Chile Economic Outlook

3rd QUARTER 2016 | UNIT: CHILE

01
Growth forecast for 2017 adjusted downwards to 1.8% following the materialisation of external and internal risks.

02
Currency appreciation has been excessive, making recovery difficult and with a potential risk of generating significant disinflationary pressures.

03
We foresee two cuts in the MPR in the next 12 months. The first would occur in 4Q16.

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China continues to be the main external risk, but delayed reaction by monetary policy is the greatest local risk.

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Closing date: 05 August 2016

1 Editorial

The global economy continued its moderate growth of previous months, with some improvement in the emerging economies. Brexit brought with it a substantial increase in financial volatility, common to most asset classes. Its effect, however, was transitory and non-systemic. The search for yield in an environment of very low interest rates and the relief produced by the Fed's delaying its action on financing conditions encouraged the redirection of capital flows to the emerging countries, which in July received the largest inflow of foreign capital since 2013.

Downward adjustment of the 2017 growth estimate to 1.8% following the materialisation of internal and external risks. Low confidence levels, a deteriorating labour market, tighter credit conditions and less fiscal impulse will hamper a more vigorous recovery of economic growth. Furthermore, a real exchange rate that remains below historic averages is seriously affecting the competitiveness of export sectors and dampening the reallocation of resources to non-mining sectors.

Current account deficit remains at sustainable levels and would close partially next year. A slight recovery in the price of copper and real depreciation of the peso would counteract weak external demand, helping the current account deficit to stand at around 1% of GDP in 2017.

Our inflation forecast remains at 3.2% YoY for December 2016 and under 3% for most of next year. After two years of high inflation linked to a significant currency adjustment process, inflation was 4% in July. We estimate that the pace of convergence toward the target could be faster than forecast by the market and the Central Bank.

Monetary policy is not being as expansive as the economy requires at this stage of the cycle. In a context of weak growth and a risk of inflation unpinning, we forecast that two cuts to the Monetary Policy Rate (MPR) of 25 basis points will be necessary in the next 12 months. This forecast is not consensus, nor is it in line with the Central Bank's moderately contractionary bias, which we consider should change in the short term.

The tightness of fiscal constraints has become more evident with the worsening performance of effective income and possible deterioration of structural parameters. Even in a scenario in which the government meets its commitment to gradually close the structural deficit, it will not manage to do so completely, leaving work for the next administration. In the meantime we are seeing strong spending pressures and we will see an effective fiscal deficit of around 3% of GDP this year and next year. We assume in our base scenario that a maximum of US$2,000 million from the Economic and Social Stabilization Fund (FEES in Spanish) will be used next year to finance the budget.

The economy needs a real exchange rate above historical averages to facilitate the reallocation of resources, which could require support from monetary policy, justified by the mid-term disinflationary effects. The recent appreciation of the peso has been significant and, to a certain extent, higher than that suggested by the fundamentals. The most likely range would be from 650 to 700 pesos to the dollar over the next few quarters.

There is a strong risk of a delayed reaction by monetary policy that will hinder the reallocation of resources and economic recovery and generate greater disinflationary pressures than desired. The risks associated with the lack of recovery in local confidence indicators and a global scenario of less growth have materialised, although the financial and real risks associated with the performance of the Chinese economy have lessened.

2 Global environment: the central banks tackle Brexit

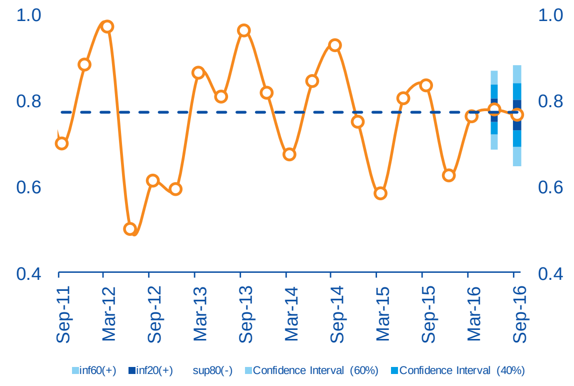
In the past three months the global economy continued the moderate trend of previous quarters, with growth rates of around 3% (Figure 1), well below the pre-crisis rates. Within this average, the developed economies have shown no signs of recovery, whereas we are starting to see some improvement in the emerging economies, especially in Asia. As a result, the globally aggregated data have either improved somewhat or slowed down their decline.

Brexit brought with it a substantial increase in financial volatility, common to most asset classes. Its effect, however, was transient and non-systemic (Figure 2), partly thanks to the response of the central banks, which either delayed the process of normalising interest rates (the US Federal Reserve) or remained ready to strengthen stimulus measures (ECB, BoE and BoJ). In particular, the Fed's response was crucial to how the emerging markets weathered the storm. The search for yield in an environment of very low interest rates and the relief produced by the Fed's delaying its action on financing conditions encouraged the redirection of capital flows to the emerging countries, which in July received the largest inflow of foreign capital since 2013.

In the US, the poor data for the first and second quarters still do not show the expected degree of recovery. This, coupled with the uncertainty surrounding the elections in the second half of the year and global risks (Brexit and other risks in Europe, and in China in the longer term), leads us to reduce our growth forecast for 2016-17 from around 2.5% to around 2%. In addition, in its latest meetings the US Federal Reserve expressed increased doubts about the US economy's potential for long-term growth in productivity and GDP, and this, coupled with the risks of the global economy, led it to put its rate normalisation process on hold. In this context, we now expect the Federal Reserve to announce one additional rate hike this year (probably in December) and two in 2017.

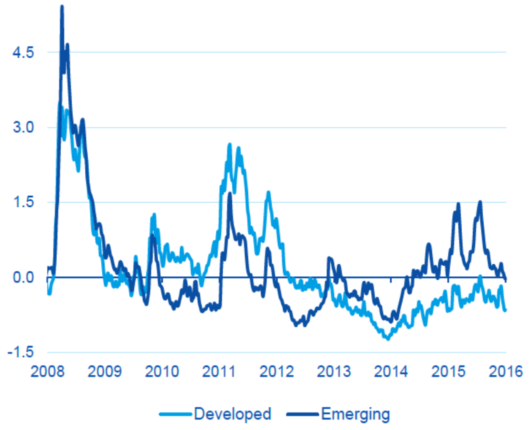
In China, fears of a sharp slowdown in the economy have partly dissipated following the stabilisation of GDP growth at 6.7% in the second quarter, although there are less encouraging signals coming from weak investment, especially by the private sector. However, we are maintaining our forecast of a slowdown in growth to 6.4% in 2016 (from 6.9% in 2015) and to 5.8% in 2017. Short-term risks persist regarding financial stability, the depreciation of the renminbi and capital outflows, as well as the property market and corporate indebtedness, while long-term questions remain about growth prospects due to the slow progress of structural reforms in some key areas, particularly in public companies.

Figure 2.1
Global GDP, % QoQ. 2Q and 3Q forecasts for 2016 based on BBVA-GAIN



Source: BBVA Research

Figure 2.2
BBVA financial stress index (normalised values)



Source: BBVA Research and Haver

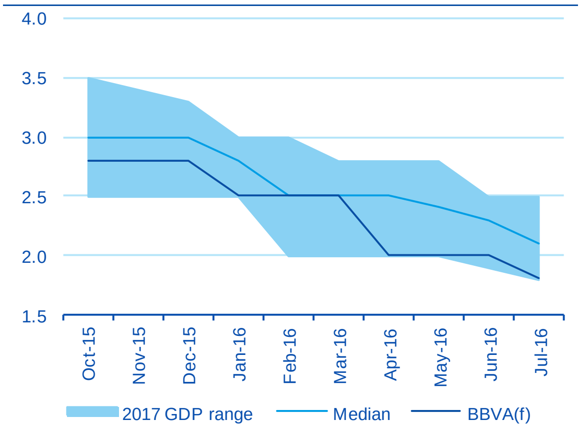
3 We revise downward our 2017 growth estimate to 1.8% following the materialisation of internal and external risks.

A real exchange rate below historical averages is seriously affecting the competitiveness of export sectors and dampening the reallocation of resources to non-mining sectors.

The consensus growth forecasts for this year have remained stable at 1.7% since March. However, for next year they have continued the downward trend that they have been recording since their second reading in April 2015, standing at 2.1% at the close of this report. The IMF also revised its growth forecast for next year downward to 2%, while the Central Bank still maintains the estimated range between 2% and 3%. Although we share the market's growth outlook for this year, we consider that there is still room for additional downward adjustments in the GDP growth forecast for 2017, which we estimate at 1.8%. This figure is 0.2 percentage points lower than that estimated in our previous report, as a result of the materialisation of the internal and external risks anticipated in that report (Figure 3.1).

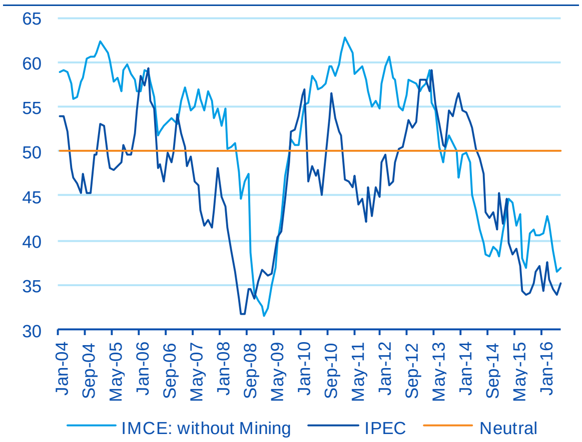
In the first six months of the year, the growth of activity averaged 1.6% YoY. Although in the first quarter of this year growth (2.0% YoY) exceeded our forecasts, the figures for the second quarter point to a growth of 1.1% YoY, slightly less than that anticipated, and therefore for the first half as a whole, the growth we now forecast does not differ greatly from that forecast in May. Looking forward, we can see that risks have materialised for the growth of both internal and internal demand, which will hinder a vigorous recovery of private spending in the second half of the year. The consumer and business confidence, far from recovering, has continued to fall and, as we said before, it is possible that it will remain pessimistic until well into 2017 and even into early 2018 (Figure 3.2).

Figure 3.1
2017 growth forecast: consensus and BBVA (%)*



* The consensus forecast is that set out in the Economic Forecast Survey of July 2016. Source: Central Bank of Chile, BBVA Research

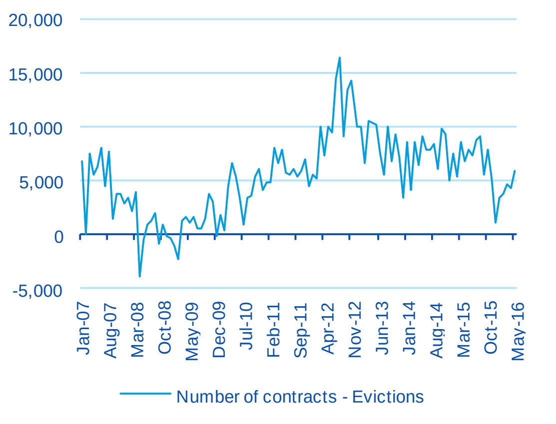
Figure 3.2
Consumer and business confidence (IPEC and IMCE respectively)*



* 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, Adimark, ICARE, BBVA Research

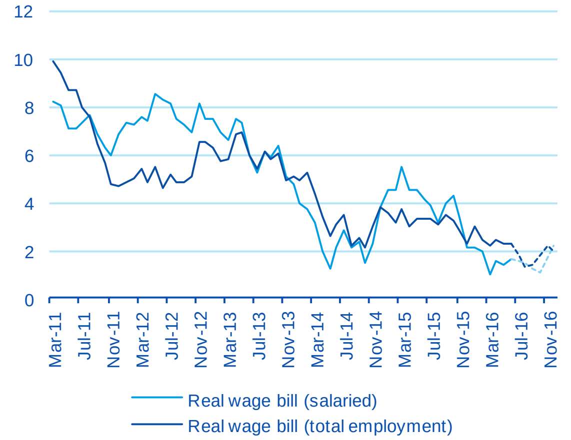
Furthermore, over the last few months we have seen a clearer deterioration of the labour market. This is reflected not only in a significant increase in the unemployment rate, but also the cautious growth of wage employment and a constrained wage dynamic. Other indicators such as the difference between the number of new contracts and lay-offs by private health insurance companies (ISAPREs) confirm this downward trend (Figure 3.3). Therefore, the reduced growth of the real wage bill continues, which, added to the above-mentioned deterioration in confidence and less-expansive financial conditions, explains the more cautious behaviour of families, leading to low growth in private consumption (Figure 3.4). We do not anticipate a significant recovery of private consumption factors in the next 18 months, which makes us sceptical about the performance of this component of demand. With an average unemployment rate of 6.6% this year and 7.2% next, and assuming neutral confidence levels only in early 2018, among other assumptions, we forecast that private consumption will grow 1.4% and 1.5% in 2016 and 2017 respectively.

Figure 3.3
New contracts, less evictions with Private health insurance institutions (ISAPRES)*



*Information at May 2016.
Source: Superintendency of health, BBVA Research

Figure 3.4
Effective real wage bill and forecasts (annual % var.)*



* Dotted line indicates forecast.
Source: National Statistics Institute (INE) and BBVA Research

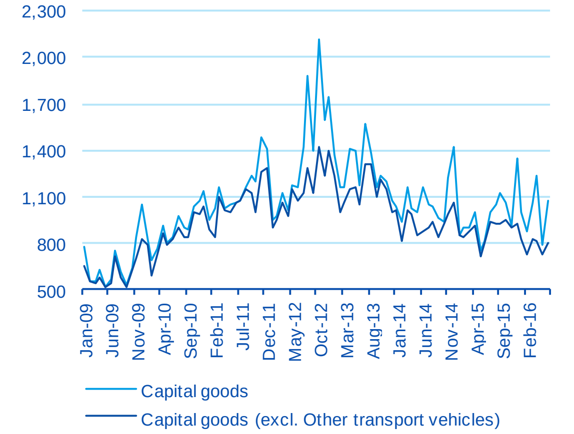
As far as investment is concerned, in the last few months we have observed another downward correction of the projects in portfolio, especially in mining and the public sector, and also persistent low dynamism in the import component of investment (machinery and equipment), apart from the import of other transport vehicles (Figure 3.5).

The main sources of growth in investment in previous years, which were mining and the real estate and public sectors, seem to have exhausted their contribution. In the next few years, the energy sector will be the one with the highest profile, mainly for projects focusing on generating unconventional renewable energies, but also due to the potential entry of new hydroelectric power projects.

For this year we forecast that investment will contract by 1.1%, driven by a significant drop in construction of a magnitude not seen since 2009. Furthermore, based on the figures of the Corporación de Bienes de Capital (CBC) and the forecast for the fundamental factors, we anticipate a further contraction of investment in 2017, this time by 0.5%, again driven by construction (Figure 3.6).

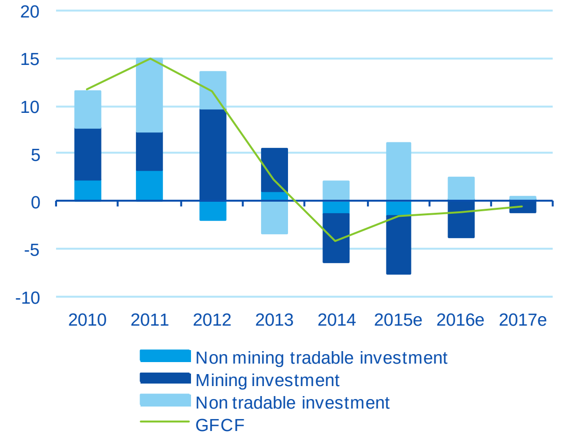
The downward adjustment of investment in 2016-17 is explained by lower investment in mining and the non-mining tradable-goods sectors, which are not compensated by an upward adjustment in the growth estimate for non-tradable goods investment, in which the amounts invested in telecommunications, housing, public works and, mainly, energy, stand out. As far as public investment is concerned, the budgetary restrictions faced by the government, added to the significant inertia of current spending commitments, will lead this component to fall back in 2016 and 2017, contributing negatively to the growth of total investment.

Figure 3.5
Capital goods imports (MM USD)



Source: Central Bank of Chile, BBVA Research

Figure 3.6
Effective and forecast investment per component (% var.)



Source: BBVA Research

The baseline scenario presented here also assumes a gradual recovery of exports by the forecast horizon, although less than forecast in the previous report, in line with the deterioration in worldwide growth prospects. For imports, we forecast contraction this year and more limited growth next year. Overall, the net external sector will make a slightly positive contribution to GDP growth both this year and next year.

At the sector level, beyond the volatility typical of natural resource-related sectors, growth in non-mining GDP also shows limited growth, demonstrating that the economy continues to operate with slack capacity. In the first six months of the year, mining GDP contracted by 3.7% on average, while non-mining GDP grew by 2.2%, a figure that compares with a potential growth estimated at around 3%.

Regarding the price of copper, we estimate that it will average US$2.14 per pound this year and US$2.2 per pound in 2017. We have not changed our long-term estimate (US$2.5 per pound), but this level will not be reached until at least the start of the next decade. Although the movements of non-commercial traders have stopped negatively affecting the price of this metal to the extent they did at the beginning of this year and Brexit does not appear to have had significant repercussions, a world copper surplus scenario continues, which will keep the price at current levels for several years. Furthermore, the risks continue to decrease, due to both supply and demand factors (increases in production in what remains of the year and next year, worldwide growth risks) and financial factors (appreciation of the dollar).

The competitiveness of the tradable-goods sectors has fallen significantly in the last few years, not only in relation to mining but also industry and, to a lesser extent, agriculture. This loss of competitiveness is a result of falling export prices in dollars and increasing local costs that have not been compensated by a multilateral depreciation of the peso. We consider it vital to have a real, multilateral exchange rate based on historical averages to support a more vigorous recovery of growth, underpinned by a reallocation of resources to tradable-goods sectors other than mining.

4 Current account continues at sustainable levels

A slight recovery in the price of copper and real depreciation of the peso would counteract weak external demand, allowing the current account deficit to stand at around 1% of GDP by 2017. External financing will continue to be led, although more moderately, by Direct Foreign Investment (IED). We forecast an external debt of 1.7% of GDP for this year.

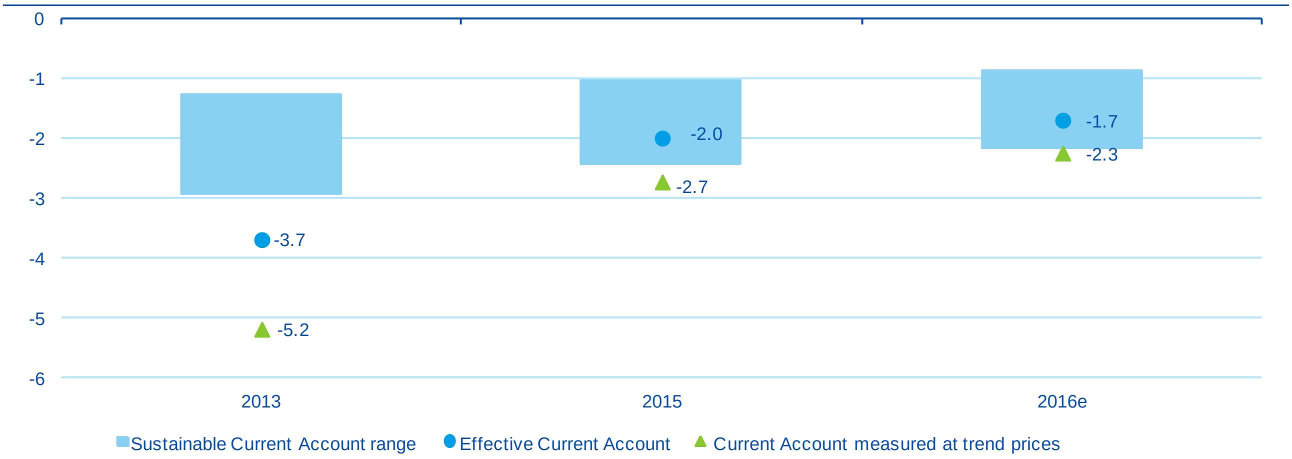
Last year the external sector closed with a negative balance of US$4.761 million and we forecast a deficit of around US$4.400 million for 2016. The rapid fall in the price of copper, combined with the slow adjustment of private consumption have caused the balance of trade to deteriorate rapidly, going from a surplus of over US$6.300 million in 2014 to one of around US$3.500 million in 2015. In 2016 we saw that this adjustment had ended for the most part, while imports of consumer goods and intermediate goods joined the deceleration of capital goods imports.

Reliance on external financing continues, but with no sustainability risk, driven by direct investment and to a lesser extent by portfolio investment components. In this context, estimates for the current account balance for the next few years will continue to be characterised by a return to equilibrium. Under our scenario, the recovery in the price of copper, slower but persistent during the next few quarters, leads us to forecast some recovery toward equilibrium in 2019.

In view of all this, we have very slightly corrected the expected external deficit for this year from 1.8% to 1.7% of GDP, while for 2017 we see a negative external balance of around 0.9% of GDP.

In terms of sustainability, we note that the current accounts show no particular need for greater adjustments. The sustainable current account deficit (SCAC) is between 0.9% and 2.2% of GDP and both the 2015 and 2016 current account deficits stand at around these values. In addition, on assessing the current account deficit at long-term prices for copper and oil (trending current account deficit – CAD), the evaluation does not change substantially (Figure 4.1).

Figure 4.1
Sustainable and trending current account deficit (% GDP)



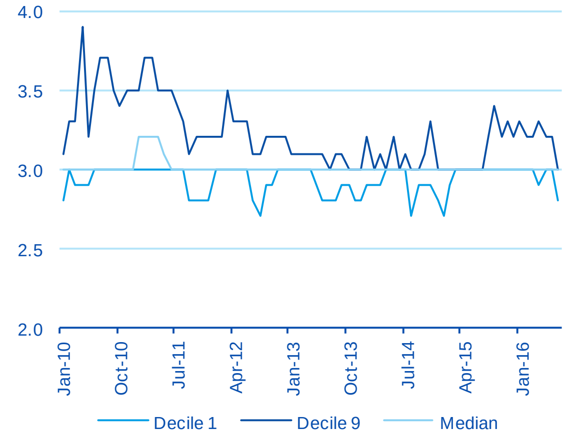
* SCA range based on the trending GDP estimate for 2016.
Source: Central Bank of Chile, BBVA Research

5 Inflation will remain below 3% for most of next year

We are keeping our CPI forecast at 3.2% for December 2016 and our view that inflation will be below 3% for most of next year.

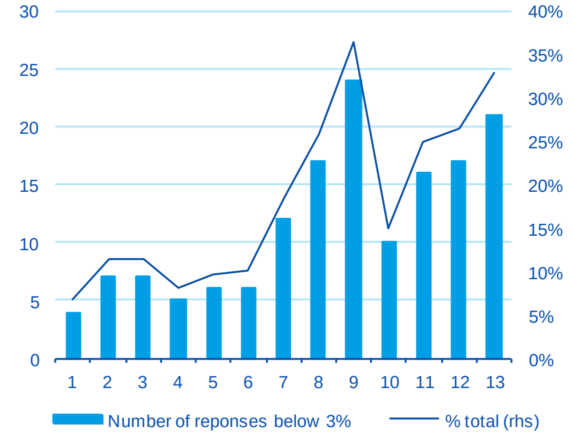
During the last quarter, the low monthly inflation records along with an exchange rate that has pulled back to levels close to $650, have contributed to moderating the market traders' inflation expectations. So, for the 12 months ahead, the forecasts went from 3.5% to 3% between January and July according to the FTS[1], while in 23 months, despite the fact that the median stands at 3%, decile 9 in July fell rapidly to 3% in the EES[2]. Furthermore, the number of respondents expecting inflation of below 3% between 13 and 24 months ahead exceeds 30% of the total in July according to the FTS (Figure 5.1 and 5.2).

Figure 5.1
EES: Inflation expectations at 23 months (%)



Source: Central Bank of Chile, BBVA Research

Figure 5.2
FTS: Number and percentage of respondents who expect inflation to be below 3% between 13 and 24 months ahead*



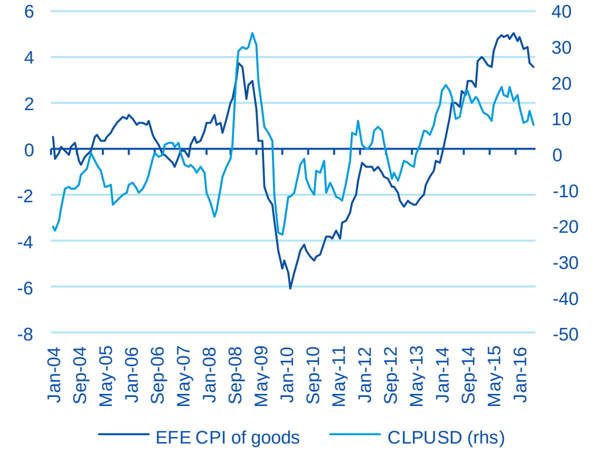
*The horizontal axis starts with the survey for the first fortnight in January 2016 (1) and ends with the first fortnight of July 2016 (13).
Source: Central Bank of Chile, BBVA Research

At the statistical closure of this report, annual inflation stands at 4% YoY, after remaining above the Central Bank's tolerance range ceiling for over 2 years. A lower rise in prices have been possible due to the strengthening of the CLP against the dollar so far this year, which has led to a deceleration in tradable goods inflation, especially the least volatile goods in the basket, reducing inflationary pressures on total CPI (Figure 5.3). The above has also contributed to containing the rise in prices of foodstuffs and energy associated with higher international prices. In our base scenario, which considers that the exchange rate will stand at $690 at the end of the year, inflation would end up at 3.2% this year.

For 2017, we maintain our inflation forecast at 2.5% (eop). We estimate that inflation will quickly converge to target during 1Q17, to then dip below 3% for the rest of the year. Although the price of the basket's most volatile products could continue to add to inflation over the next year, it will be the low underlying pressures that will lead this downward trend. Therefore, goods will add increasingly less inflation supported by the CLP's appreciation trend, while inflation from underlying services will fall back in a context of increased slack capacity (Figure 5.4).

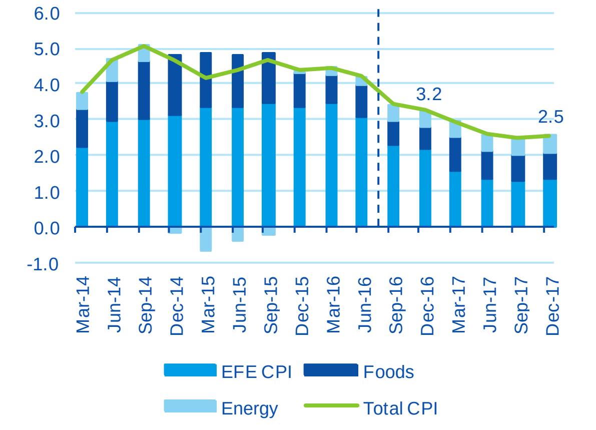
1: FTS: Financial Traders Survey
2: EES: Economic Expectations Survey.

Figure 5.3
EFE CPI of goods (% annual var.)



Source: Central Bank of Chile, BBVA Research

Figure 5.4
Inflation forecast by component (annual % var.)



* Dotted line indicates start of the forecast.
Source: Central Bank of Chile, BBVA Research

6 Monetary policy is not being as expansive as the economy requires at this stage of the cycle.

More monetary stimulus is needed in a scenario in which economic activity remains weak and forecast inflation keeps markedly and persistently below 3%. We foresee two cuts in the MPR of 25 bp. in the next 12 months.

The deterioration in local growth expectations, partly associated with lower worldwide growth prospects, along with limited room for a stimulus from the public sector, requires considering the possibility of a greater contribution by monetary policy at this juncture. This greater stimulus, as well as reducing finance costs for families and companies, will provide a more depreciated real exchange rate, which would help to redirect resources towards tradable-goods sectors other than mining. We consider that a greater monetary stimulus is required and that, although this would have inflationary effects in the short term, these would be limited, while the economy operates with low use of its installed capacity and with an internal demand that remains very weak.

In our last report we presented a scenario in which the reference interest rate remained at 3% for a long period of time, not sharing the view held by the market consensus and the Central Bank at this time about the need to withdraw stimulus. The June’s Monetary Policy Report (IPoM) postponed the rises in rates but retained a contractionary bias, sticking to the path implicit in the prices of financial assets that provided, at the time, an initial increase of 25 basic points at the end of this year or beginning of 2017 and a second increase of the same magnitude in the months after a one-year period. However, after the Central Bank's report, the economic activity and labour market figures were disappointing, the peso appreciated and the external scenario became more uncertain after Brexit, an event not considered in the forecasts, except for the effects of voting on the financial markets. As it is early days to quantify the final effects of the United Kingdom's exit from the European Union, the most probable impact is less growth worldwide and lower interest rates in a large part of the world for a long period.

The latest monetary policy meetings, which kept the rate at 3.5%, continued the moderately contractionary bias, despite the fact that the only significant political option discussed by the Council was continuing it. We consider that maintaining the contractionary bias in a context in which the interest rate is maintained for a long time, generates credibility risks that ought to be prevented. Furthermore, contrary to the monetary authority's view, our forecasts suggest that the MPR's current level is only marginally expansive if it considers different estimates for the neutral policy rate.

Our forecast for the MPR continues not to be shared by the consensus, although more recently, various commentators have accepted the idea that it will be necessary to increase monetary stimulus. Tactically a cut in interest rates must be accompanied by greater conviction from the Central Bank's Board that inflation will definitely fall, which according to our forecasts will be more evident in the last quarter of this year. The prices of financial assets at the close of this report do not take rises in the last 24 months into consideration and are tentatively starting to incorporate the possibility of a cut. Furthermore, surveys point to extended maintenance of the rate at its current level and therefore we still see room for additional falls in swap rates and we certainly forecast additional downward corrections in the analysts' consensus interest rate forecasts.

7 Further tightening of fiscal constraints in 2017 amid growing spending pressures

Less structural income limits the spending increase in 2017 to 3%, while the government commits new resources for free higher education and pensions, amid a discussion about sources of finance.

The end of this fiscal year should hold no surprises on the spending side, where the figures for the first half year permit a 100% execution of the Budget Law. In regard to revenue, Annual Taxes paid in April and May showed a good result in tax collection from non-mining companies, but confirmed the deterioration in the transfer of resources to the government by the mining sector. The above situation goes hand in hand with the meagre results for VAT collection, which saw a cumulative growth of 4.8% YoY in the first quarter, partly due to good results by the policies against evasion and obligatory electronic billing measures, but it suffered losses in April and May, hardly reaching a cumulative growth of 0.7% YoY for the first half of 2016. In any case, the 'Others incomes' revenue will stand in December somewhat above what was estimated by the Finance Ministry in July, and we therefore forecast a total revenue slightly higher than the official forecast.

The effective deficit for this year would therefore be 2.9% of GDP (around US$7,000 million), less than the 3.2% of GDP estimated by the government, with a 4.2% growth in spending. Since the deficit was practically zero at the close of the first half year, the rest of the US$7,000 needs to be financed in the second semester. Assets in pesos totalled US$ 4.3bn on 30 June, and therefore part of the assets in dollars, currently totalling US$3.0bn, would be liquidated, and the full US$10,500 debt limit authorised by law would be used (around US$ 2,700 million would remain to be issued in 2H16).

There is no greater certainty about the forecast for the 2016 structural deficit, which is key to estimating the growth of spending increase in 2017. The recent change in the method of calculating structural revenue, which will take into account the estimated structural parameters (trend GDP and long-run copper price), which have been reported to the Finance Ministry by the independent expert committees during June and July, plus the target of reducing the structural deficit at a rate of 0.25% of GDP per year, closely link the forecasts for 2017 to the 2016 result.

We estimate that both structural parameters will be revised downwards in the face of more depressed mid-term prospects than those we had in past consultations. So, the long-run copper price should stand at around US$2.47 per pound and trend GDP growth at 3%. With these figures, we estimate that the 2016 structural deficit would be 1.2% of GDP. It should be remembered that the government undertook not to incorporate capital repatriation revenue in the calculation of the convergence target, which this year will reach approximately 0.3% of GDP. The target for 2017 would therefore be a structural deficit of 1.3% of GDP (-1.2% - 0.3% + 0.25%). If these figures prove correct, the spending growth in 2017 would be around 3%, which would imply an effective deficit of 3.3% of GDP, or around US$8,300 million (Table 7.1).

The fiscal discussion recently revolved around maintaining the risk classification and its prospects. The fears mainly lie in the increase in gross debt, which in the first half year reached 20.4% of GDP and which we forecast will end up at 21.5% of GDP by the end of this year. All things considered, net debt continues to be almost zero, a low level from a historical perspective (Figure 7.1). As a result, to finance next year's effective deficit (US$8,300 million), debt maturities (US$ 2,000 million) and other financial commitments, such as bonds related to the pension system and possible capitalisations to public companies (at least US$1,000 million), without raising the gross debt at such a fast pace as this year, the option of using resources from sovereign funds, the FEES (Economic and Social Stabilization Fund, in Spanish) and the Pension Reserve Fund (FRP, in Spanish) is being considered. We consider the option of using the FEES to finance the government's financial obligations next year very probable, to a maximum of US$ 2,000 million and also the FRP at the permitted amount, US$570 million[3]. The Budget Law 2017 will therefore include a debt issue of between US$8,500 and US$9,000 million, less than the US$ 10,500 million of this year.

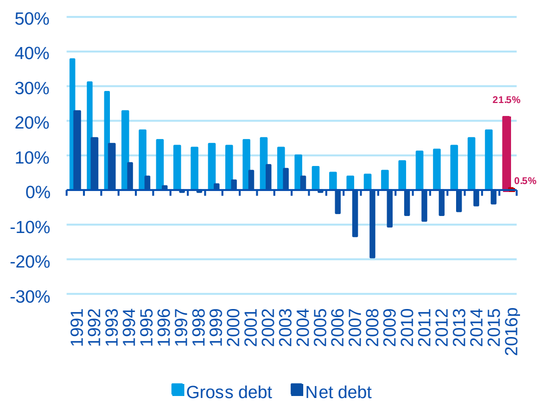
Lastly, we continue to forecast growth of over 3% in spending in 2018, given the increase in the structural revenue, which would signal the end of Retained Taxable Earnings (FUT in Spanish), in order, from 2019 onwards, to show very limited growth if the idea is to keep converging to structural balance (Figure 7.2). This proves more challenging, while continuing to commit future resources. Therefore, as spending would not be contained in the mid term, we assign a greater probability to the options available for balancing the fiscal accounts, which could lead to abandoning the gradual target of converging at structural balance or a new tax reform that generates greater resources.

Table 7.1
Variable fiscal forecast for 2016 and 2017

	2016 Min. Treasury	2016 BBVA Research	2017 BBVA Research
Ref. copper price (USc/lb)	257	247	247
Trend GDP (change YoY)	3,6	3.0	3.0
Effective deficit* (mm USD)	7,713	6,951	8,316
Effective deficit (% of GDP)	-3.2%	-2.9%	-3.3%
Structural deficit without reg. cap. (% of GDP)	-1.4%	-1.5%	-1.3%

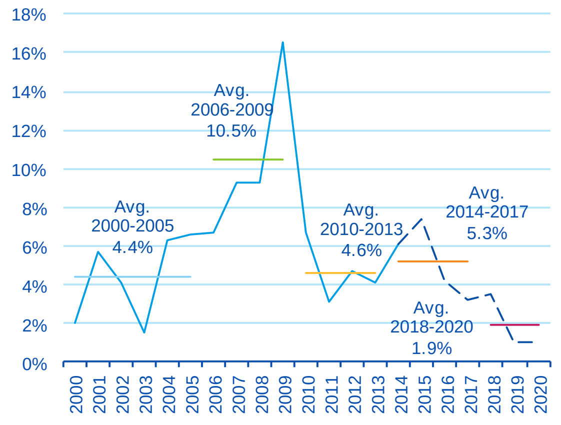
Source: Budget Directorate and BBVA Research

Figure 7.1
Evolution of gross and net debt 1990-2015 and forecast for 2016 (% GDP)



Source: Finance Ministry, BBVA Research

Figure 7.2
Growth in public spending and averages per period 2000-2020



Source: Budget Office and BBVA Research

3: With these provisions, the financing equation would close as follows: Deficit + Debt amortisation + Recognition bonds and others = Debt issue + FEES+FRP, i.e., US$8,300 + US$2,000 + US$1,000 = US$11,300 million, which could all be financed by gross debt (we estimate US$8,500 to 9,000) and the rest by liquidating FEES and FRP assets.

8 Too much appreciation of the peso delays recovery

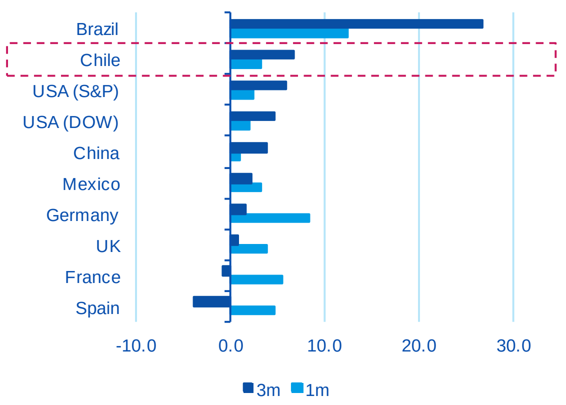
The intensity of the multilateral appreciation of the peso has been above what the cyclical position of the economy advises, leaving the real exchange rate below its historical averages. Interest rates have fallen, partly following their international counterparts.

Uncertainty about the evolution of the Chinese economy persists, although the recovery in the price of oil and other commodities has mitigated risk aversion and favoured emerging currencies. The episode of volatility brought on by Brexit has died down and the Chilean peso has showed renewed bilateral and multilateral appreciation. In this context, in the last 3 months the local stock exchange has seen a cumulative recovery of 6.8% measured in dollars (Figure 8.1).

In Chile, the peso went through a period of depreciation closely linked to the fears generated by Brexit. However, although this risk has been allayed, it has returned to levels not seen since midway through 2015. 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 of global investors' appetite for a partly recover the exposure to the greater nominal yield now offered by higher local interest rates (Figure 8.3). Furthermore, the materialisation of Brexit has had a strong impact on the pound sterling and the euro, which have fallen 11% and 3% against the dollar, respectively (Figure 8.2).

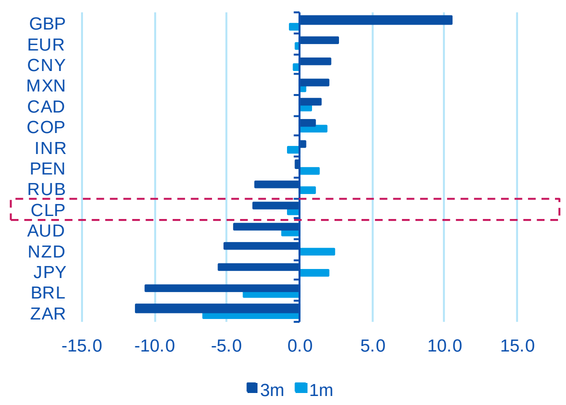
All the same, in the recent economic situation the Chilean peso has been favoured, even rather more than the currencies of Chile's trading partners, as shown by the CLP's multilateral appreciation, which is also to some extent due to the significant appreciation of the Brazilian real, in which we have also seen carry trade transactions in parallel with those in the Chilean peso.

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)*

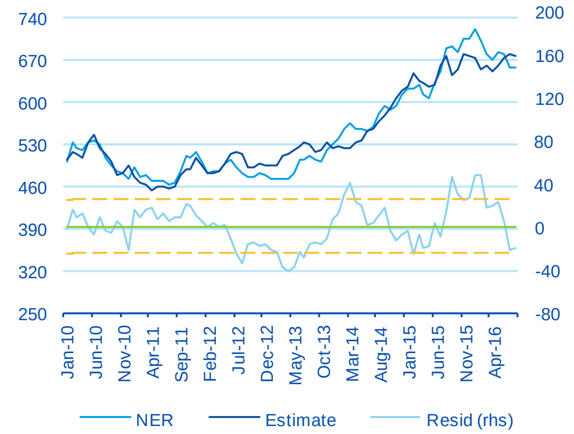


*An increase indicates depreciation of the national currency, while a decrease means appreciation of the local currency against the dollar.
Source: Bloomberg and BBVA Research

From the assessment of the exchange misalignment we deduce that the appreciation of the peso was significant and somewhat higher than suggested by the fundamentals (Figure 8.5). We do not however believe there would be room for fundamental depreciation taking the exchange rate above 700 pesos to the dollar, nor that cyclical conditions support a nominal exchange rate consistent with a real exchange rate at or below its historical averages as is the case with the most recent (Figure 8.4). 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 of the investment in commercial goods and services sectors. Support from monetary policy, justified certainly by medium-term deflationary effects, might be necessary. Indeed, the Central Bank has already stated that the recent appreciation does not favour economic recovery, rather there is a risk of a delayed monetary policy response that will end up slowing down recovery.

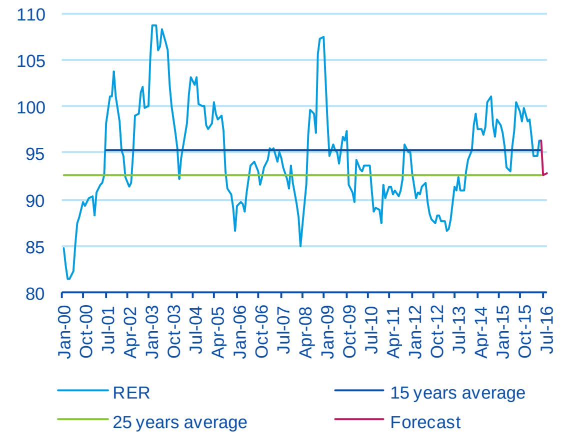
In the short term, due to the high volatility of the global financial markets, we do not rule out further depreciation of the CLP, which could bring the rate back to levels of around 700 to the dollar, but we do not consider that the conditions would exist for working permanently with those levels. The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

Figure 8.3
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. *Index* and the rate differential between Chile and the USA.
Source: Central Bank of Chile, BBVA Research

Figure 8.4
Index of the average real exchange rate (1986 = 100)



* Line for July and August correspond to estimation of RER based on evolution of the multilateral exchange rate and external inflation.
Source: Central Bank of Chile, BBVA Research

Ten-year benchmark peso interest rates have held stable during the last 3 months, while five-year rates have closely tracked changes in US dollar interest rates. In the baseline scenario, the two cuts of 25 bp in the MPR would have downward effects on rates in local pesos. However, these would be compensated by an increase in long-term external rates and by the higher exchange rate we expect to materialise by the forecast horizon.

9 China continues to be the main external risk, but delayed reaction in local monetary policy emerges as the greatest internal risk

A global scenario of less growth is materialising, which was a risk raised in our previous report. Real financial risks persist in the Chinese economy, with consequences for the price of copper.

Internally, a risk of a non-recovery of confidence is materialising and now we are expecting neutrality by the beginning of 2018. The risk of a greater appreciation of the peso than that suggested by the cyclical position of the economy has also materialised. Delayed reaction in monetary policy is turning into a new local risk.

The risk associated with the performance of the Chinese economy has tended to mitigate. News reports indicate a certain stability in manufacturing, but employment and weak external demand continue to exert pressure and could mean abrupt adjustments to the yuan, with consequences for the price of copper. We continue to expect a mild deceleration of the economy. However, a materialisation of this risk would mean a sudden adjustment, which, as we have indicated, would have significant impacts on commodities, fiscal revenue, exports, investment and ultimately on 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, and the strongly counter-cyclical policies implemented by this country's authorities. A downturn in China's economy would also have a significant impact on other 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, recent information has 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 peso that would leave the real rate of exchange markedly below its historical average, which we believe could delay a cyclical recovery and limit the reallocation of resources to non-mining tradable goods 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. This internal risk adds to that of a more prolonged maintenance of traders' pessimism than forecast.

The evolution of the mining sector is also a risk for the growth outlook of the coming years, with a scenario of further falls in the price of copper that 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 negative impact on employment.

10 Tables

Table 10.1
Macroeconomic Forecast

	2013	2014	2015	2016	2017	2018
GDP (% YoY)	4.0	1.9	2.1	1.7	1.8	2.4
Inflation (% YoY, eop)	3.0	4.6	4.4	3.2	2.5	3.0
Exchange Rate (vs. USD, eop)	529	613	704	690	680	651
Interest Rate (%, eop)	4.50	3.00	3.50	3.25	3.00	4.00
Private Consumption (% YoY)	5.5	2.4	1.5	1.4	1.5	2.0
Government Consumption (% YoY)	3.5	5.1	5.8	5.4	3.1	2.2
Investment (% YoY)	2.2	-4.2	-1.5	-1.1	-0.5	2.5
Fiscal Balance (% GDP)	-0.6	-1.6	-2.2	-2.9	-3.3	-3.0
Current Account (% GDP)	-3.7	-1.3	-2.0	-1.7	-0.9	-0.1

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	2.0	4.5	682.1	3.50
2Q16	1.1	4.1	681.1	3.50
3Q16	1.3	3.4	680.0	3.50
4Q16	2.1	3.2	689.7	3.25
1Q17	0.5	2.9	687.3	3.25
2Q17	2.1	2.6	684.9	3.00
3Q17	2.4	2.5	682.5	3.00
4Q17	2.4	2.5	680.1	3.00
1Q18	2.4	2.7	669.7	3.25
2Q18	2.4	3.0	661.4	3.50
3Q18	2.4	3.0	656.1	3.75
4Q18	2.4	3.0	650.7	4.00

Source: BBVA Research

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