BBVA | RESEARCH

Chile Economic Outlook

Second quarter 2015
Chile Unit

- Current conditions suggest growth of a shade fewer than 3% this year. We forecast GDP growth of 2.9% in 2015 and 3.5% in 2016, both with risk on the downward side.
- Inflation should be on the retreat and ought to end the year at under 3%. With a large part of the exchange rate adjustment and the transmission from tax hikes concluded, inflation readings from 2Q15 onwards should be restrained, thus paving the way for gradual convergence into line with the central bank target.
- MPR unchanged over the rest of the year and a major part of 2016. Normalisation should begin in mid-2016, taking the MPR to levels below those we would describe as neutral.
- Lower revenues will widen the fiscal deficit to 2.8% of GDP this year. Downside risk to revenues and pressure to spend pose a challenge to converging on a structural balance in 2018.

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Closing date: 30 April 2015

1 Overview

The economy is on course for growth of a little under 3% in 2015. The forecasted growth for the economy this year is 2.9%, with a slight downward revision of our estimates from the last Outlook (3.1%), which is attributable to temporary factors linked to the disaster in northern Chile and a slower-than-expected recovery of private investment. We see downside risks for economic activity from a belated recovery of expectations, and therefore private investment, in response to the bigger picture of reforms.

For private consumption we predict growth of slightly over 2%, with a rising pattern towards the second part of the year. The lower inflation expected in 2H15, together with an economy which is growing at faster rates, will lift consumer expectations and should inspire a revival of consumption decisions. **On the investment front, the big question mark still remains on how business confidence will evolve.** Up to the first quarter of 2015 business confidence had remained depressed, in retreat in YoY terms for a major part of the rest of the year.

We are revising our forecast for annual inflation for 2015 up from 2.3% to 2.9%, based on the bigger-than-expected exchange rate feed-through, second-round effects on index-linked products and services, and higher inflation under the Tax Reform (TR). **In 2016, inflation should close at an annual 3%, although it will stay under this level for a prolonged time of the year.**

Inflation is in open retreat and will end the year at under 3%, owing to the fact that: i) the exchange rate adjustment and its knock-on effects on index-linked products and services ought to have concluded; ii) private domestic demand will remain half-hearted; iii) the effects of the TR on the price of beverages and tobacco have already been priced in, and iv) food-prices locally will begin to recede given how their determining factors have evolved both at home and abroad.

We consider that the exchange rate adjustment ought to have finished and predict that the dollar exchange rate will reach around CLP600 towards the later part of 2015, not without a certain amount of volatility. The exchange rate will continue to exhibit robustness, both bilaterally against the USD and in relation to a basket of other currencies, thanks to improved economic activity figures and a scenario featuring a firmer copper price. One element of risk threatening this forecast could be the monetary normalisation process in the United States, although we expect this to be gradual and that its impact should be already substantially factored into the exchange rate.

We forecast that the MPR will remain at 3% during the remainder of 2015 and embark upon a gradual normalisation process in 2016. In a scenario in which inflation eases to below 3% at year-end, no moves in the reference rate will be deemed necessary. We do not rule out a certain additional degree of monetary stimulus being required, although for the time being it seems too early to quantify this, given its high reliance on local factors, such as the normalisation process in the advanced economies. In this Outlook we assume that the first rise in the MPR would come in mid-2016.

Our estimated actual deficit is 2.8% of GDP, with a revenue shortfall of USD1.7bn in relation to the budget for the year. Expenditure implementation has been above the one for the same period in 2014, which confirms the chances of achieving implementation of 100% or more. On the other hand, a scenario of lower growth in both activity and demand, as well as a lower copper price, account for the deterioration in actual government revenues. We again make the point that medium-term risks indicate lower revenues and greater expenditure pressure, which presents a challenge to the commitment to converging towards a structural balance in 2018.

Within the realm of risks, the cases linked to legally questionable financing in politics, as well as the employment and constitutional reform process, can potentially cut short any rallying of the confidence indexes. The available information for the first quarter of 2015 points to a gradual deceleration of world growth due to slowed growth both in the United States and China, as well as the deterioration of economic activity in other relevant emerging economies. Keeping this information in mind, we expect the world growth to be at 3.5% for 2015, 10bp lower than January estimates and only 10bp higher than 2014 figures. In 2016, world GDP should rebound to 3.9%, primarily due to the expansive monetary policy in many developed nations.

2 World growth suffers from deceleration of emerging countries

World growth has been moderate in the first quarter of 2015

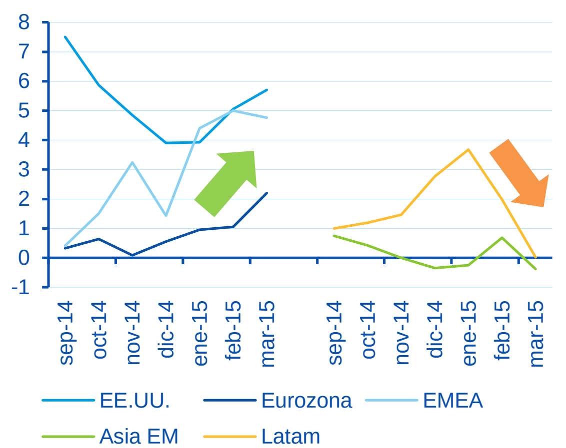
The available information for the first quarter of 2015 indicates a gradual deceleration of world growth due to slow growth in the United States and China as well as the deterioration of economic activity en relevant emerging economies like Russia and Brazil. The relatively speaking better performance in the Euro Zone and the United Kingdom was not enough to counteract this development.

The differentiation in terms of economic growth in between geographical areas and economic sectors continues. In this way the consolidation of growth in the developed nations is in strong contrast to the general loss of dynamism in the emerging economies, especially the one in Asia and Latin America (Figure 2.1).

Keeping this information in mind, we expect the world growth to be at 3.5% for 2015, 10bp lower than January estimates and only 10bp higher than 2014 figures. In 2016, world GDP should rebound to 3.9% primarily due to the expansive monetary policy in many developed nations.

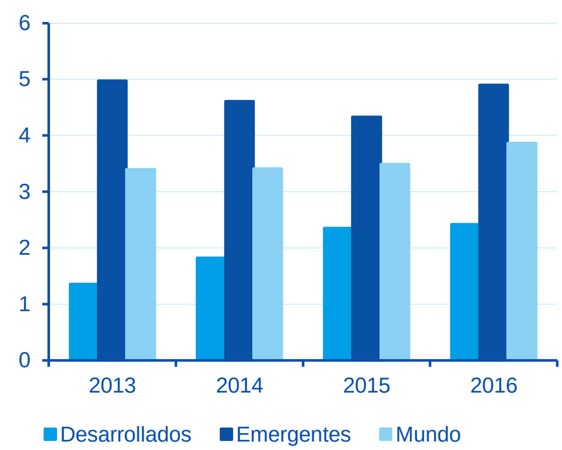
In the case of the emerging economies, the pulling effect of the developed countries and the gradual pick-up in raw material prices contribute to the reversion of the deceleration process (Figure 2.2).

Figure 2.1
Manufacturing PMI (deviation from the 50 point mark — activity holding)



Source: BBVA Research and Haver

Figure 2.2
World GDP: forecast annual growth 2015-16 (%)



Source: BBVA Research

The progressive increase of raw material prices, which are in line with our estimates, and the reinforced monetary expansion in certain economies has contributed to contain the decline in inflation and to anchor inflation expectations. However, it has not been enough to contain the increase, even though gradually and from a low base, in financial market volatility. Although the observed volatility seems to respond rather to doubts about the strength of economic recovery and the timing and intensity of interest rate hikes to be made by the FED, together with other elements of risk.

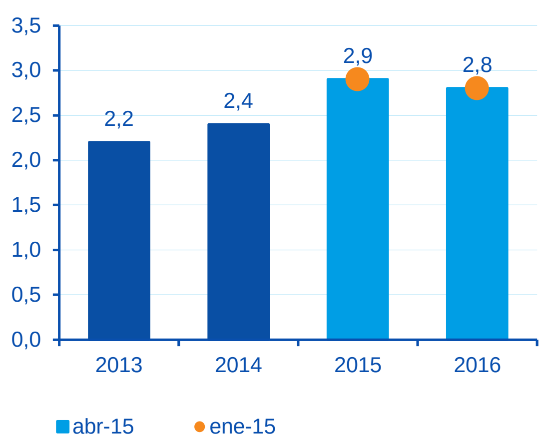
All in all, and taking into account the support offered by economic policies, the risks for the world growth in 2015 stay low. The most significant risk corresponds to the magnitude of the deceleration in China, to which one needs to add the potential repercussions generated by the normalization process of the FED. Deflationary pressures associated with the petrol price, the geopolitical tensions and the possibility of failure of the ECB to restore inflationary expectations are risks that tend to appear less probable in comparison to a few months ago and are also considered to have a minor global impact. However, these risks cannot be ignored. Finally, the possibility that Greece will not reach an agreement with its creditors still poses a latent risk.

The United States of America started the year with a slowdown of growth…

The United States started 2015 with a pronounced deceleration of its growth, which was revised down from an average of 1.0% during the course of the last three quarters to an annualized growth rate of a mere 0.2%. Climate factors explain a part of this economic slowdown, but they are not the only relevant factors. One has to add the effect of the fall in petrol prices, impacting the activity levels of the energy sector, as well as the incipient effect of the dollar appreciation on exports. The labor market continues to show strength, which supports household incomes and consumption in an environment characterized by low energy costs, improved nominal incomes and a contained inflation rate. The robustness of internal demand, and here especially the private consumption, is essential to counter the export weakness, therefore allowing the economy to grow at a proyected rate of 2.9% this year and maintain expected growth rates close to 3% in 2016 (Figure 2.3).

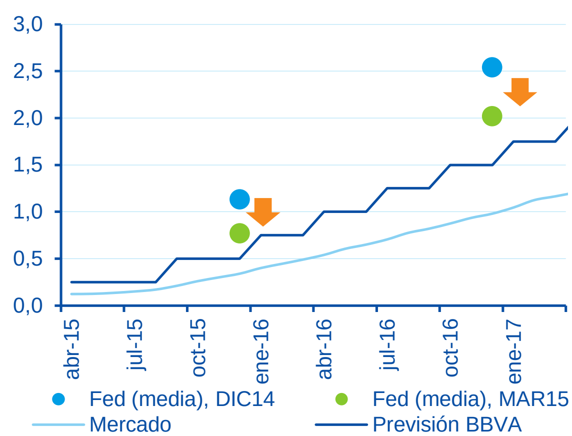
The way the FED will interpret the current economical environment, it may be considered a transitional or permanent state of slow growth, will define the corresponding reaction. In the most likely scenario the FED will begin to hike rates in September and could postpone rate hikes if the recovery is not as robust as one might hope. All in all, the process will be gradual and the MPR will most likely not exceed 1.5% by the end of 2016 (Figure 2.4).

Figure 2.3
US economic growth, % annual



Source: BBVA Research

Figure 2.4
US Fed Funds expectations (%)

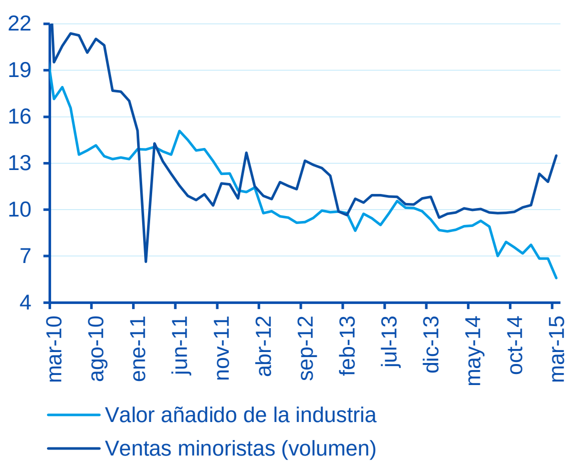


Source: BBVA Research and Bloomberg

… Just as China

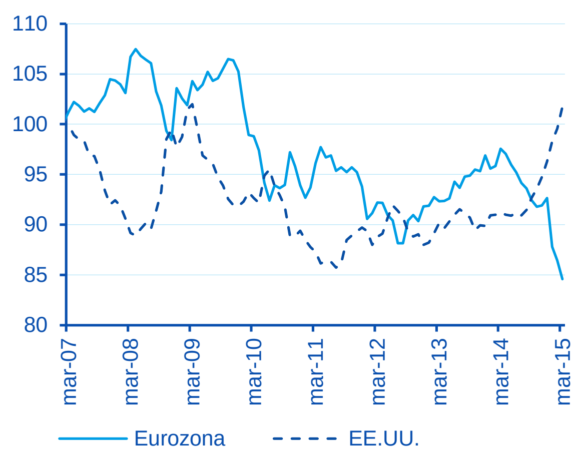
The growth slowed down to 7% in the first quarter of 2015 and the economic indicators of the different sectors suggest that this adjustment is taking place primarily in the industrial sector and the investment into fixed assets, while at the same time a relatively speaking stronger performance of the private consumption component can be observed which in turn is backed up by the force of the local labor market and the low inflation (Figure 2.5). Since the reasons for this slowdown seem to be structural, such as the corrections in the housing market, political uncertainty, loss of global competitiveness and consolidation of local governments, indicate that China will indeed continue to decelerate and experience a major volatility in the medium term. The target of 7% annual growth this year appears to be consistent with the implementation of stimulating measures which possibly include rate cuts in terms of MPR and reserve requirements of commercial banks as well as a mayor fiscal expansion. In 2016, the growth rate will adjust to 6.6.

Figure 2.5
China: Industrial production and retail sales (% YoY)



Source: BBVA Research y BIS

Figure 2.6
Real effective exchange rate, Jan 2007=100
An increase in the index implies appreciation



Source: BBVA Research y BIS

The Euro Zone showcased the strongest recuperation en the past twelve month

The Euro Zone is the developed economy that has displayed the best relative performance at the beginning of this year. The growth rate during the first quarter of 2015 might be the highest since mid-2011 and are lead by the strength in consumption and high exports that offset the persistent weakness in terms of investment. The quantitative easing program currently carried out by the ECB and the subsequent depreciation of the Euro together with the decline in petrol prices stand out as the fundamental reasons for the economic recuperation of the Euro Zone. Germany and Spain stand out as the two leaders in terms of growth in the first quarter (Figure 2.6). The less restrictive character of the fiscal policy and the containment of the decline of nominal salaries in periphery economies contribute to the pick-up in growth as well.

We expect the Euro Zone to grow by 1.6% this year, 0.3pp higher that January’s projection, and 2.2% for 2016. In this scenario, the inflation will be situated close to 0% in 2015 and below 2.2% in 2016. The mayor risks for the Euro Zone include a stronger deceleration process in China and a rise in political tensions between Greece and its creditors.

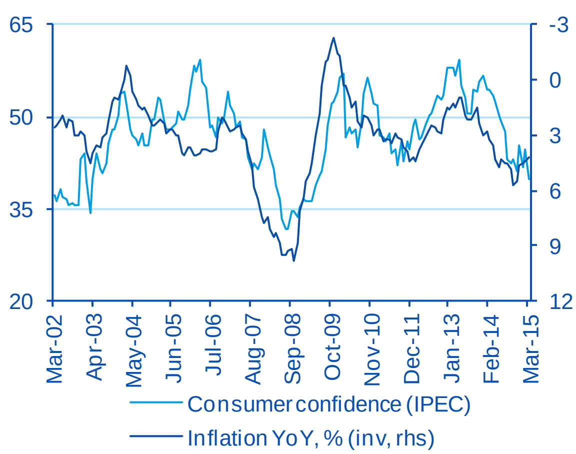
3 2015 growth of 2.9% with downside risk

After closing 2014 with growth of 1.9%, the economy is heading for growth of a fraction under 3% in 2015. Reviving expectations is still key to achieving this forecast, which involves downside risks, particularly in private investment.

2014 closed with growth of around 1.9%, which matched our forecast. In aggregated terms, the low growth last year was strongly influenced by the fall in investment, which has shown no sign of meaningful recovery over the first few months of 2015. The faster pace of budget implementation from last September managed to head off an even poorer performance by the economy. On the other hand, the drop in fuel prices, a degree of upside resilience in the unemployment rate and an declining annual inflation rate staved off further falls in consumer expectations (Figure 3.1). We foresee a scenario of mildly better expectations within the forecast horizon, up to neutral levels.

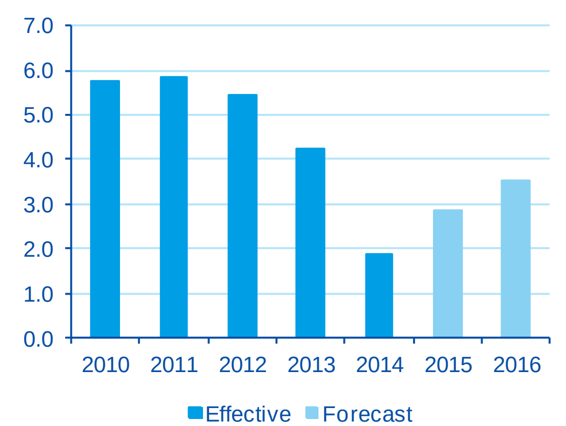
We forecast that for this year the economy will grow by 2.9%, with a slight downward revision from the estimate in our last Outlook, which is accounted for by temporary factors linked to the disaster in northern Chile and a lower-than-expected recovery in private investment (Figure 3.2). This forecast entails downside risk from greater persistence in the decline of private confidence indicators, largely on possible effects deriving from the local reform situation. Even though the reconstruction work in the north will make it possible to more than offset the adverse short term effects on activity, this will materialise only later in the year and in 2016. Our scenario of a recovery in the speed of implementation of public expenditure has been realised in combination with the similarly constructive effects of the drop in fuel prices, which has been expressed in above-consensus activity readings in the last few months of 2014 and in early 2015. The YoY shrinkage of private investment is nonetheless still present, while business confidence remains flat, indicating some justification for a downward correction in expected GDP growth, from 3.9% to 3.5%, for 2016. This last forecast assumes that consumer and business expectations will recuperate, where these decisive factors are still subject to a large dose of uncertainty.

Figure 3.1
Consumer confidence vs. inflation



Source: Adimark, Central bank, BBVA Research

Figure 3.2
GDP growth and forecasts (% var. YoY)

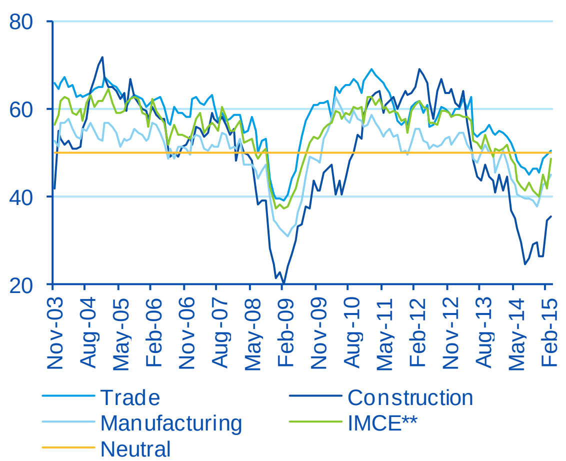


Source: Central bank, BBVA Research

For private consumption we forecast growth of a little over 2%, with a rising pattern towards the second part of the year. This takes into account that, on the one hand, certain factors will adversely affect the buying plans of families, such as the deterioration seen in the labour market, an exchange rate persisting at weak levels, and credit supply conditions that are set to remain tight. On the other hand, elements such as the lower level of expected inflation, together with an economy that is growing at a faster rate, will give consumer expectations new heart and inspire positive buying decisions. We estimate that this second set of factors will grow in importance in the second half of the year, which will mean that private consumption growth rates will materialise at around 3% YoY in the second half of 2015.

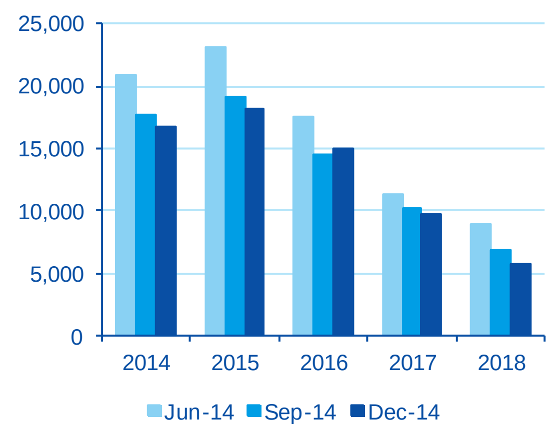
On the investment side, the main doubt still rests with how business confidence evolves. Up to the first quarter of 2015 this had languished at a low level, though with signs that it had bottomed out. That said, the information available for 4Q14 indicated a string of cutbacks in investment projects planned for the next few years. Despite this, the 2015 forecast that is described in this Outlook for GFCF (-0.4%) is on the conservative side, if one takes into account the heavy fall last year and the powerful boost that the public component will provide. These investments, according to the budget, should grow at a real rate of 27.5%, considering the budget reallocation to support the reconstruction work in northern Chile (Figures 3.3 and 3.4).

Figure 3.3
IMCE monthly business confidence indicator*



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

Figure 3.4
Private investment to be made (USD mn)



Source: CBC, BBVA Research

By economic sectors, 2014 was marked by a major fall in mining investment, which was not compensated by the upturn experienced by the non-mining tradable goods sectors. This trend should continue in 2015, since the factors behind this state of affairs, namely the end of the bull market cycle for the copper price and the higher exchange rate, will remain present.

On the public expenditure side, the government has provided specific examples of its ability to implement the budget, for which reason we can assume that implementation will also make progress this year with an execution rate of no less than 100%. We nonetheless see certain downside risks on the side of the materialisation of public investment, given that this expenditure component faces red tape that is hard to cut through and which proves elusive of direct control by the authorities. Even so, we forecast that public expenditure will grow at around 7.6% this year, with a strong contribution from investment expenditure.

Finally, the foreign sector will continue to be instrumental in GDP growth. We estimate that exports will grow by a real 4.7% YoY, in line with the scenario for world growth sketched in Section 2 of this Outlook and the exchange rate remaining weak in real terms, which will continue to add to export competitiveness. On the other hand, and unlike what happened in 2014, imports should advance by a real 2.9% YoY, spurred on by the more robust performance predicted for domestic demand.

4 We stand by our view of a surplus on external accounts

We are maintaining our forecast of a current account surplus for 2015 of around 1% of GDP. The slower recovery of domestic demand, particularly its investment component, means lower-than expected imports. This pressure in favour of a surplus, however, will be entirely offset by the tendency towards a deficit associated with the marginally downward adjustment in the expected average copper price this year. Lastly, the medium term outlook for the external balance remains healthy in the regard of sustainability.

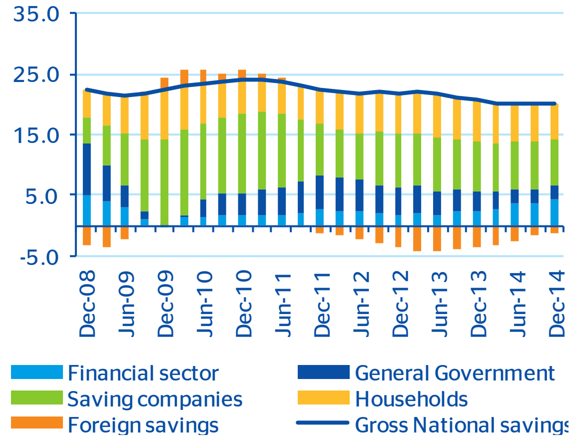
The current account balance closed 2014 with a deficit of 1.2% of GDP (USD2.995bn), which was a bit more than the expected figure of 0.9% (USD2.4bn). The discrepancy is mainly due to changes to the base data series for GDP, as well as the correction from 3.4% to 3.7% of GDP for the 2013 external deficit. It should be noted that the sharp correction in the external balance is a reflection of the weakness of investment and highlights one of the advantages of a flexible exchange rate system.

Total investment to GDP actually dropped from 24.2% in 2013 to 21.3% in 2014, on top of which national savings only fell from 20.6% of GDP in 2013 to 20.2% of GDP in 2014. As expected, given the characteristics of the current cycle, the slightly lower level of national savings was primarily attributed to general government and households, which were counteracted by increased savings by financial and non-financial sector businesses (Figure 4.1). This was attributable to the decline in both investment and corporate borrowing requirements. On the other hand, in sector terms, the fall in investment to GDP in 2014 is principally due to the fall in mining industry investment, where we do not rule out adverse effects associated with the local reform debate, although they ultimately have more to do with the gloomier outlook for the industry given the lower copper price, both the observed and forecasted.

Against this backdrop, we are standing by our forecast of an external account surplus in 2015, which should amount to a figure approaching 1% of GDP (Figure 4.2). The slow recovery of domestic demand, particularly within the investment component, lowers import expectations. Nonetheless, the slip in the expected average copper price will completely offset the before-mentioned impact to a surplus, eventually resulting in a tendency to a minor deficit. With respect to this, our forecast remains consistent with a correction from USD2.82/lb to USD2.75/lb in the average price expected for copper this year.

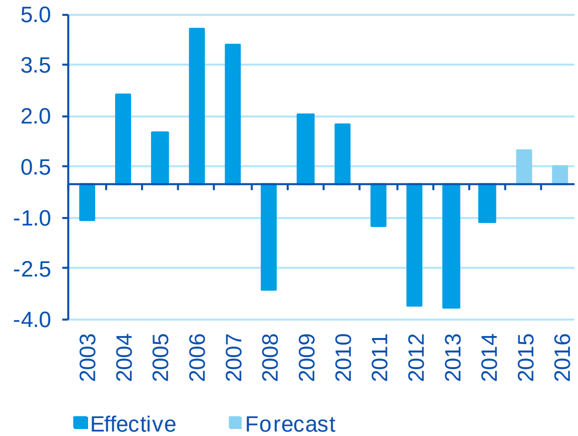
In the medium term, we expect restrained pressure in favour of a lower surplus to the extent that domestic demand picks up. Finally, we still see negligible sustainability risk over our forecast horizon.

Figure 4.1
Savings by sector (% of GDP, YoY)



Source: Central bank, BBVA Research

Figure 4.2
Current account balance and forecasts (% of GDP)



Source: Central bank, BBVA Research

5 Lower inflation readings in 2H15 will mean closing the year at under 3%

We are revising our forecast for annual inflation in 2015 upwards from 2.3% to 2.9%. Greater-than-expected exchange rate feed-through, second round effects on index-linked products and services, and increased inflation from the Tax Reform (TR) are the reasons behind our revision. In 2016, inflation will close at 3% YoY, although it will hold below this level for a large part of the year.

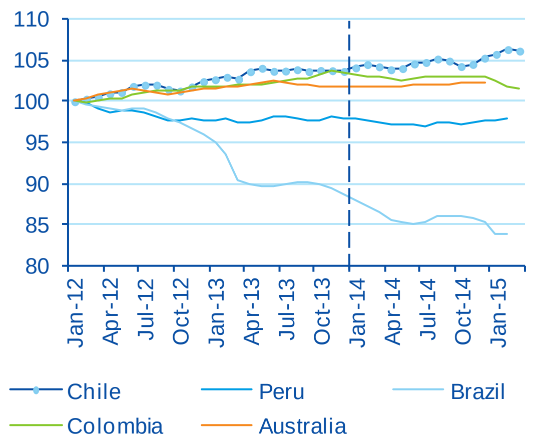
The inflation readings for January and February surprised on the high side. Both of them factored in two items which we believe we should not observe from 2Q15: i) feed-through from the sharp exchange rate depreciation against a set of other currencies and high levels of inflation dispersion, even above those observed over the last 10 years; ii) occasional shocks linked to the TR (mainly cigarettes). We nonetheless think that the recent trends in the exchange rate have ceased to be inflationary as we consider that a substantial part of the correction should have already taken place, while the higher inflation from specific taxes ought to be in its final stages, which all means that the factors that prompted inflation over a large part of 2014 and early 2015 will begin to wear off over the course of the year.

Along the same lines, the previously high inflation readings have had consequences for index-linked products and services, with rent prices notable among the latter. In this sense, their contribution to annual inflation as of March was +0.3pp, when it also had the second biggest effect on the services CPI (+0.5pp). What is striking is that when rent price trends are compared after being adjusted for inflation for a set of countries, several of which have had housing price rises that are similar or higher than those seen in Chile, a far higher local increase becomes apparent, which coincides with the methodological adjustment implemented by the INE (the National Statistics Office). An ongoing process of methodological refinement is likely to tend towards more accurate measurement of rents, which might be accompanied by a slower rate of increase for the prices in this item (Figure 5.1).

On the other hand, after persistently marking above the upper limit of the central bank's tolerance band, overall CPI inflation began to come down from November last year, after hitting 5.7% YoY in October. We nevertheless forecast that it should return to territory below 4% YoY as early as 2Q15. Similarly, the mainstream core inflation measurements show a change in trend over February and March, which should continue to chart this course throughout the rest of the year.

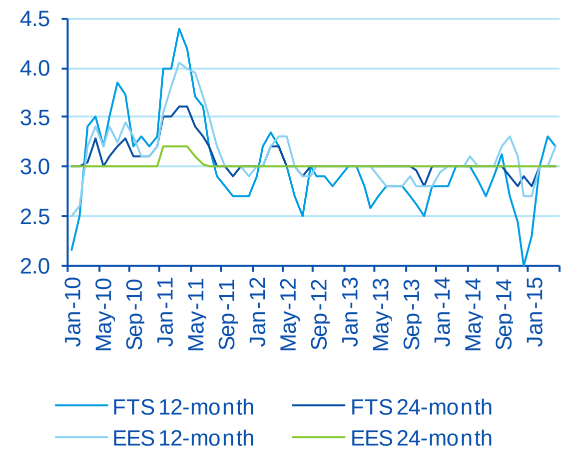
Following the inflation surprises seen in the opening months of the year and the subsequent rise in inflation forecast 2015 by the central bank (from 2.8% to 3.6%), market expectations have factored in major upside revisions in forecasted year-end inflation, which stands at 3.4% according to the Economic Expectations Survey (EEE) for April. On the other hand, expectations for 12 months have adjusted to the rise and show 3.2% for the EEE and EOF (Financial Sector Survey), whereas for 24 months ahead they are still anchored at 3% YoY with both surveys (Figure 5.2).

Figure 5.1
Index of real rental prices in selected countries (January 12=100)



* Broken line indicates the methodological adjustment in the way to measure rent prices overall in Chile.
Source: Statistics offices of the selected countries, BBVA Research

Figure 5.2
Inflation expectations 12 and 24 months out: EES and FTS* (% var. YoY)



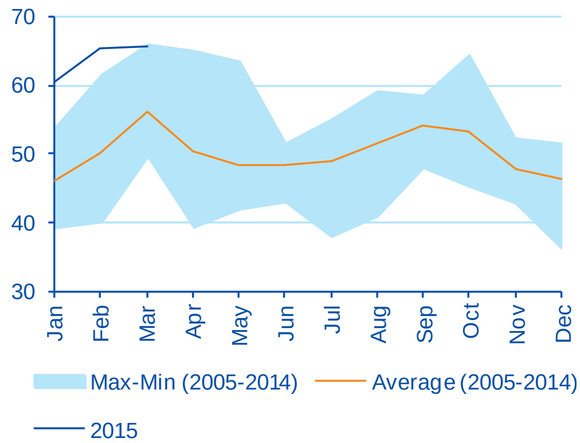
* EES: Economic Expectations Survey by the central bank with data as of April 2015.
FTS: Financial Traders Survey by the central bank with data from the second half of each month as of April 2015.
Source: Central bank, BBVA Research

For 2015, we forecast that annual inflation will continue on the same downward course it started out on towards the end of last year, reaching 2.9% as of December. Within this trend, the key factors that will facilitate the drop in inflation are: i) the end of the exchange rate adjustment, which was largely responsible for the high inflation readings over 2014 and the passing on of these onto index-linked products and services, as well as the rise in inflation dispersion from a historical standpoint (Figure 5.3); ii) still weak domestic demand in a situation of the sluggish recovery of economic activity; iii) the fact that the effects of the TR on beverage and tobacco prices should be in their final stages, and iv) the expected easing of food prices locally, given trends in their domestic and external drivers[1].

We think that 2016 will be a time when the economy will start to use up the remainder of the capacity slack that has been built up over recent years. Both the monetary and the fiscal stimuli will be gradually withdrawn, while on the external front the inflationary pressures will remain contained. In this scenario **we estimate that inflation for 2016 will be about 3% YoY** (Figure 5.4).

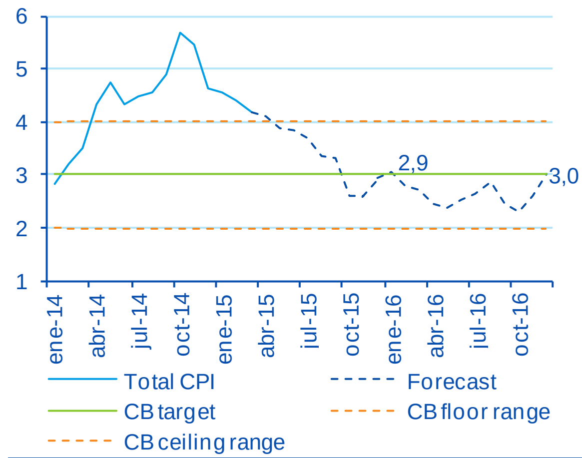
1: See *Box 1. Food inflation includes downside risks in 2015*

Figure 5.3
Percentage of products with price rises



Source: Central bank, INE, BBVA Research

Figure 5.4
Forecast inflation for 2015 and 2016 (% var. YoY)



Source: Central bank, BBVA Research

Box 1. Food inflation includes downside risks in 2015

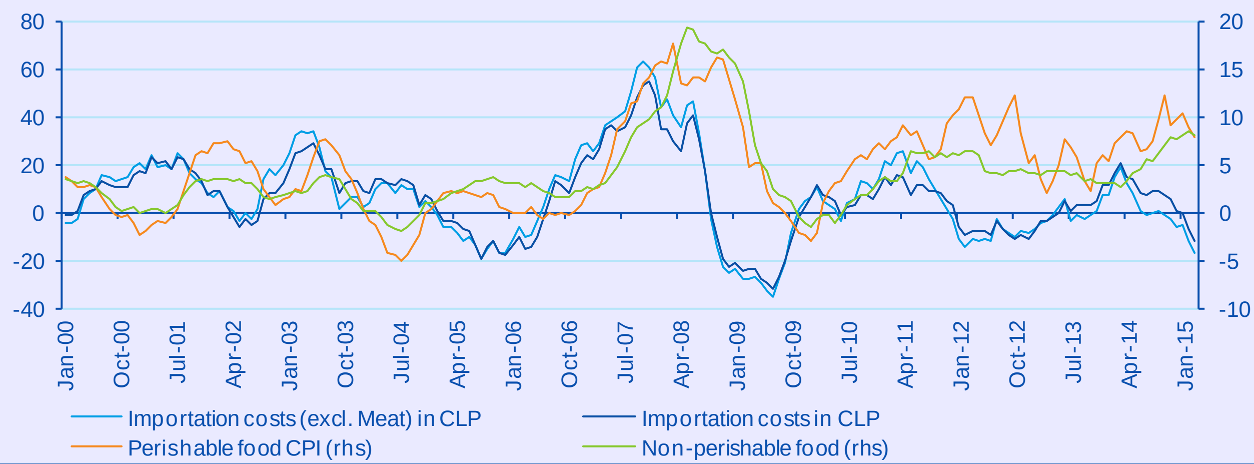
As with the situation in most of the emerging markets worldwide, the rise in food prices in Chile still has the most inflationary impact on the CPI, and the share of various food products in the basket is at 19.1%. On the other hand, it has been noted that lately the foods category has had a larger share of annual inflation within the headline CPI. In fact, as of 1Q14 the rise in food prices accounted for around 30% of overall annual inflation (+0.98pp), whereas during 1Q15 food prices represented around 38% of the total CPI increase YoY (+1.68pp). It is therefore essential to take a closer look at the fundamentals that are likely to underlie the foods item over the coming quarters[2].

Modeling of the CPI's foods category: perishable and non-perishable component approach

To gain a more exact idea of the CPI's foods category, we have divided it into the perishable elements, with a weight of 11.2% in the CPI basket accounting for 58.7% of the foods category, and the non-perishable component. In doing this we have used both local and international information on supply and demand conditions in the foods market.

As a proxy for the fundamentals in the global foods market, we have constructed a monthly indicator which captures trends in the cost of bringing goods into Chile which are important in the prediction process. This indicator weights the FAO's aggregate index for food prices[3], together with the aggregate indicator for sea freight, the Baltic Dry Index[4], and then expresses this in local currency using the average observed value of the USD (Figure B1.1).

Figure B1.1
Domestic food inflation and import costs, various measures (% var. YoY)

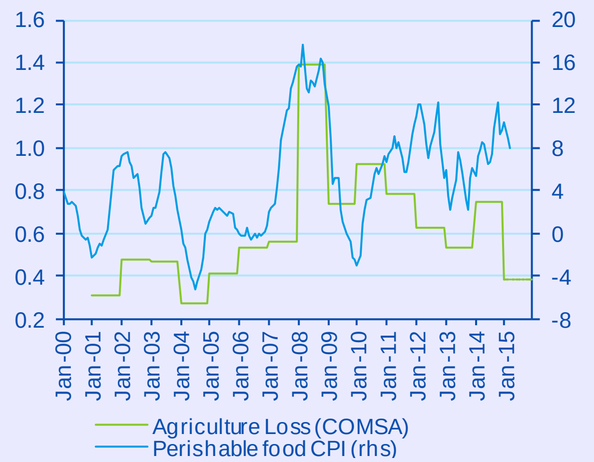


Source: FAO, Bloomberg, central bank, INE, BBVA Research

2: Further details in *"Chile Economic Watch: Food inflation will continue to decline during 2015"*
3 Index which weights international prices in USD for grain, sugars, dairy products, vegetable oils and meats. Further details at www.fao.org.
4 : The weighting for the sea freight indicator is set at 10%. We have additionally excluded import duties, given that in practical terms Chile operates as an open economy with low distortion for international trade. Nonetheless, some special tariffs exist, albeit temporary ones, in the case of grain and wheat flour imports; an exception that is far from being the general rule in Chile for international trade..

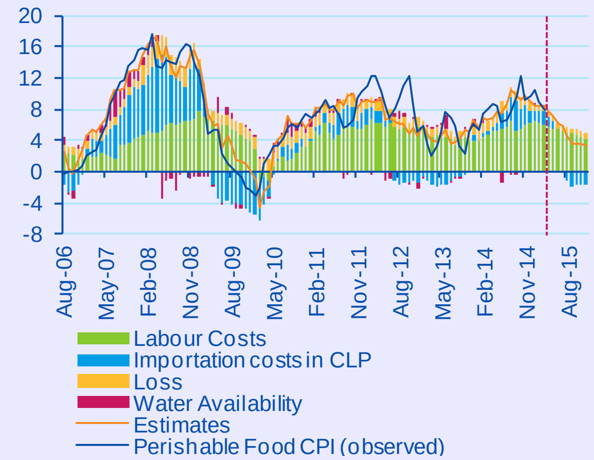
We can see that, since its last peak in March 2014, the YoY increase in import costs has slowed down substantially and even falls in the first three months of 2015. This pattern is even more pronounced in our indicator, which excludes international meat prices. Overall, the evidence points to a degree of fundamental pressure from declines in local food prices.

Figure B1.2
Perishable foods CPI vs. agricultural loss (%, % var. YoY)*



* The loss indicator is shown with a 12-month lag. Dotted line shows projection based on partial loss information for 2014.
Source: COMSA, BBVA Research

Figure B1.3
Estimated breakdown of perishable foods CPI (% var. YoY)*



* Dotted line represents start of projection.
Source: COMSA, BBVA Research

Looking at another aspect in order to capture the idiosyncratic factors in the local foods market, we have used two indicators. The first one concerns annual agricultural loss[5], which includes advanced information on the scale of domestic supply shocks (Figure B1.2). The figure suggests a positive correlation with inflation for the perishable foods CPI in the medium term. The second, relating to national water availability, we have constructed based on monthly information on rainfall, water levels and flows and the state of reservoirs which is available from the General Directorate for Waters (Dirección General de Aguas, DGA). Both indicators point to less pressure on perishable prices, which paves the way for falls in YoY domestic food inflation (Figure B1.3).

5: This is understood to mean the aggregate cost of compensation for agricultural loss relating to the climactic phenomenon out of the total value of premiums linked to these policies in a calendar year. Further details from www.comsa.gob.cl.

Outlook for foods CPI inflation

We have simulated various scenarios to arrive at projections for food CPI inflation, according to the severity and impact of the climatic phenomenon expected for 2015 (Table B1.1). In the baseline scenario we assume a benign climate which does not aggravate, yet does not correct, low irrigation water availability. Alternatively we have a more favourable scenario, with a stronger climatic phenomenon that normalises water availability levels yet does not produce any great loss to the irrigation infrastructure in Chile's south central zone. Finally, there is an adverse scenario, which is also characterised by a stronger climatic phenomenon, but where water availability levels drop due to irrigation infrastructure damage in south central Chile.

Table B1.1
Weather scenarios: projected total inflation for the foods CPI in 2015 (as at the production date)

	March 15	Favourable scenario	Baseline scenario	Adverse scenario
Perishables CPI (% YoY)	+7.9	+2.2	+3.2	+5.0
Non-perishables CPI (% YoY)	+8.1	+3.6	+4.2	+5.3
Foods CPI (% YoY)	+8.0	+2.8	+3.6	+5.1
Impact on headline CPI (pp)	**+1.53**	**+0.53**	**+0.69**	**+0.98**

* To make price projections for FAO foods we have taken the IMF's last projections for the grain and vegetable oils markets along with consensus estimates for sugar, powdered milk and meat prices. For sea freight the forecast horizon assumes a slight rally in rates. Finally the exchange rate and labour cost expectations are consistent with the BBVA Research baseline scenario for Chile.
Source: BBVA Research

The results reveal a lower impact on the CPI from food prices. This should come down from a current level of +1.53pp as of March 2015 to one of +0.69pp by the end of 2015. In other words, the lower impact on the headline CPI associated with the outlook for food prices should be 0.84pp under our baseline scenario. Based on the present evidence, we perceive the risk of a significant deterioration of local food price CPI during the next months, which supports our vision that the total inflation of the CPI will be situated slightly below 3% at the end of the year.

6 The most likely scenario emerging is that interest rates hold over the whole year

We forecast that the MPR will be kept at 3% for the remainder of 2015 and a process of gradual normalisation will commence in 2016

The higher inflation observed since our previous outlook has substantially diminished the likelihood of a new round of cuts in the monetary policy rate (MPR). Nonetheless, a scenario of more restrained inflation in the second half of the year will be key to (at least) not seeing rises in the reference rate, even if the announced process of rate hikes in the United States should materialise. Rises in the reference rate in Chile become more likely in 2016, once the economy starts to take up the slack that has been created in recent years.

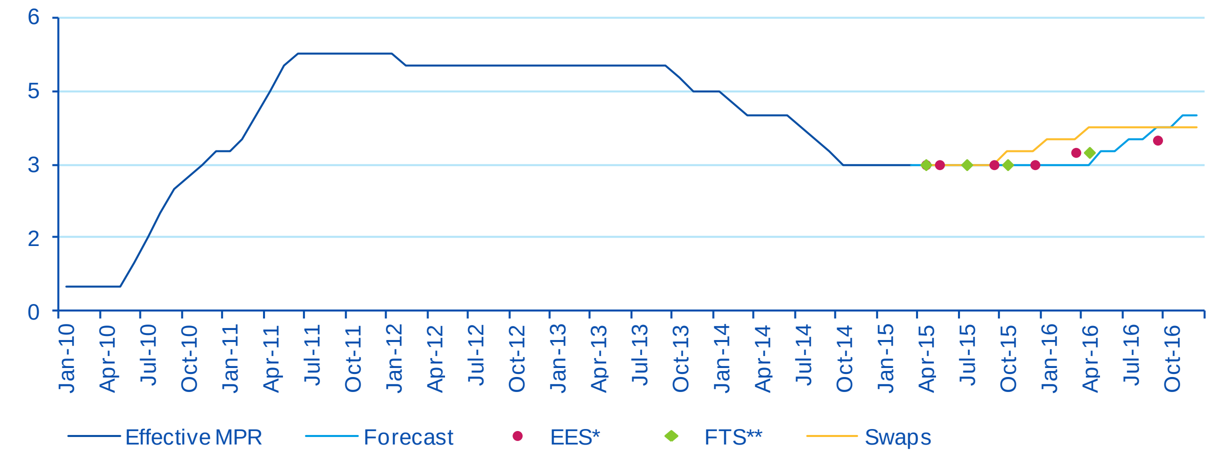
From the moment when, at its October 2014 meeting, the central bank opted to cut the MPR to 3% and eliminate the expansive bias that its statements had been indicating up to then, it began to make repeated assertions that it was unhappy with the level of inflation and its persistence. First, it verbally ruled out the possibility of further MPR rate cuts in the "foreseeable future". Then, in the March Monetary Policy Report, it revised its inflation forecast upwards and implied that interest rate rises would begin as early as the end of this year with a 25bp hike.

The central bank's year-end forecast was raised from 2.8% to 3.6%, which was above market estimates and asset prices at the time. Moreover, in an unprecedented move in the past eleven years, it forecast that inflation would continue above 3% at the end of the second year of estimates, in this case referring to December 2016. The intention behind this whole scenario, as we see it, was not only to rule out further cuts in the MPR, but to signal the need to embark on the process of raising rates, albeit while assuming the imminent risk of contributing to de-anchoring inflation expectations.

A scenario of restrained inflation for the next 12 to 24 months means that we can expect rate hikes to be modest. The March CPI of 0.6% MoM was below market expectations and served to some extent to allay views that factored in inflation on the high side and planned rate hikes for this year which had been incorporated in the last central bank report. Thus the Economic Expectations Survey for April showed that anticipated year-end inflation had gone up to 3.2%, yet the first 25-point rise in the MPR was only expected for the first quarter of2016, with a level of 3.75% two years ahead. On the other hand, the EOF (the Financial Sector Survey) predicted that the MPR would stand at 3.25% one year out, and at 3.75% after 24 months.

Our view for the reference rate is that, in a scenario where inflation recedes to 3% or below this by year-end, no rate policy moves will be required, and that the rate will have to begin to be normalised towards 2016, with estimated hikes of 100 basis points over the course of next year.

Figure 6.1
Effective MPR and implied movements in swaps and survey readings (percentage)



*EES: Economic Expectations Survey by the central bank with data as of April 2015.
**FTS: Financial Traders Survey by the central bank with data from the second week of April 2015.
Source: Central bank, Tradition, BBVA Research

We continue to reject the central bank's concern about both the signs from the labour market and core inflation, which prevented further cuts in the MPR in recent months, although we do share its concern over the high level of inflation and its persistence, which, as has been said, originated from the impact of the exchange rate depreciation, the tax hikes and the second round effects of past inflation. We forecast that all of these effects will begin to lose momentum from May on and will relieve pressure on the central bank to withdraw the monetary stimulus. An element of risk in this scenario comes from the way in which monetary normalisation will be conducted in the United States, although the signals gathered up to now suggest that this will happen at a gradual pace, which also removes any pressure to hike local rates.

Box 2. Central bank monetary policy communications: Appraisal and proposals

The task of central banks (and here the Central Bank of Chile is no exception) goes beyond merely implementing monetary policy. Its remit also encompasses informing about its policy decisions in a transparent way[6]. In this regard, the central bank has made visible efforts by increasing the number of its Monetary Policy Reports (IPoMs) each year and has got better at providing background information and minutes associated with every meeting of the Committee. It has, however, been six years since improvements have been made in this respect.

How does the central bank do compared to others? Where is the scope for improvement? In this box we answer both of these questions and compare Chile's central bank with those in 11 reference countries[7].

Methodology and findings

Picked out both because of their experience in conducting monetary policy in a context of inflation targets or since they are held to be leading countries with respect to transparency of information, we use the central banks of these countries as a reference: Australia, Canada, Colombia, the United States, the United Kingdom, Israel, Mexico, Norway, New Zealand, Peru and Sweden.

The assessment is made regarding two aspects: i) Inflation reports (comparable to Chile's IPoM) and macroeconomic variables which they forecast, and ii) monetary policy meetings (MPMs) and everything relating to these[8].

a. Monetary policy or inflation reports

On this front, Chile is among the most advanced in terms of how often it publishes its macroeconomic reports (four a year). In publishing inflation forecasts too it is in line with the other, reference countries, although a large group of these offer quarterly inflation forecasts, whereas Chile only publishes the annual figure. The categories for which the central bank does not offer forecasts, while other countries do so are:

- Activity. Nine of the eleven reference countries publish activity forecasts two or three years ahead
- MPR. Some central banks release year-end forecasts (and also for one, two and three years out), or provide 90-day interest rate forecasts.
- Exchange rate. Only three central banks give forecasts.
- Labour market. Some reports include forecasts of unemployment rates over different horizons or employment projections.

b. Monetary policy communications

In terms of number of MPMs, publishing statements and minutes of meetings two weeks afterwards, Chile is among the most transparent in the sample. This also applies to supplying information on voting by committee members and history. Nonetheless, in these two last aspects there is room for improvement, as some central banks link the arguments volunteered in discussions with the names of the committee members who put them forward, and they also hold press conferences after the meeting.

Finally, the aspect where there is most room for significant progress is in releasing short- and long-term forecasts in the statements or minutes. Table B.1 offers an overview of items assessed, verdicts and proposals.

6: Work by Bascand (2013), Dincer and Eichengreen (2009) and De Gregorio (2008) confirm this.
7: This box is a summary of the Watch headed *"Comunicación de la Política Monetaria del BCCh: Evaluación y propuestas a la luz de la evidencia internacional"*, of 23 March 2015.
8: It is worth pointing out that here we are not attempting to make any value judgments as to the relevance of publishing certain variables or how often this is done. The intention is instead to compare the Central Bank of Chile with reference countries which are at the leading edge as regards communication and transparency.

Table B2.1
Brief summary and proposals

a. Monetary policy reports	**Verdict**	**Proposals**
a. Number of reports a year	↑	
b. Economic activity forecasts	↓	•Extend the forecast horizon for GDP to two years and limit the estimate range.
c. Inflation forecasts	↑ ↓	
d. MPR forecasts	↓	•Give quarterly inflation forecasts
e. Exchange rate forecasts	↓	•Provide new forecasts: MPR, exchange rate and labour market within the monetary policy horizon
f. Labour market forecasts	↓	
b. Monetary policy communications		
a. Number of meetings	↑	
b. Releasing a statement	↑	•Minutes from monetary policy meetings: naming those who venture arguments in favour of the monetary policy decision and publishing the arguments used by the minority in voting where these exist
c. Publishing the minutes	↑	
d. Publishing voting and arguments volunteered by committee members	↑ ↓	•Making the updating process of forecasts more transparent. These updates often occur when monetary policy meetings are held.
e. Monthly forecasts of various variables	↓	
f. Monthly forecasts of key long-term variables	↓	•Holding press conferences after every monetary policy meeting to explain the decision and clear up the doubts of the specialist press
g. Miscellaneous (Background history, press conferences)	↑ ↓	

↑: In line with international practice

↓ : Not consistent with international practice.

↑ ↓ : Consistent with practice but with room for improvement

Source: BBVA Research

List of references

Bascand, G. (2013), "Communication, understanding, and credibility". Speech at the Admirals Breakfast Club, New Zealand.

De Gregorio, J. (2008). "Transparencia y Comunicaciones en la Banca Central Moderna". Economic Policy Documents. Central Bank of Chile.

Dincer & N. N., B. Eichengreen, (2009), "Central Bank Transparency: Causes, Consequences and Updates". National Bureau of Economic Research, Working Paper Series, United States.

7 Fiscal policy: With room for more spending in 2015, concerns shift to the medium term

Confirmation of expenditure execution of at least 100% for this year, while the announcements of the fiscal stimulus being maintained in 2016 pose a risk to meeting the target of achieving a structural balance by 2018.

The information on budget implementation of the first quarter to a large extent confirm the fiscal forecasts from the Q1 Outlook for 2015. A level of expenditure execution has been observed which is ahead of that for the same period in 2014, which dispels doubts and confirms that the government is capable of achieving implementation of 100% or more by the end of the year. On the other side of the equation, copper revenues have performed poorly, partly because of the lower copper price, though non-mining tax revenues collected have grown, buoyed by the tax hike last year that was associated with the initial phase of the Tax Reform.

For the close of this year, we estimate an actual fiscal deficit of 2.8% of GDP. As it can be seen from Table 7.1, the bond issue announced in January should prove insufficient, thus obliging the tax authorities to draw on their invested temporary cash surpluses from budget implementation in progress (*OATP* in Spanish). As of March, OATP assets stood at USD2.9bn, which is not much above the figure required to be cashed in for funding. In principle, it should not be necessary to use ESSF (Economic and Social Stabilisation Fund) assets.

Table 7.1
Sources and applications of fiscal resources for 2015

	Public Finances Report	BBVA
Sources	**8,447**	**10,290**
Gross debt	7,500	7,000
Financial asset sales	947	3,290
Applications	**8,447**	**10,290**
Actual deficit	5,187	7,030
Regular repayments	1,988	1,988
Social security contribution bonds	1,272	1,272

* Note: The figures are expressed in USD at the estimated exchange rates in each report.
Source: Dipres, BBVA Research

The explanation for this deficit, in relation to the content of the Budget Act, stems from reasons on both the revenue and the expenditure sides, as summarised in Table 7.2. With respect to actual fiscal revenues, these are estimated to be USD1.7bn lower than those in the budget, which is largely attributable to the worse performance within the macroeconomic scenario, with a higher exchange rate that partly offsets the downward adjustment, mainly in the lines of revenue associated with copper.

We have additionally assumed materialisation of the risk of a level of revenue collection in the Tax Reform which is lower by 0.15% of GDP (the collection target for 2015 is 0.97% of GDP according to the Financial Report). There are at least three reasons for this:

i) The taxable base for some forms of tax has not been as dynamic as was expected in mid-2014. An example of this is new autos, for which sales plunged 27.5% in 1Q15.

ii) Even assuming unit elasticity between taxes and GDP, the change in the macro scenario exhibits lower revenue collection, taking out the contribution from the Tax Reform to total actual revenues.

iii) The financial report assumed a rise in revenues equivalent to 0.3% of GDP, due to reduced tax evasion in 2015 alone, which is considered hard to achieve in a scenario of slowdown.

Even so, a more accurate appraisal of revenue collection from the Tax Reform will be possible using the information from this year's tax return campaign, for which the data is not likely to be available before June.

With respect to total expenditure, we estimate execution rate of 100.6%, which implies real growth of 7.6%. The estimate, which is larger than the figures in the Budget Act by almost USD400mn, *is not based on the disaster in northern Chile*. This is because the Treasury Minister declared that the financing of the reconstruction spending for this year will come from reallocating funds earmarked under Restricted Law for the Ministry of Defence to higher capital expenditure. This would not have an impact on total expenditure and merely implies less government consumption offset by increased public investment. The higher expenditure would be associated with a higher level of structural revenues, which makes room for the Treasury to spend more and still arrive at a structural deficit of 0.9% of GDP. This arises because the effects of a worse macroeconomic scenario are not captured by structural revenues, which are calculated using GDP and trend copper price parameters. However, a higher exchange rate does increase these revenues, since dollar copper revenues are converted to CLP at a more favourable exchange rate. *Given that the structural target for this year was a deficit of 1.1% of GDP, the result expressed here creates margin for lifting expenditure even more than we were predicting, in which case the actual deficit would also be increased by up to 0.2% of GDP.*

Table 7.2
Actual and structural balance sheet for 2015

(CLP mn)	2015 Treasury (a)	2015 BBVA Research (b)	(a) - (b) (USD mn)	Main reason for discrepancy:
Actual revenues	**33,356,904**	**32,295,792**	**-1,723**	
Tax revenue collection	**27,611,156**	**26,368,603**	**-2,017**	
Corporate income tax on major mining companies	1,601,832	1,422,356	-291	*Lower copper price offset by weaker exchange rate*
Income tax from other tax-payers	26,009,324	24,946,247	-1,726	*Lower level of activity and lower TR revenue collection*
Codelco	**1,192,757**	**1,162,658**	**-49**	***Lower copper price offset by weaker exchange rate***
Others	**4,552,991**	**4,764,531**	**343**	***Better implementation rate***
Structural revenues	**34,737,377**	**35,187,093**	**730**	***Higher exchange rate***
Total expenditure	**36,391,119**	**36,626,477**	**382**	***Assumption of execution at a rate of 100.6%***
Actual balance	**-3,034,215**	**-4,330,685**	**-2,105**	
% of GDP	**-1.9%**	**-2.8%**	**-0.8%**	
Structural balance	**-1,653,742**	**-1,439,385**	**348**	
% of GDP	**-1.1%**	**-0.9%**	**0.14%**	

Note: Both of the 2015 columns were converted to USD at the rate estimated by BBVA Research
Source: BBVA Research

Finally, we reiterate the risks for a tighter scenario for meeting the target of structural balance in 2018. In the Q1 Outlook we mentioned the likelihood of the structural parameters, trend GDP and the copper benchmark price being adjusted successively downwards. Table 7.3 simulates several average expenditure growth scenarios for 2016-18, showing which average growth rate is required to achieve the target of structural balance in 2018, and also includes various levels of actual revenue collection for the Tax Reform in relation to its financial report. On top of this there are the possible spending pressures that might crop up in the coming years. The market has already begun to factor in these motives for apprehension. In particular, the debate over the Educational Reform and the natural disaster in northern Chile, together with the obligations these imply for the tax authorities in terms of committed funds, have been a cause for alarm regarding the government's ability to finance new spending requirements and at the same time close up the structural deficit[9].

Table 7.3.

Average 2016-18 expenditure growth required for convergence towards structural balance in 2018, given various scenarios

		Average trend GDP growth					
		4.0			3.8		
		TR: 100%	TR: 80%	TR: 50%	TR: 100%	TR: 80%	TR: 50%
Av. copper benchmark price (USD cents/lb)	290	4.8	4.1	3.3	4.5	3.8	3.0
	280	4.6	4.0	3.2	4.3	3.7	2.9

Note: The same molybdenum benchmark price is assumed for all scenarios
Source: BBVA Research

9: Discussion on a potential greater fiscal stimulus in 2016 is taken up in *Box 3. Risks concerning the 2018 target of structural balance and greater fiscal stimulus in 2016.*

Box 3. Stronger fiscal stimulus in 2016: Preliminary effects

Added to all the above-mentioned points has come the news that the government is weighing up whether to keep up the fiscal stimulus in 2016 or not. In fact, in a context where growth projections indicate a growth rate below potential for the next year, with a private sector that does no recuperated its level of economic activity, the government will most likely opt for the introduction of another economic stimulus stemming from increased fiscal expenditure. Although this was only a preliminary announcement, and we do not even know how a further stimulus would be implemented next year, substantiation of the announcement would mean significant macro-fiscal effects.

Hereafter, we realized a preliminary review of the effects of further fiscal stimulus in 2016. To this end, we assume that the government would not get back on course for convergence towards structural balance and that next year a structural deficit would be set as a target of 1.0% of GDP (maintaining the structural deficit of the current year), which would translate into greater margin for spending of almost USD570mn. Table R3.1 compares the results for both scenarios. As expected, the direct effect would be an increase in the effective deficit and the level of public debt.

Table B3.1
Comparison of 2016 fiscal variables: base scenario vs. scenario of additional fiscal stimulus

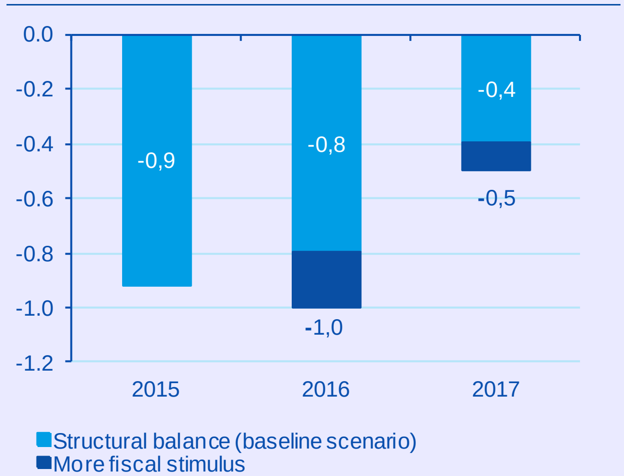
	Actual deficit (% of GDP)	Increased spending (real var.)	Financing req. (USD mn)
Base scenario (Struc. def. : 0.8% of GDP)	-2.5	6.3	-7,177
Additional stimulus (Struc. def. : 1.0% of GDP)	-2.7	7.2	-7,745

Source: BBVA Research

Which risks are associated with this scenario? First of all, postponing the termination of the convergence measures puts the target of achieving structural balance in 2018 at risk. Public expenditures growing at a fast pace poses an obstacle for a quick adjustment in 2 years, which is deemed necessary in order to reach structural balance in 2018. Therefore, it becomes more difficult to reduce the 2017 target by slightly over 0.5% of GDP, which would imply that the fiscal stimulus would be extended by at least another year. Figure R3.1 simulates two scenarios of convergence to 2018, where it explicitly shows the additional effort required of the government if it postponed closing up the deficit for another year.

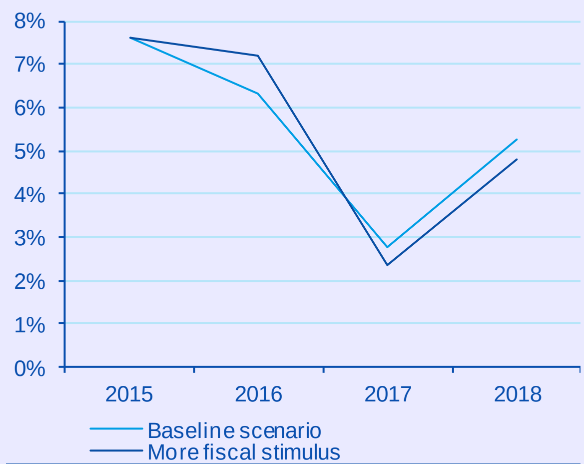
On the other hand, figure R3.2 shows what the real increases in spending would be that are associated with each scenario. It is evident that 2017 will be a tough year for the government in any event, since this is the period in which the Tax Reform delivers a marginally smaller contribution to the tax coffers. In fact, the real annual growth rate of expenditures should converge from rates close to 7% to lower rates in between 2% and 3%. Going ahead with an additional stimulus in 2016 leaves even less leeway for the Treasury to adjust spending growth in 2017, and consequently for the final tuning exercise that would allow it to achieve the target in 2018.

Figure B3.1
2015-17 structural balance
Scenarios for convergence to 0% in 2018: baseline and incorporating an additional fiscal stimulus in 2016



Source: BBVA Research

Figure B3.2
Real expenditure growth 2015-18 Scenarios for convergence to 0% in 2018: baseline and incorporating an additional fiscal stimulus in 2016



Source: BBVA Research

Figure B3.3
Cumulative expenditure growth in 12 months vs. annual variation in the nominal Remuneration Index (%)

Source: Dipres, INE, BBVA Research

Finally, there are possible undesired macroeconomic effects that keeping up the fiscal stimulus next year would produce. First, there is evidence that, in the case of Chile, increased fiscal expenditure causes crowding out with regard to output and private consumption[10]. Although in a scenario such as the current one it would be possible to question whether all the conditions are met in order for a crowding out to occur, extending the stimulus for more time increases the risk in this sense. Second, one might mention the effect which greater expenditure could have on inflation. In statistical terms, it is not possible to rule out an impact by public spending on inflation and nominal wages (see figures 7.3 and 7.4) in the past, but once again there are associated risks regarding these variables if the stimulus is continued.

10 See Juan A. Correa, Christian Ferrada, Pablo Gutiérrez & Francisco Parro (2014), "Effects of fiscal policy on private consumption: evidence from structural-balance fiscal rule deviations", Applied Economics Letters; as well as Cerda, Rodrigo; González, Hermann; Lagos, Luis Felipe (2005), "Is Fiscal Policy effective? Evidence from an Emerging Economy: Chile 1833-2000", Applied Economics Letters..

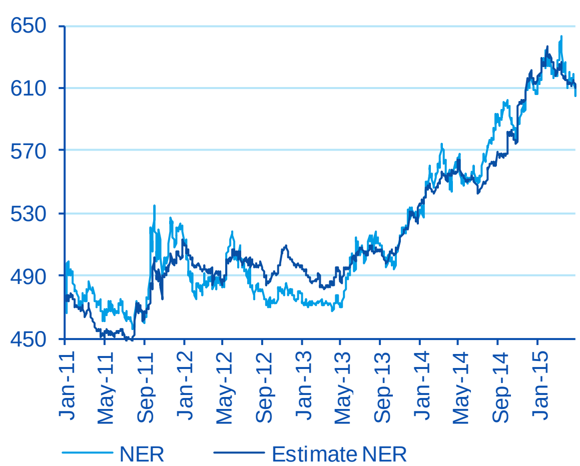
8 Most of the exchange rate adjustment should be over by now

The exchange rate adjustment should have ended by now, and so we expect the dollar exchange rate to continue to move within the CLP610-640 range in trading over the short term, and then arrive at around CLP600 towards the second half of 2015. Medium- and long-term interest rates have shown volatility in response to movements in external rates, while the view has taken hold locally that the MPR will remain unchanged for an extended period.

The exchange rate has made an additional adjustment since the close of the previous Outlook, with the CLP depreciating by between 4% and 5%, reaching levels of over CLP640 to the USD in mid-March. Nonetheless, following a somewhat less aggressive tone of speech by the Fed, a message ruling out further cuts in the MPR locally by the central bank, and activity figures which have surprised the consensus in a positive sense, the CLP has risen slightly against a basket of several currencies. All in all, no exchange rate misalignment is noticeable with looking at fundamentals (Figure 8.1).

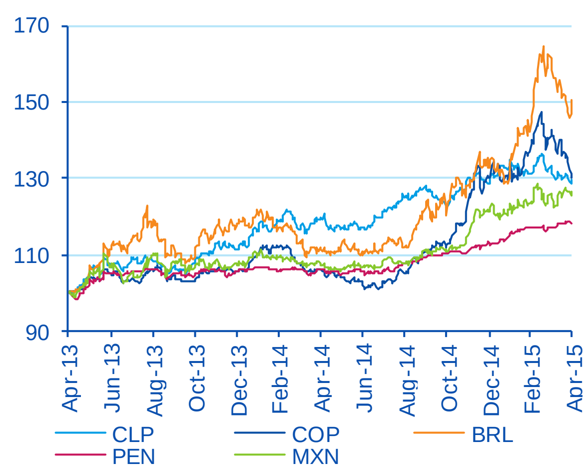
Over a medium-term view, the exchange rate is likely to experience a depreciation in advance of other Latin American economies, probably because of the greater uncertainty imparted by the scenario of reforms and the fact that the central bank did nothing to stop the currency falling, but instead cut the MPR in support of the cyclical adjustment (Figure 8.2). In this respect, the CLP should have made a large part of the cyclical adjustment in a context in which the current account deficit has closed up almost completely and inflation has begun to recede, although only gradually. We therefore do not see any room for multilateral depreciation against a basket of currencies or bilaterally against the USD that would equal the levels reached in March.

Figure 8.1
Effective and estimated exchange rate*



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

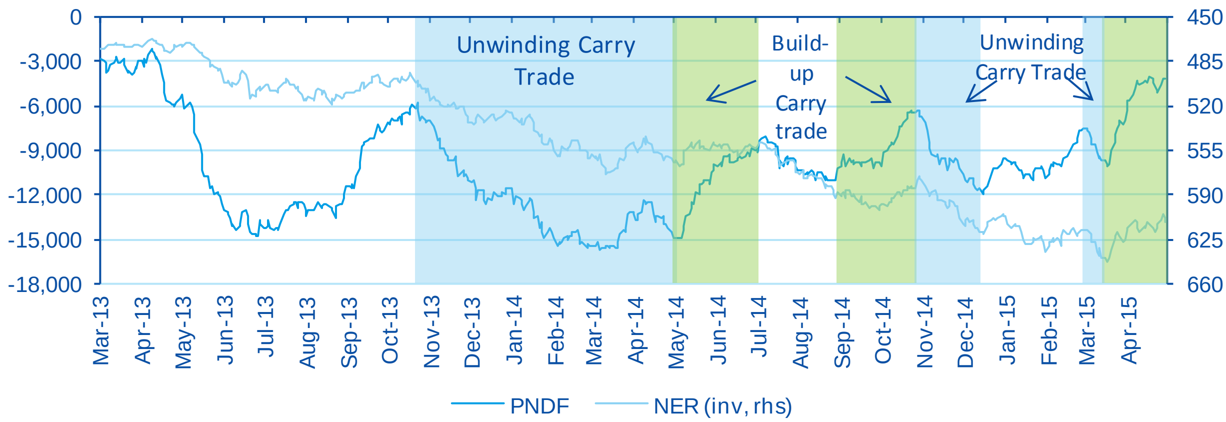
Figure 8.2
Exchange rates against the USD (30/04/2013=100)



Source: Bloomberg, BBVA Research

The rise in the exchange rate to levels close to the CLP640 mark in March coincided with a sliding copper price and unwinding of interest rate arbitrage transactions via derivatives (carry-trade strategy) by non-residents. Nonetheless, after the Fed statement of 18 March and a neutral view, even one suggesting normalisation, by the central bank at the end of March, we have seen a renewed appetite for the CLP by non-residents at the same time as appreciation which brought the dollar exchange rate to a little under CLP610 for a few days (Figure 8.3).

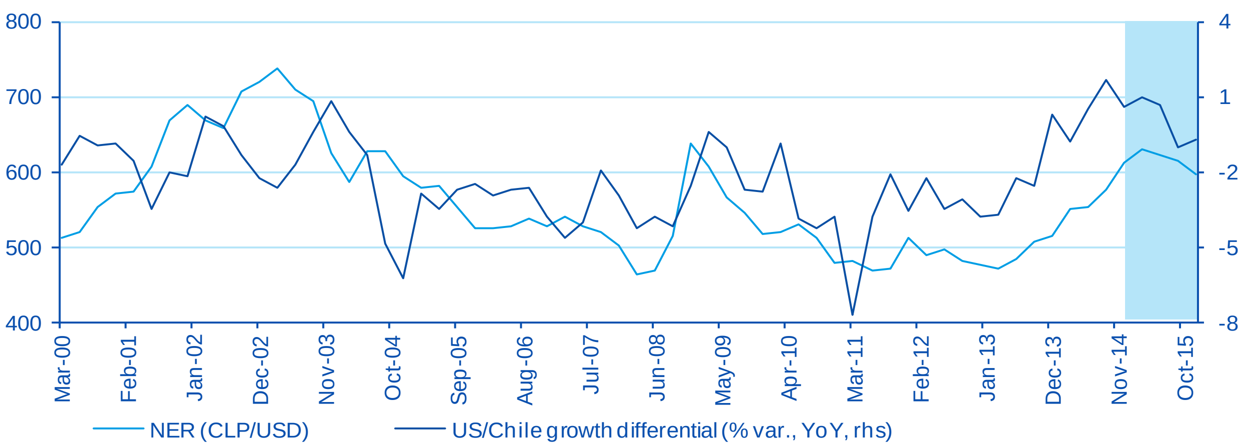
Figure 8.3
Net position in the external derivatives market and nominal exchange rate (USD mn, USD/CLP)



Source: Central bank, Bloomberg, BBVA Research

As we stated in the last Outlook, the exchange rate has shown strength, both bilaterally against the USD and multilaterally against other currencies, thanks to better activity figures and a smaller difference in terms of growth with respect to the United States (Figure 8.4). Overlaying this is a scenario of a reversal of the drop in the copper price. An element of risk to this picture could come from the process of monetary normalisation in the United States, although we predict that this will be gradual and have an impact that is already built into the exchange rate.

Figure 8.4
United States/Chile growth differential vs. the nominal exchange rate



*Shaded area represents forecast
Source: Bloomberg, BBVA Research

9 Political landscape and the reform process: A risk to restoration of the confidence of economic agents?

In the domestic scene, the cases linked to legally questionable financing in politics and the reform process, both underway and yet to come, might add measures of uncertainty into the mix and hamper the recovery of confidence indicators. On the external front, the risks still lie with uncertainty over the correction in China and the way in which the withdrawal of the monetary stimulus is handled by the United States.

The more bullish activity figures displayed by the Chilean economy since the end of last year, together with the boost from the drop in the oil price to family budgets and corporate costs, led to the beginnings of a rally in the consumer and business confidence indicators. As we have stated in previous notes, an improvement in these indicators is a key factor to sustaining the modest economic recovery forecast for this year.

An important element of risk which has emerged as of late relates to the cases of irregular financing in politics which have undermined the public's faith in the institutions and involve various arms of government and the business community. Even though the government is getting a grip on the situation by setting up a special commission to investigate the issues and make proposals that might help produce an institutional solution to the problem, a raft of legal proceedings are simultaneously going through the courts, and the potential fallout from these still remains an unknown variable. The risk of a loss of reputation spreading from the institutions on the economy, manifesting itself in mistrust in public institutions, is widely known to give rise to the emergence of populist policies and support for populist leaders, who usually end up removing basic economic goals from their list of priorities and replacing them with others designed to gather greater popular support, without considering the economic impacts.

On the other hand, a debate has begun over the labour relations agenda which has led employers to point out that the same bad habits are destined to be repeated which were on display when the tax debate opened, as a result of not taking into account all the sectors involved, including workers, employers and expert opinion; and all this without promoting the adjustments which the economy needs to encourage job creation, proper training for workers and employee participation. We would be embarking on a debate exclusively along the lines of giving more power to the unions, which is an admirable objective, but not the only one required to improve employment conditions. Once again, if the process goes ahead on the terms applying up to now, the consequences for the confidence of economic agents will be negative and ultimately impact on investment and hiring decisions. The proposal of embarking on constitutional reform towards Q3 also adds in uncertainty with regard to the procedure and amendments affecting the constitution.

On the external front, a substantially harder-than-expected landing for investment in China remains the main risk in the medium term, due to its ramifications regarding activity in the export sector, the confidence of domestic economic agents, capital flows and the fiscal accounts. This risk has been present in the more recent Outlooks and part of it has materialised recently, though the impact has been relatively small. In particular, concern remains over a hard landing in China, given the doubts concerning the fragility of its financial system and the widespread growing sensation of risk attaching to the emerging world. A decline in the Chinese economy would have major repercussions on the emerging economies too, via both financial and real channels. A special threat is posed by the implications for the copper price, as well as for growth in the economies of Chile's other major trading partners.

Another external risk that might have a short term impact is from the monetary normalisation process in the United States which, depending on how sharp or gradual it is, will set in motion a whole host of different effects on financial conditions in Chile and in the group of emerging economies. Once more, although with a rather small likelihood and impact as far as Chile is concerned, the risk which is associated with the euro zone's fiscal and financial situation persists, particularly in regard to the direction taken by future negotiations between the Euro Group and Greece.

10 Tables

Table 10.1
Macroeconomic forecasts

	2012	2013	2014	2015	2016
GDP (% YoY)	5.5	4.2	1.9	2.9	3.5
Inflation (% YoY, eop)	1.5	3.0	4.6	2.9	3.0
Exchange rate (vs. USD, eop)	477	529	613	596	581
Interest rate (%, eop)	5.00	4.50	3.00	3.00	4.00
Private consumption (% YoY)	6.1	5.9	2.2	2.6	3.2
Government consumption (% YoY)	3.5	3.4	4.4	4.5	4.0
Investment (% YoY)	11.6	2.1	-6.1	-0.4	3.3
Fiscal balance (% GDP)	0.6	-0.6	-1.6	-2.8	-2.5
Current account (% GDP)	-3.6	-3.7	-1.2	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	5.4	1.5	472.5	5.00
2Q 13	4.0	1.9	502.9	5.00
3Q 13	4.8	2.0	504.6	5.00
4Q 13	2.8	3.0	529.5	4.50
1Q 14	2.7	3.5	563.8	4.00
2Q 14	2.1	4.3	553.1	4.00
3Q 14	1.0	4.9	593.5	3.25
4Q 14	1.8	4.6	612.9	3.00
1Q 15	2.0	4.2	628.5	3.00
2Q 15	2.4	3.8	622.0	3.00
3Q 15	3.6	3.3	615.0	3.00
4Q 15	3.4	2.9	596.0	3.00
1Q 16	3.7	2.7	591.0	3.00
2Q 16	3.5	2.5	587.7	3.25
3Q 16	3.4	2.4	584.4	3.75
4Q 16	3.5	3.0	581.1	4.00

Source: BBVA Research

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This report has been produced by the Chile Unit

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