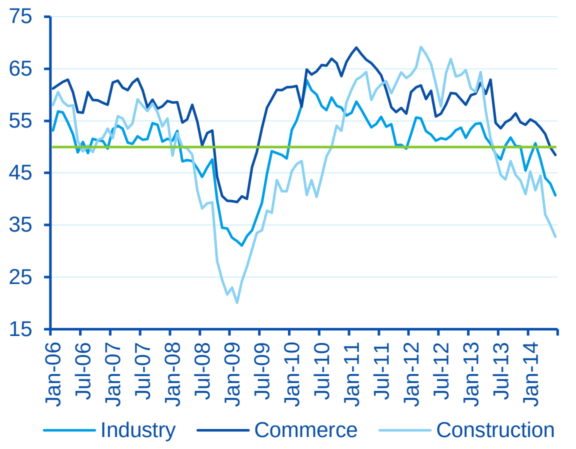
Figure 4.2
Durable RSI* (quarterly moving average, % var. YoY)



(*) RSI: Retail Sales Index.
Source: National Statistics Institute (INE) and BBVA Research

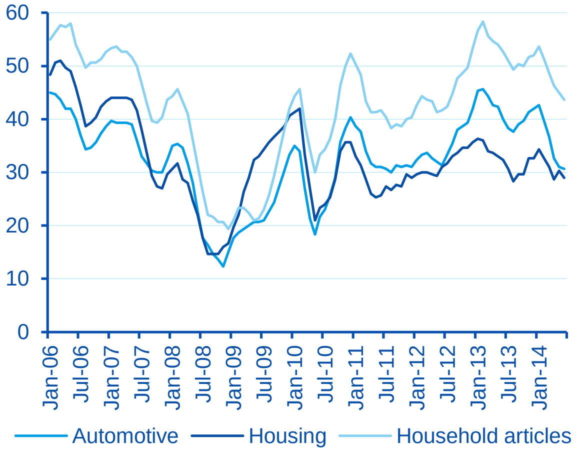
Although part of this lower momentum may be due to global factors which are affecting all emerging economies - such as the slower growth of China and the monetary normalisation process in the US -, the correction in investment in Chile has been more severe than in comparable economies. In fact, the idiosyncratic risk of a sharper drop in business and consumer confidence than anticipated in our last Economic Outlook has materialised and, at the same time, we are noticing that growth of internal demand is slowing considerably (Figures 4.3 and 4.4). We are not optimistic about growth in 3Q14, since comparisons are more demanding,added to the fact that Chile is still in the process of a reform of the tax system.

Figure 4.3
IMCE Business confidence (index)



Source: Icare and BBVA Research

Figure 4.4
Consumer confidence, % of individuals who consider this is a good time to buy



Source: Gfk Adimark and BBVA Research

Box 1. How long will the labour market's resilience last?

The unemployment rate has remained resilient in spite of the economic deceleration and in the margin it continues at low rates from a historical perspective. However, we estimate that excess of capacity are already being generated in this market; we are seeing this, for example, from the drop in job openings, fewer waged positionsand jobs in the construction sectorbeing created - a sector which usually acts as an early indicator of the cycle -, indicators which in some cases are comparable to the scenarios in the 1999 and 2009 crises (Table B.1.1).

The low unemployment level is almost exclusively sustained by the creation of self-employed jobs, which are more fragile and less stable than full-time jobs. This leads us to believe that a rise in the unemployment rate in the next few months is inevitable, up to levels which could reach 7% for a short period. However, by the end of the year the unemployment ratewill probably drop, as long as the economy returns to growth around its potential.

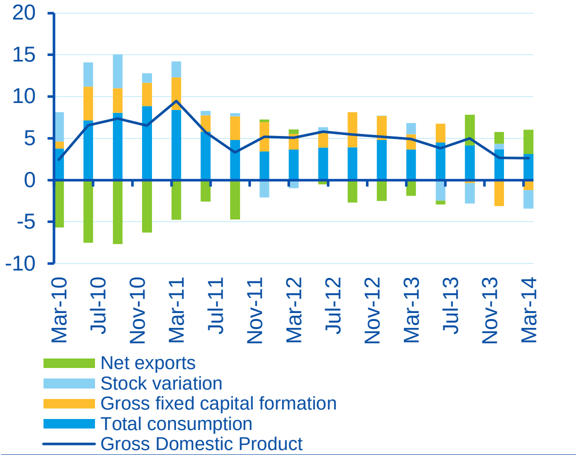
TableB.1.1
Labour market indicators during crisis episodes (1999-2009) and deceleration (2000-02)

	Increase in Unemployment (pp)	Job openings, var. (%)	Self employed ('000s/mth)	Waged ('000s/mth)	Construction jobs ('000s/mth)
Feb-98-Aug-99	6.7	-29%	3.0	-14.7	-7.0
Dic-06- Aug -09	4.8	-41%	0.7	3.7	-0.2
Mar-00-Mar-02	1.0	4%	1.9	4.4	2.6
Apr-12-Apr-14	-0.3	-39%	5.4	12.8	1.9
Dec-13-Apr-14	0.4	-17%	11.8	-4.3	-4.2

Source: Central Bankand BBVA Research

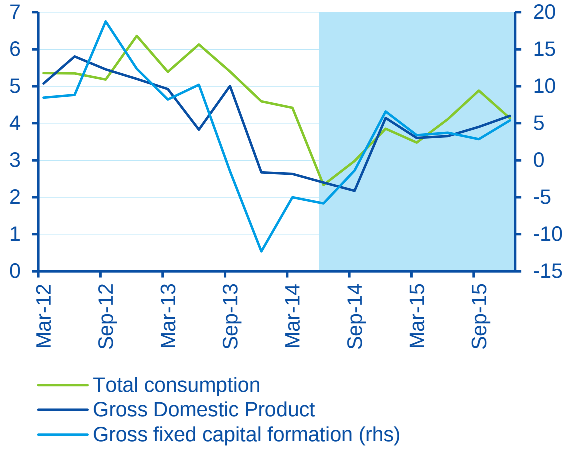
In our baseline scenario, growth will pick up in 4Q14 due not only to more favourable bases but also toa considerablerecovery in public and private investment, while private consumption will grow more slowly for the rest of the year than in the first quarter (Figures 4.5 and 4.6). Obviously, public investment depends on the government's ability to execute all the budget items. A persistently weak exchange rate in real terms and the MPR cuts which by the close of the year will total "at least" 175bp from the beginning of the easing cycle, will also contribute to this growth recovery scenarioin the latter part of the year.

Figure 4.5
Contribution to GDP growth against the same period in the previous year (% var.YoY)



Source: Central bankand BBVA Research

Figure 4.6
GDP growth, consumption and investment* (% var.YoY)



(*) Shaded area refers to the projection.
Source: Central bankand BBVA Research

In a context in which the activity cycle has been slightly more persistent, we have revised downwardsour growth estimate for 2015 from 4.3% to 3.8%. The contribution to growth for the next year will come in the first instance froma recovery in investment (mainly machinery and equipment, inventories and public infrastructure) followed by a greater momentumin private consumption around 2H15.

Finally, we consider that the main idiosyncratic risk is a fall in confidence, which may have a temporary impact on the investment recovery process, damaging private consumption even more than our projections in this report suggest. Additionally, our baseline scenario for the next two years contemplates a significant increase in public expenditure in both current and capital goods. This carriesaninherent risk: the difficulties that the public authorities may have in executing the expenditure budget, especially in the area of investment.

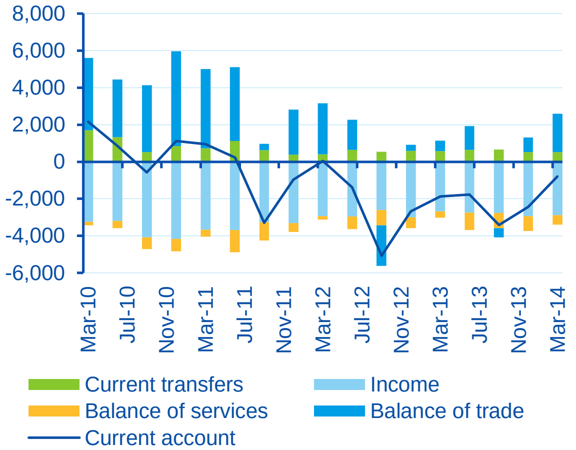
5 The current account corrected quickly in 1Q14; now back at sustainable levels it is no longer one of the risks to the economy

The economic slowdown, and in particular the deceleration of imports in a context of a reduced momentum in internal demand, is reflected in a rapid adjustment of the current account balance: it is no longer a concern for the public authorities

According to our projection, the current account will close with a deficit equivalent to 2.3% of GDP, lower than forecast in our previous report; and will remain at sustainable levels in 2015 and the next few years

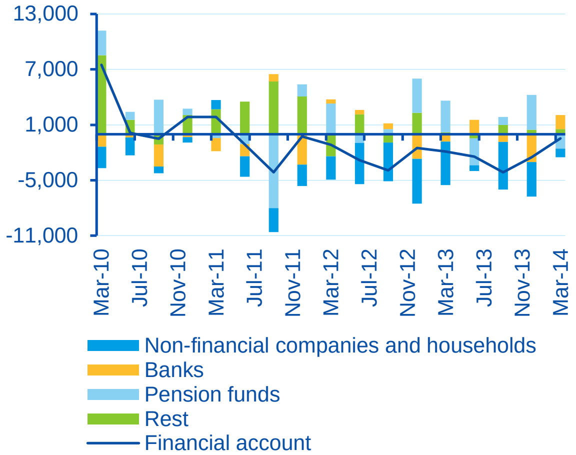
In 1Q14, the current account deficit reached the figure of USD795mn, equivalent to 1.2% of GDP, with an accumulated deficit of 3.1% of GDP in the last four quarters. The trade surplus, amounting to USD2.077bn in 1Q14, higher by USD1.504bnthan the same period in the previous year, has had a major impact, driven by reduced imports and increased exports. The income account posted a negative figure of USD2.874bn, the main component of which was income associated with foreign direct investment. This result implies that cash outflows were USD200mnhigher than the same period in the previous year (Figure 5.1).

Figure 5.1
Balance of payments:current account (USDmn)



Source: Central bank

Figure 5.2
Financial account by institutional sector, net flows* (USDmn)



(*) The rest includes: Central government, central bank and other financial institutions.
Source: Central bank

In 1Q14, the financial account registered net borrowing of USD463 mn, indicating lower financing needs compared to previous quarters. In the institutional sector, the result was due to a reduction in net active flow of pension funds (USD1.560bn), coupled with an increase in the net flow of corporate liabilities (USD958 mn). In contrast, banks posted a net capital outflow of USD1.498bn, mainly in deposits set up abroad (Figure 5.2).

All in all, we have revised our estimate for the current account deficit this year downward from 3% to 2.3% of GDP. The reason underlying our new assessmentis a more stringent adjustment in GDP growth composition, with a smaller contribution from internal demand, a greater contribution from the external sector, allied with expectations that a weaker exchange rate will hold, all of which mitigate the sustainability risk in the current account of the balance of payments. In consequence, we can confirm convergence towards sustainable levels - estimated atbetween 2% and 3% of GDP – over the forecast horizon.

6 Inflation reached ceiling in May 2014 and seeks floor for 2015

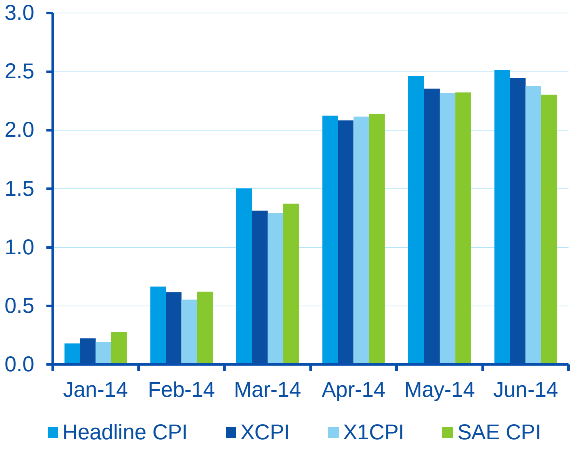
Annual inflation will start to ease in 2H14, reaching 3.6% YoY at the year end. In 2015 we foresee a scenario of contained inflation, closing at 2.5% YoY

The surprising inflation results at the beginning of 2014 have been mainly due to sharp exchange-rate depreciation combined with the second-round effects this has caused. Thus, the CPI registered an accumulated increase of 2.5% during the first half of the year and the underlying inflation measures, such as the CPIX and CPI SAE, show a similar cumulative increase (Figure 6.1). The prices of products linked directly or indirectly to the exchange rate -such as petrol, meat, new motor vehicles and bread - have registered sustained increases. A high level of dispersion must be added to the above, since 50% of products registered positive variations in June. This circumstance, as we have already discussed, is due to a great extent to fundamental variables such an annual inflation and exchange-rate movements.

However, although the FXpass-through has had a greater impact than anticipated, we estimate that the high inflation rates are a temporary issue. The greatest impact of currency depreciation has already materialised, the exchange rate is on the path of contained depreciation and the generation of excess capacity leads us to believe that annual inflation reached its peak in the middle of the year. Both the central bank scenario and the underlying inflation in asset prices herald an annual variation at the year end, near the tolerance range ceiling (4%). However, this figure is diminishing to values consistent with our more subduedinflation forecast. In this context, we estimate that inflation in December 2014 will be around 3.6% (Figure 6.2), also influenced by the implementation of Mepco, a stabilisation mechanism that curbs the excessive volatility of fuel prices.

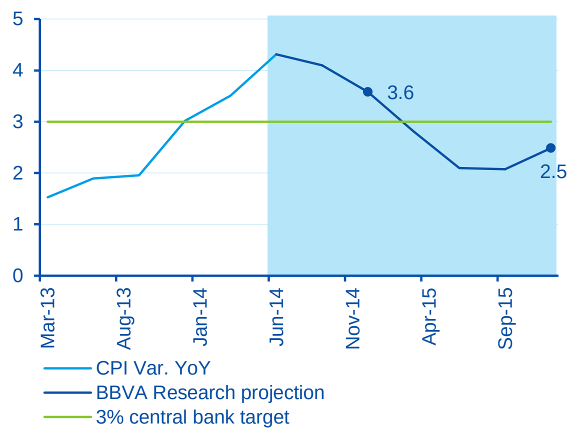
For 2015 we do not anticipate any inflationary risks. On the contrary, there are few possibilities for prices to be subject to upward pressures. The international scenario is not inflationary, we do not anticipate major exchange rate depreciation shocks, while wages will not increase at the same rates as in previous years because of thelower momentum expected in the labour market. Despite the possibility of supply shocks, we do not see any demand factors that could put pressure on inflation levels, to which we must add certain idiosyncratic factors thatwould restrain any price rises. In summary, our forecast is that inflation will fluctuate within the lower range of the tolerance threshold, closing at 2.5% YoY.

Figure 6.1
Cumulative CPI variation (%)



Source: INE and BBVA Research

Figure 6.2
Effective and projected annual inflation (%)



(*) Shaded area refers to projection.
Source: INE (National Statistics Institute), Central bankand BBVA Research

Box 2. Mepco: the new fuel price stabilisation system

The new Fuel Prices Stabilisation System (Mepco) will replace Sipco

The Mepco is similar to Sipco in its use of a price range and a reference price, although this range is more restricted and has greater persistence, activating the system on a more frequent basis than the other. The main features are: 1) the "conversion-to-peso" within the system, in other words, the range, price parity and the reference price are now calculated in pesos, in order to mitigate any rise associated with exchange-rate increases; and 2) a new limit*within the range*, to ensure that fuel prices cannot increase or decrease by more than 5 pesos in a week. This mechanism takes into account a number of guidelines proposed by BBVA Research in its Economic Watch*"Propuestas para fortalecer el Sipco"* ("Proposals for strengthening the Sipco", available in Spanish only).

We estimate that Mepco will have a significant impact on the "Fuels" item in the CPI basket. Although this is a stabilisation mechanism, i.e., it is not a permanent subsidy in the event of continued rises of fuel prices, the inflationary impact of an increase in the monthly price of gasoline is limited to within the range of +-0.1% MoM. The importance of the above is clear when comparing the impact that the "Fuels" item had between the months of December 2013 and June 2014 against the average monthly incidence of 0.10%, except for the negative figure registered in April.

Box 3. Stagflation: more a myth than a reality

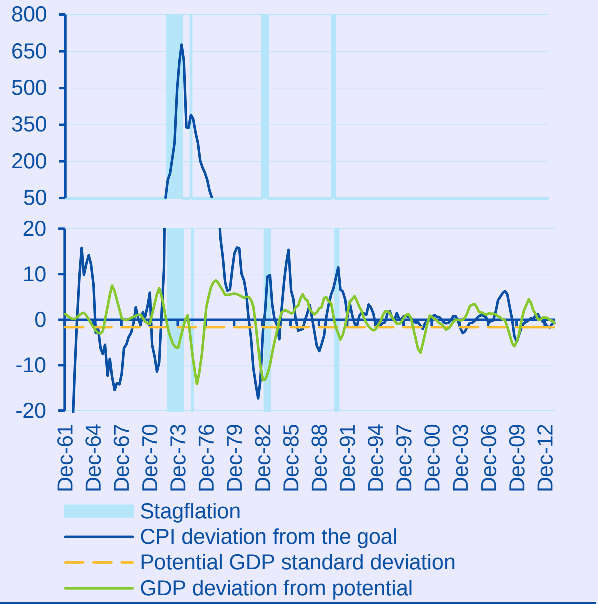
We have observed growth below potential and inflationover its target since the beginning of 2014. This has raised the alarm that we are entering into a stagflation process

A number of papers which attempt to provide a consistent historical description of stagflation have reached a degree of consensus that the stagflation episodes are associated with a supply problem. The main cause of stagflation is a sharp increase in production costs, usually energy costs, or otherwise periods of low productivity measured by several benchmarks -see Gordon (1975), Bruno and Sachs (1985) and Killian (2009). The foregoing works are further completed by other papers which explain this phenomenon in terms of existing mechanisms for setting wages.

We define stagflation in practical terms as a persistent period of GDP growth below potential, at least one standard deviation from potential GDP, and a consumer inflation growing above what is consistent with the explicit or implicit target[1].

Chile has reached a state of stagflation in three periods during the last fifty years. At the beginning of the 70s, at the beginning of the 80s and to a certain extent, at the beginning of the 90s. However, since the implementation of the fiscal policy rule (2001), and the inflation target scheme for monetary policy (1991), there have been no other periods of similar characteristics (Figure B.3.1).

FigureB.3.1
GDP deviation from potential and CPI deviation from target (% var.YoY)*



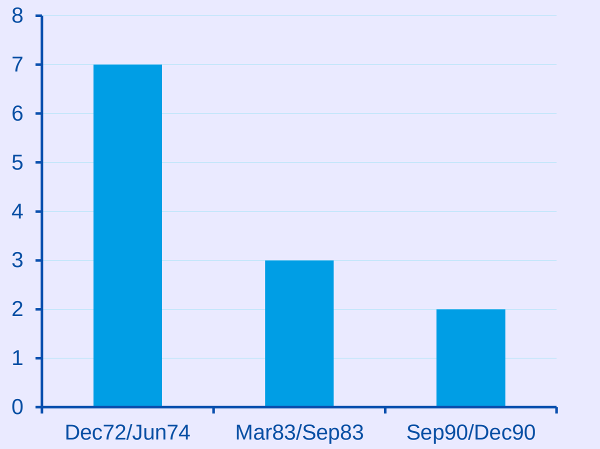
*For GDP, we take the annual variation of the moving average for the last four quarters, in order to specify what "persistent" means in our stagflation definition. For CPI inflation, we take the average annual variation on a quarterly basis.
Source: Central Bank, Budget Office, INE and BBVA Research

Improvements in institutional arrangement shave enabled both the frequency and the intensity of stagflation episodes to diminish radically over time, in line with theoretical works in this field (Knotek and Khan, 2012). The above is also illustrated by a systematic reduction of quarters during which the episodes identified as stagflation under the defined algorithm persist (Figure B.3.2).

However, in spite of this progress, the magnitude of the episodes -understood as GDP growth deviations from potential and inflation deviation from its target- does not reveal a similar pattern (FigureB.3.3), which is consistent with the international empirical evidence (Berthold and Gründler 2012).

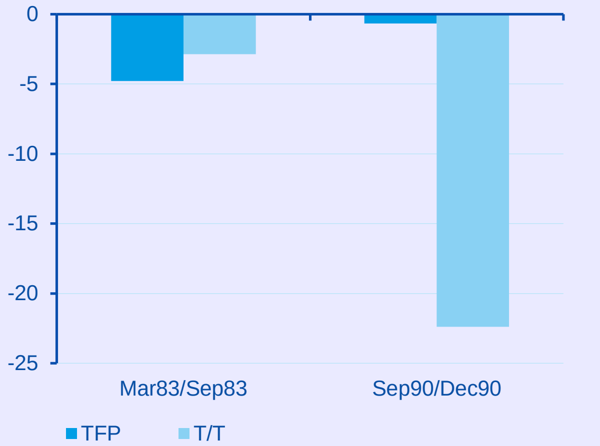
1: For more details, please refer to the Economic Watch.*"Stagflation in Chile: More a myth than a reality"*.

FigureB.3.2
Persistence of stagflation episodes (number of consecutive quarters)



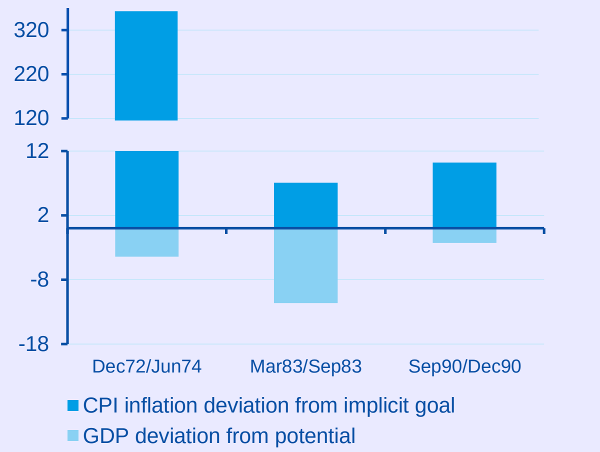
Source: Central bank, Budget Office, INE and BBVA Research

Figure B.3.4
TFP and Terms of Trade in stagflation episodes (% var. YoY, annual moving average)*



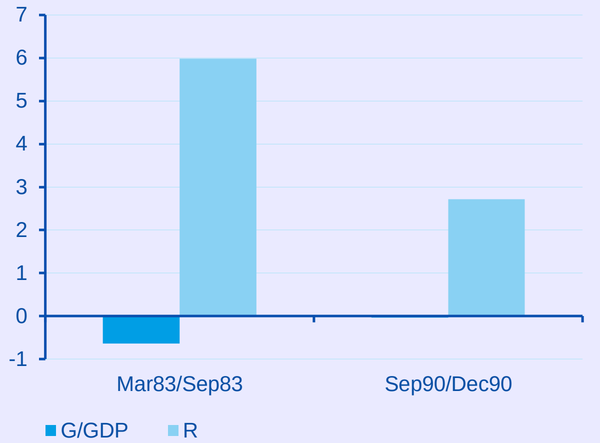
*Figures referred to average variation of these variables in the periods identified as stagflation periods.
Source: Central bank, Budget Office, INE and BBVA Research

Figure B.3.3
Magnitude of stagflation episodes (%, deviation average)



Source: Central bank, Budget Office, INE and BBVA Research

Figure B.3.5
Government size and reallong-term interest rates in stagflation episodes (%, annual moving average)*



* In the case of G/GDP this is the difference between the average observed during a stagflation periodand the existing level prior to the beginning of the stagflation episode. For R, we consider the difference between the average level observed during the period identified as stagflation and a historical average.
Source: Central bank, INE and BBVA Research

It is interesting that such episodes coincide with significant drops in the total factor productivity andterms of trade, factors which are associated with a disruption of aggregate supply. A coincidence is noticeable between these events and sharp increases in oil prices -equivalent to strongdeterioration in terms of trade- providing support to the conclusions reached by the empirical literature on stagflation (Figure B.3.4).

It is also noticeable that demand factors contemporaneously influence stagflation periods. As suggested by the literature, these episodes could be exacerbated by poor coordination of monetary and/or fiscal policy. High long-term real interest rates and drops in the real size of government(public spending over GDP) are alsovariables that coincide with these episodes (FigureB.3.5).

All in all, stagflation episodes are scarce and all of them are marked by weak institutional governance. For Chile, the macroeconomic institutional structures have not been questioned in the Tax Reform currently being debated in Congress. The fact that we are observing growth significantly below potential combined with high inflation seems to be a "healthy" adjustment of relative prices, enabling the transition to a less-favourable business-cycleto be less disruptive for the real variables.

7 Changes in the activity and inflation scenarios demand greater monetary stimulus

We project "at least" two cuts to the Monetary Policy Rate (MPR) during the second half of 2014 down to 3.25% and a gradual start of monetary normalisation in 2H15

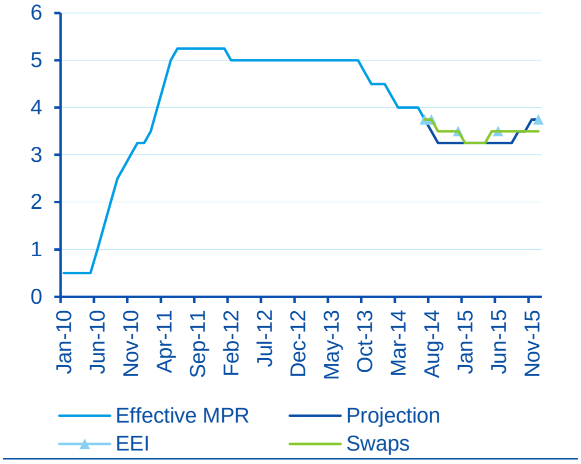
The monetary expansion process is not over and we think the central bank should continue this process as soon as possible. Given the significant and surprising increase in inflation in the first half, the central bank halted the process of cutting the policy rate in March, setting it at 4%. However, with inflation under control in June, it decided to return to cuts, agreeing to 25bpat its July meeting. In this way it succeeded in completing 125bp of monetary stimulus since October 2013, but we consider that the economy requires further MPR cuts until it accumulates at least an additional 50bp. Only with greater and immediate monetary stimulican the recovery of domestic demand be guaranteed for 2015, a component of expenditure which has suffered major corrections not only in terms of investment, but also in private consumption.

This greater stimulus is required becausethe slow economic momentum is generating excess capacity which will reduce inflationary pressures towards 2015, even though transitory rising inflation is observed due to CLP depreciation shock. To the foregoing we should add that next year there will not be significant depreciation in the local currency, which has been the main inflation driver up until very recently. Therefore, in the absence of a depreciation shocksuch aswe have seen in the last twelve months, and considering that the economy is now generating excess capacity at a rapid pace, it will be hard to achieve the inflation target over the policy horizon of the next 12 to 24 months.

If inflation surprises the market to the downside, as we expect, the way will be clear for at least two additional MPR cuts. The baseline scenario described by the central bank in its June reportforecast up to two cuts to the policy rate. However, this scenario also contemplated inflation at the ceiling of the tolerance range for the target (4%) by the close of the year. As long as inflation decreases in the forthcoming months, as we anticipate, there will be more opportunities for larger MPR cuts than the ones described in the central bank’s baseline scenario, so we consider a final level of at least 3.25% is likely.

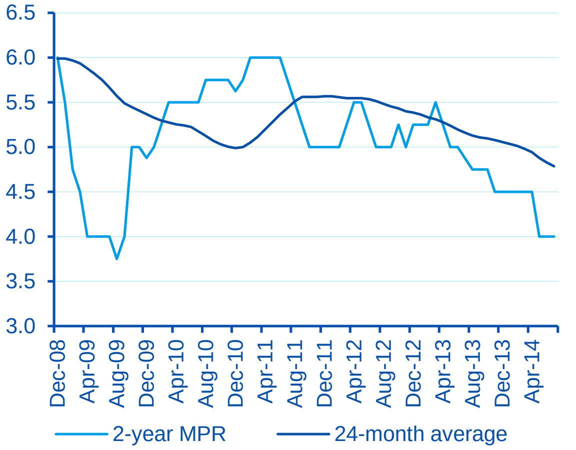
Surveys of analysts and financial tradersreveal expectations of two additional cuts of 25bp before the close of the year and a 4% MPR rate in two years. Since March, expectations for MPR have been revised downwards by analysts, in spite of risinginflation. In the survey of March expectations, analysts anticipated that the MPR would come in at 4% by the close of the year, whereas by July, they were forecasting 3.5% (see Figure 7.1). This lower policy rate is not only in the short term but also over a two-year horizon, a period during which most respondents reduced their estimates from 4.5% down to 4%, the lowest since the 2009 recession (Figure 7.2). Although these estimates are influenced by the environment at the time, we do not rule out theirindication of a lower neutral interest rate in line with the downward correction inpotential GDP growth.

Figure 7.1
Effective MPR and implicit trends in EESandswaps (%)



Source: Central bank, Tradition and BBVA Research

Figure 7.2
EES: Expected MPR over 2 years



Source: Central bankand BBVA Research

In the second half of 2015, the central bank will gradually start withdrawing monetary stimulus in line with the actions taken by the Fed, but the recovery of growth and the domestic inflationary perspectives are crucial if we are to avoid any undesired effects on exchange rates and, ultimately, on inflation. In this baseline scenario, we project that the MPR will reach 3.75% at the close of 2015 and its estimated neutral level of around 5.25% at the close of 2016.

8 Fiscal policy: changes in the reference parameters reduce the scope for spending growth in 2015

Given an anticipated real 7% increase in 2014, the variation in fiscal expenditure in 2015 will depend on how the reference parameters are affected. Revenues from the tax reform will be essential

In July, the Ministry of Finance's budgeting department submitted an update of its fiscal projections for the current year. The official figures match our estimates for the most part. A higher average exchange rate anticipated for 2014 (BBVAe: USDCLP560, Budget: USDCLP522), combined with the revenues from the tax reform in the last quarter of the year (BBVAe: 0.1% of GDP; Ministry of Finance: 0.29% of GDP), are the main sources of this increase in structural revenue for 2014, providing more scope for expenditure, which is opportune, in view of the need to finance both the government commitments and the one-off events that have occurred during the year[2]. Therefore, we anticipate that expenditure will experience 7% real growth this year, which according to our estimates would yield an effective fiscal deficit of 1.8% of GDP and a structural deficit of 0.9% of GDP.[3]

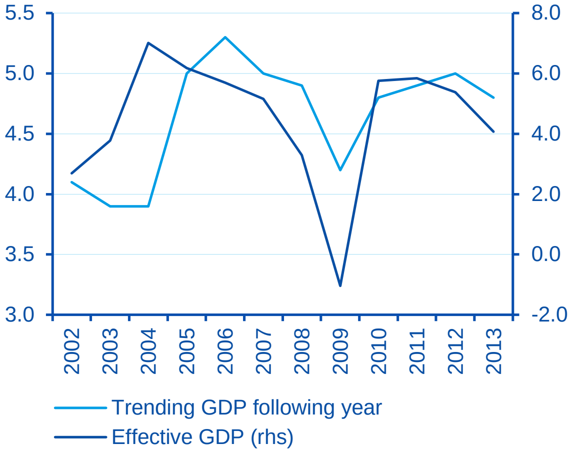
At this stage of the year, certain fiscal issues have been disclosed, such as the amount and the procedure ofCodelco's capitalisation. The USD200mn capital expansion, charged to the 2013 surplus, should reduce the Treasury's real and structural revenue by the same amount. However, improved results from the revenue campaign for the private mining corporation sector, showing the efforts made by these companies to curb their costs, combined with exchange-rate depreciation, mean that estimates for higher structural revenue can be raised, reaching a structural deficit of 0.9% of GDP. Still pending are the figures forthe exact target of the structural balancefor next year and the Treasury's financing mix (debt or asset liquidation) to cover the projected fiscal deficit.

There is a greater level of uncertainty for 2015 until we have the results of the forecasts for referencevariables which will enable us to estimate structural revenues, i.e.potential GDP growth and the long-term reference price for copper. At present, potential GDPgrowth stands at 4.8% and the reference price for copper is USD3.04/lb. These variables provided by two independent committees to the government, which are key components for drafting the 2015 national Budget, should reveal downward adjustments, reducing the scope for expenditure in 2015.

When examining the track-record of the figures provided by the Committees, potentialGDP growth expectations has historically behaved pro-cyclically, while the benchmark copper price has tended to stabilise around USD3.0/lb (Figures 8.1 and 8.2). In view of the current slowdown scenario, which has provoked heated discussions about the estimated lower potential GDP, and in view of the change in the composition of Chinese growth - which is evolving towards a model less reliant on commodities - it is very likely that both parameters will be subject to a downward correction.

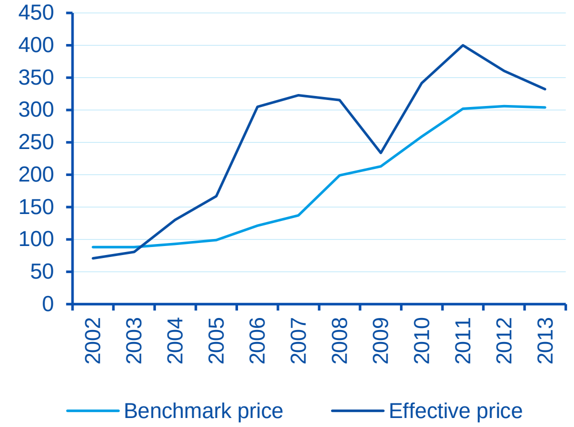
2. The government has indicated that in order to finance the reconstruction of the north of the country and Valparaiso, USD400mn will be used from the Copper Reserve Act, which allocates resources from Codelco sales as part of the funding required for defence expenditure.
3. If we disregard revenues from the tax reform, the effective deficit would account for 2% of GDP and the structural deficit would be 1.1% of GDP.

Figure 8.1
Trendingand effective GDP (%)



Source: Ministry of Finance, central bankand BBVA Research

Figure 8.2
Copper benchmark price (USc/lb)



Source: Budget Officeand BBVA Research

Although the magnitude of the adjustment is not easy to anticipate, it is possible to transfer the impact of structural revenuesover to different scenarios of trending growth and reference copper prices.If the experts were to estimate trending GDP at 4% and a long-term reference price for copper of USD2.90/lb, this would be a very negative scenario for the government in that it would entail a loss of USD1.4bn in revenues, a figure not far removed from the additional revenues expected of USD2.2bn as a result of the 2015 tax reform (Table 8.1).

Table 8.1
Lower structural income in 2015 at different levels of trending growth and benchmark copper prices (USD mn)

GDP* / Cu price*	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

In our most likely scenario, which takes the averages of the ranges in the table above (GDP* = 4.25% and Cu price* = USD3.0/lb), together with a structural deficit target of 0.75% of GDP, we estimate that expenditure should experience 7.6% real growth with an effective deficit of 1.9% of GDP.

These results use the expectations that, as a result of the tax reform, revenues will beapproximately 0.8% of GDP, based on the original project's financial analysis–before the Memorandum of Understanding -, which would increase both the effective and the structural government revenues. The foregoing would imply at least two things: (i) lower structural revenues due to the change of parameters represents 26% of the estimated additional revenues from the Tax Reform, and (ii) if there areno additional revenues as a result of the tax reform, public expenditure can only grow at a real rate of 3.6% next year.

9 The idiosyncratic risks have partly materialised and external risks persist

Locally, the risk of lower aggregate confidence has materialised and a scenario with further downturns is not altogether unlikely. Externally, the risk of sustainable growth in China is the most important, followed by financial impacts from the withdrawal of quantitative easing in the US

The idiosyncratic risk of additional contractions in business and consumer confidence,as flagged up in our previous report, has materialised. Although it is still early to make a quantitative estimate of the impact of this slide on key variables such as consumption or investment, at the same time as this sharper set-back in confidence indicators,there has been a considerable slowdown in consumption of durable goods, and the indicators linked to private investment and capital imports have shown significant YoY drops.

In consequence, the baseline scenario for this report rests on the premise that private consumption will continue to post slower growth than in the first quarter of this year, but private investment should show signs of recovery during the last quarter of 2014. The main risk in this regard is related to additional contraction of confidence, which could have a temporary impact on the recovery of investment and harm private consumption even more than we anticipate. Also, our baseline scenario forecasts a significant increase incurrent and capital public expenditure. This entails an associated risk of a slowdown in the execution of public expenditure, particularly regarding investments.

Externally, anoticeably steeperthanexpected economic slowdownin investment in China remains the main external risk because of its implications for the export sector, the confidence of domestic agents, capital flows and fiscal accounts. We have noted this risk in our last few reports and it has recently partly materialised, although not as intensely as we feared. In particular, concernsremain of a sharper slowdown in China due to doubts about the fragility of its financial system and a widespread increase in the perception of risk in emerging markets. A deterioration of the Chinese economy would have significant impacts on emerging markets, which would affect both financial and real channels. The implications for the copper price are a particular worry and also the growth of Chile’s other key trading partners.

A secondary risk is linked to early commencement of monetary normalisation in the US, which could entail less favourable conditions for Chile and emerging economies as a whole. Again, although less likely to impact on Chile, the risk associated with a complex fiscal and financial situation in the eurozone persists, to which we must now add a recent escalation of geopolitical tensions between Iraq and Ukraine, with effects on the prices of raw materials and on confidence in Europe.

10 Tables

Table 10.1
Annual macroeconomic forecasts

	2011	2012	2013	2014	2015
GDP (% YoY)	5.8	5.4	4.1	2.9	3.8
Inflation (% YoY, eop)	4.4	1.5	3.0	3.6	2.5
Exchange Rate (vs. USD, eop)	517	477	529	566	585
Interest Rate (%, eop)	5.25	5.00	4.50	3.25	3.75
Private Consumption (% YoY)	8.9	6.0	5.6	2.7	3.7
Government Consumption (% YoY)	2.5	3.7	4.2	7.0	6.7
Investment (% YoY)	14.4	12.2	0.4	-1.5	3.9
Fiscal Balance (% GDP)	1.3	0.6	-0.6	-1.8	-1.9
Current Account (% GDP)	-1.2	-3.4	-3.4	-2.3	-2.6

Source: BBVA Research

Table 10.2
Quarterly macroeconomic forecasts

	GDP (YoY)	Inflation (% YoY, eop)	Exchange rate (vs. USD, eop)	Interest rate (%, eop)
1Q12	5.1	3.8	485.4	5.00
2Q12	5.8	2.7	505.6	5.00
3Q12	5.5	2.8	475.0	5.00
4Q12	5.2	1.5	477.1	5.00
1Q13	4.9	1.5	472.5	5.00
2Q13	3.8	1.9	502.9	5.00
3Q13	5.0	2.0	504.6	5.00
4Q13	2.7	3.0	529.5	4.50
1Q14	2.6	3.5	563.8	4.00
2Q14	2.4	4.3	553.1	4.00
3Q14	2.2	4.2	571.0	3.25
4Q14	4.1	3.6	565.5	3.25
1Q15	3.6	2.8	570.6	3.25
2Q15	3.7	2.1	574.2	3.25
3Q15	3.9	2.1	579.7	3.50
4Q15	4.2	2.5	585.0	3.75

Source: BBVA Research

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