Chile Economic Outlook

First Quarter 2015
Chile Unit

- Growth should reach 3.1% in 2015, with a better relative performance in 2H15 and convergence towards its potential rate by 2016. We are standing by our forecast of three months ago. The oil-price windfall will offset a flatter-than-expected upturn in 2H14. Key here will be fiscal stimulus, the contribution from the external sector and the expected recovery of consumer and business confidence.
- Inflation will converge towards 2.3% in a setting of lower fuel prices, peso appreciation and still weak domestic demand. In this scenario, we expect cuts in the reference rate (MPR) to 2.0-2.5%, although these are unlikely in the short term.
- Public finances with expansive policies that will not last beyond this year. Public spending should grow by 7.7% in 2015 and the fiscal deficit is likely to approach 3% of GDP. Downside risks in effective revenues and in setting structural parameters mean that, even without sustainability risks, the sound fiscal base begins to weaken.
- From abroad, the main risks come from developments in the Chinese economy and the return to a normal monetary situation in the US. Domestically, the main risk is linked to the evolution of the economic agents confidence.

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Closed: 9 February 2015

1 Overview

In the most likely scenario, the improvement in the world economy will hold up in 2015 and 2016 and will surpass 3.5% on average. The global economy ended 2014 growing at over 3%, pulled up by the United States and the boost from the oil price's fall on increased supply. In 2015-16, however, there will be marked differences among areas, given the uneven effects of the drop in commodity prices and the divergence of monetary policies, both of these being events which to some extent predetermine the outlook for the world economy.

Locally, we are standing by our 3.1% GDP growth estimate for 2015. In 2016 the economy will expand in line with its potential. Fiscal stimulus, net exports, a continuation of the windfall effect from oil and revived agents expectations will be key to this forecast becoming reality. Private spending will hold its ground with modest growth this year, and 2H15 will show greater YoY GDP growth than 1H15. **The biggest risk in this sense is associated with confidence taking its time and hampering consumption even more than forecast in this note.**

The exchange rate against the dollar is under pressure to depreciate in the short term, however we expect a return to CLP600 or even below at the end of the year. A narrower growth gap between Chile and the United States and a rise in the copper price (which should average USD2.82/lb this year) would take the dollar rate to levels a fraction below CLP600. For the time being, we rule out any effects the other way that could be linked to the progressive rate hikes in the United States, which should already be factored into the exchange rate.

Downward pressure on inflation 2015 from the oil-price shock, weak domestic demand and a stronger peso. The heavy slide in the oil price at a time of half-hearted private demand paved the way for the year to open with low readings and a fall in expectations for inflation. In this scenario, which overlies a global situation of muted price pressure, the stronger peso predicted will contribute to year-end inflation of 2.3%.

The inflation rate should ease up considerably, especially in H2, and will require a bigger monetary stimulus. The policy rate should be trimmed to 2.0-2.5% from 2Q15. We forecast that the central bank will not be able to stick to its inflationary view and hold rates up in a scenario where inflation is dropping fast towards the floor of the tolerance band for the target rate. Nevertheless, given the major upward inflation surprises in 2014, the central bank will expect to see more evidence of lower inflation and whether the low oil price is long-lasting before embarking on the rate cuts which, once initiated, will take the policy rate down to a level in the 2.0-2.5% range. **We see no reason for concern about the signs from the jobs market, which we see as becoming less dynamic following the months of more seasonal employment. Similarly, as regards the rise in core inflation, this is likely to be about an adjustment in relative prices which will not bring any more inflation once it has worked through. The challenge for the monetary authority will be to keep inflation at around the 3% level in the medium term.**

It is important for the central bank to offer some clues about how long it intends to keep up the monetary stimulus, as well as what it estimates to be the neutral interest rate level. The lack of clarity about these points is keeping large amounts of uncertainty in the markets, especially as regards how long-term interest rates will move, which are key to investment decisions and durable goods consumption.

Public spending will grow by 7.7% in 2015 and the fiscal deficit should be around 3% of GDP; from 2016 the margin for spending will diminish. The government has demonstrated its ability to implement the Budget in 2014, so it seems reasonable to project a 100% execution this year. The risks on the fiscal front then are of

lower realised revenues in 2015 and smaller structural revenues from 2016 as a result of any downward adjustments to structural parameters (trend GDP and the copper price). Despite the funds attributable to the tax reform, the fiscal scenario looks short on room for financial manoeuvre from 2016.

2 Global environment: increasing divergence between the main economic areas

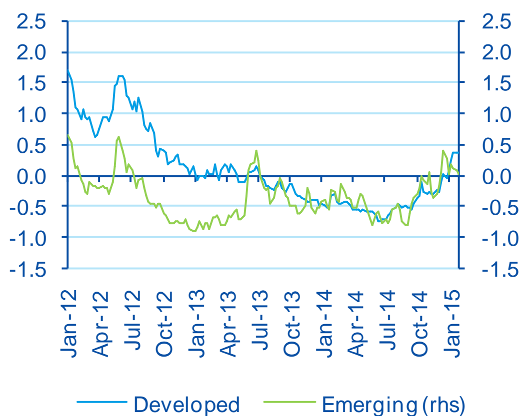
Global growth should increase to 3.6% in 2015 and 3.8% in 2016

The world economy grew in the fourth quarter of 2014 at a similar pace to the third. A dynamic economic performance in the US has been offset by the weakness of the recovery in Japan and the eurozone, and the progressive deceleration of China and other emerging economies. Therefore, we estimate that global GDP will have grown 3.3% in 2014, 10bp more than in 2013, with a slight increase in the DMs' contribution over the three previous years, and the EMs continuing to decelerate.

One of the biggest pieces of news in the global economic scenario in recent months is the very sharp fall in the oil price and its uneven impact on different countries, depending on whether they are net importers or exporters. Overall, we think the global impact of cheaper oil should be positive in terms of growth, inasmuch as the reduced burden on household and corporate income in oil-importing countries (such as the US, the eurozone and China) offsets the reduced activity in the principal producer countries.

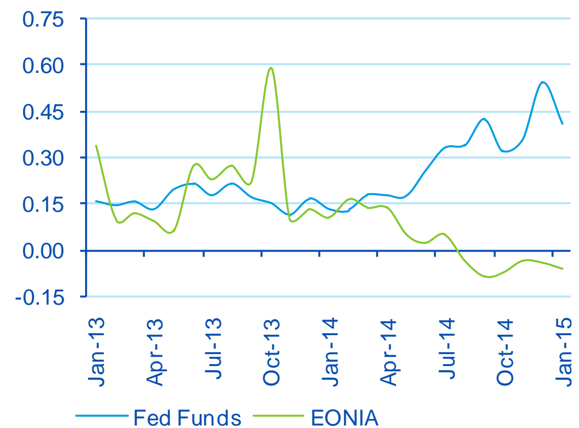
The increased volatility in financial markets, which has now reached the same level as in mid-2013, according to the BBVA Financial Tensions Index (Figure 2.1), is another of the highlights of the quarter, and one the EMs and the DMs have in common as a consequence of two factors: i) doubts about the economic development of many EMs, and ii) the uncertainty around the Fed's rate-hiking cycle.

Figure 2.1
BBVA Research Financial Tensions Index



Source: BBVA Research and Bloomberg

Figure 2.2
Monetary policy expectations: 12M fwd interest rates (%)



Source: BBVA Research and Bloomberg

In this context of low inflation and moderate economic growth, monetary policies remain accommodative in tone, although the biases differ (with the Fed and the Bank of England on the one side, and the ECB and the PBoC on the other (Figure 2.2)).

Thus, the improvement in global growth will continue in 2015 and 2016, by more than 3.5% on average, but there will be a significant differentiation between areas, given the asymmetric effect of falling commodity prices and monetary policy divergence in the development bloc, with these being the two effects that mark *a priori* the prospects for the global economic scenario.

All in all, and in spite of the support offered by economic policies and lower oil prices, the risks to world growth in 2015 remain to the downside. The risks presented by geopolitical tensions have been exacerbated by those associated with the effectiveness of the monetary policies introduced to increase inflation expectations and – in the case of the Fed in particular - to establish a strategy for withdrawing stimulus that does not erode the EMs' financing conditions to such an extent that this restricts their growth.

The US consolidates its recovery and the Fed is ready to raise interest rates

Momentum in the US recovered over the course of 2014, based onthe strength of domestic demand and also loweroil prices. Looking forward, US growth could reach 2.9% in 2015 which, together with low inflation, will accentuate the Fed's dilemma when it comes to start its monetary normalisation process. In this context, our forecast date for the first increase in the Fed funds rate remains 3Q15.

The controlled slowdown in China continues

In China, the slow deceleration in activity continued, with an estimated growth of 7.2% in the fourth quarter,the slowest since 2009 due to the loss of momentum in fixed capital investment, the deterioration in external competitiveness which was driving the yuan's appreciation and the correction in the real estate sector.

Although we have left our forecast for growth in 2015 unchanged at 7%, the risks are clearly biased to the downside as a reflection of the magnitude of accumulated financial imbalances, the uncertainty over the evolution of the real estate market and the doubts about the capacity ofpolicies to achieve a correction in the present imbalances with economic liberalisation underway. It is important to remember thatthe authorities have started to show more tolerance towards economic deceleration, provided that job-creation moves in line with the active population.

Finally, the downward pressures on inflation in Europe continue

Of the large economic areas, the eurozone is the most likely to have to deal with a scenario of inflation that is too low for too long. In addition to the negative surprises on consumer prices, the area has only a moderate economic growth profile, in line with expectations. In particular, an increase of 0.8% in 2014is anticipated, which could increase up to 1.3% in 2015, supported by the fall in the price of oil, the accumulated depreciation of the euro in recent months and the relaxation of monetary conditions thanks to the ECB's actions.

Among the main focus-points of downside risks is the increased tension in Russia's sphere of influence. A second risk factor is the uncertainty generated by the divergences between some national authorities and the EU institutions as to the most appropriate supply-side reform, the pace of fiscal consolidation and the ECB's support in fostering growth. Finally, another risk is that medium-term inflation expectations will continue to fall, discouraging consumption in the short term, and leading to a negative feedback loop.

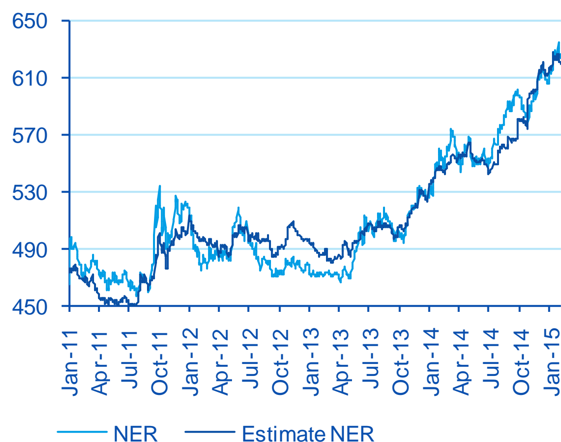
3 Local assets greatly swayed by external factors

The peso has continued to weaken against the dollar on the strength of the latter and the drop in the copper price. Medium- and long-term interest rates have been volatile in response to changes in external rates and a certain factoring in of an additional monetary stimulus locally.

The exchange rate has made a further adjustment with respect to the cut-off for the last Economic Outlook note, with the peso depreciating between 4 and 5% and touching the CLP630 level to the dollar in early February. This has been closely related to dollar strength and the retreat in the copper price. No exchange rate misalignment, providing evidence of any weakening of the peso beyond the fundamentals, is detectable (Figure 3.1).

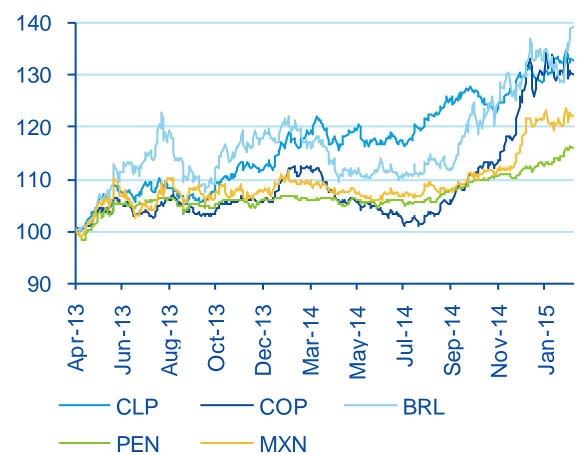
From a medium-term perspective, the exchange rate is likely to have weakened earlier than is the case for other LatAm economies, which is probably due to the greater uncertainty brought about by the scenario of reform and a central bank which did not prevent the depreciation of the currency, but rather cut the TPM to support the cyclical adjustment (Figure 3.2). In this sense, the peso is likely to have seen through the best part of the automatic adjustment.

Figure 3.1
Actual and estimated exchange rates* (USD/CLP)



*Short-term model for the USD/CLP exchange rate after Cowan et al (2007).
Source: Bloomberg, central bank and BBVA Research

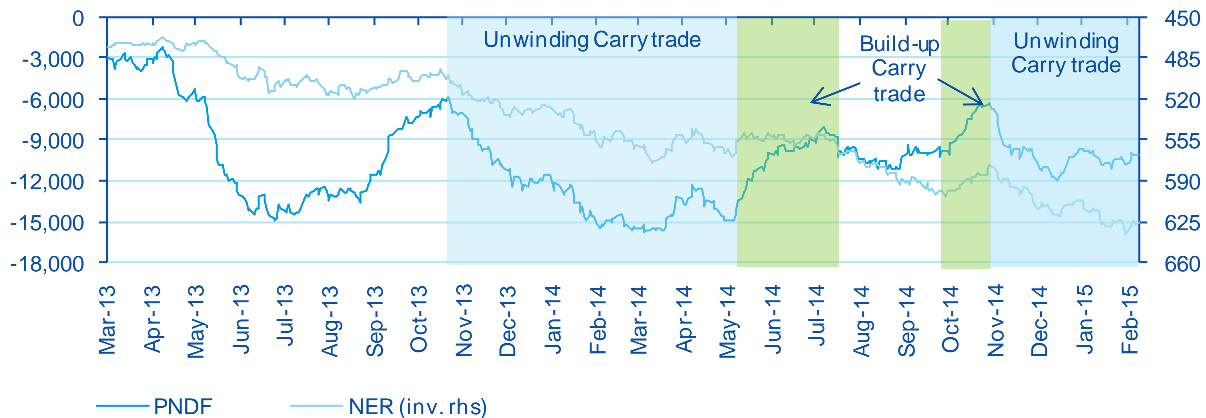
Figure 3.2
Exchange rates against the dollar (30 April 2013=100)



Source: Bloomberg, BBVA Research

The rise in the exchange rate to levels of around CLP630 coincided with a drift in the copper price (partly taken into account in our baseline scenario) and mild unwinding of interest rate arbitrage transactions via derivatives (carry-trade strategy) by non-residents (Figure 3.3).

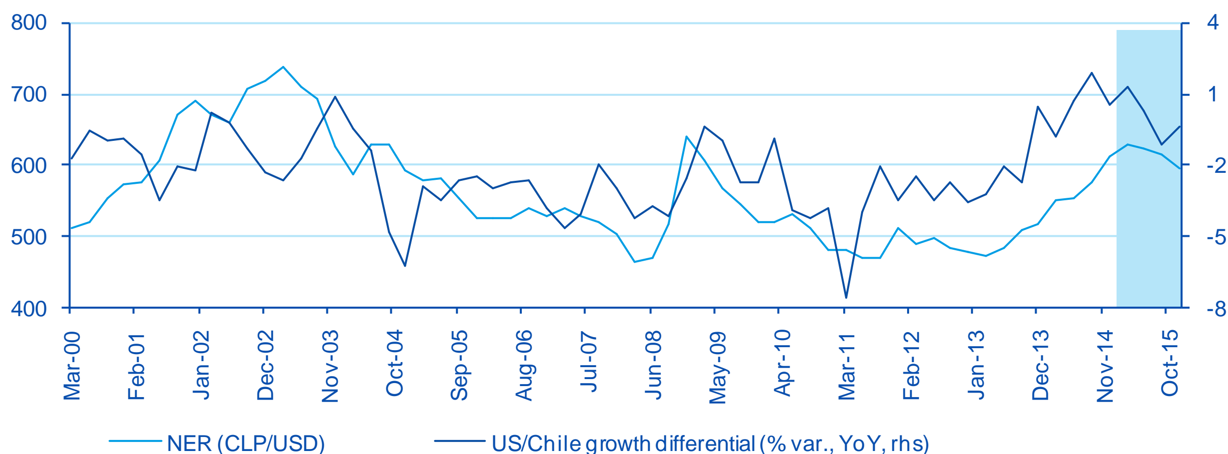
Figure 3.3
Net position in the external derivatives market and nominal exchange rate (USD mn, USD/CLP)



Source: Central bank, Bloomberg, BBVA Research

We are starting to see pressure on the peso to firm, which could take the dollar exchange rate to around the CLP600 level or even under this. The domestic activity figures might continue to surprise on the high side and thereby narrow the growth differential with the United States, which was one of the key drivers behind the weakening of the peso in 2014 (Figure 3.4). On top of this is a turnaround in the new-year slide in the copper price, which is expected to materialise in the next few months. An element of risk attaching to this projection might be monetary policy tapering in the United States, although we foresee this as happening gradually and having no further impact on the dollar value after the rate hikes take place.

Figure 3.4
US/Chile growth differential vs. nominal exchange rate



Source: Bloomberg, BBVA Research
*Shaded area is a projection.

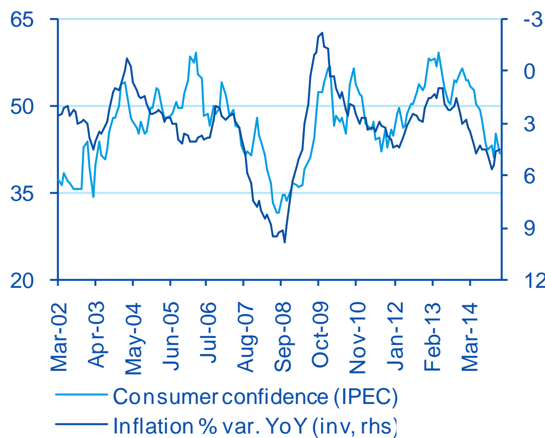
4 The lower oil price and higher public spending support a maintained growth forecast for 2015

After closing 2014 with growth at around 1.8%, the economy is set to grow at 3.1% in 2015. The lower oil price, increased public spending and revived expectations will be key to this forecast being realised.

According to the available preliminary information, 2014 should have ended with growth at around 1.8%, a shade below the forecast suggested in our last note (1.9%). In aggregate terms, the low growth last year was strongly influenced by the fall-off in investment, which was accompanied by visibly faltering private consumption within a context of a widespread decline in business and consumer confidence, although the pick-up in Budget implementation from September did manage to avert an even weaker economic performance. In the latter part of the year, however, the drop in fuel prices provided a fillip to family finances and boosted consumer expectations, which are typically very intimately linked to the course taken by inflation (Figure 4.1).

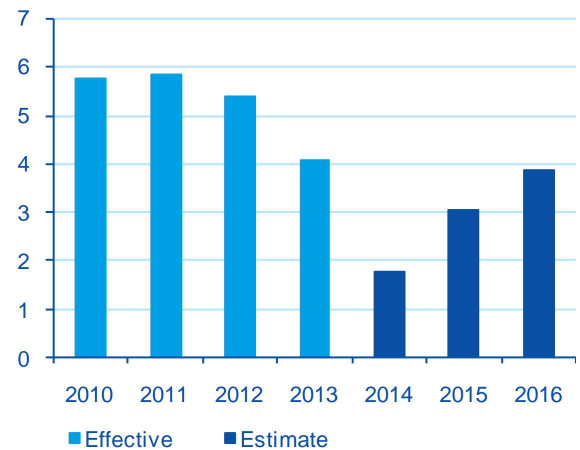
We estimate that this year the economy will grow by 3.1%, which is unchanged from the forecast in our previous note (Figure 4.2). Even though 2H14 growth was marginally lower than expected, which betrayed a flatter-than-expected upturn, we do not see this running on into 2015, as the economy will feel the lift from both a major step-up in public spending and also the positive effects of the significant drop in oil prices. The growth forecast also assumes more sanguine expectations by economic agents, which is a factor that is still very much an unknown quantity.

Figure 4.1
Consumer confidence vs. inflation



Source: Adimark, the central bank, BBVA Research

Figure 4.2
GDP growth and forecasts (YoY % var.)



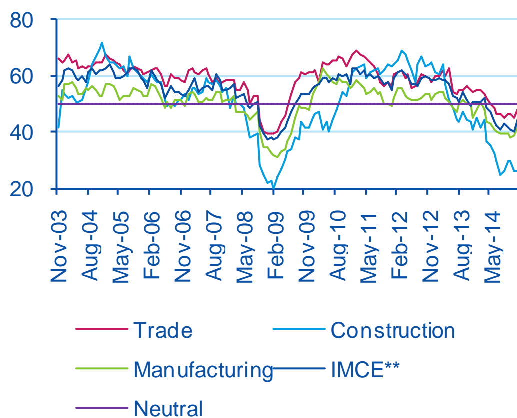
Source: BBVA Research

For private consumption, we forecast growth of a touch over 2%, very much on a par with average growth last year, although tracing a rising path towards H2. This estimate takes into account that on the one hand certain factors will adversely affect family buying plans, such as the expected worsening situation in the labour market, maintaining a depreciated exchange rate and credit supply conditions that will remain tight while on the other hand it allows for the fact that elements such as lower expected inflation and an economy that is growing at a

healthier pace will spur consumer confidence and thereby rekindle the desire to consume. We predict that this second set of factors will feature more prominently in H2, which will enable private consumption to actually post growth of an annualised rate of 3% or thereabouts in 2H15.

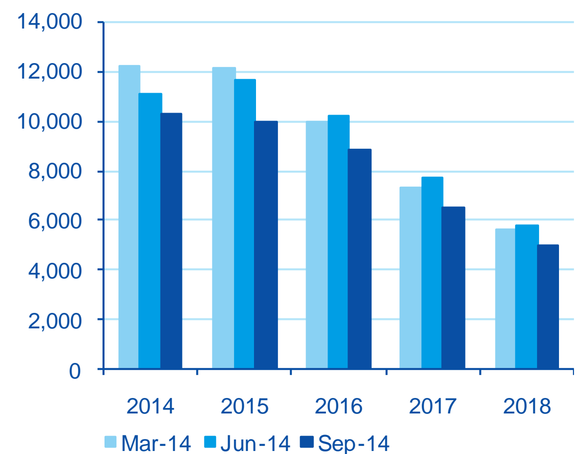
On the investment side, the big question mark is still over what developments business confidence will have to offer. At the 2014 close it was still subdued, although it did show signs of being over the worst. However, the information available for 3Q14 pointed to ongoing cutbacks in investment projects scheduled for the coming years. All things considered, the forecast for 2015 described in this note for GFCF (1.3%) is conservative, taking into account the sharp fall in 2014 and the shot in the arm that will come from the public component, with an investment that should be up according to the Budget Law by 27.5% in real terms (Figures 4.3 and 4.4).

Figure 4.3
IMCE monthly business confidence index*



*Value of over (under) 50 points denotes optimism (pessimism).
**IMCE includes the mining sector
Source: Central bank, BBVA Research

Figure 4.4
Projected private investment in construction and engineering work (USD mn)



Source: CBC, BBVA Research

At economic sector level, 2014 was marked by a substantial fall in mining investment, which the rally staged by investment in non-mining tradable sectors failed to offset (Box 1). This trend should continue into 2015, given that the factors behind it (the end of the upswing in the copper price and the rise in the exchange rate) will remain present.

Looking at public spending, in 2014 the government gave hard and fast evidence of its ability to implement the Budget, for which reason we can assume that progress is set to continue again this year. That said, we do see downside risks to public investment ultimately being settled, as this item of spending faces red-tape that is hard to cut through and out of the direct hands of the authorities. On balance, we estimate that public spending will grow by around 7.7% this year, with a large slice earmarked for investment, which could bring about as much half of the growth predicted for the year (further details in Section 8).

Finally, the external sector will continue to feed GDP growth. We forecast that exports will grow by 4.7% YoY in real terms, in keeping with the picture of world growth painted in Section 2 of this note and with the weakened exchange rate holding in real terms, which will help to make exports more competitive. On the other side of the coin, unlike what transpired in 2014, imports should grow 3.4% in real annual terms, drawn in by the stronger anticipated showing from domestic demand.

Box 1. Investment in non-mining tradable goods sectors: Where to from here?

A great deal of the explanations for this scenario of a slowdown have hinged on the performance of investment. In particular, the lower growth is noticeably attributed to the end of the mining investment cycle of recent years. On top of this, no upturn has been sighted in private investment, which is very much influenced by the gloomier business outlook.

However, there are other determinants that should be impacting positively on some components of private investment, especially the weaker exchange rate, which means that we should be seeing a pick-up in investment in non-mining tradable goods sectors (Elias & Evans, 2014). Yet the problem we have run up against is that no data series is available on non-mining investment in tradable goods that allows us to monitor how this behaves. In this section we go on to construct just such a series based on publicly released information and we analyse the path this has traced in recent years.

Methodology used in construction

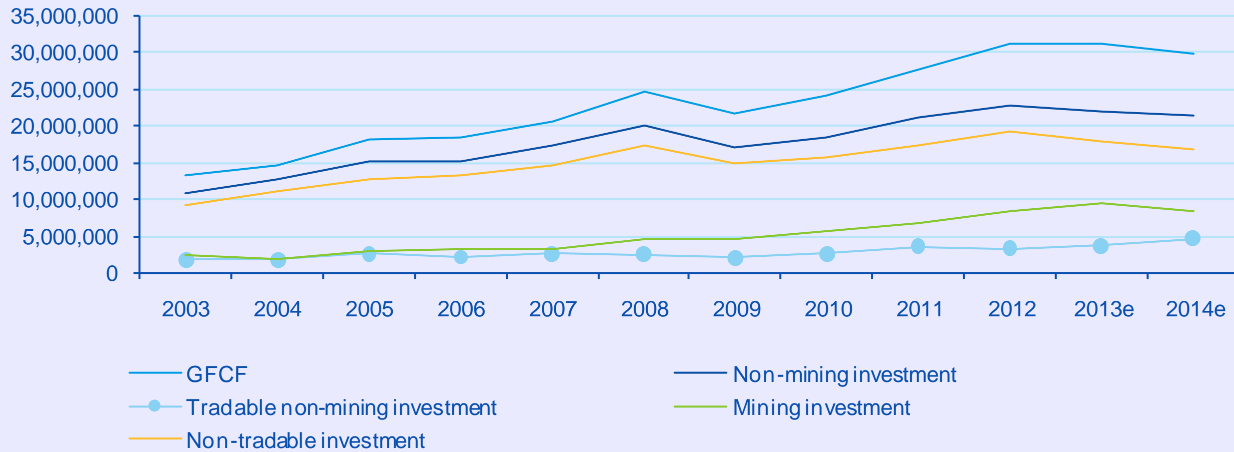
Based on the non-mining investment data series constructed by Fornero, Kirchner & Yany (2014), in the databases on the central bank website we can find annual investment series by economic sector for 2003-09 (national accounts, with base year 2003) and 2008-12 (national accounts, with base year 2008). Given that the most recent compilation referred to for the national accounts uses chain-linking price methodology, which does not permit aggregation by component to calculate the total except for the base year (Cobb, 2014), and that, also for the most recent series, information only exists since 2008, the nominal figures for investment by sector were used for 2012 (the last year with current and full information available) and a series was constructed which begins in 2003 by using the real annual variations drawn from the series published at the central bank. As can be appreciated, this series will be expressed in millions of 2012 pesos using the 2008 reference compilation as the base and, since it uses real variations in series with different reference compilations, it represents the best possible approximation using public data. For the sum total of the components to equal GFCF each year, the adjustment is made using the investment difference in non-tradable goods sectors.

To identify the non-mining tradable goods sectors we base ourselves on Restrepo & Soto (2006). As indicated in the paper mentioned, only a portion of the manufacturing industry is tradable, even though this is substantial. Similarly, elements of trade and hotels, as well as transport and telecommunications are also tradable, but in these cases non-tradable goods production is what predominates. We therefore classify the non-mining tradable goods sector as being the combination of the farming, forestry, fisheries and manufacturing industries taken together. Again, this is the most accurate way of representing the tradable goods sectors that can be attempted using public and aggregated data.

To construct the series for 2013 and 2014 we use the growth projections for investment by sector from the Corporación de Bienes de Capital (CBC), especially for mining, forestry, farming and manufacturing. This source does not have information on fisheries investment, which we consider not to entail significant changes.

This is then how the series shown in figure B.1 has been constructed for GFCF, in millions of 2012 pesos, for investment in mining, non-tradable goods and non-mining tradable goods.

Figure B.1
2003-14 Gross Fixed Capital Formation and investment by sector (CLP mn as of 2012)



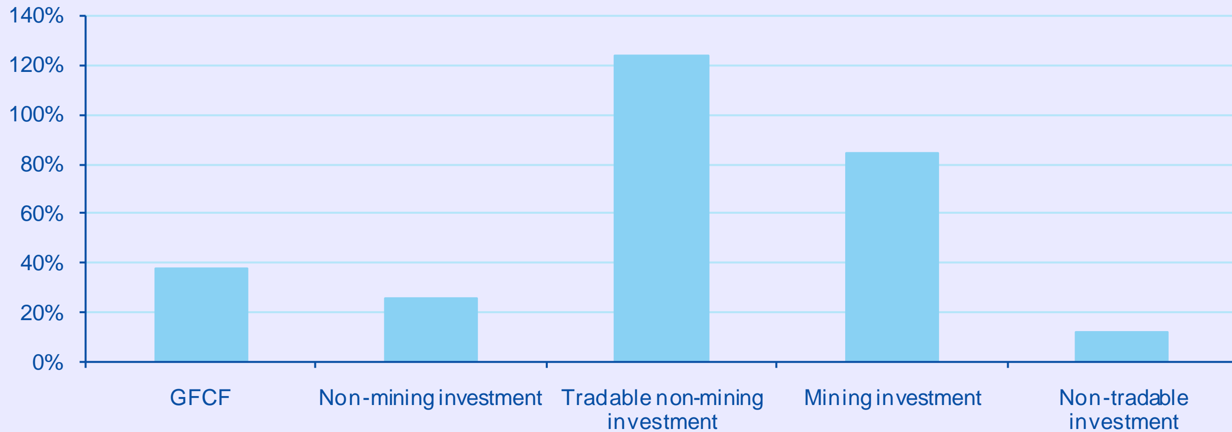
Source: Central bank, CBC, BBVA Research

Analysis of non-mining tradable goods investment

As can be seen from figure B.1, even though it represents a smaller proportion of the whole, non-mining tradable goods investment has made a slight recovery in circumstances in which both mining investment and non-tradable goods investment exhibit falls in the year just ended. Moreover, unlike in 2009, when only mining investment did not fall, on this occasion, it has been mining investment in non-tradable sectors which has remained resilient, showing increases which have held since 2010.

Figure B.2 shows cumulative investment growth by sector from 2010 to date. This illustrates how it is investment in non-mining tradable sectors which showed a higher accumulation in these years, mainly due to manufacturing investment, which has been stepped up since 2011.

Figure B.2
2010-14e cumulative investment growth by sector



Source: BBVA Research

What should we expect in 2015? While the macroeconomic conditions are ripe in terms of the exchange rate and low interest rates, a greater appetite for risk associated with a brighter business view matters as well. Yet according to CBC, investment projects in the mining sector are set to remain subdued compared to previous years.

Therefore, on the basis of forecasts of a pick-up in the export sector (especially in manufacturing) that are partly founded on a weaker and more competitive exchange rate, non-mining tradable goods investment can be expected to continue to post growth and build on its share of GFCF, even more so in a year for which the investment outlook is less than uplifting. We will thus be watching this series closely from now onwards.

List of references

Cobb, Marcus (2014). “GDP Forecasting Bias due to Aggregation Inaccuracy in a Chain-Linking Framework”. Documento de trabajo Nº 721. Banco Central de Chile. February.

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Fornero, Jorge, Markus Kirchner & Andrés Yany (2014). “Terms of trade shocks and investment in commodity-exporting economies”. Banco Central de Chile. October.

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5 Sharp adjustment of external accounts in 2015 on a weaker oil price

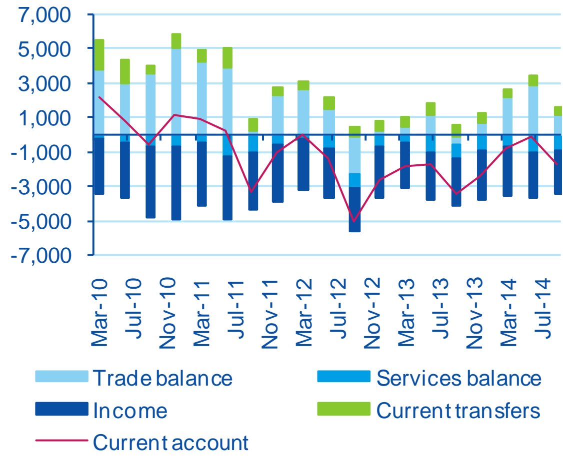
The lower oil price should prove the key driver behind an improved current account in 2015-16. On the other hand, the sliding copper price looms largest as the aspect which could push down the external balance, though this should be offset by greater export volumes and lower remittances abroad by the private mining sector.

A large part of the current account adjustment in 2014 was prompted by both the decline in imports from waning domestic demand and the weaker real exchange rate. This resulted in a recovery of the trade balance for goods and services to around the USD5.9bn level. Nevertheless, the deficit on the income balance of USD10.3bn or thereabouts and transfer inflows of USD2bn will mean that the deficit for 2014 closes in the region of USD2.4bn, equal to 0.9% of estimated 2014 GDP and a shade above the forecast made a few months ago (Figure 5.1). Within our 2.8% growth estimate for export volumes in 2014, the positive effects should come mostly from the industrial and mining sectors, which in 3Q14 showed rises of 3.7% YoY and 2.0% YoY respectively. In terms of destinations, Asia is still the main market and boasted the best relative performance at the 2014 close.

The shifting of external balances will continue in 2015. Unlike last year, the key driver will be the lower average oil price expected this year, which ought to settle at USD65/bbl (down 38% on the level three months ago). This element will more than offset the larger deficit attributable to a lower average copper price, which we estimate to be worth USD2.82/lb (2% under the 4Q14 forecast), and which will be partly offset by rising copper exports as well as lower remittances from private copper mining, which component would be included within the income balance. All told, our estimate for the current account balance in 2015 tends towards positive ground, at 1.0% of GDP. Towards 2016, with domestic demand having been rekindled and a copper price converging towards its long-term level (which we now estimate at USD2.75/lb), we will see limited pressure tending to a lower surplus on current account (Figure 5.2).

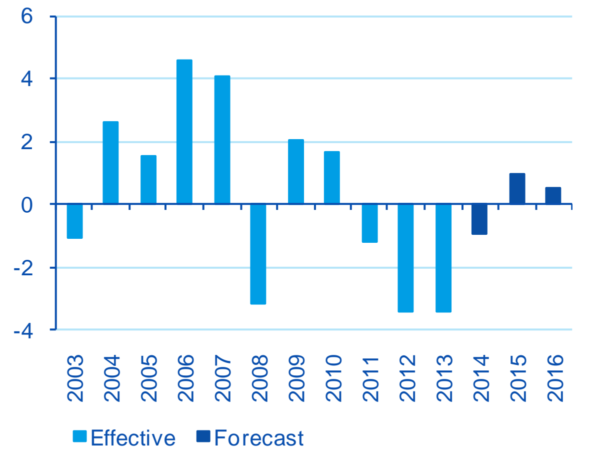
These circumstances lend weight to our view of a low risk attaching to the sustainability of external balances in the medium term.

Figure 5.1
Balance of payment on current account (USD mn)



Source: Central bank, BBVA Research

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



Source: Central bank, BBVA Research

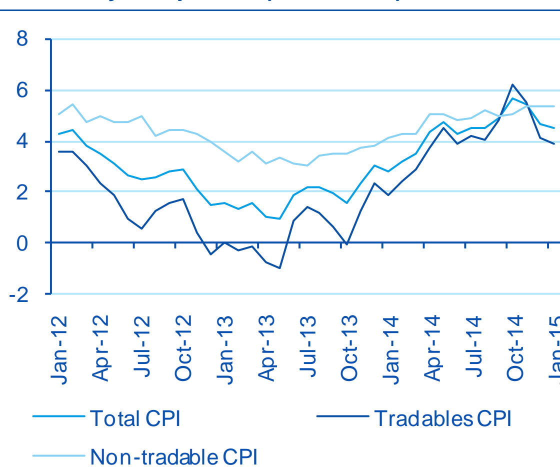
6 Inflation will converge towards the floor of the central bank's tolerance band in late 2015

Lowering of the oil price worldwide and still weak domestic demand will take inflation down to 2.3% YoY by the end of 2015. In 2016 inflation will approach the target rate of 3%.

2014 closed with inflation standing at 4.6% YoY, above the ceiling of the tolerance range for target inflation. As we have said in previous notes, the mounting inflation in the year just ended was mainly on the effect of the weaker exchange rate on the price of imported goods, which was accompanied by price rises for certain foods and tax hikes for specific products (Figure 6.1).

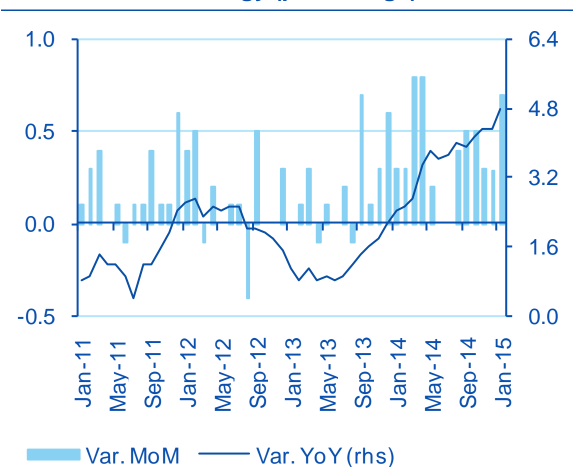
The CPI ex food and energy (IPCSAE in Spanish) ticked upwards persistently throughout the year, rising as much as 4.3% YoY in December and steepening upwards to 4.8% in the first month of this year (Figure 6.2), which sparked concern at the central bank, as far as one can gather from the latest monetary policy statements.

Figure 6.1
Inflation by component (% var. YoY)



Source: Central bank, BBVA Research

Figure 6.2
CPI ex food and energy (percentage)



Source: Central bank, BBVA Research

The heavy fall in world oil prices has substantially allayed the inflation pressure which was besetting the economy in 2014, leading to restrained inflation readings for the three months from November through to January. Crucial here was the drop in fuel prices, the impact of which has not been wholly offset by the depreciation in the peso. The low figures for headline inflation in recent months will feed through to the course prices take over the rest of the year via the substantial index effects that are a feature of the Chilean economy, meaning that core inflation will arrive at around an annualised 3% towards late 2015.

The oil-price slide has also led to a significant downturn in expected inflation, which by various measures stands at lows since records began, although these have tended upwards again following January's inflationary reading (Figure 6.3).

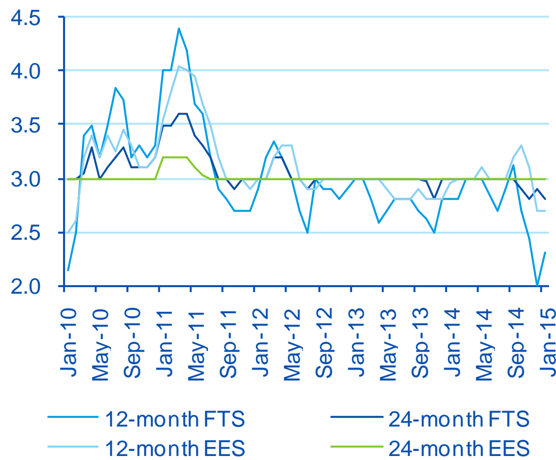
At BBVA Research, our view is that headline inflation will swiftly converge this year towards the central bank's target rate and fall to within the tolerance band by March. Over the first part of the year, the downward pressure

will mainly still come from the fall in the oil price, applying both directly to products such as petrol, diesel, paraffin and liquefied gas, and indirectly to items more associated with past inflation, such as rent, property maintenance charges, financing expenses and domestic service.

Although the feed-through of the exchange rate depreciation to domestic prices could go on for some months, non-tradable goods inflation should play a major part in how inflation evolves this year by contributing approximately 1pp less to it, as we suggested in our Economic Watch titled "*Determinants of non-tradable inflation*". The scenario of low pressure from demand-pull and expected exchange rate appreciation will help headline inflation to fall to 2.3% in December.

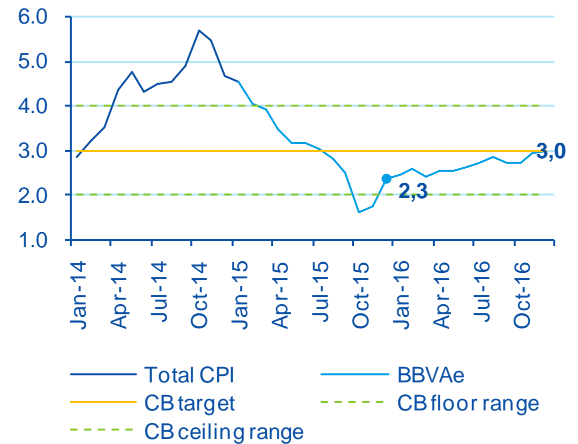
Finally, for 2016 we expect annual inflation to move rapidly towards the central bank's target rate of 3%, which is consistent with economic activity rallying towards its potential level, in a situation of monetary policy normalisation to a neutral footing (Figure 6.4).

Figure 6.3
Expected inflation 12 and 24 months ahead: EEE and EOF* (% var. YoY)



*EEE: Economic Expectations Survey by the central bank, with January 2015 data.
EOF: Financial Sector Survey by the central bank, with January 2015 data.
For the EOF the survey in the second half of each month is used.
Source: Central bank, BBVA Research

Figure 6.4
Forecast inflation for 2015 and 2016 (% var. YoY)



Source: INE, BBVA Research

7 The deflationary process underway will call for a greater monetary stimulus, though not in the short term

We forecast cuts in the policy rate to 2.0-2.5%, which should begin in around 2Q15. Normalisation to neutral levels should commence in 2016.

At its October 2014 meeting, the central bank chose to cut the policy rate to 3% and it edited out the expansive bias from its statement, thereby signalling the end of monetary expansion. This decision was backed up at the November meeting, where discussion turned to holding the MPR as the only option, an approach which was ratified in the December Monetary Policy Report, in which the central bank indicated that it would hold the reference rate at said level in the “short term”.

On several occasions, the central bank has suggested that the monetary stimulus provided since late 2013 (200bp) is enough, so that no further policy rate cuts ought to be necessary. Among the arguments cited in supporting this contention is the risk of a greater-than-expected exchange rate knock-on effect, the increase experienced by core inflation, and uncertainty over measuring unused capacity.

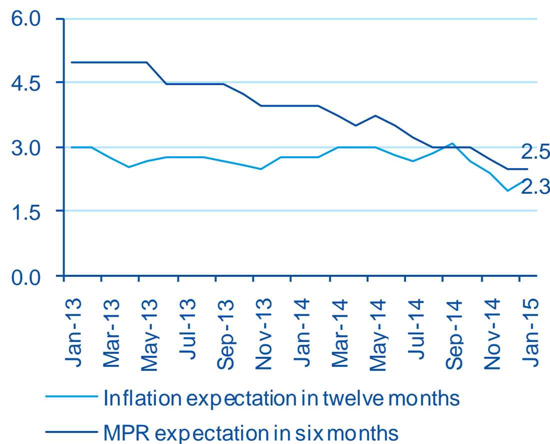
The inflationary scenario portrayed in the monetary policy report quickly became out-of-date with the oil-price fall that followed its publication. Indeed, on that occasion the central bank forecast an average price of Brent oil for the year of USD70/bbl and this stands at under USD60/bbl, with considerable risk of falling further. The December CPI came as a shock to the central bank, which had been forecasting that inflation would close the year at 4.8%, whereas the actual figure was 4.6%. On the other hand, for the end of 2015 it estimated that inflation would be 2.8%, but the risks with this forecast have a downside bias bearing in mind the substantial depreciation of the peso.

Against this backdrop, the surveys of decision-makers in the financial sector at the end of January revealed inflation expectations of around 2% for December and consequently allowed for the possibility of as many as two cuts to the MPR in the coming months. Despite the content of the central bank’s statement, such an unusually wide divergence between its view and market expectations has emerged that only the inflation figures for the opening months of the year will be able to reconcile them (Figure 7.1).

We feel that the central bank will not be able to stick to its inflationary view and hold rates in a scenario where inflation is fast approaching the floor of the target tolerance range. The risk of clinging to this idea in a context of successive low or negative CPI readings is that expectations might cease to be anchored from a policy perspective. Nevertheless, given the upward inflation shocks in 2014, the central bank will expect to have more evidence of deflation and the staying power of the low oil price before embarking on rate cuts, which, once begun, will take the MPR to a level in the 2.0-2.5% region (Figure 7.2).

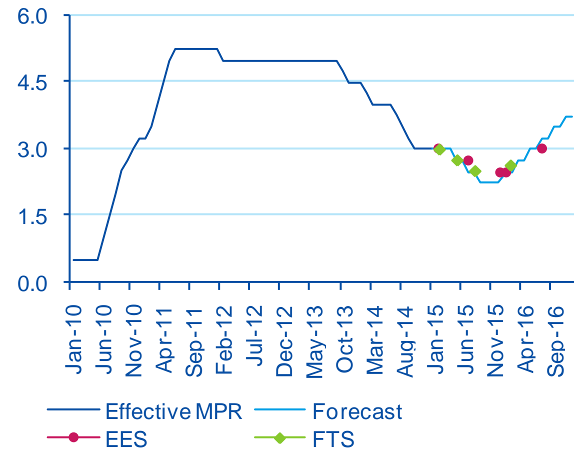
We expect the central bank to start hiking the policy rate in 2016, when the economy is growing at closer to its potential rate. Any such hikes should come after the Fed lifts its own rates.

Figure 7.1
Expectations of inflation and the MPR in the EOF* (percentage)



*EOF: Financial Sector Survey by the central bank, with January 2015 data. The survey in the second half of each month is used.
Source: Central bank, BBVA Research

Figure 7.2
Actual MPR and implied paths for the EEE/EOF* (percentage)



*EEE: Economic Expectations Survey by the central bank, with January 2015 data.
*EOF: Financial Sector Survey by the central bank with data as of the second week of January 2015.
Source: Central bank, BBVA Research

Based on the available information, we do not share the concern over either the signs from the labour market or core inflation which have anticipated cuts in the MPR in recent months. In fact, we think that the labour market will start to show signs of creaking as the seasonal effects wear off, given that the economy needs growth rates of 4% or higher to stabilise unemployment, which will not happen this year (see Economic Watch: "*Growth and unemployment: the worst is yet to come",* in Spanish only). Similarly, the rise in core inflation is not a sign of demand-pull pressure or of tight capacity in the economy, but more plausibly is a reflection of the impact of the depreciation in the exchange rate (an adjustment of relative prices) and the second-round effects of inflation last year. Both factors should subside over the course of the year and thereby allow core inflation to ease off too.

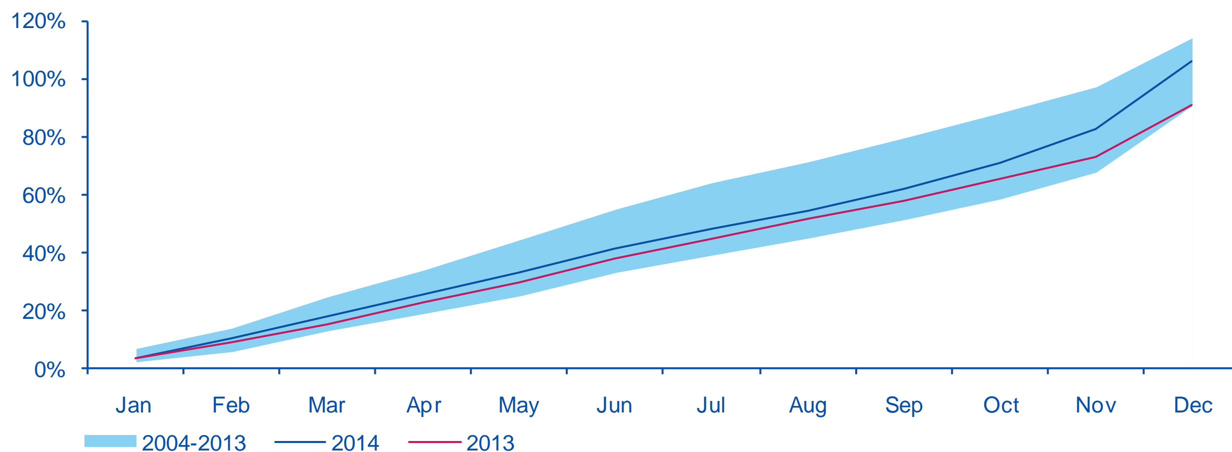
Finally it is important to make the point that the central bank has not offered any clues as to how long it intends to keep up the monetary stimulus, or what it considers to be the neutral interest rate, which leaves a great deal of uncertainty looming over the markets, especially as concerns how long-term interest rates will evolve, which are key to investment decisions and durable goods consumption.

8 Fiscal policy: public spending will grow 7.7% in 2015, but the scope for this will narrow from 2016

The government has demonstrated its ability to implement the Budget. Risks attach to lower realised revenues in 2015 and scarcer structural revenues from 2016.

The 2014 close has left two big lessons for fiscal policy projection in the coming years. First, the commitment to full implementation of government spending in 2014 was more than fulfilled, which gives added credibility to similar pledges for 2015. Last year spending rose by 6.5%, with the implementation level reaching 102.1% in relation to the earmarked spending total that was passed in the Budget Law. Specifically, capital spending implementation was 106%, far higher than the figure of 90.8% attained in 2013, where the bulk of the difference came about in the final four months of the year (Figure 8.1).

Figure 8.1
Progress in implementing public investment 2004-14



Source: Budget Office and BBVA Research

Second, the revenues which we estimate to stem from the passing of the Tax Reform were USD840mn, which is 0.3% of the GDP projected by the government in its financial reports[1]. This is a very sound initial step towards achieving target receipts of 3% of GDP in around 2018, although it is still too early to assert that the whole of this amount will be collected.

These aspects do, however, have consequences for the 2015 fiscal scenario in various ways. The ability shown by the Treasury in implementing expenditure is good news for GDP growth this year. An implementation level of the full complement passed under the Budget legislation for 2015, which is the scenario we assume[2], looks feasible based on the evidence from 4Q14. This way spending will grow 7.7%, which equates to 23.6% of GDP.

1: The details of this estimate can be found in the Economic Watch on fiscal matters of 2 February 2015.

2: Although our working scenario assumes implementation of 100%, the structure would differ from the Budget plans. We assume over-implementation of current spending and capital transfers, but under-implementation of investment spending, given past evidence and the problems posed in implementing this item, which reasoning we set out in our Watch, in Spanish only, titled "The challenge of implementing public investment. Implications for the 2015 Budget".

This will pump between 1.5pp and 2.0pp into increasing activity this year, supporting our estimate of 3.1% growth.

With respect to the revenue attributable to the Tax Reform, our assumed scenario is that the sum budgeted for 2015 is collected, which is approximately 1% of GDP (USD2.5bn). This projection is not devoid of risks, though, given that a large portion of the greater revenues will come from a reduced evasion level and the plugging of loopholes. Added to this is the recent fall in the copper price, which presents downside risks for tax revenues from Codelco and private sector mining, in a scenario in which copper revenues still count for a lot in the fiscal accounts (Figure 8.2).

If we compare the macro scenario in the Budget legislation with our current take, we can see that the actual deficit will be 2.7% of GDP, higher than the official estimate of 1.9% of GDP given in September (Table 8.1).

Within a risk scenario which assumes an average copper price of USD2.50/lb, an average dollar exchange rate of CLP630 and growth in line with the results of the central bank's January Expectations Survey, realised revenue should be of the order of USD2bn below the amount envisaged in the Budget legislation and the actual deficit could rise above 3% of GDP.

Table 8.1
Comparison of macro-fiscal scenarios for 2015

	Public Finances Report	BBVA Research Baseline forecast
GDP (var. YoY)	3.6	3.1
Domestic demand (var. YoY)	3.9	3.2
CPI (av. var. YoY)	3.0	3.0
Exchange rate (average)	585	617
Copper price (USD cents/lb)	312	282
Tax revenue* (USD bn)	57,020	52,536
Actual deficit* (USD bn)	-5,187	-6,413
Actual deficit (% of GDP)	-1.9%	-2.7%
Structural deficit (% of GDP)	-1.1%	-0.8%

*Exchange rate for each scenario
Source: Budget Office, BBVA Research

These scenarios for 2015 implicitly entail two important aspects. The first is that the downside risks regarding tax revenues are from realised and not structural variables. The higher exchange rate even contributes positively to the level of structural revenues. Thus, for all scenarios we forecast that the structural deficit target will be more than achieved.

The second aspect, is that the recently announced USD7bn bond issue might not be enough. The deficit could climb above this sum (without counting the financing of social security contribution bonds and ordinary debt repayment). In this scenario it could become necessary to eat into ESSF assets this year[3].

Finally, we factor in the distinct possibility from now on of less room for spending to grow in 2016, which in turn poses risks as regards the target of convergence to a structural balance in 2018. The current growth path for

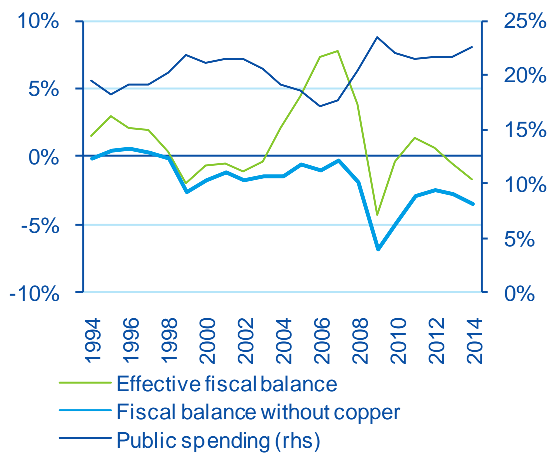
3: It should be noted that the drop in revenue due to a lower copper price is partly offset by the greater exchange rate depreciation.

trend GDP that was submitted by the committee of experts last July assumed that 2014 growth would be far better than it actually was. Moreover, consensus growth for 2015 onwards is below the level estimated in July last year. These facts appear to indicate that both the level and the rate for trend GDP growth are probably below the estimate submitted by the committee in July. To illustrate the impact of this adjustment, a projection of potential growth of 4% for 2016 onwards would reduce structural revenues by between 0.2% and 0.3% of GDP each year.

Added to this is the lower copper price. The benchmark price is also based on the forecast for the copper spot price for the next 10 years made by a committee of independent experts. A copper price forecast of under USD3.0/lb presents serious downside risk for the current benchmark of USD3.07/lb, where every cent lower spirits away approximately USD60mn from structural revenues each year.

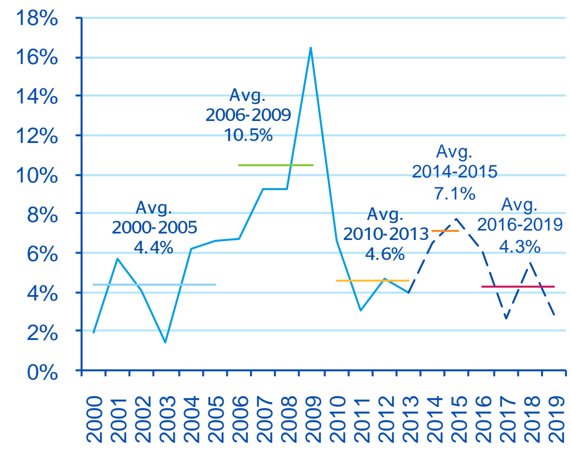
For our forecasts from 2016 onwards we work on the basis of the following scenario: i) trend GDP growth of 4%; ii) a benchmark copper price converging towards USD2.75/lb; and iii) a structural deficit target of 0.8% of GDP for 2016, 0.4% in 2017 and 0% in 2018. This means that spending growth could not be greater than 6% in 2016, and the average for 2016-19 would only reach 4.3%. There is no doubt that converging towards the target of structural balance in 2018 will require a great amount of determination from the Treasury, given the current scenario of a slowdown and the spending commitments associated with delivering on the government programme (see figure 8.3).

Figure 8.2
Actual fiscal balance with and without copper revenues (% of GDP)



Source: Budget Office and BBVA Research

Figure 8.3
Public spending growth and interval averages 2000-19



Source: Budget Office and BBVA Research

9 The risk of a slow recovery in confidence levels persists

The risk dogging Chinese growth persists, although this has partly dissipated of late. The uncertainty surrounding the impact of tapering in the United States still lingers, as it does with regard to the effects associated with any spill-over of the delicate situation in Russia into other emerging economies. Locally, the risk of a drop in consumer and business confidence having materialised, the risk is that levels will become mired in negative territory for a prolonged period.

The idiosyncratic risk of bigger slides in business and consumer confidence has become reality. A major slowdown has been observed in durable goods consumption, which has percolated through to non-durable goods, while indicators linked to private investment such as capital imports have not rallied beyond upticks explained away by temporary phenomena.

The baseline scenario in this note assumes that private consumption should show growth of a little over 2% YoY, and that private investment will have a limited rally. The main risk in this aspect is that the recovery of confidence is very sluggish and has an added effect on consumption relative to forecasts in this note. Our baseline scenario likewise incorporates a significant increase in public spending, in both the current and capital categories. The risk in this sense is the tardiness that is a feature of implementing public spending, particularly investment, although recent application figures which point to significant dynamism serve to mitigate risk of this nature.

Looking abroad, a hard landing beyond expectations for investment in China remains the chief risk in the medium term, given the implications of this for the export sector, the confidence of domestic agents, capital flows and fiscal accounts. This risk has been present in the last few issues of this note and more recently part of the risk has been realised, although less forcefully than expected. In particular, concern remains over a sharper slowdown in China on doubts over the fragility of its financial system, as well as the general increase in perceived risk regarding the emerging markets. A decline in the Chinese economy would have major reverberations among the emerging nations and feed through via financial and real channels. Of particular concern are the implications for the copper price as well as growth for other trading partners which are key for Chile.

An additional risk from outside that might have an impact in the short term is the process of monetary normalisation in the United States, which could make financial conditions less favourable for Chile and the emerging economies collectively. Once again, though with a likelihood and impact that are somewhat less substantial in Chile’s case, the risk still lingers regarding the complex fiscal and financial situation in the eurozone, added to which there is the risk that cannot be ruled out of spill-over into other emerging economies of the delicate Russian fiscal and economic situation, resulting from the drop in the oil price.

10 Tables

Table 10.1
Macroeconomic forecasts

	2012	2013	**2014**	**2015**	**2016**
GDP (% YoY)	5.4	4.1	1.8	3.1	3.9
Inflation (% YoY, eop)	1.5	3.0	4.6	2.3	3.0
Exchange rate (vs. USD, eop)	477	529	613	596	581
Interest rate (%, eop)	5.00	4.50	3.00	2.25	3.75
Private consumption (% YoY)	6.0	5.6	2.1	2.2	3.4
Government consumption (% YoY)	3.7	4.2	5.0	6.6	5.6
Investment (% YoY)	12.2	0.4	-4.7	1.3	4.0
Fiscal balance (% GDP)	0.6	-0.6	-1.7	-2.7	-2.5
Current account (% GDP)	-3.4	-3.4	-0.9	1.0	0.5

Source: BBVA Research

Table 10.2
Macroeconomic forecasts

	GDP (YoY)	**Inflation (% YoY, eop)**	**Exchange rate (vs. USD, eop)**	**Interest rate (%, eop)**
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	2.7	3.5	563.8	4.00
2Q14	1.9	4.3	553.1	4.00
3Q14	0.8	4.9	593.5	3.25
4Q14	1.9	4.6	612.9	3.00
1Q15	2.4	3.9	630.0	3.00
2Q15	3.0	3.2	622.0	2.75
3Q15	3.9	2.5	615.0	2.25
4Q15	3.2	2.3	596.0	2.25
1Q16	3.7	2.4	591.0	2.75
2Q16	3.9	2.6	587.7	3.00
3Q16	3.9	2.7	584.4	3.50
4Q16	4.0	3.0	581.1	3.75

Source: BBVA Research

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