BBVA | RESEARCH

Chile Economic Outlook

Fourth quarter 2014
Chile Unit

- Slow global recovery, with less growth in the main European economies and emerging deceleration, plus greater financial volatility. Global growth will reach 3.2% and 3.7% in 2014 and 2015 respectively.
- We are correcting our GDP growth forecasts for 2014 and 2015 to the downside, to 1.9% and 3.1% respectively. Economic deceleration has dug in as a result of internal risks materialising and the international scenario has become less favourable. Growth in 2015 is based mainly on fiscal and external momentum, neither of which is risk-free.
- Inflation by the end of 2015 will be near the bottom of the tolerance range while risks trend downwards. The factors which accounted for this year's higher inflation will no longer be present by next year, and the situation will be one of greater excess capacity and external disinflationary pressures.
- The central bank will continue to deliver monetary stimulus, taking the MPR to at least 2.5% in 2015, keeping it at that level during the whole of next year, and then following the normalisation of interest rates in the US with some lag, first with a change of bias and then with rate hikes.
- Sovereign bonds will have to be liquidated to finance the 2015 fiscal budget. The convergence towards structural balance has been postponed, replaced by a robust promotion of investment, without jeopardising fiscal sustainability.

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Report closed: 7 November 2014

1 Summary

Global indicators point to a slower recovery in world growth and higher financial tensions. In particular, lower growth expected for Europe and Japan comes on the back of emerging deceleration, with more important adjustments in South America. For these geographies, both monetary and fiscal policy will continue to give support to the process of recovery. On the one hand, expectations of rate hikes in the US are going hand in hand with increased financial volatility, in emerging markets above all. In this environment, global growth is expected to reach 3.2% and 3.7% in 2014 and 2015 respectively.

We have corrected our growth estimates for 2014 and 2015 to the downside and forecast that the recovery will be slower. GDP growth will comes in at 1.9% and 3.1% in 2014 and 2015, delaying the convergence to growth potential to 2016-17. Weak internal demand will persist for longer because of the severe correction in relative prices and greater weakness in the labour market. The fall in investment has deepened, coming on top of a notable slowdown in private consumption, both durable and non-durable. Expectations of slightly higher growth in 2015 are underpinned, above all, by significant fiscal momentum and a larger contribution from the external sector.

Inflation will close 2014 at 5.1% YoY, explained by factors which will have dissipated by 2015. A large part of this year's inflation is directly linked to the effects of exchange rate depreciation and, to a lesser degree, to tax rises. Without these effects, in a context of growing excess capacity and lack of international inflationary pressure, inflation next year will be closer to the floor of the inflation target tolerance threshold. We forecast inflation of 2.3% YoY by close of 2015, with a marginal risk to the downside.

Economic weakening and its medium-term inflationary implications mean that more monetary stimulus is required. The central bank will keep the monetary policy rate (MPR) in 3,00% this year and cut it to at least 2.5% in 2015, where it will remain during the whole of next year, before following the process of monetary normalisation in the US, first through a change in the bias and then through rate increases. We believe the injection of monetary momentum needs to be higher than forecast three months ago, as a result of greater-than-expected economic weakening not only locally, but also on the international stage, with the corresponding disinflationary implications.

The penalisation of asset prices due to local factors has peaked. After peaking at USDCLP 600, the exchange rate has returned to levels more consistent with its fundamentals, although we do not rule out additional short-term depreciations if the market internalises higher cuts in the MPR. In 2015, the gradual process of economic recovery and greater fiscal momentum between them will encourage a moderate trend of appreciation on the part of the Chilean peso.

Medium- and long-term sovereign interest rates have shown volatility, in what we estimate as a slight trend to the upside, thanks to higher external rates and internal activity figures which no longer disappoint, partly offset by a lower monetary policy rate than that currently priced into assets.

The government has submitted a countercyclical 2015 Budget with a focus on public investment. We estimate that it will be necessary to dip into the Economic and Social Stability Fund (FEES in the Spanish acronym) next year as a source of financing. A greater rate of execution in the final months of this year will enable public sector spending to close the year at around 5.4% in real terms. With this base, we

estimate that the 2015 Budget is consistent with 8.8% growth in spending, which will be partly funded by resources from the tax reform and partly by liquidating between USD1bn and USSD2.5bn from the FEES. The effective fiscal deficit will rise to 2.7% of GDP, but without endangering compliance with the structural balance target.

Deceleration of domestic demand has contributed to a rapid improvement in the current account. We have corrected our current account deficit forecast to the downside, to 0.2% and 0.1% of GDP for 2014 and 2015 respectively, from our forecasts of -2.3% and -2.8% in the last Outlook report. The larger contribution estimated from the external sector, together with expectations that the depreciated exchange rate will continue, has also contributed to this change.

At a local level, the risk of lower confidence across the board has materialised; in the future this may imply a more gradual and moderate recovery than forecast. Likewise, our baseline scenario sees a significant increase in both current and capital account public spending. This brings its own risk, that of under execution of public spending, particularly on investment. In the external arena, the sustainability risk in China's growth is the most worrisome in the medium-term, followed by the short-term risk associated with the financial impact of monetary stimulus withdrawal in the US.

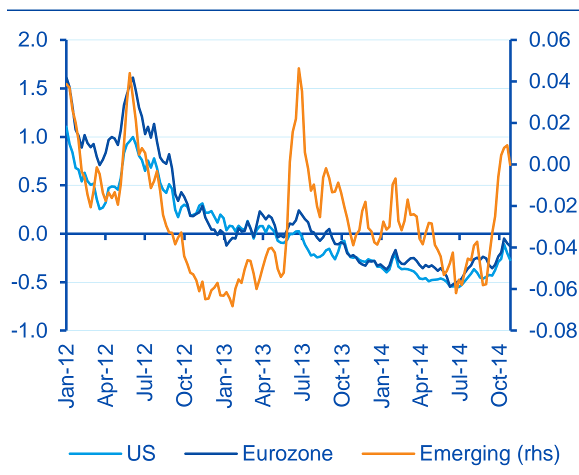
2 Slow global recovery with greater financial volatility

World growth is still rising, closing 2014 at 3.2% in 2014 and 2015 at 3.7%. But financial tensions and geopolitical risks are on the increase as well

Global economic growth continued in the third quarter. However, quarterly growth is very moderate in the more developed economies, and of these, more in Japan and the eurozone than in the US.

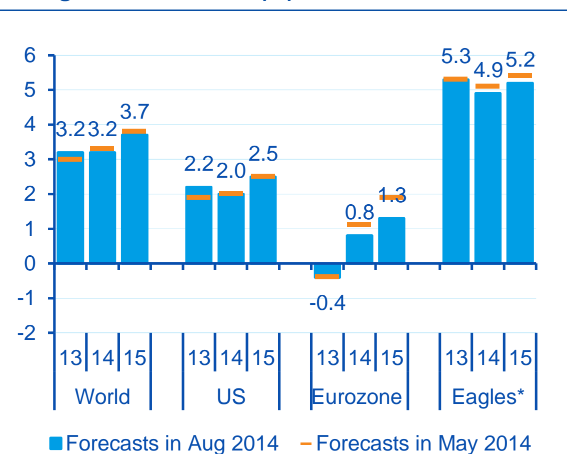
The confidence indicators for September remain consistent with the expansion of manufacturing activity, although it has been some months since they stopped improving in the key economic areas. An additional sign of the fragility of the present cyclical recovery is the uptick of the tension indicators in the financial markets since mid-September. In the case of the emerging economies (EMs), these have reached levels not seen since May 2013 (Figure 2.1). Then the market discounted a rapid withdrawal of Fed stimuli that actually never happened and is still pending. At the same time, geopolitical risks have been multiplying and negative surprises are building up on the consensus in the activity indicators, particularly in the eurozone and South America.

Figure 2.1
BBVA Research Financial Tensions Index



Source: BBVA Research

Figure 2.2
GDP growth forecasts (%)



* EAGLES is the group of emerging economies which will contribute most to world GDP in the next 10 years. Group made up of China, India, Indonesia, Brazil, Russia, Turkey and Mexico.
Source: BBVA Research

Altogether, the most likely scenario is that global growth improved from the second to the third quarter, rising from 0.6% QoQ to an estimated 0.8% respectively. However, there is downside risk to these figures given that the industrial activity indicators and world trade in September could still moderate, and the effects of the financial volatility on confidence could be more persistent than we expect. Also, there are the geopolitical risks associated with the situation in Syria and Iraq and the fragile agreement between Ukraine and Russia. It is worth noting that sanctions are already having an impact on activity in important sectors such as Russian energy.

In this context, monetary policy will remain focused on supporting activity, while fiscal policy will be less restrictive in tone in 2014-15 in both the US and the eurozone than in the recent past. Even in China, together with the budget consolidation at the local and regional government level it is felt that additional measures to support growth could be implemented.

Finally, we must point to the fall in oil prices as a favourable factor for global growth expectations – although not for exporter countries to the extent that this is a result of a positive supply shock.

Growth in the US remains in line with expectations, and is likely to reach 2.5% in 2015

After the unexpected and transitory drop in activity in 1Q14, the activity, spending and employment indicators have recovered, implying that the pace of GDP growth could be around 2.5% in the second half of the year, and thus average 2% for 2014 as a whole (Figure 2.2). The role of the Fed, which emphasises caution and patience before acting on the signs of improvement in the economy, continues to support our scenario of a cyclical recovery in the US underpinned by the solid creation of employment and the increase in household wealth.

Our outlook for China is unchanged, but with a downward bias due to the external environment and the supervision of shadow banking

In the third quarter GDP growth continued to decelerate, to 7.3%, reflecting the moderation in domestic activity, particularly in the construction and real estate sectors, but partially offset by an unexpected and intense upturn in exports. We maintain our outlook for GDP growth at 7.2% in 2014. Altogether, the risks to growth in China continue to be to the downside from 2015 onwards (7.0%), precisely because of the brake on external demand that the situation in Europe might imply and the adjustment underway in the real estate sector in a context of high leverage and the introduction of measures to control its less regulated banking system.

China is facing the task of managing the present deceleration of economic growth while reducing its financial risks and rebalancing growth in favour of domestic demand. In this scenario, the authorities will intervene so that the deceleration does not intensify, and growth does not fall below the targets set. Thus we would not be surprised to see additional monetary policy easing (with cuts in the reserve ratio or liquidity injections), expansive central government fiscal policy (albeit with consolidation at the local government level) and on-going execution of structural reforms.

In the eurozone the recovery will be even slower than we were expecting

The stagnation of GDP growth in the second quarter, with weaker performances in general in the larger economies, has led us to revise our outlook for growth in the region downwards for 2014 and 2015 (Figure 2.2). The Ukraine/Russia crisis is having an impact on trade and the confidence indicators of the economies in the centre of Europe, including Germany. The ECB has continued to take action, with measures designed to bring inflation expectations more closely into line with the objective of price stability, which have been de-anchoring since 2012. In our most likely scenario, euro depreciation has to make a contribution, given the different expectations of Fed and ECB actions, with a withdrawal of stimuli by the former and balance-sheet expansion by the latter.

3 The penalisation of asset prices due to local factors is over

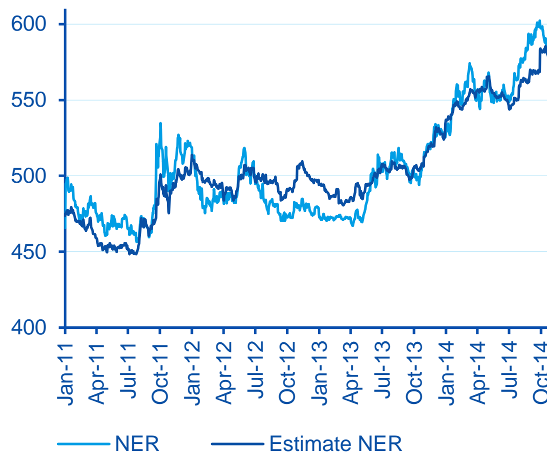
Much of the peso depreciation has ended, while medium- and long-term interest rates have responded with volatility to the expectations of a slight improvement in the economic cycle. The supply of local sovereign paper has increased and there have been significant variations in external rates

The exchange rate has corrected again since we closed our last Outlook report, with the peso depreciating between 4% and 5%, passing USDCLP 600 at the end of September. Some of this depreciation was reversed at the beginning of October and, on the closing of this report, the exchange rate was only marginally higher than the rate suggested by nominal and real determinant models which consider, among other variables, changes in terms of trade and the dollar on international markets (Figure 3.1).

First of all, we believe that part of this difference is accounted for by the negative surprises in activity, combined with a degree of scepticism about the recovery of growth in the next few quarters, as well as the uncertainty of the reformist scenario, reflected in the deterioration of business expectations. We continue to view it as likely that the USDCLP exchange rate will remain close to its current level in the short term, although better activity prints and less room for cuts in the monetary policy rate (MPR) could bring limited appreciation to the peso in the medium term.

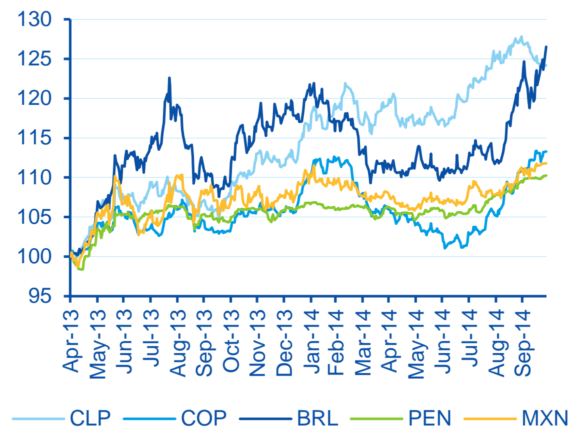
The local exchange rate has suffered a higher depreciation than others, a situation which indicates there will not be very strong exchange rate hikes over the next few months, given that the floating exchange and the swift adjustments in the MPR have already built in enough depreciation for the cycle to improve in the medium term (Figure 3.2).

Figure 3.1
Effective exchange rate and estimate * (CLP/USD)



(*) Short-term exchange rate model for USDCLP, following Cowan et al (2007).
Source: Bloomberg, central bank of Chile and BBVA Research

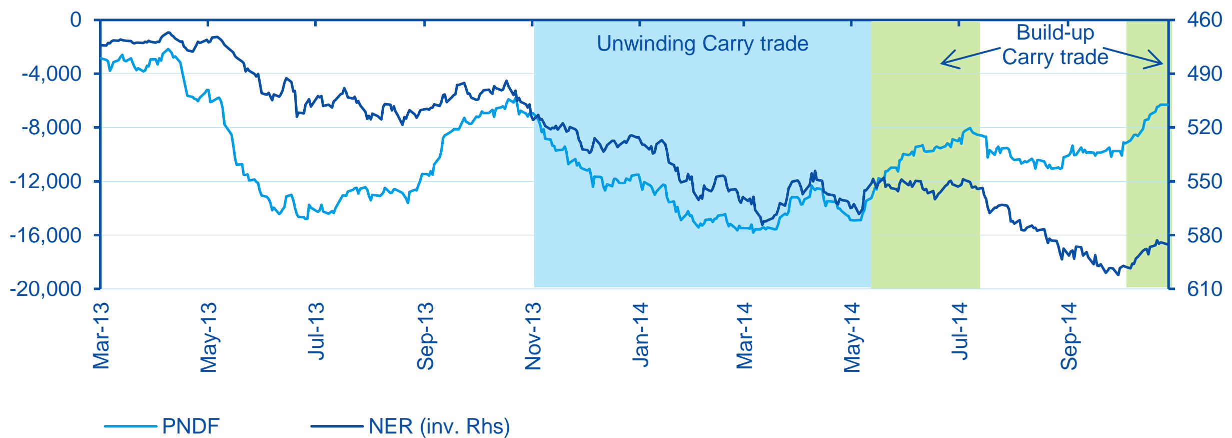
Figure 3.2
Exchange rates against the dollar (30 Apr 2013 indexes=100)



Source: Bloomberg and BBVA Research

The rise in the exchange rate to levels around USDCLP600 coincided with a contraction in the copper price, part of our baseline scenario for this metal, the increase in geopolitical risks and the unwinding of interest rate arbitrage operations using derivative instruments (*carry trade*) carried out by non-residents, together with cuts in the MPR (Figure 3.3). With the arrival of volatility, foreigners have stopped betting on further falls in the MPR, which was more marked after the neutral bias of MPR in October. In this context, we forecast that the exchange rate will remain at around USDCLP 590-595 for the rest of the year, provided that our forecast - of a recovery in activity and additional MPR cuts limited to 2.50% - materialises, in a scenario which also includes a moderate multilateral appreciation of the dollar.

Figure 3.3
Net position in the external derivative market and nominal exchange rate (USD mn, USD/CLP)



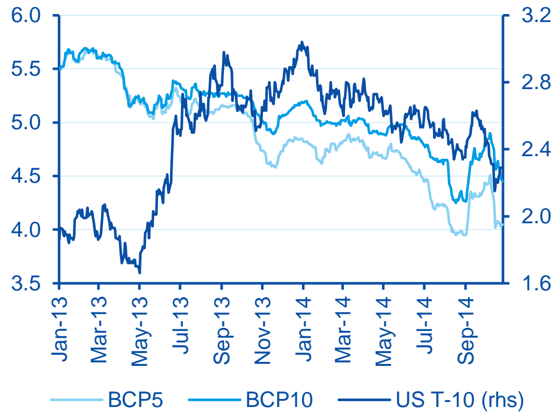
Source: Central bank and BBVA Research

Medium- and long-term interest rates have responded with volatility to the expectations of a slight improvement in the economic cycle. The supply of local sovereign paper has increased and there have been significant variations in external rates

Medium- and long-term interest rates have been volatile in a slightly bullish environment, consistent with our view of a degree of decoupling from the fundamentals, as flagged up in our last Outlook report. The BCP-10 stands at around 4.5%, and the BCP-5 at 4.1%. This is all taking place at the same time as the US 10-year Treasury bond showed significant fluctuations, moving between 2.6% and 2.2% on mixed news from China, and increased risk aversion for diverse reasons, among them geopolitical, health and world growth risks (Figure 3.4).

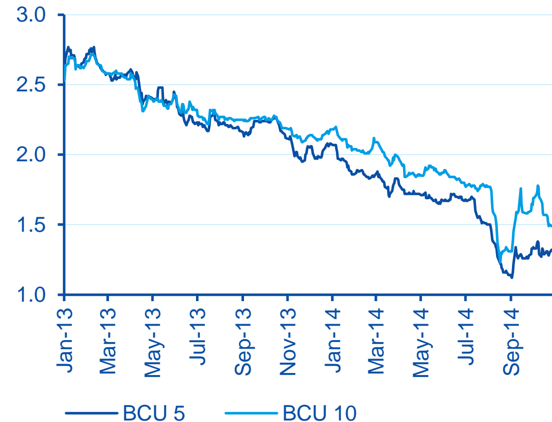
Meanwhile, interest rates on inflation-linked instruments (BCU) at 5 and 10 years also suffered from noticeable volatility, accumulating increases of 20 and 18 basis points (bp) respectively over their September lows (Figure 3.5). Thus, the implicit average inflation compensation stood, on closing this report, at 2.8%.

Figure 3.4
5- and 10-year BCP rates and 10-year US T bills, %



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

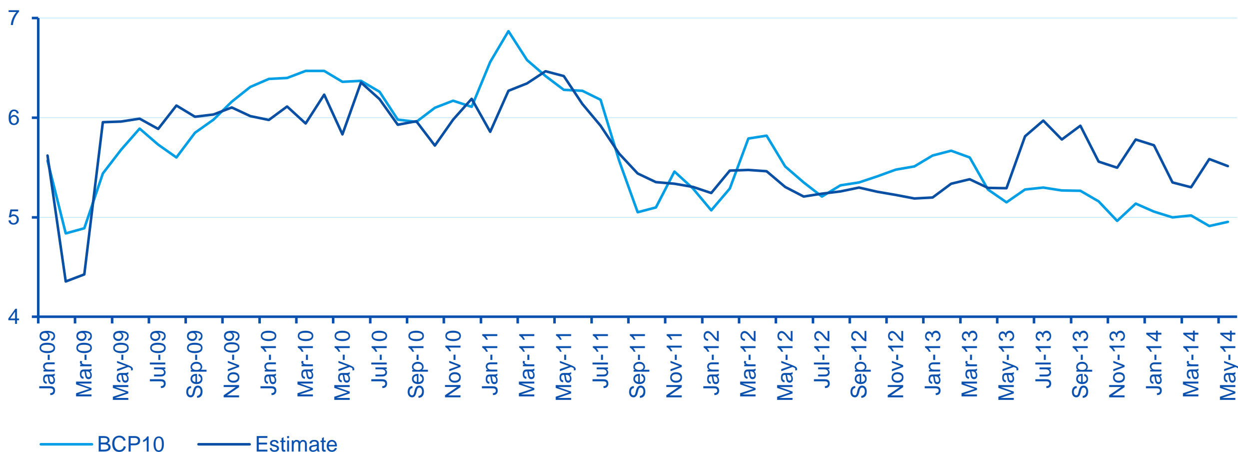
Figure 3.5
5- and 10-year BCU rates, %



Source: ABIF and BBVA Research

Our models for determining long-term sovereign yields cannot yet entirely account for their current levels (Figure 3.6). This difference could be a response to a set of reasons, among them certain frictions in judging yield levels, the relative scarcity of non-resident investors and the lack of supply of papers with buy and hold policies on the part of institutional agents. All in all, and although there have been partial reversals to the upside in the yield levels, additional increases cannot be ruled out in long-term yield rates in the future.

Figure 3.6
Estimated long-term sovereign rate, %



(*) Estimates based on uncovered parity model.
Source: central bank and BBVA Research

As part of this diagnosis, we have examined the factors behind this reverse in local yield rates and we see that a not inconsiderable part is due to negative surprises in activity (Table 3.1). We used the 10-year BCP as a basis. As long as the negative shocks do not continue, local yield rates will be more linked to their external counterparties.

Table 3.1
Impacts of activity shocks and external rates on the 10-year BCP: January to August 2014

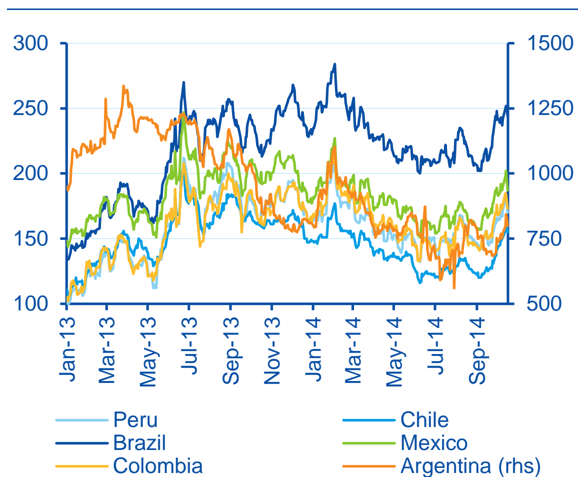
		Impacts on BCP-10 (bp)
BCP-10 in December	**5.04%**	
Activity shocks *	-4.3pp	-21 bp
US 10Y T-bond fall	-48bp	-27 bp
Other factors (shortage of paper, etc.)		-24 bp
BCP-10 in August	**4.32%**	

*Shocks up to the June Imacec published in August
Source: Bloomberg, BBVA Research

The sovereign risk premium measured by the EMBI has increased somewhat since our last Outlook report, 17bp below the peak reached at the beginning of February. This trend is similar to that shown by other countries in the region (Figure 3.7).

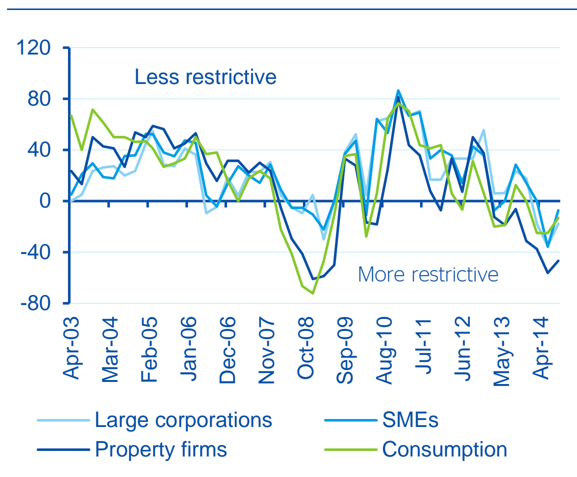
When it comes to internal financing conditions, in last quarter's Outlook we flagged up that there would be a deceleration at some point, given that the central bank's Credit Survey revealed certain supply restrictions and a slackening in demand. This has happened. In the case of consumer loans, although in the margin credits are being given in the same conditions, demand is weaker, which has led to lower momentum in small loans (Figure 3.8). However, it is also true that the reduction in the Conventional Maximum Rate has continued, which may have contributed to this deceleration in the flow of credit to individuals.

Figure 3.7
EMBI Chile and LatAm (bp)



Source: Central bank and BBVA Research

Figure 3.8
Variation in demand for credit * (% net responses)



*Corresponds to the difference between the %'age of those surveyed who think there has been a strengthening in requests for credit from the previous quarter to some degree, and the %'age of those who consider that these requests have weakened to some degree, as %'age of total replies.
Source: Central bank Banking Credit Survey

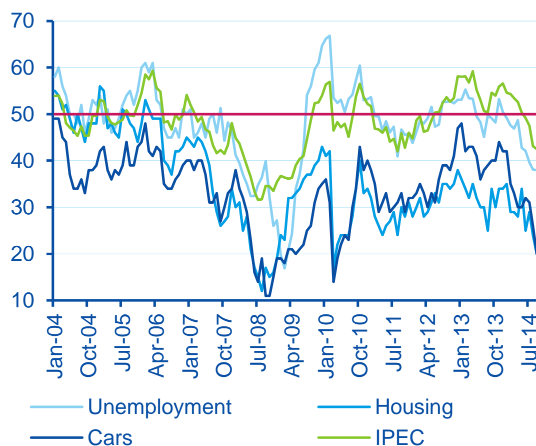
4 Lower local growth and slower recovery than expected

GDP growth will reach 1.9% and 3.1% in 2014 and 2015, delaying the convergence towards estimated growth potential of between 4% and 4.5%. Weak domestic demand will be more persistent because of the severe correction in relative prices and greater weakness in the labour market

Activity continues to surprise negatively, illustrated by GDP growth in 2Q14 of only 1.9% YoY, while leading figures for 3Q14 show that the slowdown is deepening, with growth of around 1.0% YoY. In our baseline scenario, GDP growth will edge up a little starting in 4Q14, not only because of more favourable bases but also thanks to a greater contribution on the part of fiscal spending, although still in a scenario of moderate fiscal execution.

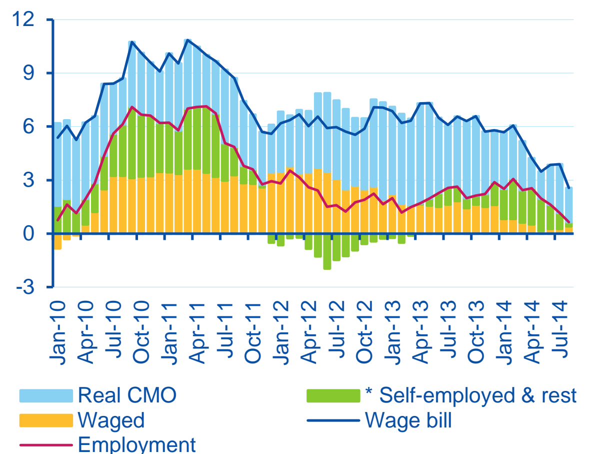
It is already the case that weak private consumption is having a greater impact, making the current cycle of lower growth more persistent and the recovery of growth potential rates longer in coming. Consumer expectations are in pessimistic territory and lower growth, in both occupation and real wages, will be the main determinants (Figure 4.1 and 4.2). The loss of momentum in consumption that we saw first in the durable component — particularly in automobiles — is now reaching non-durable goods as well, gaining persistence. In this context, we forecast private consumption growth of 1.9% and 2.2% for 2014 and 2015 respectively.

Figure 4.1
Consumer confidence and perception of unemployment * (indexes)



*Value over (under) 50 points indicates optimism (pessimism)
Source: Central bank, Adimark, BBVA Research

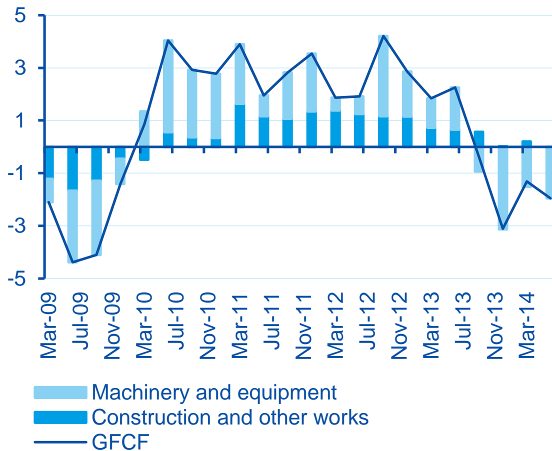
Figure 4.2
Wage bill (% var., YoY)



*Includes employers, domestic and unpaid household staff and represents about 10% of total employment.
Source: INE, BBVA Research

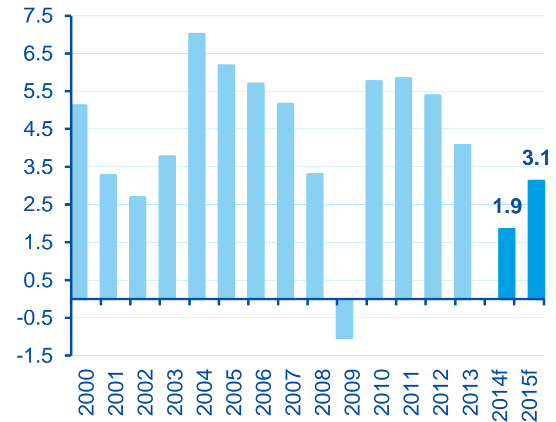
On the other hand, investment is not showing signs of stabilising, while the public component continues to make a negative contribution to its growth. On the contrary, after gross fixed capital formation (GFCF) fell 8.1% YoY in 2Q14, the figures for 3Q14 point to another YoY reverse, although a more moderate one. By components, investment in machinery and equipment continues to show a pronounced decline YoY, and there is increasing weakness in construction investment. All in all, we forecast a more severe drop in GFCF this year (-4.0%) and a slow recovery next year (1.5%), dragged down by poor performance in the construction component (Figure 4.3).

Figure 4.3
Contribution by component to GFCF spending (% YoY)



Source: Central bank, BBVA Research

Figure 4.4
GDP growth and forecasts (var. % YoY)



Source: Central bank, BBVA Research

The greater fiscal boost will be a determining factor in justifying recovery expectations and generating a turning point in aggregate confidence. However, we have noticed recently a degree of difficulty in public spending execution, particularly its capital component. This makes us doubt the government's capacity to meet its commitment of executing 100% of the budget to the end of 2014, which will delay part of its reinvigorating effect until 2015 (more details in Section 8).

The external sector will continue making a positive contribution to GDP growth, and will be one of the components which will lead the recovery, supported by a more depreciated real rate of exchange and global growth that is returning, albeit slowly. In this context, although we expect less vigorous performance from real exports this year (at 2.3%), we will continue to see recovery throughout 2015 (at expansion rates of 4.7%). The severe slowdown in domestic demand, meanwhile, and its sluggish recovery, will mean that imports have a more pronounced boost than forecast, with a 5.6% fall in 2014 and modest 3.3% growth in 2015.

In short, we interpret that the current activity cycle, associated with a sharp correction in relative prices, has been exacerbated by pessimism, reflected in confidence indicators, which has not been offset in a timely manner by counter-cyclical policies. The debate on local reforms has actually had the effect of lengthening the most important impacts of the local slowdown: a sharp adjustment in relative prices (or else in the exchange rate) associated with the end of the mining investment boom, the consequence of lower growth in China and its change in composition towards less investment, coming on top of the expected forthcoming withdrawal of quantitative easing and the rise in interest rates in the US.

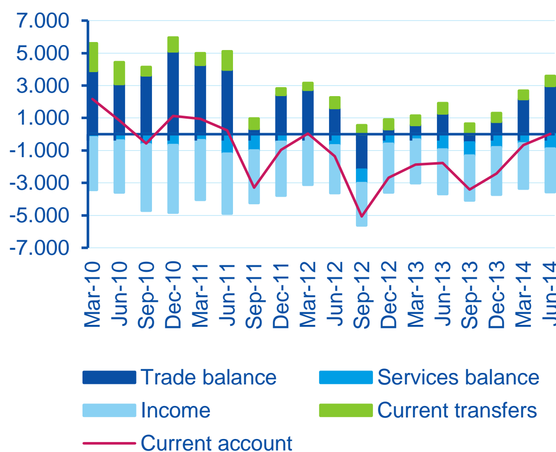
5 Substantial improvement in the current account in a climate of greater local deceleration

Greater slowdown has contributed to a swift improvement in the current account deficit. Exchange rate flexibility has played a key role in stabilising external accounts

In 2Q14 the current account balance had a small surplus of USD28mn, having previously accumulated a USD1.662bn deficit, equivalent to 2.4% of GDP, in the previous four quarters. These figures point to a robust correction in external accounts, boosted by a bigger trade balance in goods, principally associated with a severe fall-back in imports (Figure 5.1). Revenue deficit was lower in 2Q14 (USD2.677bn), in line with lower net FDI and therefore lower associated remittances. In financing terms, the aggregate deficit to date continues to be mostly financed by FDI.

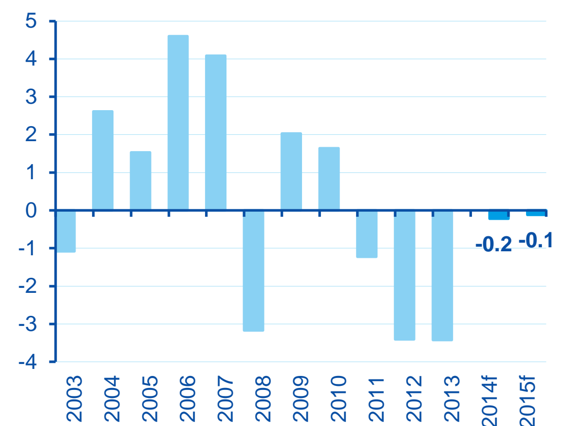
We have adjusted downwards our current account deficit estimate, to 0.2% and 0.1% of GDP for 2014 and 2015 respectively, from 2.3% and 2.8% as forecast in our last report (Figure 5.2). The explanation for our re-evaluation is still anchored in a tighter adjustment in the composition of growth, a lower contribution on the part of domestic demand, a bigger one from the external sector and expectations that the real exchange rate will remain depreciated. In terms of future perspectives we now expect the recovery in private spending to take longer.

Figure 5.1
Balance of payments current account (USD mn)



Source: Central bank, BBVA Research

Figure 5.2
Current account deficit and forecasts (% of GDP)



Source: Central bank, BBVA Research

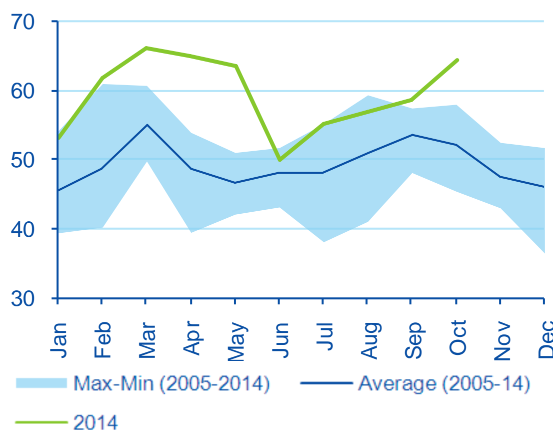
6 2014 will close with inflation at 5.1% YoY, explained by factors which will no longer be present by 2015

This year's increase in inflation is accounted for by factors such as the depreciation of the peso, methodological changes in the measurement of CPI and the tax reform. The year will close with inflation at 5.1% YoY, while by the end of 2015 it will be 2.3% YoY, with a marginal risk to the downside

2014 has been a year in which the Chilean economy underwent a series of changes, in terms of both structural debates and corrections in the labour market, activity and relative prices. After several years of positive results, the economy started to falter, which has translated into a deceleration in investment, accompanied by signs of less dynamism in the labor market and lower momentum in private consumption. Despite greater slack capacity, price momentum has continued the upward course it began at the end of 2013, when the peso's depreciation started to pass through to local prices and was aggravated by tax hikes.

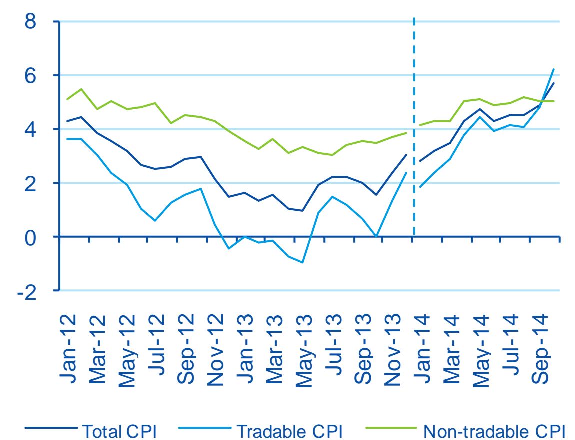
This year methodological changes were made to the way in which some CPI items are measured and to the composition and quantity of the basket of goods, improving, for example, the measurement of those tradables which in the past have deflated the CPI (clothing and footwear and electronic articles, in the main). Furthermore, as we pointed out in our last Outlook report, the surprising inflation prints since the start of the year have been brought about, above all, by the severe depreciation of the peso, which materialised through across-the-board hikes in different products in the CPI basket, setting the inflationary dispersion at the high end of the spread over the last ten years (Figure 6.1). Thus, to October, the YoY inflation of total CPI and of tradables showed variations of 5.7% and 6.2% YoY respectively (Figure 6.2).

Figure 6.1
Products suffering price rises (%)



Source: Central bank, INE, BBVA Research

Figure 6.2
Total CPI and analytical indexes* (% var., YoY)



*Dotted line marks the beginning of the new average baseline basket; 2013=100.
Source: INE, BBVA Research

In parallel, the draft tax reform (TR) law was being debated for most of the year, which will have direct impact on the price of certain products that are included in the CPI measurement, in particular tobacco, alcoholic and non-

alcoholic beverages, and new cars. This provoked earlier price hikes for some of these products, in anticipation of the forthcoming tax rises which will come into force once the law is passed.

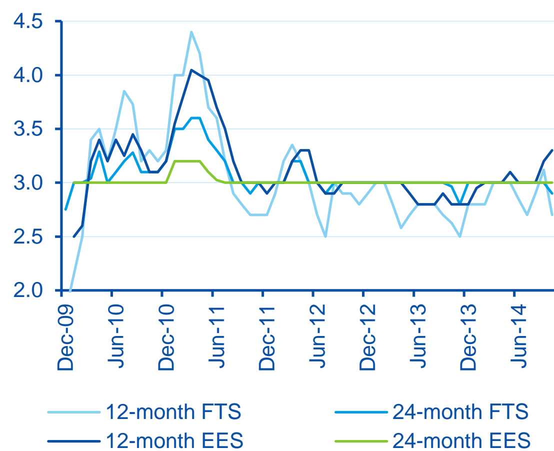
For these reasons, in October 2014 aggregate inflation reached 5.1%, surprising the market with higher-than-expected rates for eight of the ten months, while the principal core measurement, CPI excluding food and energy, increased by 4.1% YoY, slightly above the central bank's tolerance range.

However, we consider that a good part of the inflationary shocks described above will be transitory and will no longer be present by 2015, to the extent that a significant part of the peso's depreciation will be over (see our more detailed analysis in Section 3). When we review the behaviour of inflation expectations in the Economic Expectations Survey we see a short-term correction, coming in at 3.3% YoY in the first 12 months of the forecast, staying anchored at 3% in the longer term. The Financial Traders Survey shows that expectations at 12 and 24 months have remained anchored at 3%, which reaffirms the diagnosis of transitory shocks being responsible for high effective inflation (Figure 6.3).

Thus, for the rest of the year, the main contributory factors to inflation will be the remaining effects on prices due to the coming into force of the TR, adjustments in electricity tariffs and seasonal factors which will principally affects certain foodstuffs and transport. In consequence, our baseline scenario for 2014 includes an upward correction at year end, from 3.6% in our earlier report to 5.1% YoY.

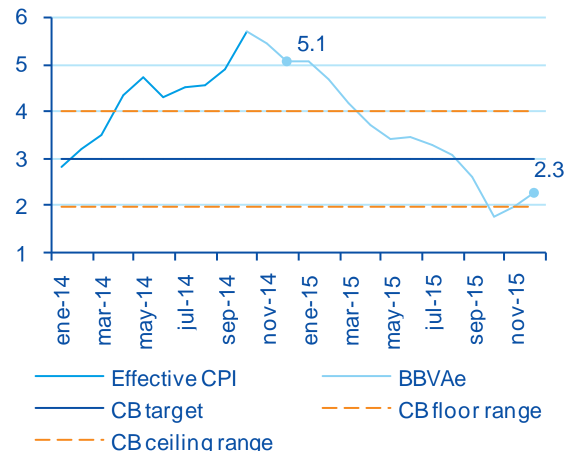
In 2015, as we indicated, most of the factors contributing to inflation in 2014 will have dissipated. Thus, a scenario with increasing slack capacity where the wage bill is growing at a very limited rate, a slightly more appreciated exchange rate and an absence of major inflationary pressures internationally allow us to forecast that inflation in 2015 will be contained, converging swiftly to the central bank's tolerance band, to end the year at or even below 2.3% YoY (Figure 6.4).

Figure 6.3
Inflation expectations at 12 and 24 months: EES and FTS* (var. % YoY)



**EES: Central bank's Economic Expectations Survey with data to October 2014.
FTS: Central bank's Financial Traders Survey with data to the second week of October 2014.
Weekly data
Source: Central bank, BBVA Research

Figure 6.4
Inflation projection, 2014 and 2015 (% var., YoY)



Source: INE, BBVA Research

7 A weakening economy and its medium-term implications for inflation mean that greater monetary stimulus is required

In our baseline scenario, the central bank will keep MPR at 3.00% this year and cut to 2.5% in the first half of 2015, staying at that level for virtually the whole of next year. Normalisation to neutral levels will also be more gradual than we forecast three months ago

In our 3Q14 report, we indicated that the central bank would reduce the monetary policy rate (MPR) to "at least" 3.25%. At the time of writing this 4Q14 report, the central bank had not only cut the policy rate to that level, but had also announced in its September Monetary Policy report that the terminal rate would be between 2.75% and 3.0%. This greater monetary stimulus was consistent with an economy which, while presenting upside surprises in inflation, also showed significantly greater-than-forecast weakness in activity and demand, with disinflationary implications which will be more visible in 2015.

At its September meeting, after discussing the policy implications of reducing MPR by 50bp or 25bp, the central bank cut MPR by 25bp and moderated the expansionary bias, a decision which was accompanied by several statements by members of the committee, announcing that the end of the monetary expansion process was at hand. In October, after the higher-than-expected September CPI figure was published, the central bank opted to reduce the MPR to 3%, in line with consensus expectations, but it also eliminated the expansionary bias from its statement, heralding the end of monetary expansion.

The scenario depicted by the same authorities in September has undergone major changes. Economic growth will post within the lower part of the 1.75-2.25% band (BBVAe 1.9%), but by the end of the year inflation will be above 4.1% (BBVAe 5.1%). Despite these changes, we believe the central bank needs to lead the MPR to at least 2.5%, which will only be feasible once it reviews the macroeconomic scenario for the next few quarters and recognises that there are hardly any inflationary pressures. The factors pushing inflation up this year — especially the pass-through of exchange rate depreciation and the effects of tax rises — will not boost inflation in 2015, and in addition there will be increasingly slack capacity.

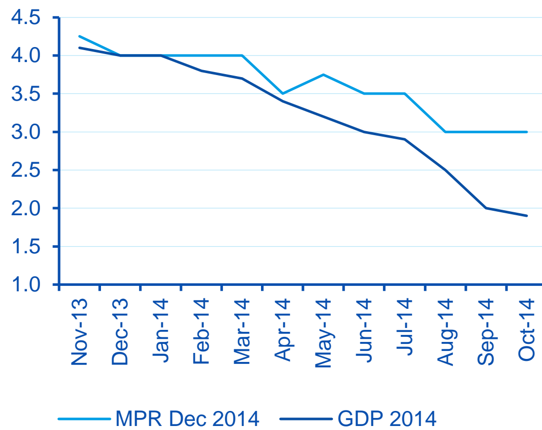
The international scenario is also looking weaker, with significant falls in international prices of non-metal commodities, principally oil and foodstuffs, which has obvious disinflationary implications.

As a result of the downward corrections it has made to its growth estimates this year, the market has been pricing in further cuts in the policy rate. At the close of this report, the consensus among analysts was that the MPR would close the year at 3% (Figure 7.1).

But it is not only the terminal MPR that will be lower than forecast three years ago, we also forecast that a greater monetary stimulus is needed; in other words, that the rate should be kept low for longer, to the extent that economic deceleration has been sharper and more persistent than forecast. In our baseline scenario we have postponed convergence to growth potential to 2017 and, as a result, this scenario means that MPR will stay at 2.5% for the whole of next year, subsequently beginning a gradual process of normalisation, to end at a neutral level, estimated as between 4.25% and 4.75% by the end of 2016 or the beginning of 2017.

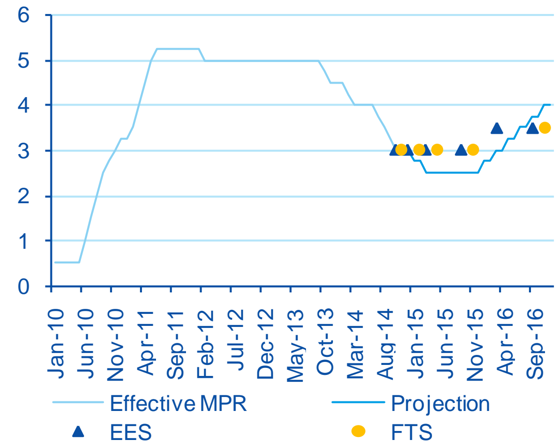
On this final point, it should be noted that to date the central bank has shed no light on how long it plans to maintain monetary stimulus, nor about its forecast for the neutral interest rate, both of which condemn the market to significant degrees of uncertainty. For the moment, the surveys available (Economic Expectations Survey and Financial Traders Survey) suggest that the market expects the central bank to set the MPR at only 3%, but that it will keep it at that level for all or most of 2015, raising it by only 50bp over a 16 month horizon (Figure 7.2).

Figure 7.1
Analyst expectations, EES*



* EES: Central bank's Economic Expectations Survey with data to October 2014.
Source: Central bank, BBVA Research

Figure 7.2
Effective MPR and implicit trajectories in EES/FTS * (%)



* EES: Central bank's Economic Expectations Survey with data to October 2014.
FTS: Central bank's Financial Traders Survey with data to the second week of October 2014
Source: Central bank, BBVA Research

8 2015 fiscal budget: focus on public-sector investment and dipping into the FEES pot

We estimate effective deficits will be bigger in 2014 and 2015 than the government's forecasts. In 2015 between USD1bn and USD2.5bn of monies from FEES will be used, given that the Budget Law's debt ceiling of USD 7.5bn would not be sufficient

With the publication of its Public Finances Report (PFR), the government has provided all the background necessary to estimate the macroeconomic impact of public-sector spending on public expenditure for the rest of 2014 and in 2015. This report gives a detailed breakdown of the macroeconomic scenario expected by the Ministry of Finance, the spending forecast for 2014 and 2015, and the estimate of the ministry's financial assets at the end of this year, among other information. This makes it possible to analyse the implications of the figures published by the government and the effects of a macroeconomic scenario that is potentially different from the one depicted by the Ministry of Finance (Table 8.1).

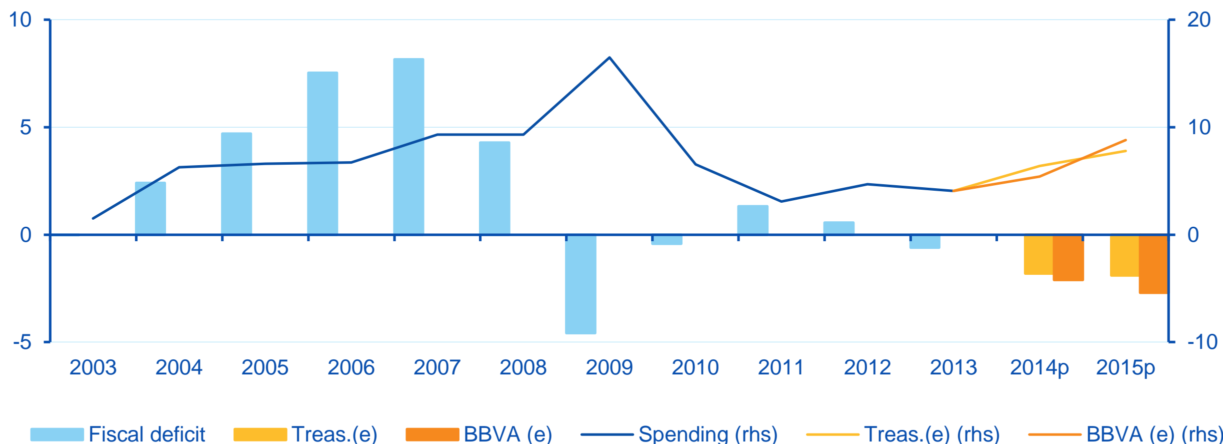
Table 8.1
Macroeconomic and fiscal variables for 2014 and 2015

	2014		2015	
	MinFin	BBVA	MinFin	BBVA
Macroeconomic scenario				
GDP (var. YoY)	2.1	1.9	3.6	3.1
Domestic demand (var. YoY)	-0.1	-0.1	3.9	3.2
CPI (Avg. var./avg.)	4.2	4.4	3.0	3.3
Exchange rate (USDCLP)	565	569	585	581
Copper price (USc/lb)	315	308	312	287
Molybdenum price (USD/lb)	12.5	12.1	13.0	11.2
Fiscal scenario				
Structural deficit (% of GDP)	-0.9	-1.1	-1.1	-1.1

Source: Budget Office (Dipres), BBVA Research

While the Ministry is forecasting an effective deficit of 1.8% of GDP in 2014, lower revenues will make this result more negative, although partly mitigated by lower spending. Our estimate is of an effective deficit of 2.1% of GDP, which would equate to around USD5.5bn. The difference arises from lower revenues as a result of: i) a less dynamic macroeconomic scenario than forecast by the Ministry of Finance, and ii) lower additional revenues from the Tax Reform than estimated for this year (Budget Office (Dipres): 0.3% of GDP, BBVAe: 0.1% of GDP). This result is partly compensated, given that we consider it unlikely that the government will meet the spending figure forecast in the PFR, which would imply execution of 101.9% and an average real growth rate in spending of 9.3% YoY in the last four months of the year. Despite the slow rate of budget execution this year, we do not rule out that a little more than 100% of the budget is finally executed. Thus, with an execution of 101.0%, spending would increase by a real 7% YoY in the last four months, and by 5.4% over the year (Figure 8.1).

Figure 8.1
Government spending (% real var., YoY) and effective fiscal deficit (% of GDP)



Source: Budget Office (Dipres), BBVA Research

A larger effective deficit in 2014 makes the need to sell assets in order to finance the government's obligations more acute. Between USD500mn and USD1.3bn will be disposed of in 2014, while in 2015 FEES dollars to the tune of between USD1bn and USD2.5bn will be sold. In the PFR, the government is calculating an asset sell-off over the year for around USD3.16bn, so that by the end of the year Other Public Treasury Assets (OPTA) will stand at USD722. It is not planning to use FEESthis year[1]. Nevertheless, in BBVA Research we forecast a large effective deficit, which would raise the amount of assets needing to be sold by a further USD730mn. With this sum, the government still has scope to liquidate its other assets without having recourse to sovereign funds in 2014 (Table 8.2). According to information to August, the OPTA are USD4.787bn, with 72.2% of this in local currency, and the remaining 27.8% in FX.

Table 8.2
Sources and uses of fiscal resources 2014 and 2015, USD mn

	2014		2015	
	IFP	BBVA	IFP	BBVA
Sources	**7,277**	**8,008**	**8,187**	**10,069**
Gross indebtedness	4,118	4,118	7,500	7,500
Sale of financial assets	3,160	3,891	687	2,569
Uses	**7,277**	**8,008**	**8,187**	**10,069**
Effective deficit	4,759	5,490	5,187	7,069
Periodic amortisations	1,079	1,079	2,000	2,000
Recognition bonds	1,439	1,439	1,000	1,000

*Note: the figures are expressed in USD using PFR exchange rates. Some figures have been rounded.

Source: Dipres, BBVA Research

For 2015 too, we forecast a scenario with lower effective revenue and larger deficit as a result of the differences with the macro scenario assumed by the Ministry. Keeping the figure in the Budget law as the total expenditure

1: Law 20.759 allocated USD400mn of the Reserved Copper Law to spending associated with the reconstruction in the north and in Valparaíso. Although this modification does not imply changes in total revenues, it does have a repercussion on greater asset liquidation since it is likely that by virtue of the law, this sum will have been used to finance spending in foreign currency (the so-called COSUDENA).

(that is, assuming 100% of execution), and also that the tax reform results in the collection of the sum estimated - 0.97% of GDP - for 2015, a macroeconomic scenario such as that posited by BBVA Research is consistent with lower effective revenues. Thus, with spending increasing in real terms by 8.8% next year, we estimate that the Treasury will have lower revenues, equivalent to USD1.8bn, than the PFR estimate, bringing the effective deficit to 2.7% of GDP, instead of the 1.9% of GDP estimated by the Treasury.

Whatever the result in 2015, the debt ceiling of USD7.5bn set in the Budget law is not high enough, and an asset liquidation is unavoidable. Even if the deficit were only 1.9% of GDP (USD5.187bn in the Treasury's figures), the USD2bn of debt amortisation planned for 2015 and the payment of recognition bonds to the tune of USD1bn mean that the shortfall will be around USD700mn, which will have to be funded by an asset liquidation; meanwhile, the larger effective deficit of USD1.8bn resulting from our macro scenario could mean that further sums could be required, bringing the total up to USD 2.5bn. On top of these figures, there is the capitalisation of Codelco at some point, worth USD1.0bn, which will be financed with more debt. Bearing in mind that a significant part of Other Public Treasury Assets will be sold this year, we cannot rule out that, in 2015, FEES will have to be used to finance the budget. This need to sell assets next year should be put in the context of our view that the peso's depreciation because of external factors will be limited; in consequence, we still think that the exchange rate will hover around USDCLP 570 in the medium term.

The changes in the macroeconomic scenario do not have repercussions on the estimate of the structural deficit, so that meeting the target or not will not be altered by this variation. The aim of the rule is precisely that of ensuring a fiscal deficit that is well adjusted to the cycle, and a level of spending dependent on the target which is not affected by the cyclical changes in the economy. We anticipate a larger deficit for 2014 only, given that we are expecting lower collections from the tax reform this year. In any event, we have already mentioned that a marginal delay in meeting the structural goal should not bring with it greater costs in terms of the cost of sovereign debt for the country (Box 1).

The risks as we see them for 2015 are partly offset, and have to do with tax collection resulting from the reform and spending execution. A large proportion of the higher collection of 0.97% of GDP is associated with less tax evasion and the closure of certain loopholes, for which reason there are clear risks that revenue collection for these items may be lower than estimated. Offsetting this, the potential structural problems in the budget execution could extend this year's slow execution into next year, endangering budgetary execution in 2015.

Box 1. Sustainability and fiscal rule in Chile: forecasts and international comparison

The Chilean fiscal rule, consisting of setting the government's spending on the basis of structural, or cyclically adjusted, revenues, together with a target for structural balance, will have posted 10 consecutive years of structural deficits by 2017. In this context, it is worth asking ourselves whether these results endanger the sustainability of public finances or whether, on the contrary, it would not be a significant risk, given the net creditor status of the government. One could go further: if fiscal sustainability is thought not to be at risk, the government might consider the possibility of postponing convergence to the structural equilibrium until 2018, which in practice would allow annual public spending to rise by up to USD2.7bn (1% of GDP). This discussion is particularly germane in an economy with persistent and extensive unmet needs in areas as wide-ranging as public infrastructure, health and education, among others.

This box looks at the dilemma from two angles: first, it quantifies how the level of net public debt as a percentage of GDP would be impacted by the effect of diverse possible scenarios for the target of structural balance, including scenarios of convergence, keeping the deficit stable and deficit divergence. Second, it reviews the international evidence for evaluating the possible effects in terms of interest rates and of the risk premium which the government would pay were public debt to rise to the levels of other countries normally included in international comparisons.

1. Estimate of debt dynamics

1.1. Methodology

Taking as our starting point the debt dynamics equation used in the literature (see, for example, Buiter, 1985), three idiosyncratic features of the Chilean economy are included (see Villena et al., to be published): i) the structural balance rule, ii) the importance of copper revenues, and iii) the sovereign funds policy pursued by the country, and particularly the Pensions Reserve Fund (PRF). So, the law of motion of debt can be written as:

$$\Delta d_t = -\frac{1-i_t}{1+\gamma_t}\gamma_t d_{t-1} + \frac{\Delta FRP_t}{P_t Y_t} - \left(\overline{be_t} + ac_t\right) \quad (1)$$

where the variables in lower case denote that they are expressed as a percentage of GDP, i_t is the nominal interest rate associated with net debt in the period t, π_t is the inflation in the period t, and γ_t is the same as the sum of $\pi_t + g_t + \pi_t g_t$. g_t is the real product growth rate; ΔFRP_t is the variation in the PRF, $P_t Y_t$ is nominal GDP, $\overline{be_t}$ is the structural balance goal as a percentage of GDP, and ac_t is the cyclical adjustment as a percentage of GDP in year t. Note that adding the sum of the structural balance and the cyclical adjustment together gives us the effective balance.

Thus, the structural balance goal and the cyclical position of the economy are the two variables which will determine the Treasury's rate of indebtedness. In turn, the cyclical situation will be determined by the breach between the effective variables and the structural parameters, that is, the trending GDP and the benchmark prices for copper and molybdenum.

1.2. Assumptions

This exercise has two simplifying assumptions. First, we omit the indebtedness that the recognition bond issue may generate. Furthermore, given the essentially private pensions system in Chile, and based on long-term spending projections (Budget Office, 2014), we assume that PRF interest payments are not withdrawn or used. Spending pressures which may appear from the areas of health and education may increase the tax burden, but we do not assume changes in the tax regime over and above the recently passed tax reform.

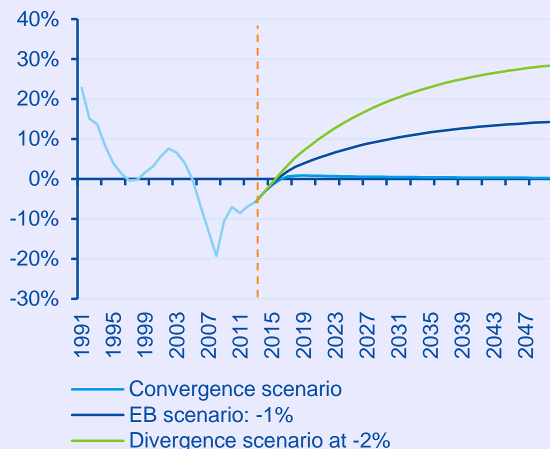
1.3. Scenarios and results

We assume two important macroeconomic scenarios: one is the closing of the output gap by 2018, with GDP potential growth of 4.2%, and the other where the growth of GDP potential is achieved in 2015 and is 2.5%, but is overestimated by the independent committee of experts and a positive cyclical adjustment is calculated to 2020.

We assume three structural balance targets for both macroeconomic scenarios: i) for a structural balance equilibrium in 2018 (at the rate of 0.25% of GDP a year), staying balanced until 2050, ii) that the structural deficit is not closed, but remains at 1% of GDP from 2015 to 2050, and iii) divergence in structural deficit reaching 2% of GDP in 2018 and staying at that level until 2050. In all cases we assume interest rate and exchange rate trajectories in line with the debt levels for each scenario.

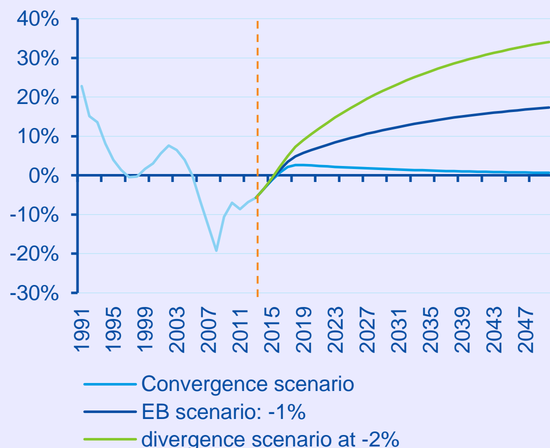
The dynamics of total net debt (bearing in mind the fiscal assets registered with the PRF) for the scenarios proposed are illustrated in Figures B1 and B2.

Figure B.1
Total net debt under three structural deficit targets (% of GDP)



Source: Treasury, BBVA Research

Figure B.2
Total net debt under three structural deficit goals and overestimate of GDP potential (% of GDP)



Source: Treasury, BBVA Research

As the two figures above illustrate, in both cases the worst scenario in terms of the structural deficit takes net debt to around 30% of GDP, although with real annual spending variations at a different level (in the long term, spending increases at the same rate as GDP potential, so that a more limited product growth implies a smaller spending growth). As such, it is a

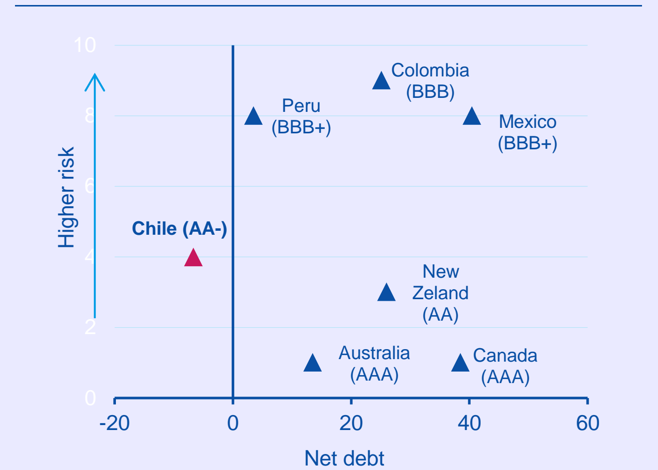
fact that, under any scenario, the Treasury will cease to be a net creditor in the next few years; also that in the non-convergent scenarios, debt could reach levels not seen since the beginning of the nineties. The questions that should be asked at this point are: i) whether net debt in these ranges endangers the sustainability of debt or, on the contrary, is manageable for an economy such as Chile's, and ii) whether the government could sustain a YoY growth in spending of 2.5% or, on the contrary, in a scenario such as this, will need to increase still further its indebtedness in order to finance greater spending growth. To help build an answer to the first question, the next section reviews the evidence from abroad.

2. International comparison

When Chile's net debt is compared with that of similar economies, whether in terms of their per capita income, their policy framework or their production structure, we see clearly that the Chilean economy is in a relatively good position. Chile is a net creditor; this, and its other macroeconomic and institutional performance variables, mean that the country has a very good risk classification compared to other countries in the region and, in consequence of this, has a low risk premium and can access low yields in its sovereign debt issues. The possible loss of these privileges is one of the arguments generally used by those who are not in favour of raising public debt.

We will compare below Chile's debt and risk classification with that of similar economies, where the better relative position of the Chilean economy is apparent. If in the future the country progresses towards increasing its levels of net debt to the range of between 20 and 40% of GDP, there are two possible scenarios for the way in which its risk indicators will go. One we shall label "positive equilibrium": in its economic development process the country increases its debt to reach a status of developed country, along the way increasing public investment in infrastructure, technology, energy and human capital, which will bring us closer to countries such as Australia, Canada and New Zealand, which, even though they have higher levels of net debt, have better risk indicators. This could also be similar to the first scenario in which GDP potential growth is not affected. The other solution we will label "negative equilibrium", and is one in which the higher levels of debt are used for ends which do not serve to reach developed status, or directly misspent, in which case we would be moving to a situation which, together with the increase in the debt level, would have a deleterious effect on the risk indicators and make public and private financing more expensive. This case would be similar to the scenario where GDP potential sharply reduces its growth to 2.5% (Figure B3).

Figure B.3
Relationship between net debt (% of GDP) and risk classification (S&P)



Source: IMF, Bloomberg, BBVA Research

3. Conclusions

Going by the analysis above, we should not belittle the role which fiscal responsibility has played in the global perception of the Chilean economy in the last fifteen years, so this must be preserved and built upon in the future.

Having said this, we estimate, given the Treasury's position as net creditor, a scenario in which non-convergence to structural balance by 2018 does not necessarily lead to a deterioration in the sovereign risk indicators, nor to increases in financing costs on the foreseeable horizon. In a scenario such as this, the way in which resources are used is critical. In particular, an increase in debt issuance to finance public infrastructure projects or in an alliance with the private sector on energy projects, for example, could help Chile make the transition to a developed country.

Nevertheless, a situation of non-convergence would not pass without criticism, both political and economic, and has been the lot of Australia in recent years. Furthermore, we should not rule out risk scenarios where public finances have to deal with an additional pressure to those that are assumed in the exercises presented here, such as external shocks which have repercussions on revenues and require greater fiscal stimulus. However, if the increase in debt is gradual, moderate and used for ends that support economic growth, the benefits could far outweigh the associated costs.

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9 Risk of slow recovery in the confidence indicators

The risk of lower confidence in the aggregate has materialised and, in the future, this may imply a more gradual and moderate recovery than forecast. In the external arena, the sustainability of China's growth remains a risk, followed by the financial impacts of the withdrawal of monetary stimulus in the US

The idiosyncratic risk of greater setbacks in business and consumer confidence has become real. There has been a significant slowdown in the consumption of durable goods which has permeated to non-durable goods, while the indicators linked to private investment, such as capital imports, have not shown recovery.

As a consequence, the baseline scenario for this report assumes that private consumption will continue growing at slower rates than in the first quarter of this year, but that private investment ought to show recovery in the final quarter of 2014. The key risk in this dimension is associated with the fact that confidence is taking a very long time to recover and this is impacting on the recuperation of private investment, hurting private consumption even more than forecast in this report. Likewise, our baseline scenario includes a significant increase in public spending, both current and capital. That carries the risk of the slowdown inherent in public spending execution, particularly in investment.

In the external arena, a notably worse-than-expected economic deceleration in investment in China remains the principal external risk in the medium term, because of its implications for momentum in the export sector, confidence in domestic agents, capital flows and fiscal accounts. This risk has been mentioned in previous editions of this report, and more recently part of this risk has materialised, although with less intensity. In particular, worries remain about a more pronounced deceleration in China in the light of doubts about the fragility of its financial system, and the generalised increase in the risk perception of the emerging world. Deterioration in the Chinese economy would have a major impact on those of emerging countries, being transferred by financial and real channels. Of particular concern are the implications for the copper price, as well as on the growth of other important trading partners for Chile.

An additional external risk, which could have an impact in the short term, is that monetary normalisation in the US is brought forward, perhaps making financial conditions for Chile and emerging economies as a whole less favourable. Once again, with a somewhat lower likelihood and impact on Chile, the risk associated with the eurozone's complex fiscal and financial situation persists. Added to this, we cannot rule out the hardening of geopolitical tensions in the Middle East, with their effects on the price of commodities, as well as on confidence in Europe. Finally, the global health risk as a result of the Ebola virus also requires continued monitoring.

10 Tables

Table 10.1
Macroeconomic forecasts

	2011	2012	2013	2014	2015
GDP (% YoY)	5.8	5.4	4.1	1.9	3.1
Inflation (% YoY, eop)	4.4	1.5	3.0	5.1	2.3
Exchange rate (vs. USD, eop)	517	477	529	595	570
Interest rate (%, eop)	5.25	5.00	4.50	3.00	2.50
Private consumption (% YoY)	8.9	6,0	5.6	1.9	2.2
Government consumption (% YoY)	2.5	3.7	4.2	5.6	6,6
Investment (% YoY)	14.4	12.2	0.4	-4.0	1.5
Fiscal balance (% GDP)	1.3	0.6	-0.6	-2.1	-2.7
Current account (% GDP)	-1.2	-3.4	-3.4	-0.2	-0.1

Source: BBVA Research

Table 10.2
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	2.4	3.5	563.8	4.00
2Q14	1.9	4.3	553.1	4.00
3Q14	1.0	4.9	593.5	3.25
4Q14	2.0	5.1	595.0	3.00
1Q15	2.4	4.2	588.6	2.50
2Q15	3.0	3.4	582.4	2.50
3Q15	3.5	2.6	576,1	2.50
4Q15	3.6	2.3	570.0	2.50

Source: BBVA Research

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