MACROECONOMIC ANALYSIS

Fiscal Policy Formula 1

Chile Unit

- We reiterate the need for USD3bn in asset liquidation this year to finance the effective fiscal deficit. We cannot rule out that this liquidation has already begun.
- The cost of the deceleration in 2015 structural revenues: the new structural parameters – GDP potential at 4.3% and the copper price at USD 3.07/lb – there are USD1.2bn of structural revenue left, ***half*** of the additional revenue accruing from the tax reform.
- Depending on the structural deficit target defined by the authorities, for 2015 we will have:
    - An effective fiscal deficit of at least USD 5.5bn, and perhaps as much as USD 6.7bn.
    - Treasury sovereign debt issues of at least USD10.5bn and as much as USD 11.7bn. Maturities, recognition bonds and Codelco capitalisation are included.
    - Real growth of fiscal expenditure no lower than 6.7% and as high as 9.0%.
- Without the tax reform, real spending growth would have been contained within a 2% to 4% range.
- We estimate that fiscal debt will give inflation indexed instruments an advantage over CLP. A USD2bn bond will be issued overseas. The central bank will issue no more than USD500mn, or will simply opt for non-issuance. Our BBVA Research estimate of the composition of the Treasury's indebtedness is given below.

2014 Fiscal situation: USD liquidation may have already started

Effective fiscal revenues for 2014 will show a more pronounced reduction than the government indicated in July of this year. Taking as our baseline a macroeconomic scenario close to the one published recently by the central bank in its Monetary Policy Report (IPoM), together with the execution of income and expenditure to July, we estimate a real annual drop in total effective revenue of 1.3% (Budget Office: -0.4% YoY). This fall is mitigated by resources from the Tax Reform, which we estimate for the current year will have a ceiling of 0.1% of GDP (Budget Office: 0.3% of GDP). In fact, the fall in effective revenues without the tax reform would represent 1.8% YoY. The greatest reductions are in fiscal revenues associated with copper, that is, the large private mining corporations and Codelco.

Even with the recent announcements of greater capital expenditure in the shape of reactivation plans, we believe that total spending will be no different to the Budget Office forecast for July. This would imply real annual spending growth of 6.6%, with an execution of 101.9% of the budget. This estimate has a bias to the downside, given the rate of execution of expenditure in July, when only 53.6% of budgeted expenditure was executed. However, given the Ministry of Finance's commitment to execute the entire budget and even some additional spending, we hold to the fiscal spending forecast we made a few months ago.

With respect to structural revenues, we estimate that these have also deteriorated, particularly in the area of indirect taxation, since these have diminished more than the GDP gap, being more associated with lower domestic demand.

This year's structural deficit will come in at 1.2% of GDP, whereas the effective deficit will be 2.2% of GDP. The latter figure is equivalent to an effective deficit of nearly USD6bn. This, added to the debt maturities (USD1bn) and the payment of recognition bonds (USD2bn), **confirms our belief that there will be asset liquidation from now on until the end of the year to a value of USD3bn, given that borrowing needs will exceed the debt limit of USD6bn.**

Structural parameters and their effects on fiscal policy in 2015: the structural deficit target will determine whether the expansion in real spending takes us into high or ultra-expansive territory

The correction of structural parameters for 2015 over 2014 will imply structural income that is lower by nearly USD1.2bn. Finally, we are setting the growth of GDP potential at 4.3% for 2015 and estimate that the reference price for copper will rise marginally to USD 3.07/lb. Furthermore, the reference price for molybdenum will fall to USD16/lb. **Why by as much as USD1.2bn? Perhaps some are considering an adjustment of 4.8% to 4.3% (-0.5pp), which would have less of an effect and be offset by the marginal increase in the copper price. However, that would be a mistake.** The level of GDP potential suffered a massive downward adjustment, given that it also corrected potential growth for 2014 GDP. So the calculation needs to take the lower base into account. We estimate the following breakdown for the change in structural revenues: i) –USD1.160bn as a result of lower non-mining taxes; ii) +USD190mn because of the higher long-term copper price; iii) –USD170mn because of the price of molybdenum; and iv) –USD69mn for public healthcare contributions.

As we have argued in the past, in order to discover the size of the 2015 budget, it is not only the structural parameters which are key, but also the structural deficit target - which will be announced with the publication of the Budget Law on 30 September - and the additional revenue from the tax reform, which will affect both the effective and structural revenues to a similar degree.

In view of the above, we expect fiscal expenditure to grow at a real YoY rate of between 6.7% and 9.0% in 2015, depending on the structural deficit target set by the government. Table 1 contains different scenarios for an effective fiscal balance sheet, spending growth and debt limit, depending on which structural deficit target the government decides upon. Let us remember that the current administration has committed to converging towards structural balance, although it has not specified the route it will be taking towards this convergence.

Table 1
2015 fiscal results based on the structural deficit target

Structural deficit target (% of GDP)	-0.75	-1.00	-1.25
Effective balance (% of GDP)	-2.1%	-2.3%	-2.6%
Effective balance (USDbn)	-5.5	-6.1	-6.7
Expenditure growth (real var. YoY)	6.7%	7.9%	9.0%
Debt limit (USDbn)	10.5	11.1	11.7

Note: The public elasticities published in several Budget Office and Finance Ministry reports have been used, together with in-house estimates.

Source: BBVA Research

We expect the budget to include the revenues accruing from the tax reform of 0.97% of GDP (approx. USD2.5bn). We have allocated a risk to the downside on these revenues, which provides space for a possible use of FEES resources. Indeed, if the risks of lower tax revenue materialise, the higher deficit which will be generated during 2015 will be funded by asset liquidations, given that the debt limit will be defined in the Congress budget debate (we think it unlikely that the executive will resort to demanding increased indebtedness half-way through 2015). As an aside, were the revenues from the tax reform not forthcoming, spending could only increase by a real rate of between 2.0% and 4.0% next year.

The sovereign debt figures include those maturing in 2015 (USD2bn), an estimate of recognition bonds (USD2bn) and that fraction of the capitalisation of Codelco which will be financed with debt (USD1bn), together with the effective deficit resulting from where the structural target is set.

Breakdown of Treasury issues in 2015: USD2bn outside the country

By the end of September the debt limit will be published and, by the end of the year, its composition. Table 2 shows our estimates that the bulk of this indebtedness (70%) will be in indexed (UF) debt, while the remaining 30% will be in nominal paper. This composition assumes the yield on maturity of BTU5s at the equivalent of USD1.5bn at the beginning of next year, which we estimate will be partly replaced by new issues on the same terms. On the other hand, the composition takes into account the greater appetite in the local market for indexed paper with the average UF/CLP composition of recent years.

In view of the low level of sovereign debt issued abroad and the still favourable financial conditions, we think it wise and very likely that the government will take its issues abroad for a sum of around USD2bn next year. Only 15% of total sovereign debt is subject to foreign legislation (USD5.1bn of USD33bn), which compares very favourably with the OECD and other emerging economies. The stock of current external sovereign debt is in the lower bracket of emerging economies and this would be a factor likely to tip the balance in taking issues back to foreign markets during this administration.

Table 2
Estimate of Treasury issues composition, with a debt limit of USD11bn (USD mn)

BTP			
5 years	10 years	20 years	30 years
500	**1,000**	**800**	**400**
BTU			
5 years	10 years	20 years	30 years
1,000	**2,300**	**1,800**	**1,200**
External bond			
2,000			

Source: BBVA Research

The central bank will issue hardly any debt, or maybe even none at all, in 2015

The central bank did not take part in tendering one-year term instruments (BCU/BCP) in 2014. The decision surprised the market at the time, and we cannot rule out that this was part of the reason for the scarcity of financial instruments in the local market, which would partly explain the current level of long-term interest rates *(see our Chile Flash for details)*.

2015 will be another year in which the central bank will largely abstain from offering debt instruments. There are at least two reasons for this strategy: i) renewed concern about the central bank's negative patrimony, and ii) low maturities on paper. The central bank's instrument yield profile is such that the most important maturities fall due from 2016 onwards, closely linked as they were with the process of sterilising the exchange rate interventions between 2008 and 2011 (Table 3). **In a context in which we estimate that the monetary base will grow between 10% and 15% (USD800mn to USD1.0bn), BCP/BCU issuance will be nil or insignificant. The calendar will be released at the end of this year: at the moment issues above USD500mn seem to us to be highly unlikely.**

Table 3
Central bank maturities (USD mn)

	BCP	BCU	**Total**
2015	1,270	331	**1,601**
2016	1,207	2,705	**3,912**
2017	603	1,353	**1,957**
2018	989	2,746	**3,735**
2019	-	40	**40**
2021	810	1,821	**2,631**
2022	603	1,297	**1,901**

Source: Central bank, BBVA Research

In a context of higher Treasury offerings, we will continue to see this sovereign debt *punished* relative to the Chilean central bank issues.

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