BBVA | RESEARCH

Chile Economic Outlook

FOURTH QUARTER 2016 | CHILE UNIT

01
We are maintaining our growth projections for 2016-17. Our view continues to be more conservative than that of the market for 2017

02
We expect inflation to end the year close to the Central Bank's target and to fluctuate below 3% in 2017

03
We are projecting at least two cuts in the Monetary Policy Rate by 1Q17. We do not rule out a possible need for greater monetary stimulus

04
Cuts in the Monetary Policy Rate are needed in order to bring about a more competitive exchange rate and to anchor inflation

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Closing date: 28 October 2016

1. Editorial

World growth will hold at around 3% in 2016 and will increase slightly to 3.2% in 2017. We are revising our forecast slightly downwards, partly in view of the worse-than-expected results of the first half of the year in certain areas, and also in the light of the lower growth foreseen in the USA.

On the domestic front, we are maintaining our growth projections for 2016 and 2017 at 1.7% and 1.8% respectively. The information available leads us to project growth of close to zero for total investment next year, while private consumption will continue to show limited growth and we will see less fiscal stimulus. More optimistic projections for 2017 rely on increased drive from the mining and external sectors, to which we do not subscribe.

Our forecast of lower inflationary pressures has been confirmed. In the past few months we have seen inflation fall faster than anticipated by the market but in line with our view. Underlying this trend is not only the exchange rate but also a sustained moderation in inflation of services, consistent with an economy that is operating with spare capacity and in which the labour market is continuing to weaken. We estimate that inflation will end 2016 close to the Central Bank target and will remain below 3% throughout next year.

In this scenario, we project at least two cuts of 25 bps in the Monetary Policy Rate between now and 1Q17. We consider that these cuts will be necessary in order to avoid inflationary expectations slipping their anchor and declining, and to contribute towards bringing the exchange rate to a level that will make Chile's exports more competitive. The perceived need for greater monetary stimulus is increasingly shared by the market and has been feeding in to asset prices, albeit with a lag relative to us.

Downward adjustments to benchmark interest rates look set to continue. Although higher international interest rates would have an effect on domestic rates, we believe the dominant force, especially in the short part of the yield curve, will be the incorporation of greater monetary stimulus than that currently implicit in prices.

Limited growth in public spending in 2017, in accordance with the Fiscal Rule and without yielding to political pressures. Despite this, the fiscal deficit will again increase, as will indebtedness. There will be a need for fiscal adjustment, responsibility for which will rest with future governments. The fiscal situation will continue to command attention in the next few years, in a context of intense social pressures and weak prospects for the growth in public sector revenues.

There are increased internal risks associated with the possibility of economic agents' confidence not being restored and action on monetary policy taking too long. On the external front, the risks associated with China's macroeconomic adjustments and monetary normalisation in the US have eased, but by no means disappeared.

2. Global Environment

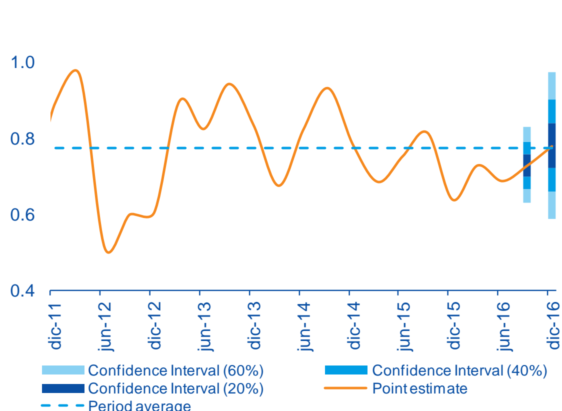
Slow recovery with the support of central banks

There has been very little news in the past few months on the performance of the world economy. Financial stresses have remained moderate, while global activity seems to be showing signs of slight improvement (Figure 2.1) following a weak first half-year and some stabilisation of international trade. All this with the continued support of the economic authorities, especially the developed countries' central banks. In particular, the US Federal Reserve's more cautious tone confirms a very gradual normalisation of interest rates once the second hike materialises, probably in December.

Meanwhile the emerging economies continue to see inflows of capital driven by the search for yield and low volatility, plus the recovery in oil and other commodity prices. As regards currencies, the US Federal Reserve interest rate hike expected before year-end is favouring the dollar's generalised appreciation.

Figure 2.1

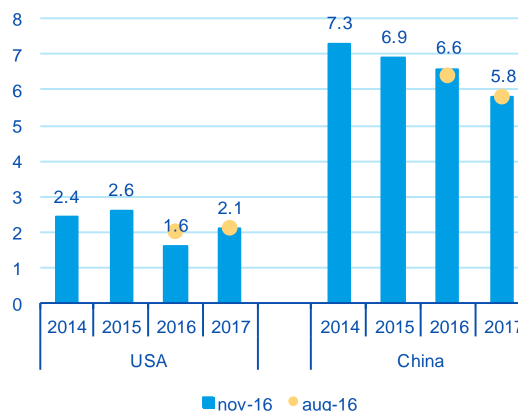
Global GDP, % QoQ. 3Q and 4Q forecasts for 2016 based on BBVA-GAIN



Source: BBVA Research

Figure 2.2

GDP growth in the US and China (%)



Source: BBVA Research

Changes in forecasts for the US and China, the two economies with the most influence on Latin America, have gone in opposite directions. The latest US data point to less robust growth in the second half of the year than was foreseen three months ago, following a first half that was already weak, and this leads us to revise our growth forecast for this year downwards by 0.4 pp to 1.6% (Figure 2.2). This represents a clear moderation in activity relative to the average annual advance of close to 2.5% in the two-year period 2014-15.

The composition of the growth continues to stoke concerns about the medium-term potential, as it continues to show a two-speed economy, with solid private consumption but investment that might fall slightly for 2016 as a whole, after advancing by less than 1% on average in the past five years. Expectations of lower long-

term growth potential might be holding back investment decisions, and might in turn feed back into reduced increases in productivity in the future, with a labour market at practically full employment. Even so, we still expect a moderate advance of 2.1% in 2017.

World growth will increase slowly in 2017 relative to 2016

Turning to China, the fiscal and monetary stimulus measures put in place at the beginning of the year to stabilise growth have borne fruit and will allow the short-term growth target set by the authorities to be met, at the expense of building up growing imbalances. We are therefore revising our growth forecast for 2016 upwards to 6.6% (Figure 2.2). Nonetheless, the outlook is still for gradual slowdown to 5.8% in 2017. Moreover, medium-term risks are increasing, especially those of overheating in the real estate sector, financial instability, depreciation of the yuan and capital flight, and companies' indebtedness. In the long term, doubts about growth prospects persist given the slow progress of structural reforms in certain key areas, particularly state-owned companies.

In this context, we have revised our global growth forecast slightly downwards, partly in view of the worse-than-expected results of the first half of the year in certain areas, and also in the light of the lower growth foreseen in the USA. In any case, growth will hold at around 3% in 2016, with a slight increase to 3.2% in 2017.

3. Benchmark interest rates close to all-time lows

The peso still needs to depreciate further in order to improve the cyclical position of the economy

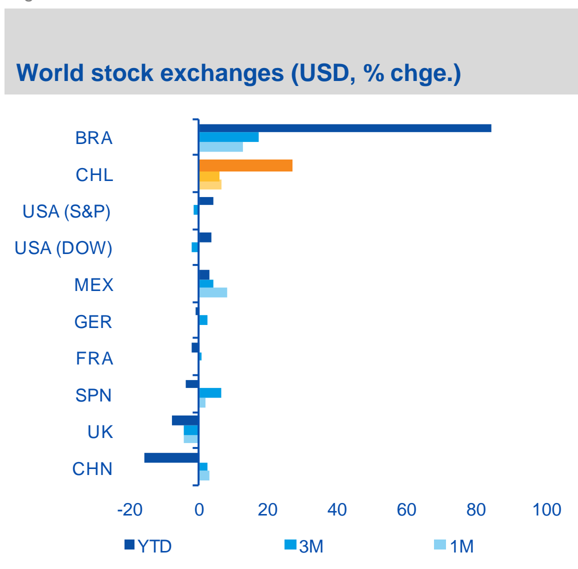
Uncertainty about trends in China's economy remains in force, although the recovery in the price of oil and other commodities has mitigated risk aversion and favoured emerging market currencies. The bout of volatility brought on by Brexit has died down, and the Chilean peso has retained the resistance to depreciation seen since the beginning of the year. In that context, the Chilean stock exchange has recovered by a cumulative 26% measured in dollars since January (Figure 3.1).

The real exchange rate remains close to historical averages, insufficient to support reallocation to non-mining sectors

In Chile, the peso went through a period of depreciation closely linked to the fears generated by Brexit. However, now that this risk has been dispelled, it has again appreciated towards levels last seen in mid-2015 (Figure 3.2). This development has coincided with a surge in interest rate arbitrage transactions using derivative instruments (carry trade), reflecting global investors' appetite for regaining a degree of exposure to the greater nominal returns offered by higher domestic interest rates. This has also been seen with the Brazilian real (Figure 3.3), although with greater volatility lately. Also, domestic institutional investors, particularly pension funds, have been repatriating capital in response to their contributors' decisions to move to more conservative funds, and this has also led to an increase in the supply of dollars, underpinning a certain degree of appreciative pressure (Figure 3.4).

Figure 3.1

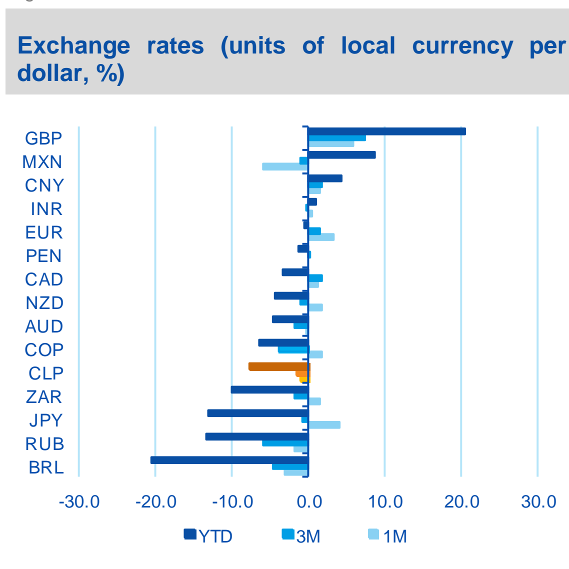
World stock exchanges (USD, % chge.)



Source: Bloomberg and BBVA Research

Figure 3.2

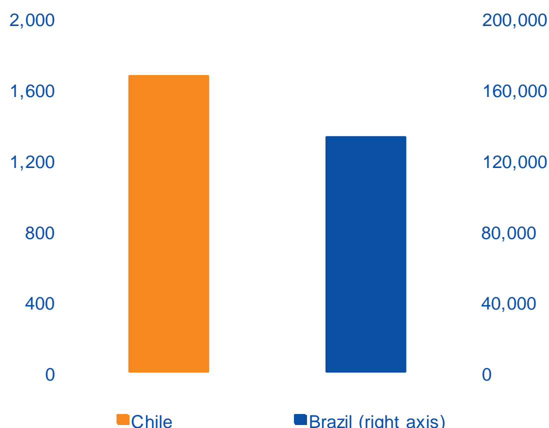
Exchange rates (units of local currency per dollar, %)



Source: Bloomberg and BBVA Research

Figure 3.3

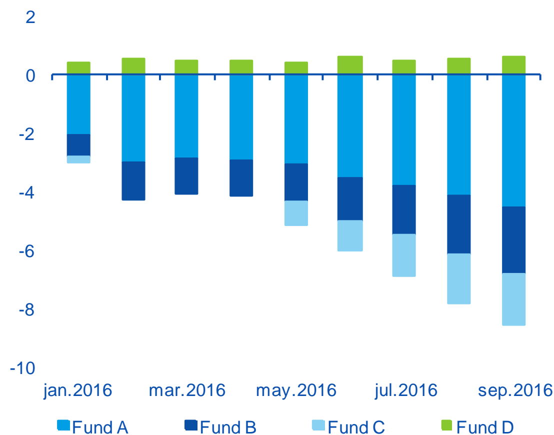
Increase in the long position of the Chilean peso and the Brazilian real*



* Standardised contracts for Brazil for an amount of US$50,000. Increase seen between 24 May and 14 October 2016.
Source: Banco Central de Chile, BM&F Bovespa and BBVA Research

Figure 3.4

Net transfers of resources to the E-fund (the most conservative pension fund) (change in share of total during 2016, %)



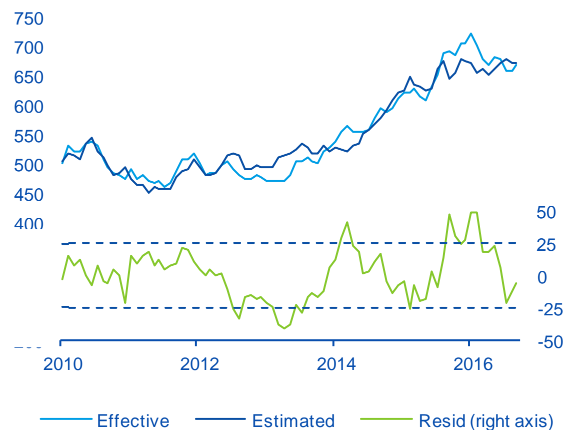
Source: *Superintendencia de Pensiones* (Chilean Pensions Supervisor) and BBVA Research

From our evaluation of nominal misalignment, we see no clear evidence of the currency's being at a different level from that suggested by the terms of trade and other short-term factors (Figure 3.5). However, although we did at one time believe that there would be no room for fundamental depreciation taking the exchange rate above 700 pesos to the dollar, we also do not now think that the cyclical conditions support a nominal exchange rate consistent with a real exchange rate at or below its historical averages as has most recently been the case (Figure 3.6). 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 of investment in commercial goods and services sectors. There might well be a need for support from monetary policy, which would certainly be justified in view of the medium-term deflationary effects of this strengthening of the peso. Our baseline scenario envisages depreciation of the peso at the forecast horizon brought about by cuts in the monetary policy interest rate which would allow the currency to trade at between 680 and 700 to the dollar towards the end of 2016.

Low interest rates, symptomatic of lower long-term growth

Figure 3.5

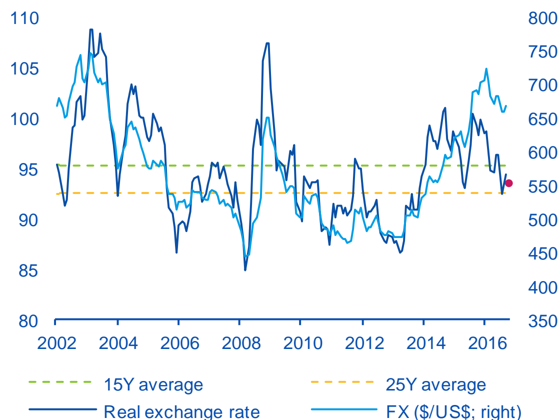
Actual and estimated exchange rates (pesos per US$) *



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

Figure 3.6

TCR real exchange rate (average, 1986 = 100)



* Red dot shows projected TCR for October (93.4).
Source: Banco Central de Chile and BBVA Research.

Benchmark interest rates at terms over five years have fallen from the levels seen in our previous report, in a context of low external rates, downward adjustment of growth expectations, a degree of internalisation of greater additional monetary stimulus, and demand from institutional investors. In this context, we see no misalignment relative to the fundamentals. In the baseline scenario, interest rates of long-term instruments in dollars are adjusted upwards at the projected horizon, via the process of monetary normalisation in the US. This would affect domestic interest rates, but we believe the dominant force, especially in the short part of the yield curve, will be the incorporation of greater monetary stimulus than that currently implicit in prices.

4. Growth projections for 2016-2017 unchanged

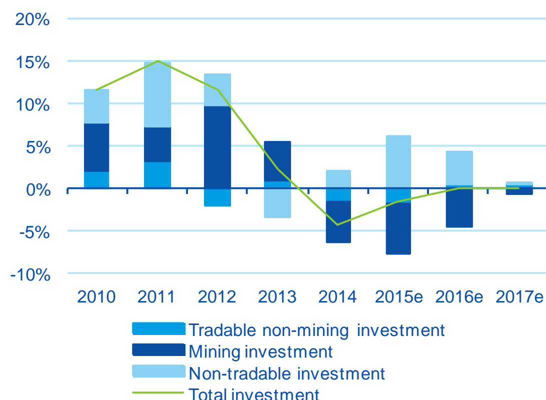
For 2017 we are projecting similar growth to that of this year, below consensus expectations

Short-term activity figures have shown high volatility in the past few months, but beyond this, with the information available, it seems to us that the 1.7% growth estimate for the year which we first presented in our April report remains fully valid. In terms of components, the first half-year showed domestic demand figures ahead of forecast, which led us to make a slight correction to our estimates of growth in domestic demand for this year and next. The main surprise came from fixed investment, which however was also accompanied by increased growth in private consumption, following a change in methodology which added new information for the calculation. This increased contribution from domestic demand is however offset in the projection by a reduced net contribution from the external sector in the two-year period 2016-2017.

The definitive information on investment for the first half-year, plus the figures from the investment register of the CBC (*Corporación de Bienes de Capital* or “Capital Goods Corporation”) and the figures from the Budget for 2017, lead us to make a slight upward correction to our estimates of fixed investment. Whereas three months ago we were projecting a decline in this component of demand this year and next, we now see it remaining virtually unchanged in both periods. As regards the determinants of investment, despite the persistence of historically low interest rates, the low level of business expectations, plus the high degree of uncertainty still remaining in respect of a number of legal and regulatory aspects, the deterioration in growth prospects and the end of the upbeat cycle of investment in mining and real estate generate a scenario of practically no growth in fixed investment this year and next. As the adjustment in the mining sector draws to a close, none of the other sectors looks like taking over the investment baton next year (Figure 4.1).

Figure 4.1

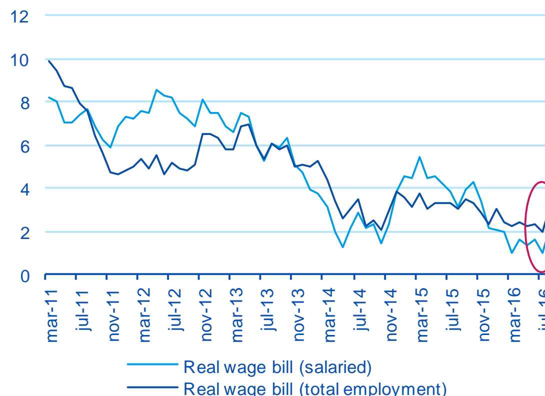
Real growth in total investment (GFCF) and effect by component



(e): estimated.
Source: Banco Central de Chile, CBC and BBVA Research

Figure 4.2

Total wage bill (Chge. % YoY)



Source: INE (National Statistics Institute) and BBVA Research

In the case of private consumption, after incorporating the higher figures estimated by the Central Bank for 2015 and the first half-year of this year, we continue to foresee limited growth of this component of demand, and we are maintaining our growth projection for next year. Consumer confidence has remained around all-time lows, while the labour market has continued to weaken and will continue to do so. Indeed, the slow pace of salaried job creation, the limited increase in pay, and persistently restrictive lending conditions combine to stall the possibility of our seeing greater dynamism in household consumption. In this context, one positive aspect is the decline in inflation, which reduces the erosion of purchasing power caused by rising prices in the past two years (Figure 4.2).

As for public spending figures, for this year we are projecting a degree of under-execution, mainly in the investment component, and for 2017 we are provisionally relying on the Budget currently under discussion in Congress, so we anticipate that total spending will grow by around 2.7%, with a fall of 3.7% in the investment component. These figures are not significantly different from our previous estimates, and they reflect the declining contribution of government spending to demand, relative to what happened in 2014 and 2015.

Consensus GDP growth projections for 2016 have been gradually adjusted downwards, and are not now significantly different from our estimate that has been in place since the beginning of the year. For 2017 on the other hand, we see significant differences. Whereas the surveys point to growth of close to 2%, official estimates (Treasury and Central Bank) are centred on 2.25%. Both are above the 1.8% assumed by our baseline scenario. As has been pointed out, the most optimistic projections for next year apparently rely on two assumptions, for both of which there are serious risks of non-materialisation, namely increased global growth and increased mining production, and for this reason we do not subscribe to them. Finally, we are maintaining our growth projection for 2018 at 2.4%, a figure which presupposes a gradual recovery of activity towards growth rates closer to the potential, which would take place in a context of gradual recovery of economic agents' confidence and slowly improving international conditions.

5. Inflation is anchored to the target, but conditional on greater monetary stimulus

The data have validated our view of inflationary normalisation. We are projecting annual inflation to end the year at 3.1% and we are maintaining our projection of 2.5% for whole-year 2017

In the last few months we have seen inflation (especially core inflation) fall faster than anticipated by the market but in line with our view of generalised low inflationary pressures, which should lead it to end 2016 at around 3.1% annual and hold below 3% throughout next year.

Core inflation (CPI stripped of food and energy) has fallen significantly in the past few months, driven not only by lower inflation of goods but also by a clear slowdown in inflation of services, as evidenced by the increased slack in capacity (Figure 5.1 y 5.2). The commercial components of the basket, goods mainly linked to the exchange rate, have reacted symmetrically to the appreciation of the peso, quickly dissipating the inflation generated during 2015. In September, core inflation of goods declined to 2.3% on an annualised basis, with the biggest September fall for 20 years, surpassing both market expectations and the baseline scenario of the central bank's latest Monetary Policy Report published in September.

Inflation of services falls below the average for the past 15 years

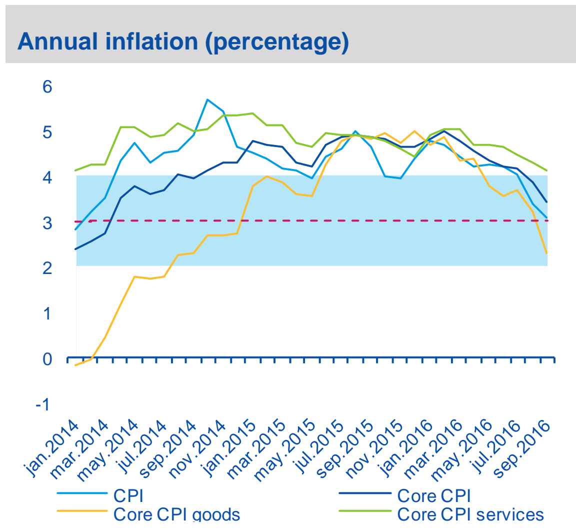
Added to this is the decline in inflation of services, the most persistent component of the CPI, which on the back of reduced domestic dynamism and the adjustment in the labour market fell to 4.1% on an annualised basis in September, even falling below the average services inflation rate of the past 15 years (4.2%). If we were to discount the one-off effect of the January 2016 increase in stamp duty, annual inflation would be around 0.3 pp less, and inflation of services would be markedly below its historical average.

As regards the most volatile components of the basket, food and energy, although we have seen increases in international prices in the past few months, we consider that their impact on inflation will be limited, in line with the strengthening of the peso and seasonal effects, and already factored in to market expectations. As far as food is concerned, while we have seen significant increases in certain products, particularly perishables, these are mainly due to seasonal factors which will start to reverse in the October figures and will do so increasingly in November and December. Meanwhile prices of non-perishable foodstuffs, especially cereals and meat and, more recently, sugar, have risen in international markets, but we do not believe that this will pose a threat, since the increases have largely been reflected in the latest inflation

figures and the incidence of those that have not is limited[1]. Also, recent movements in international prices of oil and refined fuels are expected to generate zero or even negative pressure on the domestic market during the final months of the year.

Figure 5.1

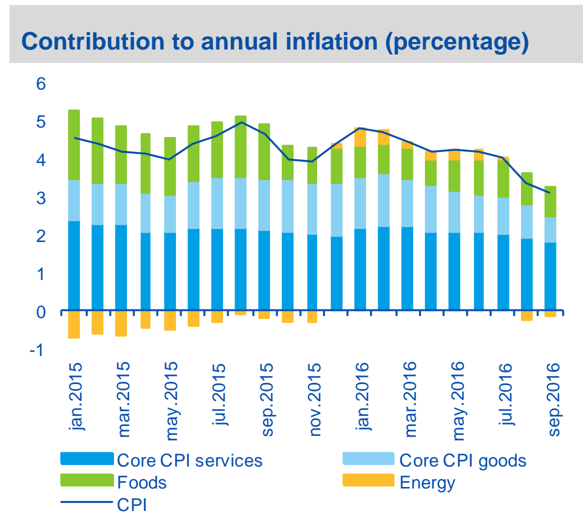
Annual inflation (percentage)



Source: INE (National Statistics Institute) and BBVA Research

Figure 5.2

Contribution to annual inflation (percentage)



Source: INE and BBVA Research

Following September's surprisingly low CPI (0.2% MoM), the market surveys (EEE and EOF)[2] for October show a downward adjustment to inflation projections, and both incorporate expectations of at least one 25 bps cut in the Monetary Policy Rate in the next few months, as explained in more detail in the chapter on monetary policy in this report.

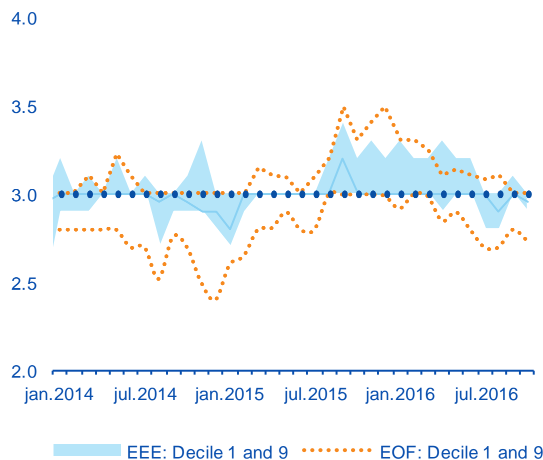
Anchoring of inflation conditional on cuts in the Monetary Policy Rate

Although on average the surveys continue anchored to inflation of 3% at a two-year horizon, this is conditional on a reduction in the Monetary Policy Rate as incorporated into these surveys (Figure 5.3). If this scenario does not materialise, we might logically expect inflation to become unanchored at the policy horizon in the absence of unforeseen developments in activity and/or inflation relative to the assumptions inherent in these surveys. This is also reflected in the inflation implied in prices of financial assets, which show a sharp downward correction in October and include two interest rate cuts in 2017. Moreover, if we consider that the latest (September) Monetary Policy Report already included core inflation of 2.5% for 2017, and that as far as fuels are concerned we see no great differences from our baseline scenario assumptions, these surprises could bring the Banco Central projection down even further, holding it below 3% for longer than envisaged.

1: According to our analysis, changes in international prices (FAO Food Price Index) affect domestic prices with a lag of approximately seven months. For further details, please refer to our Chile Economic Watch: *"Alza de preciosinternacionales de alimentos: aúnlejos de serunaamenazapara la inflation local"* ("Rising international food prices: still far from being a threat to domestic inflation" (available in Spanish only)). See https://www.bbvaresearch.com/publicaciones/chile-precios-internacionales-de-alimentos-lejos-de-ser-una-amenaza-para-la-inflacion/
2: EEE: Survey of Economic Expectations EOF: Survey of Financial Operators

Figure 5.3

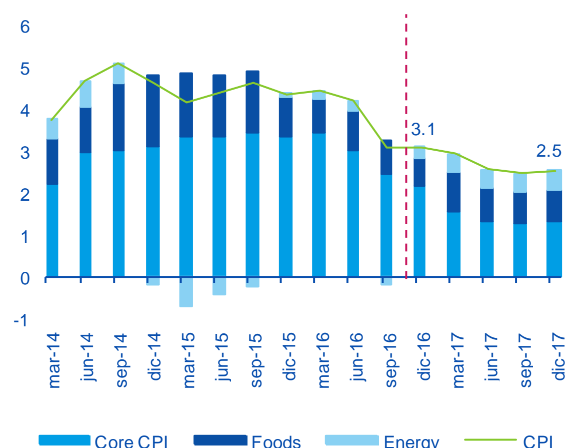
Inflationary expectations at two years* (%)



* The points correspond to the median of each survey (EEE and EOF). EEE: Survey of Economic Expectations EOF: Survey of Financial Operators
Source: Banco Central de Chile and BBVA Research.

Figure 5.4

Projected inflation (chge. % annual, eop)



* Dotted line indicates start of the forecast.
eop: end of period.
Source: INE and BBVA Research

At the statistical closure of this report, annual inflation stands at 3.1% YoY, after remaining above the Central Bank's tolerance range ceiling for over 2 years. In our baseline scenario, which assumes that the exchange rate will stand at $690 at year-end, inflation would end this year at 3.1%. For 2017, we maintain our year-end inflation forecast at 2.5%. We estimate that inflation will remain below 3% throughout the year. Although the most volatile products, food and energy, will continue to contribute to inflation next year, the low underlying inflationary pressures on both goods and services will determine the downward trend of overall inflation. The contribution of underlying inflation of goods will be very limited, in line with a rising trend in the peso during the year, while inflation of services will continue to ease in a context of increased slack in capacity (Figure 5.4).

6. Greater monetary stimulus to head off the risk of inflation's becoming unanchored

We confirm our forecast and are projecting at least two 25 bps rate cuts by 1Q17

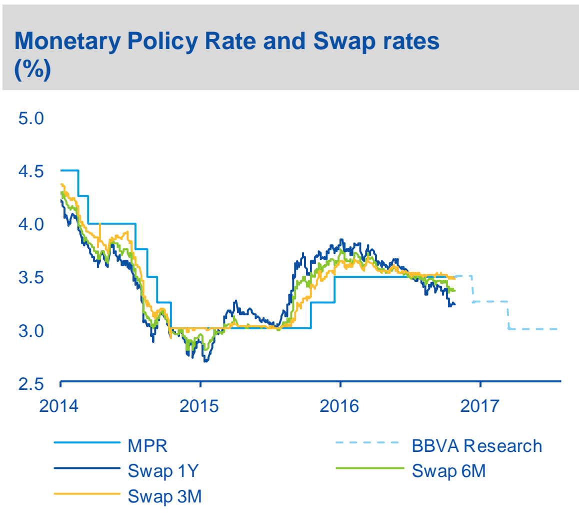
In its latest meetings, without cutting the Monetary Policy Rate, the Central Bank took significant steps towards acknowledging the need for greater monetary stimulus and translating it into tangible actions. In the scenario painted in its June report, the Central Bank's working hypothesis was that the Monetary Policy Rate would be increased twice to 4% at the policy horizon. Then in August, the bias of monetary policy was changed from contractive to neutral, and in the September report the working assumption was that the reference rate would be held at 3.5% at the projected horizon, dismissing any possibility of raising it.

In the September monetary policy meeting the option of cutting the interest rate was discussed, albeit still without majority support in the Council, as was made clear in the minutes. Finally, in line with our expectations, and subsequently to September's surprising CPI, the Council maintained the neutral bias but reported the deflationary surprise and its consequences for inflationary expectations, all of which are below the inflation target at the monetary policy horizon. We consider that with this information the way is cleared even further for a 25 bps cut in the Monetary Policy Rate at the December meeting.

This shift in official monetary policy discourse was accompanied by a fall in swap rates which assumed first one and then two rate cuts despite the Central Bank's maintaining a neutral bias (Figure 6.1). In the same way, the surveys of economic expectations and financial operators started to show growing numbers of respondents anticipating rate cuts, until in the October readings both clearly included at least one cut of 25 bps (Figure 6.2). This general trend was reinforced by the surprising CPI for September, which was markedly below both market and Central Bank expectations.

Figure 6.1

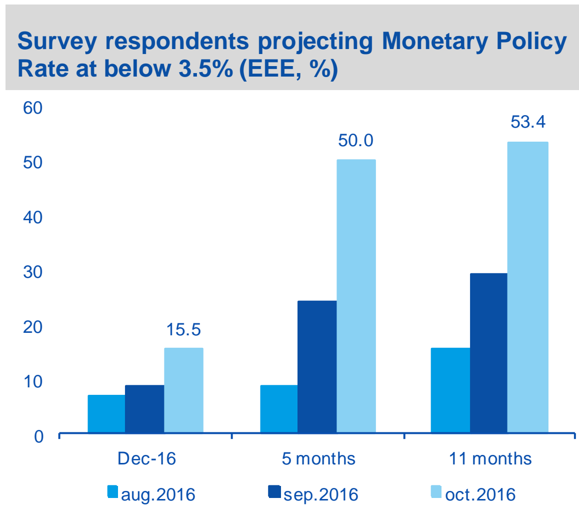
Monetary Policy Rate and Swap rates (%)



Source: Banco Central, Bloomberg and BBVA Research

Figure 6.2

Survey respondents projecting Monetary Policy Rate at below 3.5% (EEE, %)



Source: Banco Central de Chile and BBVA Research

Although inflationary expectations at the two-year horizon have remained anchored to the target, which may provide some comfort to the Central Bank, these expectations assume that there will be at least one rate cut of 25 bps within six months, which, as we have pointed out, has not so far been confirmed by the Central Bank. We consider that delaying the change in diagnosis, together with the observation of low monthly CPI figures in the last part of the year and during the summer, could trigger a more intense and prolonged unshackling of inflationary expectations than that seen in August, and that there are already slight signs of this in the October survey of financial operators. We believe the monetary authority has tended to subscribe to these concerns, and it is for this reason that we stress the need to deliver greater monetary stimulus promptly, no later than December, i.e. even earlier than suggested by the surveys and asset prices. We hope that this decision will be preceded by a change of bias in the November meeting and that it will be explained together with the new macroeconomic scenario in the December Monetary Policy Report, which should also make clear the magnitude of the monetary stimulus to be injected into the baseline scenario.

We project that a second rate cut should take place during the first quarter of 2017, rather than being postponed as indicated by the surveys and asset prices. We do not rule out the possible need for additional cuts to ensure that inflation remains anchored to the target, but this is not our baseline scenario. This could be necessary in a risk scenario in which activity and especially inflation were to be markedly below our forecasts next year.

In no way do we believe that increased monetary stimulus is the solution to the problem of low growth in the Chilean economy; rather we are calling for it to be allowed to work through the usual channels in order to keep inflationary expectations anchored. In fact, while it is true that the main reasons for the low rate of growth are related to the end of the mining cycle and critical lack of confidence at domestic level, we also think that in a context in which exchange rate and demand pressures are well contained, greater monetary stimulus will help to reduce the cost of financing for households and businesses and above all will make it possible to sustain a higher exchange rate, at levels commensurate with the cyclical position of the economy.

7. Limited growth of fiscal expenditure in 2017

As we anticipated, growth in public spending in 2017 will be less than 3%

The stability of the macroeconomic projections relative to last quarter is also reflected in the fiscal accounts. At the time of writing we continue to estimate an effective fiscal deficit of 2.9% of GDP for this year, somewhat better than the 3.1% of GDP estimated by the Ministry of the Treasury. The differences are due to our projecting a slight under-execution of non-capital spending and more revenue from sources other than taxation and mining. With this, spending would grow by 4.0% in 2016 and gross debt would end the year at 21.6% of GDP.

When the structural parameters for the 2017 Budget were made known (GDP trend growth of 3% and copper reference price of 2.56 USD/lb), we anticipated that room for growth in spending would be less than 3%. Even so, such a limited increase in spending seemed difficult to implement from a political point of view, given the calls for more countercyclical spending and the fact that 2017 is both a presidential and parliamentary election year. For this reason we would highlight the 2.7% growth announced by the government, which continues to be determined by the Fiscal Rule and is in line with the target of reducing the structural deficit at the rate of one quarter of a percentage point of GDP per year.

The effective deficit projected by the government for 2017 is 3.3% of GDP. At BBVA Research we estimate a slightly higher deficit of 3.4% of GDP. The difference is due to our estimating less tax income and mining revenues, in a scenario of lower economic growth and also of a lower exchange rate, partly offset by more revenues unrelated to the cycle. All the same, this level of deficit corresponds to a financing requirement of close to US$8.6 billion.

Surprisingly, the deficit will be financed solely by increased borrowing

As can be seen in Table 7.1, in accordance with the fiscal authority's statements, the US$11.5 billion debt issue authorised for next year will mainly be used to finance the fiscal deficit. However, one of the main surprises is the non-use of the FEES (*Fondo de Estabilización Económica y Social* or "Economic and Social Stabilisation Fund", Chile's main sovereign wealth fund) for financing, given that this option was referred to by the Ministry of the Treasury itself as a way of avoiding a greater accumulation of gross debt. What is more, US$1 billion has been earmarked for mandatory contributions to the FRP (*Fondo de Reserva de Pensiones* or Pension Reserve Fund, Chile's other sovereign fund). Given this, we share the government's estimate of gross debt for 2017 at 25% of GDP, and we consider that at least for now the growth in spending and the attainment of the structural deficit reduction target would enable Chile to retain its sovereign debt rating and outlook.

Table 7.1

Issue of debt and breakdown by use for 2017

Financing needs:	US$ millions
Fiscal deficit	9,000
"Recognition Bonds" (pension entitlements for contributors who switched systems)	1,000
Multilateral organisations	500
Contribution to Sovereign Wealth Funds	1,000
Total	**11,500**

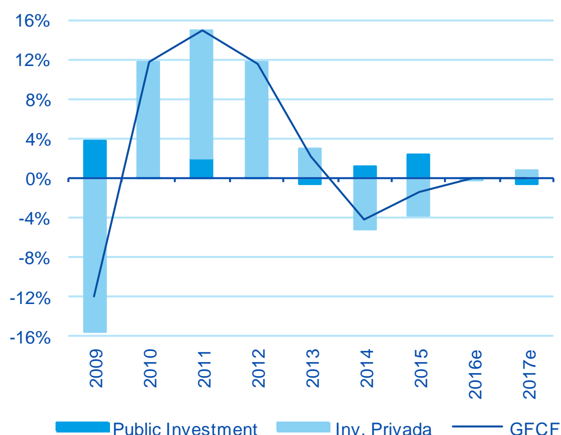
Source: Treasury Ministry, BBVA Research

The draft budget envisages a decline of 3.7% in public investment, completing a second year of reductions in this component (Figure 7.1). As we anticipated, current spending is more difficult to cut, especially in a context of reforms involving increased state subsidies and grants. Even so, given the extra resources to be generated by the end of the FUT (Retained Taxable Earnings) regime in 2018, in that year there will once again be room, albeit limited, for growth in capital expenditure.

We reiterate our concern regarding fiscal policy from 2019 on, when in order to continue meeting the target for structural deficit reduction, room for increased spending will be limited to around 1% p.a., which does not currently seem politically viable. Added to this is the fact that there are no positive fiscal balances in sight, at least until after 2020, so that generating debt will continue to play an important role in financing the treasury (Figure 7.2). In view of the foregoing, we do not rule out the possibility of some presidential candidates promoting a new tax reform to increase the tax burden again in order to finance increased spending. We do not believe that this is the best option, and are rather inclined towards generating the room needed for new spending initiatives within the framework of the Fiscal Rule, which requires spending to be cut in areas with relatively lower priority.

Figure 7.1

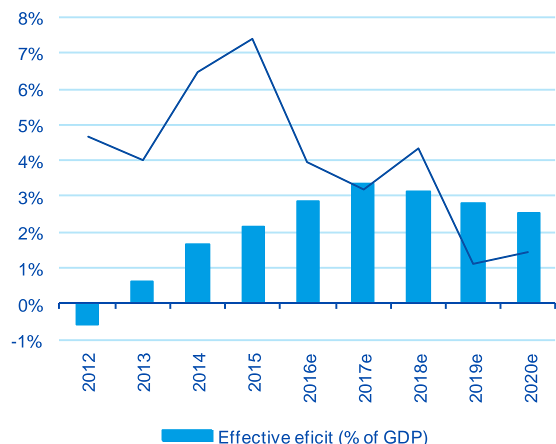
Contribution of public and private investment to annual growth in GFCF (%)



(e): estimated.
Source: BBVA Research based on Central Bank and Budget Office

Figure 7.2

Effective deficit and annual growth in expenditure 2012– 2020e



(e): estimated.
Source: BBVA Research based on Budget Office

8. Recovery will be delayed if the peso does not depreciate soon

Delay in monetary policy support could also lead to a slower process of recovery

The main risk for Chile in the medium term is the performance of the Chinese economy. Recent figures show some stability in the process of redirecting spending towards private consumption with less reliance on investment. We continue to expect China's economy to slow gently, and although the risk of a disorderly process remains, anecdotal evidence tends somewhat to allay the concerns we had in earlier reports. If China's economy were to slow further as a result of the excessive credit that has accumulated, this could lead to a sudden adjustment, which, as we have indicated, would have significant repercussions for Chile, in terms of commodities, fiscal revenue, exports, investment and ultimately growth. A downturn in China's economy would also 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, anecdotal evidence has lent support to a gradual process, which has relieved the pressure on Chile's monetary policy, allowing it to remain longer at stimulus levels.

However, since our last report the peso's appreciation has intensified, and we consider that this could delay 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 for too long in real terms but also push medium-term inflation down below levels consistent with the inflation target.

The risk of a slower-than-expected recovery of economic agents' confidence also remains, and this could even delay recovery in the private components of demand, consumption and investment beyond next year. For now, our baseline scenario envisages neutral levels of confidence in the latter part of next year or in any case not later than the beginning of 2018.

9. Tables

Table 9.1

Macroeconomic forecast

	2013	2014	2015	2016	2017	2018
GDP (% YoY)	4.0	1.9	2.3	1.7	1.8	2.4
Inflation (% YoY, eop)	3.0	4.6	4.4	3.1	2.5	3.0
Exchange Rate (vs. USD, eop)	530	613	704	690	680	651
Interest Rate (%, eop)	4.5	3.0	3.5	3.3	3.0	3.0
Private Consumption (% YoY)	5.5	2.4	1.9	1.8	1.5	1.9
Government Consumption (% YoY)	3.5	5.1	5.8	5.4	3.2	2.9
Fixed Investment (% YoY)	2.2	-4.2	-1.5	-0.1	0.0	2.0
Fiscal Balance (% GDP)	-0.6	-1.6	-2.2	-2.9	-3.4	-3.2
Current Account (% GDP)	-3.7	-1.3	-2.0	-1.6	-1.8	-1.0

Forecast closing date: 28 October de 2016.
Source: BBVA Research

Table 9.2

Macroeconomic Forecast

	GDP (% YoY)	Inflation (% YoY, eop)	Exchange Rate (USDCLP, eop)	InterestRate (%, eop)
1Q 14	2.7	3.5	563.8	4.0
2Q 14	2.3	4.3	553.1	4.0
3Q 14	0.9	4.9	593.5	3.3
4Q 14	1.6	4.6	612.9	3.0
1Q 15	2.7	4.2	628.5	3.0
2Q 15	2.3	4.4	630.0	3.0
3Q 15	2.5	4.6	691.7	3.0
4Q 15	1.7	4.4	704.2	3.5
1Q 16	2.2	4.5	682.1	3.5
2Q 16	1.5	4.1	681.1	3.5
3Q 16	1.6	3.1	668.6	3.5
4Q 16	1.7	3.1	689.7	3.3
1Q 17	0.9	2.8	687.3	3.0
2Q 17	1.6	2.4	684.9	3.0
3Q 17	2.4	2.6	682.5	3.0
4Q 17	2.1	2.5	680.1	3.0
1Q 18	2.5	2.7	669.7	3.0
2Q 18	2.8	3.0	661.4	3.0
3Q 18	1.8	3.0	656.1	3.0
4Q 18	2.7	3.0	650.7	3.0

Forecast closing date: 28 October de 2016.
Source: BBVA Research

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