BBVA | RESEARCH

Chile Economic Outlook

2ND QUARTER 2016 | UNIT CHILE

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Growth projection for 2017 adjusted downwards due to materialisation of risks that moderate the slope of the recovery

02
Inflation will settle at 3% in 2H16 and will fluctuate below that level in the base scenario without changes in the central bank's key interest rate

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Closing date: 29 April 2016

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Available data for the first quarter of 2016 confirm our prediction that world economic growth would stabilise at a low rate but a slightly higher one than at the end of 2015. The Chinese authorities' strengthening of their stimulus measures have helped to soften the effects of the adjustment to the manufacturing sector on aggregate production and therefore on the country's flows of trade with the rest of the world. The postponing of expectations of the next interest rate hike is explained by the importance that economic agents attach to the deterioration in the international environment as reflected in the reactions of the US Federal Reserve.

To the extent that developed countries' central banks hold the course of monetary policy of the past few months, authorities in emerging markets will have more room for manoeuvre to prioritise economic recovery among their objectives. All the same, the relative improvement in the global economic scenario in the last quarter continues to be fragile and dependent, in the short term, on how China's economy evolves, the process of monetary normalisation in the US and the resolution of the sources of geopolitical instability present in Europe.

Internally, we are projecting economic growth of 1.7% for this year and 2% next, with a downward bias. The information received since our last quarterly report reveals that certain downside risks have materialised and, as a result, the speed of economic recovery will be less than that forecast in our previous report. We believe the economy has completed most of the macro-adjustment required to accommodate itself to the new context of external and internal conditions, but we see no significant growth drivers allowing growth rates of over 2% next year. Taking into account the average duration of the confidence cycles of a large group of countries, we believe that even if there are no additional negative shocks, economic agents' confidence will not return to neutral levels before the end of 2017 (Box 1).

In a context in which the economy still has slack in the use of installed capacity and very little imported inflationary pressure, we estimate that inflation will fall to around 3% in the latter part of this year and fluctuate below that level during 2017. The downward correction to projected inflation for 2016-17 is largely explained by the projection of a stronger peso and a somewhat greater slowdown in inflation as regards services. Moreover, we consider that the low international food prices have yet to be passed on to domestic prices, and that this will take place over the remainder of the year, contributing to the slowing of inflation to levels of around 3.2% at the end of this year and 2.5% at the end of next.

The base scenario of this report is consistent with the central bank's key interest rate being held at 3.5% throughout this year and next, which should naturally be anticipated by a shift in the bias from contractive to neutral, which we expect to occur in the next two to three months. Additionally, we do not now see the central bank's key interest rate moving to neutral levels before 2018, although we do not rule out the possibility of earlier cuts being necessary. Indeed, moving from a contractive to a neutral bias implies in practice that the there are similar probabilities of cuts or increases in interest rates, and given the risks we see for the base scenario, we consider that the possibility of interest rate cuts in the next few quarters cannot be ruled out.

In the fiscal area, on top of the under-execution of the Budget in Q4 2015 came an adjustment to expenditure at the beginning of the year, paving the way to a scenario of greater austerity and consequently a smaller role being played by public spending in bringing about growth and creating jobs. Given this adjustment, together with the updating of the macroeconomic scenario, we estimate growth of 4.2% in public spending for 2016 and an effective deficit of 2.7% of GDP. Consequently, debt issues this year will be more than sufficient to finance the fiscal deficit, even leaving some over for next year. Projecting further cuts in the estimates of the structural parameters, with a reference price for copper of US$2.40 per pound and trend GDP growth of 3.2%, we estimate a structural deficit of 1.3% for this year. **For 2017 we are projecting growth of 3.4% in public spending (fiscal deficit of 2.9% of GDP)** in a scenario in which the government fully executes the Budget this year and meets its commitment to reduce the structural deficit by 0.25% of annual GDP.

There is very little room for growth in public spending from 2019 on, unless there is an upward revision of the long-term parameters that determine the Budget (copper prices and trend GDP growth). In that context, **we raise the risk of a new discussion on increasing the tax burden, which could take place in 2018, considering that in that year the tax reform comes into force and ceases to bring the government incremental resources from 2019. Nor can the option of once again postponing the return to structural balance be ruled out.**

Our view of the CLP's having depreciated somewhat more relative to fundamentals in our previous report was subsequently accompanied by significant multilateral appreciation. We now consider that this appreciation was rather more than that suggested by the fundamentals. **We consider that the real rate of exchange should remain at levels above its historical averages in order to facilitate the reallocation of resources to exporting sectors other than mining and so allow recovery from the cyclical position of the economy, for which it might be necessary to provide support through monetary policy, which would certainly be justified by the medium-term deflationary effects.**

The most likely range would be from 650 to 700 pesos to the dollar over the next few quarters. In the short term, due to the high volatility in the global financial markets, we do not rule out further depreciation of the CLP, which could bring the rate back to levels of around 700 to the dollar, but we do not consider that the conditions would exist for working permanently with those levels.

In the base scenario, interest rates on long-term instruments in both pesos and dollars are adjusted upwards at the projected horizon, although to a limited extent, in line with the process of monetary normalisation in the US. However, interest rates of long-term instruments could fall back and continue at historically low levels following the moderation of the contractive bias in Chile's monetary policy and greater caution on the part of the US Federal Reserve in normalising interest rates.

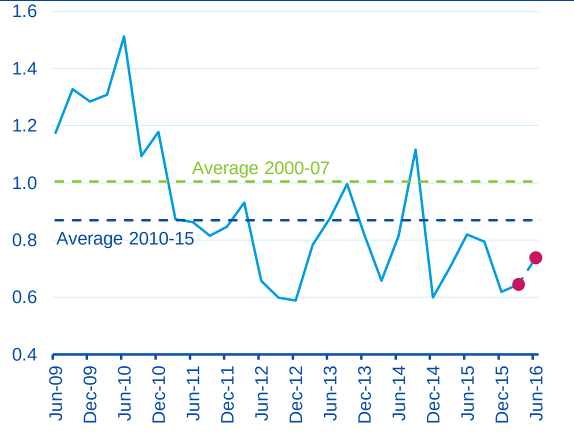
With regard to the risks presented by the macroeconomic scenario described in this report, at domestic level there remains a risk that the pace of recovery in confidence will be slower than forecast in this report, which assumes neutrality towards the end of 2017. A further domestic risk is that the peso will be stronger than is appropriate to supporting cyclical recovery, leading to greater falls in inflation in the medium term, with a delayed reaction from monetary policy. Externally, a global scenario of lower growth is materialising, which was a risk referred to in our previous report, and real financial risks persist in the Chinese economy, which would have negative effects on the price of copper and economic growth, among other variables.

2 Global growth is fragile and reliant on China

Available data for the first quarter of 2016 confirm our prediction that world economic growth would stabilise at a low rate but a slightly higher one than at the end of 2015. The BBVA-GAIN indicator[1] estimates the quarterly increase in world GDP at 0.6% (2.6% annualised), well below the average recorded between 2010 and 2015 (Figure 2.1). This rate of growth could accelerate slightly in the second quarter if the signals of reduced deterioration being transmitted by available indicators of production, trade and business confidence are confirmed, but it would still not be enough for the world economy to grow by 3.2% in the year (our forecast for whole-year 2016).

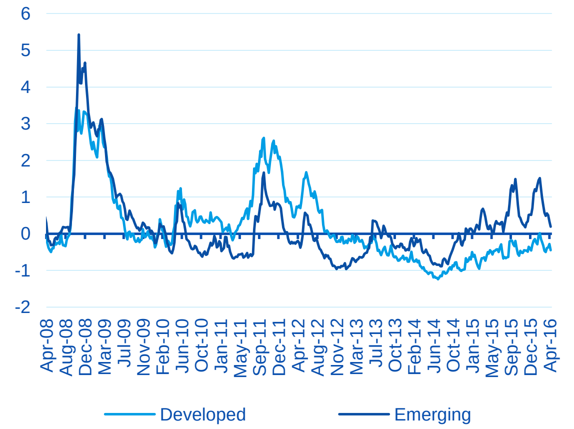
The sharp increase in financial volatility seen between December 2015 and February 2016, as well as being in response to the slowdown in global activity, also threatened to exacerbate it if it persisted with the same intensity and ended up being translated into a contraction in spending decisions. The better-than-expected balance of China's economic indicators, together with the reduced downward pressure on the yuan exchange rate, the recovery of commodity prices and the moderation of expectations of interest rate hikes by the US Federal Reserve were crucial to the easing of financial tensions from then on and to the reduction, in turn, of the probability of occurrence of a worldwide stress scenario in the short term.

Figure 2.1
World GDP, % QoQ. Forecasts for Q1 and Q2 2016 based on BBVA-GAIN



Source: BBVA Research

Figure 2.2
BBVA index of financial stress (normalised values)



Source: BBVA Research and Haver

China: fewer short-term risks, but more long-term doubts

The Chinese authorities' strengthening of their stimulus measures, both monetary and fiscal, have helped to soften the effects of the readjustment to the manufacturing sector on aggregate production and therefore on the country's flows of trade with the rest of the world. In the short ter, the implementation of countercyclical measures may facilitate a more gradual than expected slowdown in the economy; however, if this brings with it a delay in the correction of fundamental imbalances such as the high leverage of the corporate sector or the excess supply in certain branches of industry and construction, China's vulnerability to shocks such as that seen at the beginning of the year will increase, as will its potential to destabilise the rest of the world. Taken as a whole, these factors lead us to revise our 2016 growth forecasts for China upwards to 6.4%, maintaining our growth forecast of 5.8% for 2017.

1: See https://www.bbvaresearch.com/en/publicaciones/global-gdp-growth-remains-stuck-at-2-6-yoy-in-q1-less-cloudy-outlook-but-the-same-risks/

The international environment is partly determining the US Federal Reserve's decisions and thus helping to relieve the pressure on emerging markets

The postponing of expectations of the next interest rate hike is explained by the importance that economic agents attach to the deterioration in the international environment as reflected in the reactions of the US Federal Reserve. As against the two rate hikes predicted by FOMC members for 2016, the market has postponed the next increase to early 2017. The response of the dollar, depreciating despite the continued relatively positive trend in US domestic demand, and the easing of the long segments of the dollar interest rate curve, have contributed to relieving the restrictions on financing in the emerging markets, as reflected by: (i) the BBVA financial stress index for this region, which has corrected all of the upturn seen in the first few months of 2016 (Figure 2.2), and (ii) the reactivation of inflows of foreign capital, with net capital inflows to emerging markets since mid-February, due in part to the relocation of investment to instruments with higher returns.

Furthermore, to the extent that developed countries' central banks maintain the direction of monetary policy of the past few months (strengthening or maintaining stimulus measures in the case of the ECB and the Bank of Japan; caution in normalising interest rates on the part of the US Federal Reserve), emerging market authorities will have more room for manoeuvre to prioritise economic recovery among their objectives. The gradual approach expected of the US Federal Reserve (which supports capital inflows to the region) and the recent recovery of currencies (containing the possible increase in inflation caused by dearer imported goods) limit the need for aggressive interest rate hikes.

All the same, the relative improvement in the global economic scenario in the last quarter continues to be fragile and dependent, in the short term, both on how China's economy evolves and on the resolution of the sources of geopolitical instability present in Europe. In any case, repeat bouts of financial volatility like the one seen at the beginning of this year (of greater or lesser intensity) cannot be ruled out in a context of high uncertainty about the ability of the emerging markets to manage their slowdown and of the developed countries' central banks to reactivate growth.

3 Downward correction to growth projection for 2017 in the absence of significant drivers

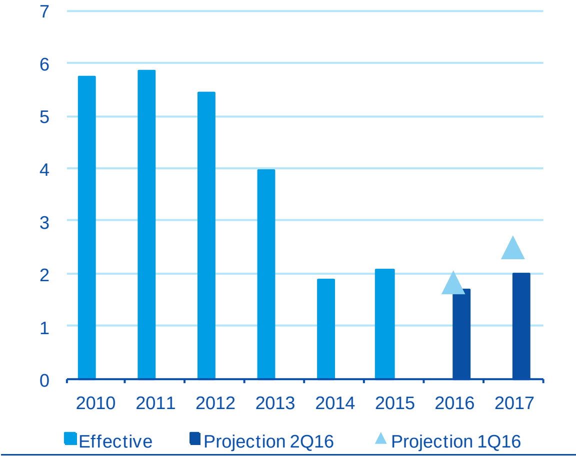
Growth in 2017 will again be around 2%, below the forecast of three months ago in view of clear evidence of a slower pace of recovery in the private sector components of demand. Despite our projection's being below the consensus, we consider that the risks continue to be biased downwards.

Year-end 2015 revealed significant slowing in economic activity and spending in the last quarter of the year, even more significant than might have been anticipated based on the available IMACEC figures (IMACEC being the Spanish acronym for Monthly Indicator of Economic Activity.) Thus GDP growth was just 1.3% YoY in Q4 20150, the lowest since Q3 2014; private sector consumption grew by 1.1% YoY and once again invested posted year-on-year contraction, ending the year 1.5% down. Corrected for seasonality, GDP grew by just 0.1% QoQ in Q4 2015 and domestic demand shrank be 1.4% QoQ, following four consecutive quarters of QoQ increases. This weakness observed in the economy at year-end 2015 comes on top of the forecast development of the main factors determining demand, and translates into a flatter growth trajectory than that foreseen in our last report, with effects extending beyond this year.

We are now projecting GDP growth for 2016 and 2017 at 1.7% and 2.0% respectively. The materialisation of some of the risks anticipated a few months ago, and a reassessment of the economy's ability to grow are the main reasons leading to the downward revision of our projections for this year, but more particularly of those for next year, where the correction is more significant (Figure 3.1). The passage of time has revealed that two of the main determining factors of private sector consumption, the labour market and confidence, will not contribute as much as we had hoped to recovery. Consumer confidence remains at pessimistic levels, and according to the available evidence could take until the beginning of 2018 to return to neutral levels (See Box 1).

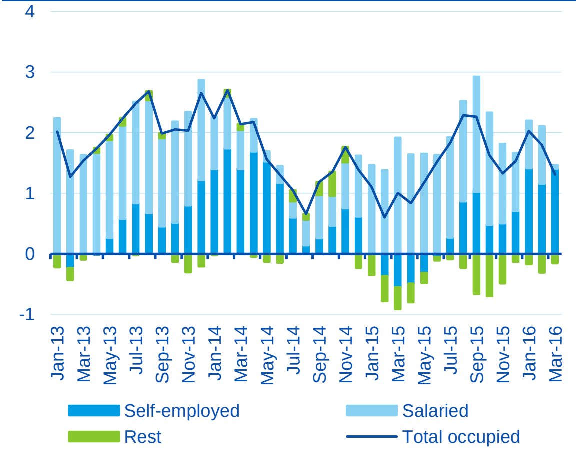
As for the labour market, the unemployment rate has started to rise, significantly so in the mining regions and in Greater Santiago according to figures of the University of Chile, on top of other adjustments that have taken place in the labour market, such as lower salaried job creation, which has been replaced by self-employment, and the significant slowdown in real remuneration (Figure 3.2).

Figure 3.1
Real and projected GDP growth (change % YoY)



Source: Central Bank of Chile and BBVA Research

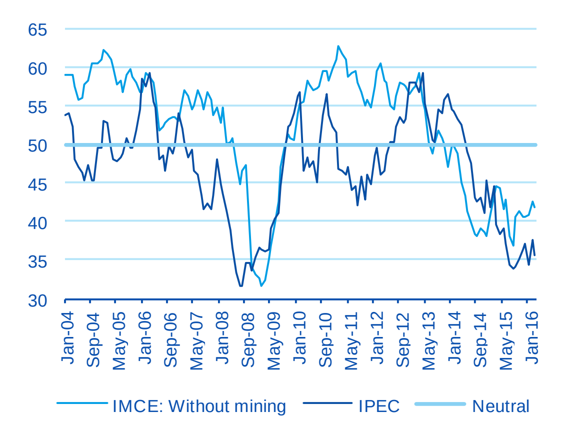
Figure 3.2
Employment by categories (chge. % YoY)



Source: INE (National Statistics Institute) and BBVA Research

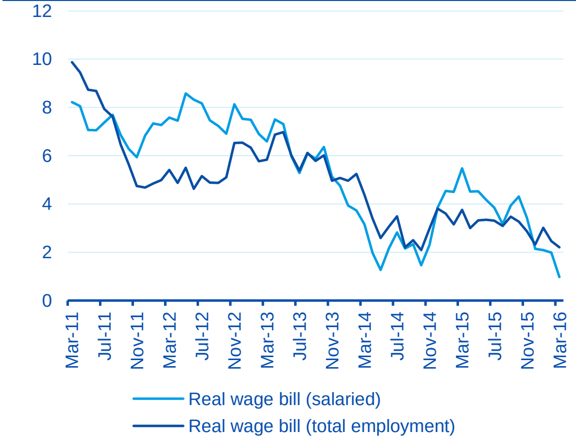
As a consequence, total payroll has suffered a very significant loss of dynamism, and if we add to this less favourable credit terms, the result is the slowdown in private sector consumption that we are seeing and which could become more intense in the next few quarters. The projections contained in this report assume a gradual recovery in these determinants, at a slower pace than envisaged three months ago, which leads us to anticipate that private consumption will continue to grow at around or below 2% this year and next (Figures 3.3 and 3.4).

Figure 3.3
Consumer and business confidence (IPEC and IMCE respectively)



*IPEC being the Spanish acronym for Index of Perception of the Economy and IMCE for Monthly Indicator of Business Confidence
Source: : Central Bank of Chile and BBVA Research

Figure 3.4
Total payroll (Chge. % YoY)*



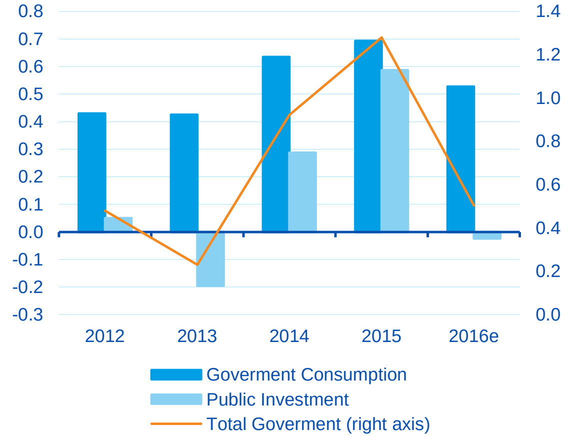
*Points correspond to projection for March 2016. Source: INE (National Statistics Institute) and BBVA Research

One aspect to continue monitoring is the relatively good performance of sales of new cars in the first few months of the year, which could lead to this year's ending up on last, or at least without contraction as in the past two years. However, imports of this kind of goods remain at low levels, reflecting the fact that businesses in the sector remain cautious as to the outlook for demand in the next few quarters.

As regards capital expenditure, although we believe the adjustment has come to an end following the falls seen in 2014 and 2015, which were heavily influenced by the contraction in capital expenditure in the mining sector, the low level at which business expectations remain, the lower growth forecasts and the reduced role that public investment will play from this year all lead us to be cautious with this component of spending, for which we anticipate growth of only 0.9% this year and 1.5% next (Figure 3.5). As in the case of private sector consumption, the main adjustment to projections for investment concerns 2017, for which we anticipate a less strong recovery than we foresaw three months ago. The base scenario presented here also assumes a gradual recovery in exports, which will contribute positively to growth, especially in 2017, helped by a recovery in our trading partners' growth and a stabilisation of the terms of trade.

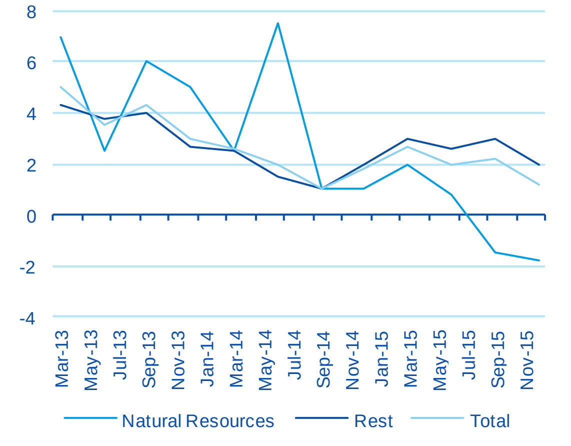
In terms of sectors, beyond the volatility that is typical of the sectors related to natural resources, growth in the rest of GDP - which is more significant for gauging spare capacity - has also moderated, and we do not expect this situation to change materially this year or next. Thus we predict that the economy will continue operating with spare capacity, which is consistent with persistent limited inflationary pressure from demand (Figure 3.6). All the same, this spare capacity is limited, since we have reassessed our estimate of long-term growth to rates around 3%

Figure 3.5
Effects of government consumption and public investment on GDP growth (pp)



Source: Central Bank of Chile, BBVA Research

Figure 3.6
Total GDP, natural resources and other (Change % YoY)



Source: Central Bank of Chile, BBVA Research

In summary, we consider that although the economy has already made much of the macro-adjustment during the last two years, we see very few signs of recovery in the determinants of private sector demand, and this, together with a reduction in fiscal room for manoeuvre, leads us to be more cautious as regards GDP growth next year and to anticipate a rate of expansion that will not be materially different from that of the period 2014-2016.

Box 1. Stylised facts about confidence indicators: no neutrality until the end of 2017

Confidence persistently in pessimistic territory

In this box we analyse the extension of the confidence cycles in a broad sample of countries including Chile, with the purpose of measuring the duration of the periods of distrust and obtaining estimates of the appropriate period for estimating neutrality[2].

Consumer confidence: slow recovery to neutral levels

The first observation that can be made on the basis of the data is that consumer confidence does indeed show cyclical behaviour. In the sample of countries considered, including the aggregate of the OECD, it is not possible to observe periods of permanent pessimism or optimism, and in the majority of cases, about 50% of the time the indicator is above the pivot point and close to 50% of the time it is below the pivot point. This observation is significant in that it provides a certain support to the projections' considering that the economy is passing through a cyclical period of mistrust, which should however reverse sooner or later. However, on average the OECD countries are more optimistic than Chile.

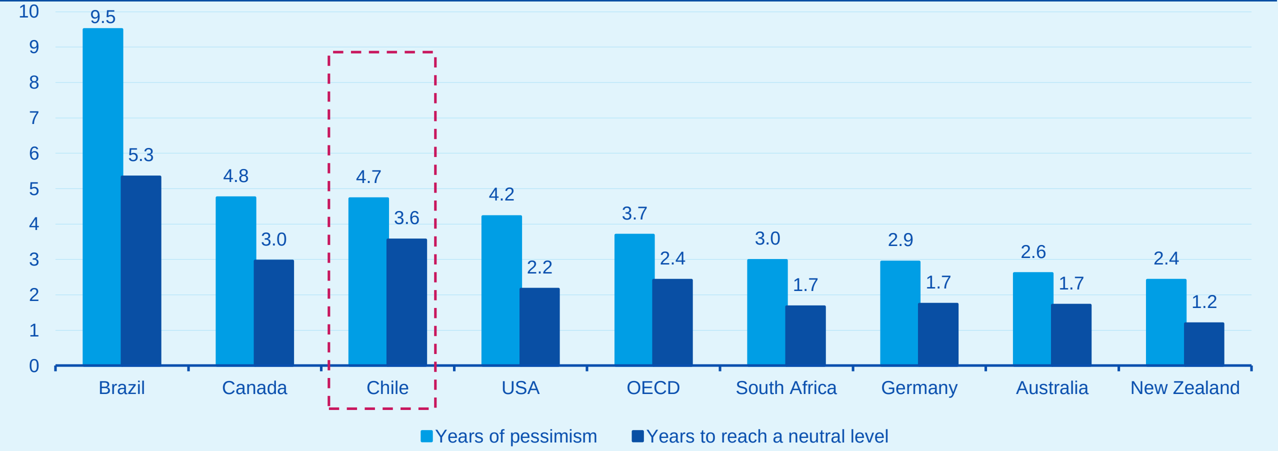
The immediate question arising is how long it will take for levels of distrust to reverse. To answer this it is necessary to establish a somewhat more precise metric for measuring the cycles. We consider periods in which the confidence index was below the threshold for at least 18 months, to catalogue a cycle of pessimism. With this criterion we succeed in identifying 36 phases of pessimism from 1960 to today, depending on the availability of data for each country. We now go on to calculate their average duration and how long it took the indicators to return from their low points to the neutral level.

The results indicate that for the OECD countries the average duration of the periods of distrust was 3.7 years and that, on average for all these countries in aggregate, confidence took 2.4 years to recover from its low point to neutral levels. In the case of Chile, the data show that the cycles of pessimism[3] last on average 4.7 years, with a recovery phase extending on average to 3.6 years (Figure R.1.1). The foregoing indicates that the phases of generally deteriorating confidence are not symmetrical but the indicator's return toward its low points tends to be faster than recoveries towards the neutral level. Confidence is quickly lost but takes time to recover.

Lastly, regarding the question as to how long this phase of domestic consumers' pessimism could last, based on the experience of this set of countries we see that if we take the average time as a reference, there is room for the current bout to last as long as two more years, i.e. until the first half of 2018. This calculation takes as its reference the average duration of the cycles of consumer pessimism in the OECD countries on aggregate. In these two years we could see either periods of further deterioration in confidence followed by a period of recovery, or a long period of recovery in confidence to neutral levels.

2: Apart from Chile, the sample of countries includes Australia, Brazil, Canada, Germany, New Zealand, South Africa, the US and OECD countries. These countries were chosen considering similarities in the framework of policies or characteristics of exporters of commodities, as well as criteria of availability of long time series, which was especially significant in the case of the developed countries and in the aggregated case of the OECD.
3: We carried out sensitivity tests, varying this threshold between 15 and 20 months, and found no great changes in the results.

Figure R.1.1
Consumer confidence index: average time of pessimism and recovery



Source: BBVA Research based on OECD data

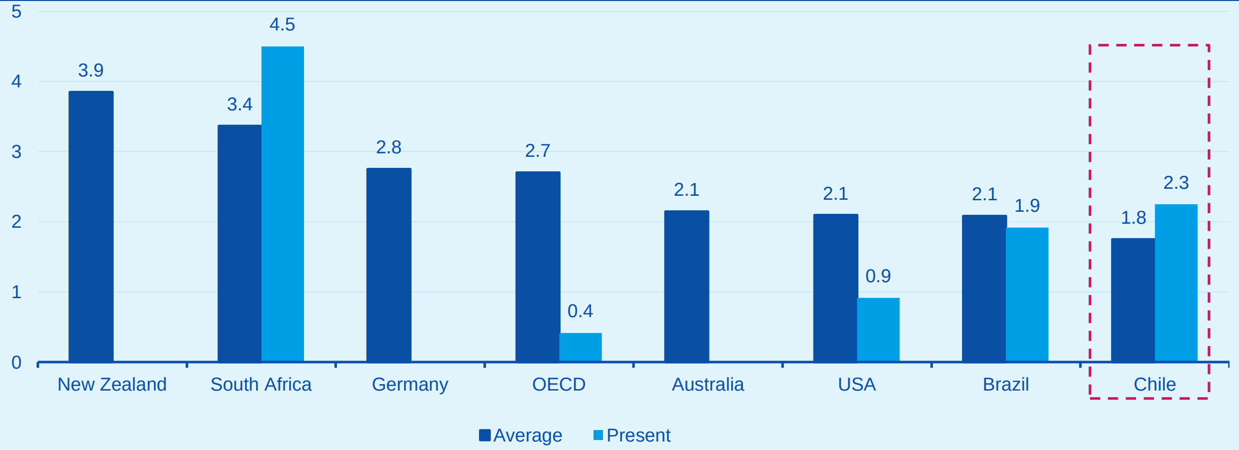
Business confidence: we are close to surpassing the average pessimism time of OECD countries

We applied a similar analysis to business confidence. Again we found that confidence behaved cyclically, with the indicator for the OECD in pessimistic territory 51% of the time. The analysis of 40 business confidence cycles revealed that their duration was less than that of the consumer confidence cycles in the OECD countries, although at country level there was a degree of disparity. For example in New Zealand and South Africa cycles of pessimism tend to be longer for businesses than for consumers[4]. Consequently, if business confidence in Chile were to behave like the average for the OECD, we could expect it to reach neutral levels somewhat before consumer confidence.

For the OECD the average duration of the phases of business pessimism is 2.7 years. Considering that in Chile we have had more than two years of pessimism, this cycle shows every sign of lasting longer than can be considered normal or standard. If we take as a reference countries like New Zealand or South Africa, where cycles of business confidence have the longest average duration, then the current cycles of business pessimism still has between a year and eighteen months left to run, in other words it will not end until well into 2017 (Figure R.1.2).

4: Account is taken of cycles of confidence for this sample of countries from 1950 to the present, depending on the availability of data for each country.

Figure R.1.2
Business confidence index: time of pessimism (years)



At present business confidence in New Zealand, Germany and Australia is not in pessimist territory.
Source: BBVA Research based on OECD data

4 The current account deficit is stable as a percentage of GDP and does not constitute a macroeconomic risk

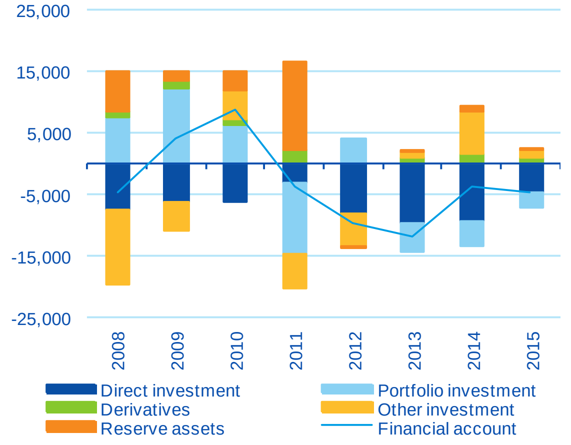
Weakness in external demand and less favourable terms of trade will delay the closing of the current account deficit, which will remain at around 2% of GDP at the projected horizon, well below the level at which it would constitute a macroeconomic risk factor.

Last year the external accounts showed a negative balance of US$4.76 billion, nearly US$1.4 billion more than projected three months ago. The surprises came from every component, most notably new statistical adjustments to the balance of trade, mainly in goods for an amount of US$650 million, and an increase of US$660 million in the revenue deficit. In this context, the current account showed a negative balance of 2.0% of GDP in 2015, compared with the 1.4% of GDP projected at the beginning of the year.

All the same, the latest adjustments to the statistical series of trade in goods merely confirm the weak impetus of the external sector component of GDP, despite the sharp adjustment to relative prices channelled through the depreciation of the Chilean peso against the dollar in the past few years. Thus if recovery of the trend growth is to come from the external sector, it would seem to require a greater degree of multilateral weakening of the peso, which is quite a challenge in such a fragile environment for the global economy. Consequently, reliance on external financing continues, but with no imminent risk of becoming unsustainable, driven by the direct investment (FDI) and to a lesser extent portfolio investment components. In particular, FDI is tending to stabilise at levels of around US$20.5 billion (8.4% down on 2014), half of it being driven by greater flows in debt instruments, to the detriment of direct foreign equity holdings and/or ploughing back of profits, a phenomenon observed since 2012 (Figure 4.1). Low external interest rates and what would appear to be the end of the major part of the currency depreciation still make this form of leverage attractive, but it also stands out as the main source of risk for the corporate world given the greater degree of credit risk.

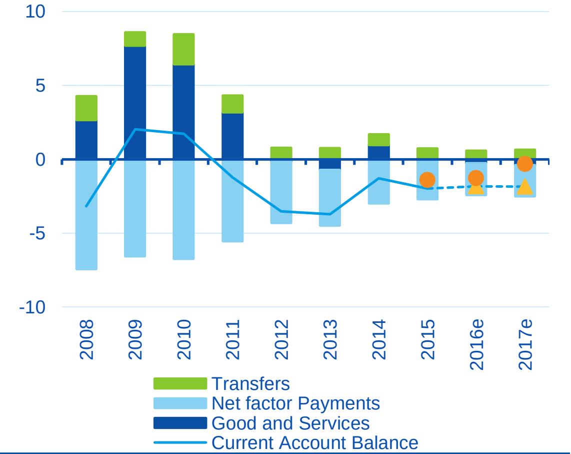
In this context, estimates of the current account balance for the next few years will continue to be characterised by a slow return to equilibrium. In particular, the new downward correction in long-term copper prices - from US$2.60 per pound to US$2.50 per pound due to the lower trend growth expected in China - added to the prospect of continuing weakness in global demand, will continue to weigh on the balance of trade in goods and services. Lastly, we expect the revenue balance to remain stable but to contribute about US$6 billion a year to the annual deficit, due to the stabilisation of remittances and a slight recovery expected in corporate margins - in particular in the mining sector - once the effects of the depreciation of the peso have worked through. Even so, we have corrected the external deficit expected for this year from 1.3% to 1.8% of GDP (equivalent to about US$4.44 billion), while for 2017 we see a negative external balance of around 1.9% of GDP (as opposed to 0.3% previously), with no significant progress towards closing the deficit, but with no risk of non-sustainability either (Figure 4.2).

Figure 4.1
Financial accounts by source (US$ millions)



Source: Central Bank of Chile, BBVA Research

Figure 4.2
Current account balance (% of GDP)



Source: Central Bank of Chile, BBVA Research

5 Inflation could recede more than expected by the consensus, to below 3% in 2017

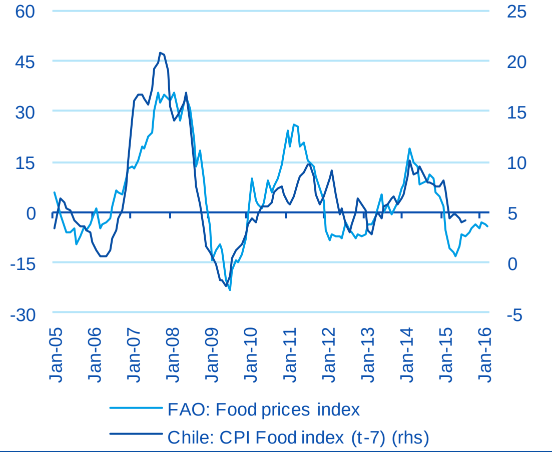
We have revised our inflation forecast downwards, from 3.7% to 3.2% for this year and from 2.9% to 2.5% for 2017. The downward correction to projections is largely explained by the projection of a stronger peso and a somewhat greater slowdown in inflation of services.

During the first quarter CPI inflation continued above the ceiling of the central bank's range of tolerance, although much influenced by one-off or transitory effects on certain products in the basket. Notable among these were the effects of the Tax Reform on financial expenses and cigarettes and the delayed effects of past high inflation on electricity charges and education. Even so, the CPI for March, which is usually one of the highest of the year, increased by just 0.38% MoM, less than forecast by analysts and less than factored into the price of financial assets, leading to sighs of relief from many who had been fearing a new upturn in inflationary pressures. In light of these data, which also included a reduction in dispersion towards more normal levels, we have moderated our projections of inflation for the end of the year.

However, since our last report the nominal rate of exchange (pesos per US$) has evolved favourably for relieving future inflationary pressures, since the dollar has depreciated globally against other major currencies and the price of copper has increased (more details in Chapter 8). This is a relief for companies' profit margins, which have been squeezed significantly in the past few years. Consequently, and given our forecast of a lower average exchange rate in 2016, we are now projecting that inflation of goods will start to slow significantly from the second half of the year, mainly via imported consumer goods (see Box 2).

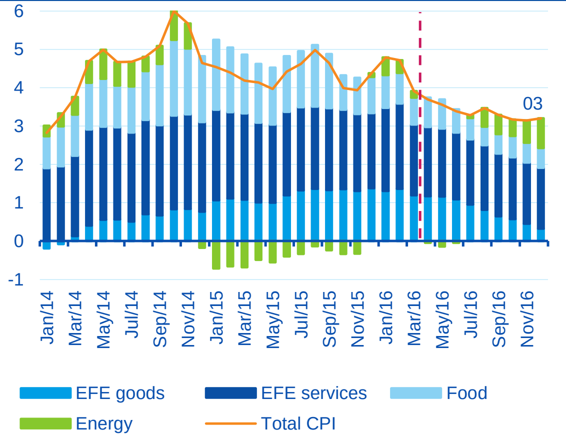
Similarly, food inflation in Chile continued to slow in the first quarter, albeit to a limited extent due to international prices in pesos having started to increase relative to their low points reached towards the middle of last year (Figure 5.1). However, we consider that the low international food prices have yet to be passed on in domestic prices, and that this will take place over the remainder of the year. In view of the foregoing factors we have revised our projection of annual inflation downwards, from 3.7% to 3.2% for whole-year 2016 (Figure 5.2).

Figure 5.1
Food prices (change % YoY in pesos)



Source: Bloomberg, FAO and BBVA Research

Figure 5.2
Projection of CPI inflation by components (Change % YoY)*



*Information from dotted line on corresponds to projection.
Source: INE (National Statistics Institute) and BBVA Research

For 2017 we foresee limited inflationary pressures from external factors, while the economy will continue to operate with spare capacity - more than estimated in our last report. This is consistent with limited inflationary pressures on demand, which will manifest themselves mainly through a moderation in inflation of services, complementing the deflationary effect associated with the appreciation of the peso. Thus, we project that inflation will continue to fluctuate below 3% over the course of next year, closing at 2.5% in December.

Box 2. Imported consumer goods in inflation

Depreciation contained for now

Currency depreciation has been the main factor behind the current over-target levels of CPI inflation. Nonetheless, and in spite of the high volatility, we have recently observed significant degrees of containment of the level of the exchange rate, with the currency even appreciating so far this year, which we believe would reflect the fact that much of the exchange adjustment has already been completed.

CPI goods more sensitive to exchange-rate pass-through

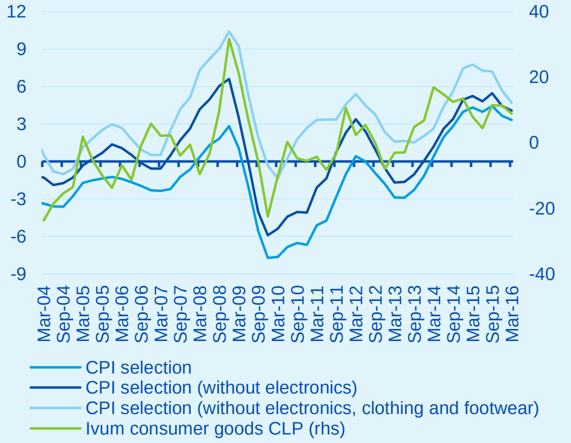
In this environment, the question arises as to what would be the most likely trajectory for the prices of a given set of imported goods, which we believe are the most sensitive to changes in the exchange-rate.

The products sharing this characteristic and whose prices we can capture in aggregated form include new cars, several electrical and electronic products - televisions, computers and mobile phones, among others -, household appliances, clothing and footwear, perfumes and personal care products, imported alcoholic and soft drinks, manufactured and processed foods.

We obtain the information on the prices of these products from the IVUM (import price indexes) for consumer goods[5]. When we contrast the IVUM with a weighted index of prices for these CPI products, we see contemporaneous transfers between the IVUM for consumer goods and this set of prices in the CPI basket (Figure R.2.1).

We devised several different ways of aggregating these products so as to eliminate certain structural effects such as the secular fall in prices of electronic goods, clothing and footwear.

Figure R.2.1
IVUM (import price indexes) in pesos and set of CPI goods (Chge. % YoY)



Source: Central Bank of Chile, INE (National Statistics Institute) and BBVA Research.

As can be seen in Figure R.2.1, when these products are excluded, higher exchange-rate pass trough are seen.

We should stress that the products considered amount to a weighting of close to 27% of the CPI basket, so analysing and projecting them should enable us to obtain a good approximation to the contribution of these goods to inflation in the remainder of the year.

Will goods imported this year cease to inject inflation?

At present, this group of goods in the CPI basket is slowing, showing weighted price growth of 3.3% YoY with an incidence of +0.86 pp on the annual CPI, nearly one fifth of the 4.5% YoY inflation observed as of March 2016. According to our base scenario - both for international prices of imported goods and for the peso/dollar exchange rate[6] - this incidence will be gradually diluted over the course of the year, and we think it highly likely that its contribution will become deflationary between Q4 2016 and Q1 2017 and that it will cease to be a significant contributor to CPI inflation at the projected horizon.

5: Based on the external trade statistics of Banco Central de Chile. The IVUM (index of unit value of imports) for consumer goods captures the value in dollars of these products, so it is corrected to take account of fluctuations in the exchange rate to obtain an IVUM of consumer goods in local currency.
6: For further details on the assumptions, please refer to Table R.2.1.

Given the high volatility and the recent surprise appreciation of the Chilean peso, we have constructed risk scenarios for inflation of this set of products, which would be triggered by alternative trajectories for the exchange-rate. For the rest of the products in the price basket we used the projections from the base scenario. In different exchange rate scenarios we would also expect to see significant effects on products not taken into account in the results presented in Table R.2.1.

Thus we see that in a scenario with a stronger peso - about 5% stronger than in our base scenario - the incidence of this set of CPI products will be clearly deflationary, by about 0.5 pp relative to the zero contribution of the base scenario at the end of 2016. This alternative exchange rate scenario would be consistent for example with less uncertainty about China's growth and copper prices recovering by more than expected.

Alternatively, in a scenario of further bouts of weakness for the peso, leading it to depreciate by 5% more than in the base scenario, the reduction in the inflationary incidence of this set of products on the CPI towards year-end would be less than in the most likely scenario, i.e. from the current +0.86 pp it would not fall below +0.49 pp in December. This could come about, for example, as a result of the US Federal Reserve's adopting a more hawkish and hurried approach to monetary normalisation, leading to renewed bouts of short-term depreciation for the Chilean peso.

All in all, we see that the deviations from the base scenario in year-end exchange rates place our expected year-end 2016 CPI inflation in a range of 2.7% to 3.7% YoY, whereas in the central scenario it is 3.2%.

Table R.2.1
Projection of CPI inflation for 2016

	Current (March 2016)*	Base scenario (as of December)	Risk of appreciation (as of December)	Risk of depreciation (as of December)
CPI inflation (chge. YoY %)	4.5	3.2	2.7	3.7
Inflation set of goods CPI (chge. YoY %)	3.3	-0.1	-2.0	1.9
Incidence of goods associated with the IVUM (import price indexes) (pp)	+0.86	-0.02	-0.53	+0.49
Exchange rate (chge. YoY %)	7.4	-2.9	-7.7	2.0
Exchange rate as at December 2016 (pesos per US$)	675	684	650	718
IVUM (import price indexes) in USD (chge. YoY %)	-4.6	0.2	0.7	-0.3

* In the case of the IVUM (import price indexes) in US$, the information corresponds to Q4 2015.
Source: Central Bank of Chile, INE (National Statistics Institute) and BBVA Research.

6 Soon a neutral bias would allow cuts in the central bank's policy rate, but for now prolonged hold is the most likely scenario

Three months ago we were pointing out that room for continuing to withdraw monetary stimulus was running out. This was ratified by the Central bank in its March Monetary Policy Report and by the moderation of the contractive bias in April's meeting.

We predict that the bias of monetary policy will shift from contractive to neutral, giving way to a prolonged period in which the central bank's policy rate will remain at 3.5%. Although the base scenario does not envisage rate cuts, they cannot be ruled out in advance.

In our report for the first quarter we pointed out that room for continuing to withdraw monetary stimulus was running out and, contrary to the consensus view at that time, brought about by the central bank's communication of monetary policy projecting two rate hikes this year, we projected just one additional increase, which we thought would take place in March or April of this year.

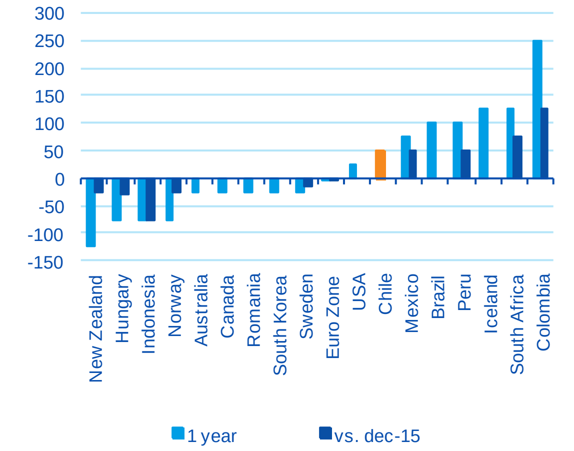
Although the March IPoM and the moderation of the contractive bias at the April RPM (monetary policy meeting) confirmed our view of just one more rate hike in the remainder of this year, we believe there is still room for open discussion on the view of interest rates, since we continue to see downside risks to activity, especially in 2017, with a slower recovery in private sector demand in the second part of the year compared with that envisaged by the central bank and with inflation moving rather faster to the target, or below it, at the monetary policy horizon.

Internationally, monetary policy has become more expansive in the past three months, with interest rate cuts in some economies, expansion of quantitative stimuli in others and prospects of a slower pace of normalisation as in the case of the US, albeit with notable exceptions in some Latin American countries (Figure 6.1). All this has happened in a context of downward revisions to estimates of world growth and very little global inflationary pressure, as described in Chapter 2 of this report.

Thus the base scenario of this report is consistent with the central bank's key interest rate being held steady throughout this year and next, which should naturally be anticipated by a shift in the bias from contractive to neutral. Additionally, we do not now see the central bank's key interest rate moving to neutral levels before 2018, although we do not discount the possibility of earlier cuts being necessary. Indeed, moving from a contractive to a neutral bias implies in practice that the there are similar probabilities of cuts or increases in interest rates, and given the risks we see for the base scenario, we consider that the possibility of interest rate cuts in the next two years cannot be ruled out.

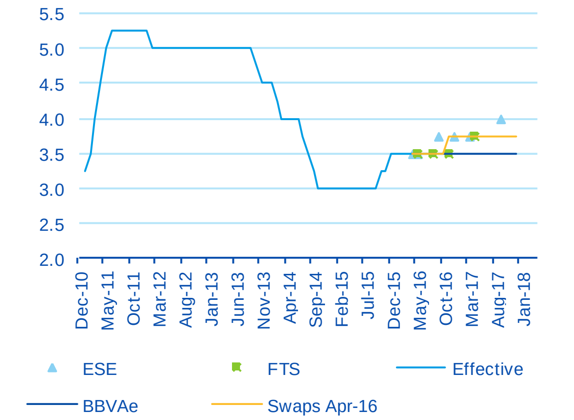
This view has not yet been factored in to economic agents' expectations, although various surveys and the prices of financial assets are postponing the next rate hikes. For example, the most recent Survey of Economic Expectations projects a hike of 25 basis points in the next five months and another one of the same amount in 17 months' time; the Survey of Financial Operators projects an interest rate increase of 25 basis points in 12 months and a level of 4% in 24 months (Figure 6.2).

Figure 6.1
Monetary policy interest rate adjustments in selected countries (basis points)



Source: Bloomberg and BBVA Research

Figure 6.2
Effective and estimated Monetary Policy Rate and trajectories implicit in swaps and surveys (percentage)*



* Central Bank of Chile Survey of Economic Expectations, data as of April 2016 and Survey of Financial Operators, data as of the second week of April 2016.
Source: Central Bank of Chile, Tradition and BBVA Research

7 A new adjustment to the structural parameters would limit growth in public spending to less than 4% in 2017

We predict that a further cut in the reference parameters, plus closing in on the target of structural equilibrium, will curtail room for spending in 2017, growing by just 3.4%. From 2019 on, in the absence of new resources from Tax Reform, scope for expenditure narrows significantly.

The beginning of 2016 was marked by the announcement of fiscal adjustment by the Ministry of Finance at the end of February. It announced a cut in the expenditure approved by the Budget Act of approximately 1% (US$540 million), 70% of it in current expenditure and 30% in public investment. This change reduced even further the already diminished incidence that public expenditure would have on growth this year, actually leading it (mainly public investment) to have a slight negative incidence (Figure 3.5).

Given the announcement of fiscal adjustment, together with the updating of the macroeconomic scenario, we estimate growth of 4.2% in public spending for 2016 and an effective deficit of 2.7% of GDP. The reduced growth in public expenditure relative to that envisaged three months ago is due exclusively to the fiscal adjustment. The lower effective deficit compared with our previous projection and the Ministry of Finance's estimate is due to the reduced expenditure and the increased revenues projected. On this last point, although the projected scenario is more degraded in terms of activity, and the currency stronger (two drivers of tax revenues), the improved outlook for copper prices and revenues not included in our previous projection, incorporated in the first few months of the year (pending transfers from Codelco, repatriation of capital and taxes on fuels) raise our outlook for total revenues. In any case, our estimates are subject to the results of Operation Revenue, to be carried out in April and May, which will be a new challenge for the effectiveness of the government's tax collection in a new phase of implementation of the Tax Reform. Lastly, we see no need for further indebtedness or for dipping into the sovereign wealth funds this year.

We foresee that as a result of the consultations with the committees of experts in mid-year the new reference price for copper will fall from US$2.57 per pound to US$2.40 per pound. We also estimate that the experts will reduce trend GDP from 3.6% to 3.2%[7]. This leads us to estimate a structural deficit of 1.3% for the year. For the projection of the fiscal situation in 2017-2020 we follow the government's commitment to converge by 0.25% of GDP per year. Table 7.1 shows our projections.

Table 7.1
Projection of main fiscal variables

	2016	2017	2018	2019	2020
Trend GDP (change YoY)	2.7	2.7	2.7	2.7	2.7
Reference price of copper (USc/lb)	257	257	257	257	257
Target Structural Balance (% of GDP)	-1.2	-0.95	-0.70	-0.45	-0.20
Effective balance (% of GDP)	-2.7	-2.8	-2.5	-2.1	-1.7
Growth in spending (change YoY)	4.2	3.1	4.2	1.0	0.9

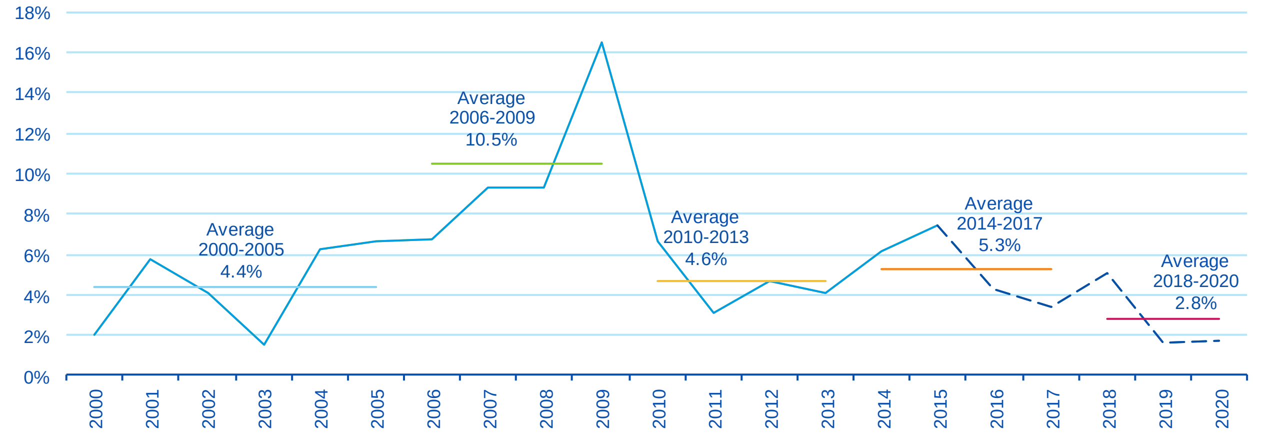
Source: BBVA Research

7: As every year, both figures will be revised by the experts before the presentation of the Budget for 2017.

The new figures do not change our perception that 2017 will be a year of very little margin for Budget growth. We see expenditure growing by 3.4%. What is more, the adjustment to the growth outlook for next year and its effect on revenues will man that 2017, not 2016, will be the year with the biggest fiscal deficit since the crisis (2.9% of GDP), even with the limited growth in expenditure. For the following years, we continue to point to the risk of lower growth in tax revenues after 2018 when the tax reform comes into force, leaving very limited room for growth in expenditure from 2019 on (Figure 7.1). If that happened, it would lead to the start of a more profound process of fiscal adjustment, in which government consumption, and above all public investment, would cease to make any significant contribution to growth. In the scenario we consider most likely, expenditure would barely have room to grow from 2019 on. The alternatives in this context are the following:

- Upward corrections in the benchmark price of copper and trend GDP growth. This is beyond the scope of decision of the authority.
- Promote awareness in the population and in the political sphere of the fact that spending cannot continue to grow indefinitely and may have to remain constant in real terms in some years or even be reduced in others. This would involve abandoning certain government reforms, and would leave very little room for manoeuvre to the next administration.
- In view of the growing social demands implying that spending must continue growing at 3-4% per year as a minimum (i) abandoning the objective of achieving structural equilibrium or ii) carry out another tax reform that will deliver incremental resources for a few more years, which would have to be discussed and approved during 2018.

Figure 7.1
Growth in public spending and averages per period 2000-2020



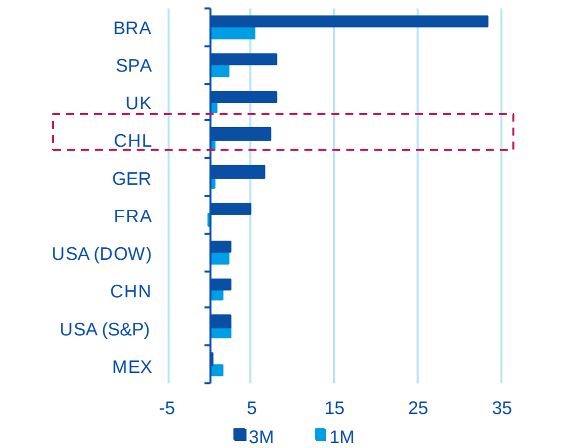
Source: Budget Office and BBVA Research

8 Too much appreciation of the peso would not be good for the recovery

In our previous report we projected a moderate nominal appreciation of the peso at the projected horizon (2016-2017), consistent with a recovery in the price of copper and a multilateral weakening of the dollar. Although this has materialised, the intensity has been greater than the cyclical position of the economy would suggest. Although long-term peso interest rates have held steady, the risk of an increase in the base rate associated with a widening of term premiums continues to exist.

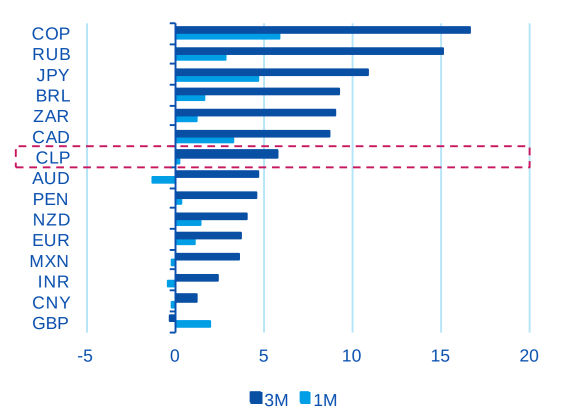
Uncertainty about the development of China's economy persists, although the recovery in the price of oil and other commodities has mitigated risk aversion and favoured emerging market currencies. In that context, the Chilean stock exchange has recovered by a cumulative 8% measured in dollars since the end of January (Figure 8.1). Apart from this, rising oil prices have been a fundamentally decisive factor in the appreciation of various oil-exporting countries' currencies, as is the case of the Colombian peso, the Russian rouble, the Brazilian real and the Mexican peso (Figure 8.2).

Figure 8.1
Main stock exchanges in the world (USD, % variation)



Source: Bloomberg and BBVA Research

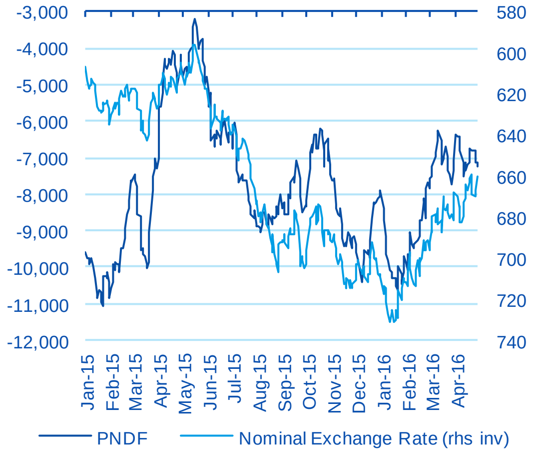
Figure 8.2
Exchange rates (units of local currency per dollar, percentage)*



*An increase indicates appreciation of the national currency, while a decrease means depreciation of the national currency against the dollar.
Source: Bloomberg and BBVA Research

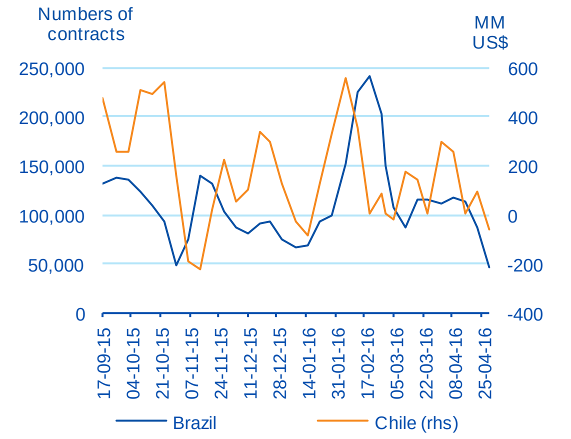
In Chile, the peso has appreciated since our last report, reaching levels below $670 to the dollar towards the end of April. This development coincided with a significant surge in interest rate arbitrage transactions using derivative instruments (carry trade) for some US$2.5 trillion, eloquent testimony to global investors' appetite for resuming a degree of exposure to risk on Chile (Figure 8.3). All the same, in the recent economic situation the Chilean peso has been favoured, even rather more than Chile's trading partners' currencies, as shown by the CLP's multilateral appreciation, which is also to some extent due to the significant appreciation of the Brazilian real, win which we have seen carry trade transactions in parallel with those in the Chilean peso (Figure 8.4).

Figure 8.3
Net position in the external derivatives market and nominal exchange rate (US$ millions, pesos per US$)



PNDF is the net NDF position of national banks with non-residents.
Source: Central Bank of Chile, Bloomberg and BBVA Research

Figure 8.4
Net position in the external derivatives market Chile vs. Brazil*



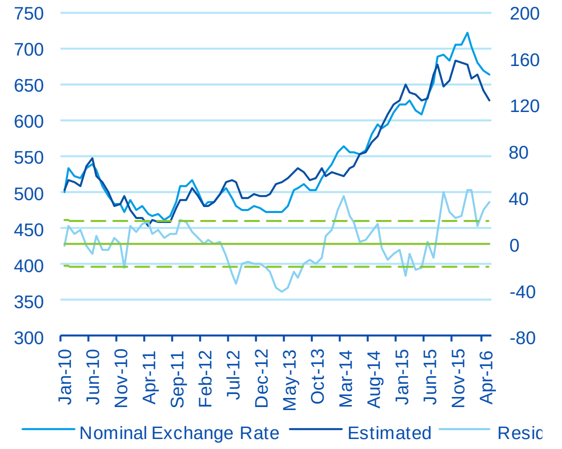
* Two-week moving average. For Brazil it corresponds to the contracting of daily flows between residents and non-residents of USD/BRL futures. For Chile it corresponds to the change in the stock of NDF.
Source: Central Bank of Chile, BM&F Bovespa and BBVA Research

Our view of the CLP's having depreciated somewhat more relative to fundamentals in the previous report was subsequently accompanied by significant multilateral appreciation. From the reassessment of the misalignment we deduce that the appreciation was significant, albeit somewhat less than suggested by the fundamentals (Figure 8.5). Although we do not believe there would be room for fundamental depreciation taking the exchange rate above 700 pesos to the dollar, nor do we believe that cyclical conditions support a nominal exchange rate consistent with a real exchange rate at or below its historical average (Figure 8.6).

We consider that the rate of exchange should remain at levels above its historical averages in order to facilitate the reallocation of resources to exporting sectors other than mining and so allow recovery from the cyclical position of the economy. Support from monetary policy, justified certainly by medium-term deflationary effects, might be necessary. In fact the central bank has already indicated that the recent appreciation is not conducive to economic recovery.

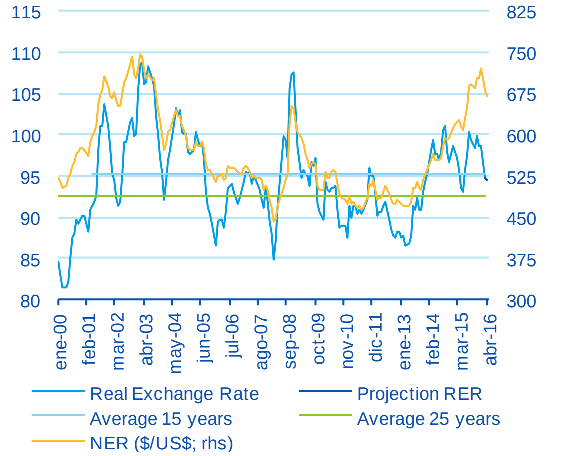
In the short term, due to the high volatility in the global financial markets, we do not rule out further depreciation of the CLP, which could bring the rate back to levels of around 700 to the dollar, but we do not consider that the conditions would exist for working permanently with those levels. The most likely range would be from 650 to 700 pesos to the dollar over the next few quarters.

Figure 8.5
Actual and estimated exchange rates (pesos per US$)*



*Model for determining the nominal exchange rate based on movements in the price of copper, business confidence, the dollar index and the interest rate differential between Chile and the USA.
Source: Central Bank of Chile and BBVA Research

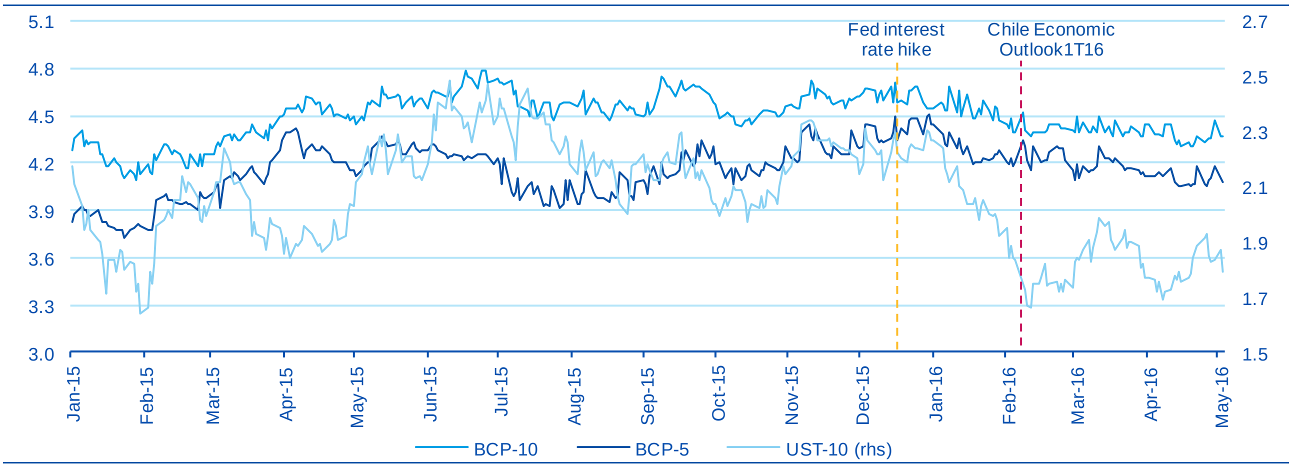
Figure 8.6
Index of the average real exchange rate (1986 = 100)



Source: Central Bank of Chile and BBVA Research

Five- and ten-year benchmark interest rates in pesos have held steady since our last report, as have their international counterparts (Figure 8.7). In the base scenario, interest rates on long-term instruments in both pesos and dollars are adjusted upwards at the projected horizon, although to a limited extent, in line with the process of monetary normalisation in the US However, interest rates of long-term instruments could fall back and continue at historically low levels following the moderation of the contractive bias in Chile's monetary policy and greater caution on the part of the US Federal Reserve in normalising interest rates.

Figure 8.7
Local and external interest rates (%)



Source: Bloomberg and BBVA Research

9 Balance of risks for activity shows a downward bias, with China standing out as the main threat

At domestic level there remains a risk that the pace of recovery in confidence will be slower than forecast in this report, which assumes neutrality towards the end of 2017. A further domestic risk is that the peso will be stronger than is appropriate to supporting cyclical recovery, leading to greater falls in inflation in the medium term, with a delayed reaction from monetary policy.

Externally, a global scenario of lower growth materialized, which was a risk referred to in our previous report, but real and financial risks persist in the Chinese economy, with effects over copper prices.

The main risk for Chile is the performance of the Chinese economy. News reports indicate stability in manufacturing, but employment and weak external demand continue to exert pressure and could lead to abrupt adjustments to the yuan, with consequences for the price of copper. Although we continue to expect a gentle slowdown of the economy and we have adjusted China's growth downwards for the next few years, it is not possible to rule out a scenario of abrupt adjustment which, as we have pointed out, would have a significant impact on commodity prices, fiscal revenues, exports, investment and, bottom line, growth. This risk was mentioned in the last few editions of this report: just lately it has seemed to recede somewhat thanks to the dollar's global depreciation which has supported commodity prices. Looking ahead, concerns remain about a more marked slowdown amid doubts surrounding the fragility of its financial system. There has also been a generalised increase in the perception of risk on the emerging markets in general. A downturn in China's economy would have a significant impact on emerging markets, transmitted through both financial channels and the real economy.

Another external risk factor referred to in earlier reports is the effect that the start of the process of monetary normalisation in the US would have. However, extraneous circumstances have led to a more hesitant process, which has relieved the pressure on Chile's monetary policy, allowing it to remain longer at stimulus levels. However, a new risk emerges in this report, regarding an appreciation of the currency that would leave the real rate of exchange below its historical average, which we believe could delay a cyclical recovery and limit the reallocation of resources to non-mining commercial sectors. Undue delay in monetary policy action could not only leave the peso too strong in real terms but also push medium-term inflation down below levels consistent with the inflation target.

How the mining sector evolves also poses a risk to the growth outlook for the next few years, since a scenario of further falls in the price of copper cannot be ruled out. This would involve further adjustments to mining output, with negative effects not just on this sector but on all the sectors providing services to mining and those that benefited in the past from the copper price boom such as trade, construction and financial services. A scenario such as this would, of course, also have a more negative impact on employment.

10 Tables

Table 10.1
Macroeconomic forecast

	2013	2014	2015	2016	2017	2018
GDP (% YoY)	4.2	1.9	2.1	1.7	2.0	2.5
Inflation (% YoY, eop)	3.0	4.6	4.4	3.2	2.5	3.0
Exchange Rate (vs. USD, eop)	529	613	704	684	658	631
Interest Rate (%, eop)	4.50	3.00	3.50	3.50	3.50	4.00
Private Consumption (% YoY)	5.5	2.4	1.5	1.5	1.9	2.3
Government Consumption (% YoY)	3.5	5.1	4.8	4.3	2.7	3.7
Investment (% YoY)	2.2	-4.2	-1.5	0.9	1.5	2.5
Fiscal Balance (% GDP)	-0.6	-1.6	-2.2	-2.7	-2.8	-2.5
Current Account (% GDP)	-3.7	-1.3	-2.0	-1.8	-1.9	-1.8

Source: BBVA Research

Table 10.2
Macroeconomic Forecast

	GDP (% YoY)	Inflation (% YoY, eop)	Exchange Rate (USDCLP, eop)	Interest Rate (%, eop)
1Q14	2.7	3.5	563.8	4.00
2Q14	2.3	4.3	553.1	4.00
3Q14	0.9	4.9	593.5	3.25
4Q14	1.6	4.6	612.9	3.00
1Q15	2.7	4.2	628.5	3.00
2Q15	2.1	4.4	630.0	3.00
3Q15	2.2	4.6	691.7	3.00
4Q15	1.3	4.4	704.2	3.50
1Q16	1.5	4.5	682.1	3.50
2Q16	1.8	3.9	675.3	3.50
3Q16	1.6	3.0	680.4	3.50
4Q16	1.9	3.2	684.0	3.50
1Q17	1.6	2.9	670.0	3.50
2Q17	1.8	2.9	662.8	3.50
3Q17	2.2	2.9	657.2	3.50
4Q17	2.2	2.5	657.5	3.50
1Q18	2.2	2.8	649.7	3.75
2Q18	2.2	3.0	641.4	4.00
3Q18	2.9	3.0	636.1	4.00
4Q18	2.9	3.0	630.7	4.00

Source: BBVA Research

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