BBVA | RESEARCH

Chile Economic Outlook

FIRST QUARTER 2017 | CHILE UNIT

01
Growth projection for 2017 has been corrected to 1.6% in view of the weakness observed at the beginning of the year

02
The exchange rate (pesos per dollar) is close to intervention level

03
Limited inflationary pressures are confirmed, which creates room for cuts in the monetary policy rate to 2.5%

04
The medium-term fiscal situation is becoming more complex and will require an adjustment, which the next government will have to define

Contents

Closing date: 6 February 2017

1. Editorial

The global environment improved in the last months of 2016 and is continuing to do so in early 2017. Despite this acceleration, the outlook for 2017 and 2018 is fraught with uncertainties. The main one is associated with the economic policy of the new US administration, which is still largely undefined. Global economic growth is expected to increase from 3% in 2016 to 3.2% in 2017 and 3.3% in 2018.

We project that the Chilean economy will grow by 1.6% this year, a rate not very different from that observed in 2016. The weak start of the year, with growth once again below 1% YoY, will make it difficult to attain a figure closer to the consensus estimate.

The nominal exchange rate misalignment is evident, and the real exchange rate is approaching intervention levels. As well as the increase in the price of copper, which we consider transitory, this movement is explained by operators taking arbitrage positions in search of returns and repatriation of capital by institutional investors (basically pension funds) in response to their contributors' decisions. Benchmark interest rates for their part are at rock bottom due to expectations of greater monetary stimulus and decompression of term premiums explained mainly by greater demand from the pension funds.

Marginal data confirm the very limited inflationary pressure faced by the economy. Our forecast is for the central bank to cut its reference rate by a total of one percentage point in the first half-year, to 2.5%, and for inflation to end the year at 3.2%. Without monetary stimulus of this kind and the depreciation of the peso that it would entail, we would see inflation fluctuating in the lower part of the range of tolerance, with a significant risk of expectations slipping their anchor. Although in December the central bank announced only two 25 bps reductions in the reference rate, market rates and surveys anticipate greater stimulus. We expect that the publication of the March monetary policy report will be the time chosen to acknowledge the need for more stimulus.

The greatest risks to the fiscal scenario are in the medium term. We estimate that in the next three years there will be no fiscal leeway, indeed there will be a shortfall of US$2.96 billion (0.9% of GDP) and that gross public debt will increase to 35% of GDP in 2021. The recent change made to the outlook by Fitch and S&P makes a downgrade of the sovereign debt rating in the next few months very likely. Correcting the lack of leeway is going to be difficult, since it will require spending cuts, not meeting the commitment on converging with the structural balance and/or further tax increases. This decision will of course fall to the next government.

The balance of risks, internal and external, for this year continues to be negative. From a domestic point of view, the risk that a tardy and inadequate response of monetary policy would involve has not dissipated. Another additional risk factor this year is in the form of the presidential elections, which are already generating considerable political debate about significant reforms for various sectors and for the economy as a whole. Investment for its part shows limited growth in our baseline scenario and is not free of risks, given the possibility that business confidence might not recover and the risk inherent in the materialisation of projects in development, particularly in the energy sector. The risk of a ratings downgrade for sovereign risk has risen significantly, and if it were to materialise it would have adverse consequences for the cost of financing, making any recovery process even more difficult.

2. Global growth

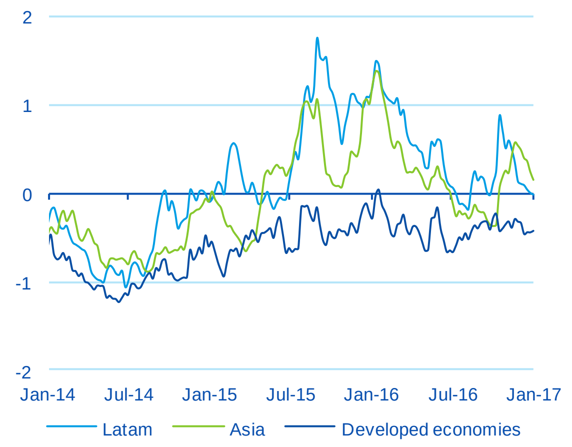
Global environment: more growth, higher uncertainty and long-term risks

The global environment improved in the last months of 2016 and is continuing to do so in early 2017. World growth accelerated in the last quarter of 2016, confidence indicators have improved clearly in all areas, and the industrial sector indicators are growing along with an incipient improvement in global trade.

Despite this acceleration, the outlook for 2017 and 2018 is fraught with uncertainties. The main one is associated with the economic policy of the new US administration, which is still largely undefined. Fiscal stimulus measures have been announced, as has deregulation in various sectors; this was welcomed by markets in the developed economies but not in those of emerging economies, which saw capital flight and currency depreciation, reflected in an increase in financial stresses at the end of 2016 (Figure 2.1). However, announcements of protectionist measures may seriously harm international trade in the medium and long term and affect confidence sooner than that, especially outside the US. Also, the lingering uncertainties about US economic policies seem to have been tempering the markets' optimism since the beginning of the year.

Figure 2.1

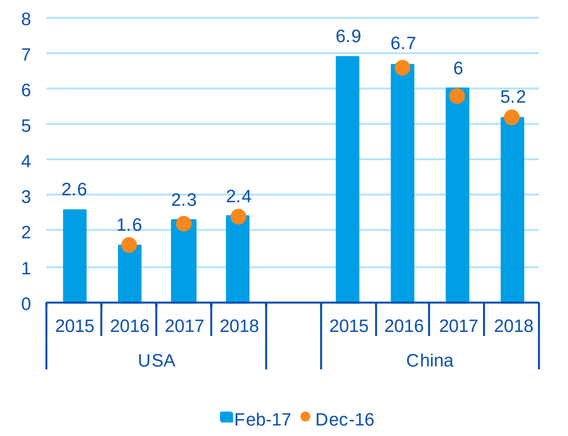
BBVA financial stress index



Source: BBVA Research

Figure 2.2

GDP growth in the US and China (%)



Source: BBVA Research

The magnitude of the inflationary pressures is another unknown at global level. Commodity prices, and particularly oil prices, have recovered more than expected in recent months, following the OPEC agreement and the improvement in activity. If to this we add the size of the balances accumulated by developed countries' central banks in recent years due to quantitative easing programmes and the prospects of fiscal stimulus, the result is that the risks of deflation of just a few quarters ago have been replaced by inflationary pressures in the developed economies, generating a number of questions about the reaction of their respective monetary policies.

In principle, the Federal Reserve is maintaining a cautious stance and continues to aim for a relatively slow normalisation of interest rates. Our forecast is for two rate hikes this year and two more in 2018. We expect the ECB for its part to begin the process of tapering QE in early 2018 and to decide on the first interest rate hike at the end of that year.

Overall, our growth projections for 2017 for the major economies have not been substantially revised, although they are subject to greater uncertainty than usual. The base effect of higher growth in late 2016 and its inertia effect, together with the expected fiscal stimulus in the US, have led us to revise our forecasts for the US and Europe very slightly upwards, and for China a little more, while revising forecasts for Latin American countries downwards, mainly due to idiosyncratic factors. In particular, in the US we anticipate growth of 2.3% and 2.4% in 2017 and 2018 (Figure 2.2). In China, we are expecting growth of 6% in 2017, falling to 5.2% in 2018, given the vulnerabilities faced by the economy and an economic policy more oriented towards ensuring financial stability than maintaining growth. In this way, global economic growth should increase slightly, from 3% in 2016 to 3.2% in 2017 and 3.3% in 2018.

World growth will increase from 3% in 2016 to 3.2% in 2017 and 3.3% in 2018.

The risks are mainly on the downside and are dominated by the aforementioned uncertainty linked to protectionism in the US, a less welcoming attitude towards immigration and the danger that fiscal stimulus policies will have no effect on growth and will generate inflation, or that the deregulation announced in various sectors will not be managed properly. To this is added the possible reaction of other countries or regions to these protectionist moves. An unexpected rise in inflation could lead to the tightening of monetary policy by the main central banks, with global consequences. In the long term, the risk of imbalances building up in China, together with the lack of structural reforms in state-owned enterprises, may have an impact on the country's capital flows and currency and lead to an abrupt slowdown. In Europe, the political risk is high, in a year with a full electoral calendar. And in general, geopolitical risks remain high.

3. 2017 growth faces headwinds

A disappointing start to the year makes it difficult to attain the 2% estimated by the consensus

Growth in 4Q16 was considerably less than expected - just 0.5% YoY, and down on the previous quarter in seasonally adjusted terms. With these figures, 2016 ended with growth of just 1.5%, one step lower in the slowdown that the economy is going through.

Although Chile did not technically go into recession in 2016, there were two non-consecutive quarters of QoQ contraction in GDP (Figure 3.1). The slow pace of growth has left the economy in a vulnerable state which could easily lead to sharper contraction in the event of new supply shocks. The quarterly growth dynamic observed in 2016 was underpinned by the trend in public spending, which grew strongly in the first three quarters of the year before having to be curtailed in the last quarter in order to comply with the authorised budget. Another thing that became clear with the final figures for 2016 was the debilitated state of activity generally, which rather weakens the argument that the mining sector was responsible for the low rate of growth. Lastly, the fact that the year ended with such weak growth has consequences for the speed of expansion with which the economy faces the early part of this year and is therefore having a negative effect on growth projections for 2017 and 2018.

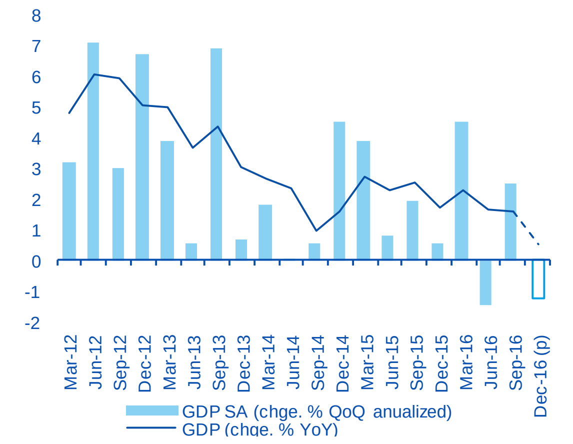
We estimate that this year it will be very difficult to grow by 2% as the consensus estimates, starting out from a first quarter with growth of less than 1%. We project that in 2017 the economy will grow by around 1.6%, a rate not significantly different from that observed in 2016. This projection assumes that in the last quarter of the year the economy would be growing at close to its potential, which is estimated at around 3%, and that in 2018 it would grow by around 2.4%.

The first factor that we think will have less impact on domestic demand this year is public spending, which has exhausted its room for growth and will have to be significantly curtailed this year, following the 5.7% p.a. expansion in real terms over the past three years. The positive aspect of this withdrawal of public demand is the room it opens up for greater monetary stimulus, which we believe should not be less than 100 basis points in this cycle that began in January. The effects of this greater monetary stimulus on demand and activity will become clearer in the second half of this year and in 2018.

As for private consumption, although marginal data suggest a very tenuous recovery, we forecast that the year will end with expansion not very different from that seen in the past three years, namely around 2%. This projection is compatible with continued limited growth in wages, a low level of wage earners job creation and an unemployment rate that is rising on average and exceeds 7% in the winter. It also assumes that consumer expectations, anecdotally reported to have improved with lower inflation, will remain pessimistic during much of the year. An opposite effect would be exerted by lending conditions, which would become somewhat more favourable if there were in fact to be a 100 bps cut in interest rates in the first half-year.

Figure 3.1

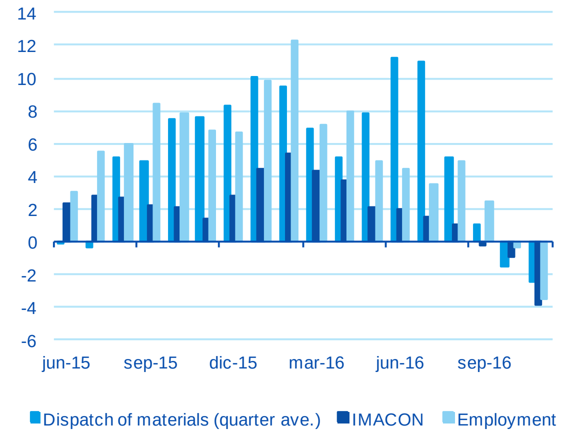
Quarterly GDP growth



(p): projection.
Source: Central Bank of Chile, CBC and BBVA Research

Figure 3.2

Indicators of construction activity (chge. % annual)



Source: Central Bank of Chile and BBVA Research

We forecast that fixed investment will grow by 1% this year, although this projection has downside risks mainly associated with the materialisation of pending projects in the energy sector. In terms of components, construction is in a cycle of contraction that we believe has only just started and will last throughout the year (Figure 3.2), while plant and equipment, although no longer falling as sharply as in 2013-2015, is not contributing to growth of investment. Public investment will fall in accordance with amounts approved in the Budget. A contrary effect might come from inventories, the run-down of which had a very negative effect on growth in domestic demand in 2016 and which we believe should recovery somewhat this year. Additionally, the lower interest rates will lead to more favourable financing conditions for companies, but until we see a clear and sustained recovery in business confidence, the marginal contribution of improved credit terms to investment will be rather limited.

Lastly, exports have not made any significant contribution to economic growth, and that is due entirely to the insufficient depreciation of the peso. The projection presented in this report assumes that the real exchange rate (pesos per dollar) will rise to around its historical average, which we consider a necessary minimum condition for exports to recover and contribute to the reallocation of resources to export sectors other than mining.

4. Market interest rates at new lows

The exchange rate (pesos per dollar) is below the level explained by fundamentals, and close to intervention level

Uncertainty persists about how China's economy will evolve, although the recovery in the price of copper in the past few months has somewhat improved the terms of trade. On the other hand, we consider that the continuing strength of the Chilean peso is preventing a faster adjustment process, since it discourages investment in export sectors, although it also contains additional adjustments to cuts in investment in the mining sector. In this context, the stock exchange has seen some rallies, particularly in the last month (Figure 4.1).

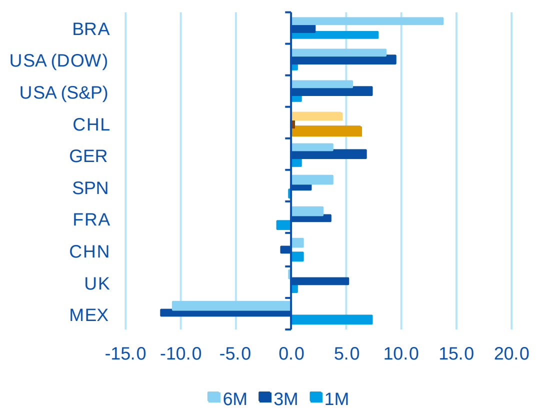
The real exchange rate remains below historical averages, making reallocation to non-mining sectors difficult

Despite the Federal Reserve's rate hike and the news of a significant fiscal stimulus in the US, leading the dollar to strengthen against other developed economies' currencies, the peso continues to trade at around $640, and has even appreciated relative to pre-Brexit referendum levels (Figure 4.2). This development has coincided with a rise in the price of copper and 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 4.3), 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 led to an increase in the supply of dollars, underpinning a certain degree of appreciative pressure (Figure 4.4).

Figure 4.1

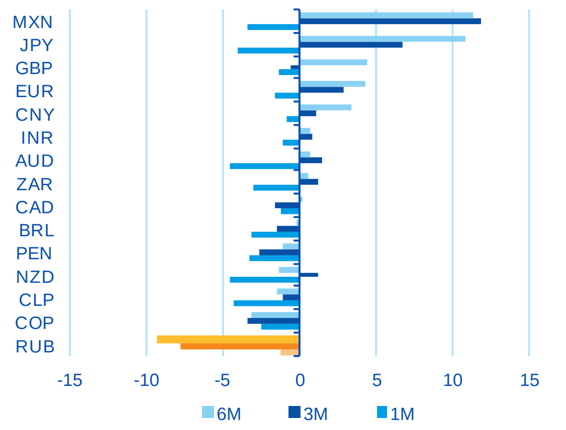
World stock exchanges (USD, % chge.)



Source: Bloomberg and BBVA Research

Figure 4.2

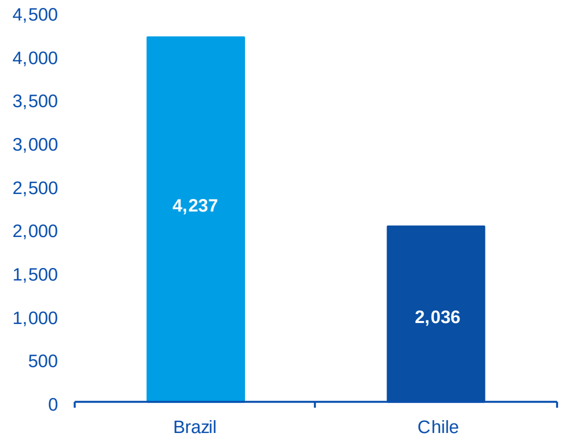
Exchange rates (units of local currency per dollar, %)



Source: Bloomberg and BBVA Research

Figure 4.3

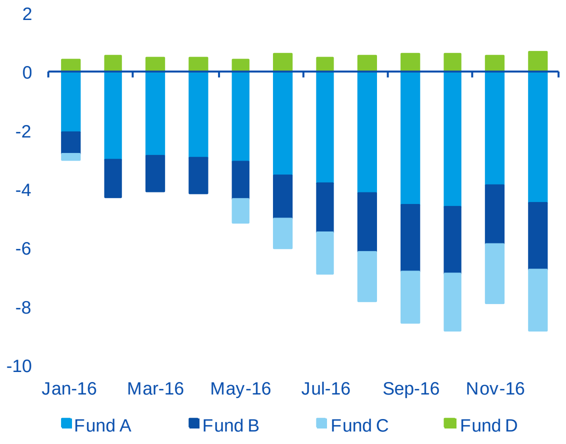
Increase in the long position of the Chilean peso and the Brazilian real*



* Standardised contracts for Brazil for an amount of US$50,000. Increase observed between 2 December 2016 and 3 February 2017.
Source: Central Bank of Chile, BM&F Bovespa and BBVA Research

Figure 4.4

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



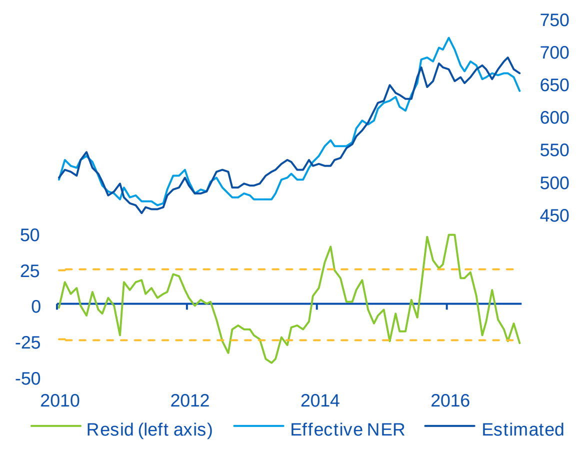
* E-fund is the most conservative pension fund.
Source: *Superintendencia de Pensiones* (Chilean Pensions Supervisor) and BBVA Research

Low interest rates driven by falling term premium and greater monetary stimulus expected

From our evaluation of nominal misalignment, we see evidence of the currency's being at a lower level than that suggested by the terms of trade and other short-term factors (Figure 4.5). Similarly, the real exchange rate is below its historical average, which does not help with the reallocation of resources to export sectors, and close to previous intervention levels (Figure 4.6). The monetary policy, which is certainly justified by the medium-term deflationary effects that this strengthening of the peso would entail, has started to act. Our baseline scenario envisages a depreciation of the peso at the projected horizon thanks to cuts in the monetary policy rate which could place the currency at around 700 pesos to the dollar by the middle of this year.

Figure 4.5

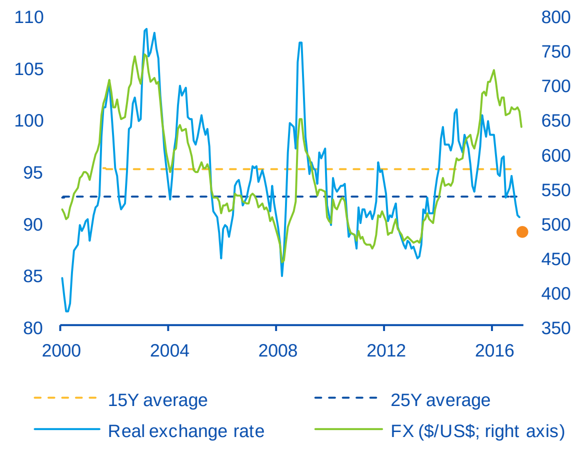
Actual and estimated exchange rates (pesos per US$)*



* 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 4.6

Real exchange rate (average, 1986 = 100)

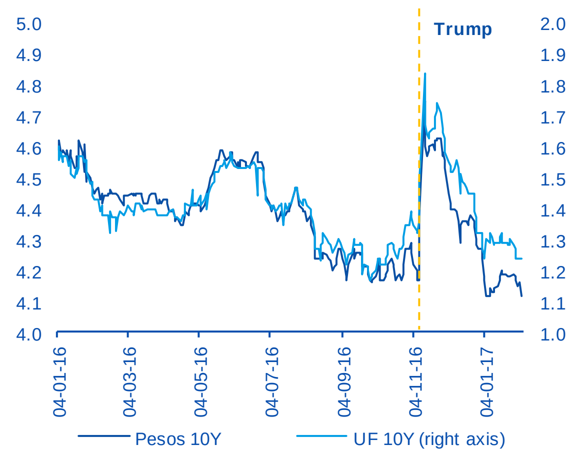


* Orange dot shows projected real exchange rate at closing date.
Source: Central Bank of Chile and BBVA Research.

Benchmark interest rates rose sharply following the US presidential elections, but when this report went to press, nominal rates at terms over five years were at all-time lows, while inflation-indexed rates had also fallen back considerably (Figure 4.7). We carried out an analysis of the size of the term premium, concluding that movements in the market rate are largely linked to the correlated movement of domestic and external term premiums but also to the increase in demand for these instruments on the part of institutional players (basically pension funds), which have contributed to compressing the term premium in view of their members' large-scale shift into less risky funds (Figure 4.4 y 4.8).

Figure 4.7

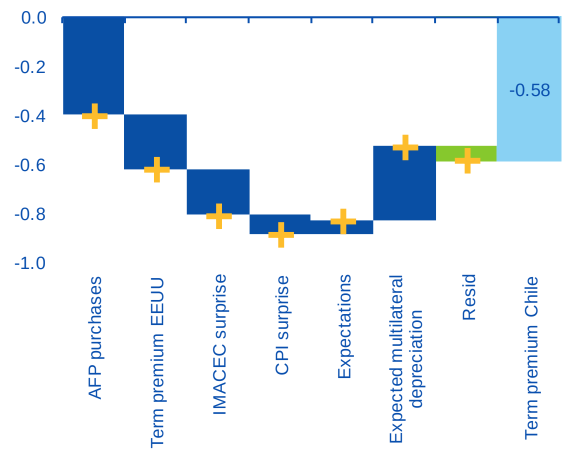
Interest rates at ten years in pesos and UF* (%)



* UF: *Unidades de Fomento* or CPI-adjusted units of account.
Source: BBVA Research

Figure 4.8

Effects on change in Chile's term premium (percentage points)*



* Change from June 2015 to November 2016.
Term premium estimated in accordance with the methodology of Adrian et al. (2013). Breakdown of the term premium based on a scaled-down model of determinants of the term premium for Chile.
Source: BBVA Research

5. Inflation should pick up in the second half of 2017

We project inflation at 3.2% for December 2017, providing the forecast currency depreciation comes about

In the last few months of 2016, inflation continued to be surprisingly low, converging to target faster than expected by the market and confirming our view of generalised low inflationary pressures. Core inflation (CPI stripped of food and energy) has continued to fall significantly in the past few months, driven not only by lower inflation of goods linked to the exchange rate but also by a clear slowdown in inflation of services (Figure 5.1). The annual effect of goods minus food and energy on CPI has practically disappeared following several negative monthly figures in the lower part of the seasonal range. In December, price inflation of goods minus food and energy fell to 1.0% YoY, with a fall of 0.5% for the month, the lowest monthly figures since the year 2010.

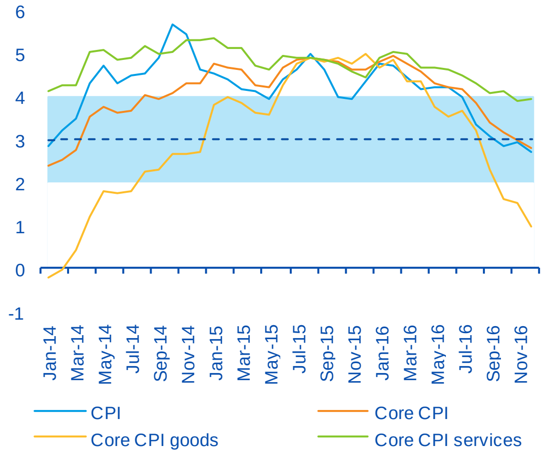
Core inflation will continue to slow until mid-year

Together with this, inflation of services, a component with a greater degree of indexation and impetus in the CPI, has continued to slow in the past few months, in line with sluggish domestic demand which continues to widen capacity gaps, and a persistently weak labour market. In December, annual inflation of services without food and energy was 4.0%, slightly below its average for the past 15 years (4.2%), and at a similar level to that seen in 2014 in the throes of a slowdown and monetary policy rate cuts. If we also discount the one-off effect of the increase in stamp duty of January 2016, annual inflation of services could quickly approach 3% towards mid-year.

The most volatile components of the basket, such as food and energy, have continued to inject some inflation in the past few months, in line with increases in international prices. As regards food, price inflation of non-perishable foodstuffs are holding steady, and in spite of the higher international prices, their effect should remain limited. Perishable foodstuff prices have fallen sharply in the past few months, in line with the seasonality of fruits and vegetables; this will no doubt come to an end in January and February, but the effect on annual inflation should remain limited. Fuels injected some inflation in the period November to January, in line with the increase in the price of oil and, initially, the depreciation of the peso. In our baseline scenario, in which the price of oil (Brent) gradually increases to around US$58 a barrel by the end of 2017, we estimate that fuels will inject inflation throughout the year, due to base effects.

Figure 5.1

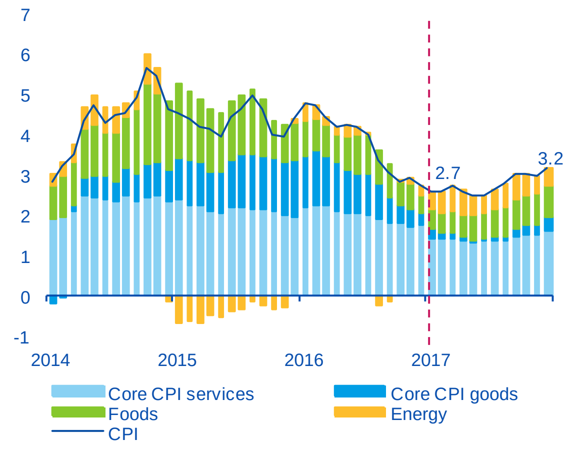
Annual inflation (percentage)



Source: National Bureau of Statistics (*INE*) and BBVA Research

Figure 5.2

Projected annual inflation (percentage)



Core CPI: CPI excluding food and energy.
Source: National Bureau of Statistics (*INE*) and BBVA Research

Anchoring of inflationary expectations conditional upon at least three rate cuts in 2017

Although the average of the surveys (EEE, Survey of Economic Expectations and EOF, Survey of Financial Operators) continue anchored to inflation of 3% at a two-year horizon, this is conditional on reductions in the monetary policy rate as incorporated into these surveys, namely at least three rate cuts during 2017. If this scenario does not materialise, even if there are no additional surprises regarding activity and/or inflation, we see a risk of inflationary expectations slipping their anchor at the horizon of the policy. Prices of financial assets confirm these expectations, including of three rate cuts this year, which seems to indicate that the assumption used in the last monetary policy report (December), of a cut of only 50 bps, is no longer enough for the market. At closing date, annual inflation was at 2.7% YoY (December 2016), clearly slowing, indeed slowing faster than expected by the market, after two years above the ceiling of the central bank’s range of tolerance.

In our baseline scenario for 2017, we assume that the exchange rate will be above 700 pesos per dollar and we project year-end inflation at 3.2%, although being below 3% for much of the year. If our assumptions of further reductions in the monetary policy rate materialize and the convergence of the price of copper and the depreciation of the peso prove correct, inflation should pick up during the year, mainly base on greater inflation of goods (Figure 5.2). However, if there is no currency depreciation, inflation will remain stuck at the bottom of the central bank’s range of tolerance for longer than estimated, without significant pressures for core inflation. For 2018 we project inflation continuing to fluctuate around 3%, which is consistent with a monetary policy rate held at 2.5% in the first half-year and gradually starting to normalise in the second half of the year.

6. The process of reductions in the reference rate has started

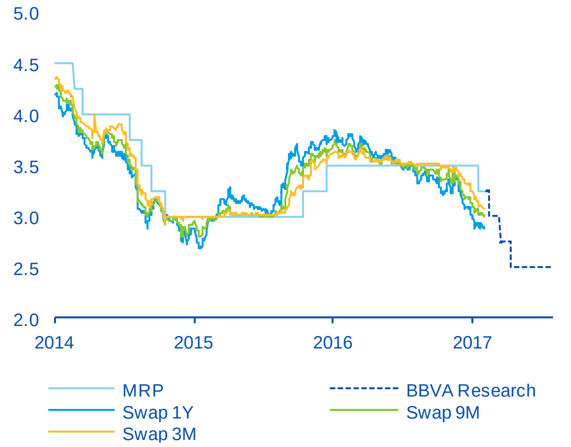
Medium-term deflationary pressure has led the central bank to start the process of rate cuts as we anticipated.

In its last meetings of 2016, 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 its December report, the central bank implied that the monetary policy rate would reach 3%, after holding it at 3.5% throughout the year. So it was that in the January 2017 meeting the central bank started the process of reductions, after some negative surprises on inflation and activity in the last part of 2016, which leads us to think that the cumulative reduction of 50 bps will not be enough to ensure that inflation moves towards the middle of the target range.

This gradual change in official discourse on monetary policy, which had been going on since the June Monetary Policy Report, was anticipated by movements in swap rates, which at the time of writing factored in the monetary policy rate's reaching 2.75% in the course of the year (Figure 6.1). Similarly, a growing number of financial operators and other respondents to surveys of economic expectations now anticipate bigger cuts than those announced by the central bank, possibly even as far as to 2.5% (Figure 6.2)

Figure 6.1

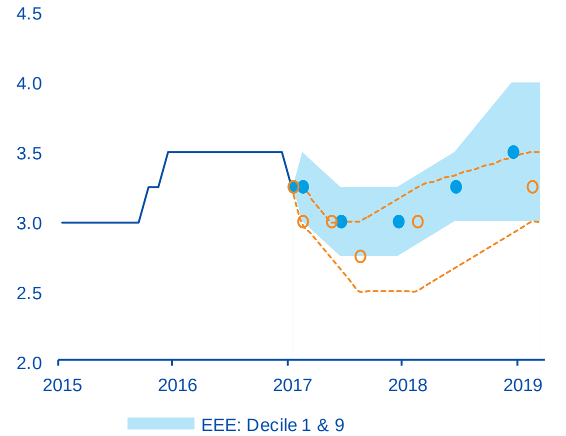
Monetary policy rate and Swap rates (basis points)



Source: Central Bank of Chile, Bloomberg and BBVA Research

Figure 6.2

Expectations of the monetary policy rate according to surveys (EEE, EOF, %)



EEE: Economic Expectations Survey
EOF: Financial Traders Survey
Source: Central Bank of 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 two rate cuts of 25 bps within six months. The change in the baseline scenario and the downward adjustment to the bias of monetary policy lead us to anticipate rather more decisive action by the central bank to ensure the convergence of inflation. However we have not recently observed any factors that might act as catalysts for greater inflation, particularly with the significant appreciation of the peso in real terms, which makes it difficult to close the capacity gaps and exerts deflationary pressure on the portion of the basket of prices that is most reactive to the exchange rate. Consequently, our scenario of cuts in the monetary policy rate, which assumed cuts of “not less than” 50 bps from the monetary policy rate of 3.5%, is now centred on a monetary policy rate of 2.5%, with cumulative cuts of 100 bps over the first two quarters of the year.

According to our projections, a second rate cut should take place not later than March 2017, while the subsequent cuts would take place almost consecutively over the remaining months so as to leave the monetary policy rate at 2.5% at mid-year. In our baseline scenario the reference rate is held at 2.5% until the middle of 2018 before starting a gradual process of normalisation during the second part of that year and not reaching neutral levels until 4Q19.

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. Fiscal policy: no leeway

Effective deficit for 2016 less than expected

The year 2016 ended with a fiscal deficit of 2.8% of GDP, less than the 3.2% estimated by the Ministry of the Treasury in September, which in turn implied less use of Other Public Treasury Assets for financing. This brings the structural deficit to 1.6% of GDP, without counting the revenue for reimbursement of capital, which is used by the government to meet its fiscal target. The main difference between the fiscal result at the end of 2016 and the official estimate of September was due to lower tax refunds to major private sector mining companies, which meant greater effective and structural revenues.

Although the “fiscal rule” was designed with the idea that public spending should be independent of the cyclical fluctuations of the economy (acyclical), the loss of the fiscal anchor during the crisis of 2008-2009 left space for public spending to be strongly countercyclical, growing on average well in excess of the growth of the economy, at the cost of not closing the structural deficit. In the past three years the economy grew by 1.9% on average, while spending increased by 5.7% on average.

Fiscal revenues for 2017: higher copper prices offset by lower growth

Given the effective growth in spending of 3.7% in 2016, the new projections for inflation and increased spending because of the fires in the south, real growth in spending in 2017 will be 4.0%. In view of the emergency, execution of the Budget this year should be over 100%. As regards capital spending, which is the most difficult component to execute, it should grow by at least 1.2% in real terms, which constitutes a floor since it is not known how much of the increased spending will for to investment.

As can be seen, we are incorporating increased spending for the fires that are affecting the south of the country. The Ministry of Finance has already indicated that the fiscal cost of this disaster will amount to US$333 million. On this subject: 1) not all the spending will be carried out in 2017, since it largely relates to reconstruction work, and 2) US$100 million will be financed by budgetary reallocations, but US$233 millions will be financed by using the FEES (Economic and Social Stabilisation Fund, Chile’s main sovereign wealth fund). We understand that these figures are preliminary and it is not know whether they will be completely finalised this year. However, taking them at face value, the US$233 million from the FEES has a direct equivalence in increased spending of approximately US$155 million, equivalent to 0.1% of GDP.

Table 7.1 compares the assumptions of the Ministry of the Treasury for the Budget Act with those of BBVA Research for this year. While lower growth in GDP and domestic demand will have a negative effect on effective revenues for this year, this should be more than offset by the increase in the price of copper, the weaker peso and increase in other revenues not related to the cycle. The increased spending we estimate on account of the emergency would bring the effective deficit to 3.3% of GDP at year-end. Given that part of the financing of this spending will come from the FEES, the possibility arises that the Treasury might not consider it necessary to use up the entire US$11.5 billion of debt issuance authorised by the Law.

Lastly, since this is an election year, we cannot rule out pressures for greater spending, this being one of the risks of our macro-scenario. This would occur in a context in which the marginal contribution of the Tax Reform to tax revenues is less (0.46% of GDP according to the financial report) and the risk remains of a return below that projected, especially after two years in which the increased tax revenues were based largely on one-off items, as was the case with the repatriation of capital in 2015 and 2016, and the low rate for withdrawing resources from the FUT (Retained Taxable Earnings) in 2016.

Fiscal tightness in the medium term could lead to a new tax reform or to not meeting the target for convergence to structural balance

The greatest risks to the fiscal scenario are in the medium term. The recent change made to the outlook by Fitch and S&P could be followed by a downgrade of the sovereign debt rating. This is one of the national risks that has increased in probability at the margin, and which would have a significant impact on the perception of sovereign risk.

The risk of a downgrade has increased in probability at the margin

As we have mentioned in previous reports, in 2018, with the additional revenues from the FUT (Retained Taxable Earnings) together with the increased rate of corporation tax, there would be room for greater growth in spending. We predict expansion of around 4.5% and an effective deficit of 3.2% of GDP, marginally less than that of 2017 and meeting the goal of reducing the structural deficit by 0.25% of GDP. From then on, the exhaustion of the new revenues relating to the Tax Reform, limited structural parameters and the ongoing commitment to reducing the structural deficit in 2019, would allow limited growth somewhat in excess of 1%. Figure 7.1 shows the projection of gross debt, assuming the structural parameters are held at their current levels and the convergence target is met, and adds the maturities reported by the Ministry of Finance for each year to an amount for the payment of *Bonos de Reconocimiento* (former pension system bonds), accounting for an increase in debt to 35% of GDP in 2021.

Table 7.1

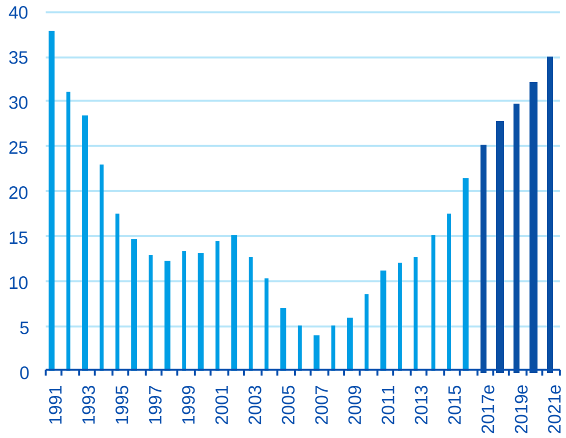
Comparison of 2017 Budget Act assumptions and BBVA Research estimates

	Ministry of Finance	BBVA Research
GDP (chge. YoY)	2.25	1.6
Domestic demand (chge. YoY)	2.8	1.8
CPI (ave. chge. YoY)	3.0	2.8
Exchange rate (CLP/USD)	700	704
Price of copper (USc/lb)	220	241
Public spending (chge. %)	2.7	4.0
Effective deficit (US$ millions)	8.121	8.050
Effective deficit (% of GDP)	3.3	3.3
Structural deficit (% of GDP)	1.5	1.6

Source: Budget Office, BBVA Research

Figure 7.1

Actual and projected gross debt (% of GDP)



(e): estimated.
Source: BBVA Research

All the same, the risks if the target of convergence to the structural balance is not met are high, and this becomes abundantly clear when we project the leeway for spending with that of the Treasury's accounts in the next few years. Each year, the Budget Office in its Report on Public Finances (IFP) estimates a medium-term scenario. In this report it first calculates "committed spending", in other words the total disbursements that it is obliged to make by law or decree in the next few years. It then calculates "target-compatible spending", which is the level of spending that meets the government's medium-term structural balance or deficit target. This fiscal leeway is defined as the difference between target-compatible spending and committed spending. In the last two IFPs, the leeway has been negative, in other words committed spending exceeded the level required to meet the target for convergence to structural balance. And this result was built on assumptions regarding GDP and domestic demand which, compared with market projections, were optimistic.

Using the level of committed spending from the latest IFP, in Table 7.2 we calculate the leeway compatible with our macro-fiscal scenario, which come to a negative US$2.96 billion (1.0% of GDP) in the next few years. As can be seen, our assumptions on domestic demand and the exchange rate have a negative effect on structural revenues and reduce the scope for increased spending in line with the convergence target even further. Furthermore, we project greater effective deficits than those of the IFP, even with lower target-compatible spending than that estimated by the government, due mainly to our assumptions on GDP and the price of copper being lower than those of the Treasury for the period. Correcting this situation to meet the commitments given is going to be difficult, since it will require spending cuts, not meeting the commitment on converging with the structural balance and/or further tax increases. This decision will of course fall to the next government.

Table 7.2

Fiscal leeway, IFP and BBVA Research (in millions of 2017 pesos)

	2018	2019	2020	Cumulative
Committed spending	44,541,857	45,573,698	46,459,934	
Target-compatible spending				
According to the IFP	44,282,276	45,159,847	45,958,018	135,400,141
BBVA Research	44,217,003	44,796,702	45,750,830	134,764,536
Fiscal leeway (in US$ millions)				
According to the IFP	-382	-627	-784	-1,793
BBVA Research	-492	-1263	-1206	-2,960
Effective balance with target-compatible spending (% of GDP)				
According to the IFP	-2.8%	-2.1%	-1.5%	-6.4%
BBVA Research	-3.2%	-3.0%	-2.8%	-9.0%

Source: Budget Office, BBVA Research

8. Greater risks to growth, both external and internal

Political factors combine with new economic risks to produce a negative balance

Although the central bank cut rates at its January meeting, the risk that a tardy and inadequate response would involve has not dissipated. The monetary stimulus should not be less than 100 basis points and should come about in the first half-year in order to have significant effects as soon as possible on the competitiveness of the export sector and on lending.

Another additional risk factor this year is in the form of the presidential elections, which are already generating considerable political debate about significant reforms for various sectors of the economy. There is no way of knowing whether the final effect of this debate will be positive or negative for the economy, but we do know that it will generate noise, at least until the candidates' concrete proposals are known, and perhaps even until the result of the elections in December.

As already mentioned, investment shows little growth in our baseline scenario and is not free of risks, given the possibility that business confidence might not recover and the risk inherent in the materialisation of projects in development, particularly in the energy sector. For now, our baseline scenario continues to envisage neutral levels of confidence in the latter part of this year or in any case not later than the beginning of 2018.

Following the change in outlook by Fitch and S&P, the risk of a change to the sovereign risk rating has risen significantly, and we do not rule out its taking place in the course of the first half of the year. If these changes were to materialise, the consequences would be adverse for the cost of financing, making any recovery process even more difficult.

On the external front, the main risk to Chile in the medium term is still the performance of China's economy, which might surprise us with a disorderly adjustment that would have significant effects on commodities, fiscal revenues, exports, investment and ultimately growth. 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.

Added to this in the short term is the high degree of political and economic uncertainty brought about on the one hand by Donald Trump's election as president of the US and on the other by the busy electoral calendar in Europe this year. Although Trump's policies might have positive short-term effects on the US economy, the impact of protectionist measures on international trade, and the possibility of the Federal Reserve's having to speed up its process of monetary normalisation, are factors tilting the balance of risks downwards for emerging economies, including Chile.

9. Tables

Table 9.1

Macroeconomic forecast

	2013	2014	2015	2016	2017	2018
GDP (% YoY)	4.0	1.9	2.3	1.5	1.6	2.4
Inflation (% YoY, eop)	3.0	4.6	4.4	2.7	3.2	3.0
Exchange Rate (vs. USD, eop)	530	613	704	667	706	665
Interest Rate (%, eop)	4.5	3.0	3.5	3.5	2.5	3.0
Price of copper (USc/lb)	3.32	3.11	2.50	2.21	2.41	2.34
Private Consumption (% YoY)	5.5	2.4	1.9	2.1	1.8	3.1
Government Consumption (% YoY)	3.5	5.1	5.8	5.6	3.9	4.9
Investment (% YoY)	2.2	-4.2	-1.5	0.4	1.0	3.4
Fiscal Balance (% GDP)	-0.6	-1.6	-2.2	-2.8	-3.3	-3.2
Current Account (% GDP)	-3.7	-1.3	-2.0	-1.7	-1.7	-1.6

Source: Central Bank of Chile, BBVA Research

Tabla 9.2

Macroeconmic quarterly forecasts

	GDP (% YoY)	Inflation (% YoY, eop)	Exchange Rate (USDCLP, eop)	Interest Rate (%, 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	2.3	4.5	682.1	3.5
2Q 16	1.6	4.1	681.1	3.5
3Q 16	1.6	3.1	668.6	3.5
4Q 16	0.5	2.7	667.2	3.5
1Q 17	0.5	2.8	698.6	2.8
2Q 17	1.1	2.5	710.2	2.5
3Q 17	1.6	3.0	711.8	2.5
4Q 17	3.1	3.2	705.7	2.5
1Q 18	2.4	3.0	691.2	2.5
2Q 18	2.7	3.0	682.1	2.5
3Q 18	1.8	3.0	670.9	2.8
4Q 18	2.7	3.0	664.6	3.0

Source: Central Bank of Chile, BBVA Research

DISCLAIMER

This report has been produced by the Chile Unit

Chief Economist for Chile
Jorge Selaive
jselaive@bbva.com

Hermann González
hgonzalezb@bbva.com
+56 2 29391354

Cristóbal Gamboni
Cristobal.gamboni@bbva.com
+56 2 29391034

Waldo Riveras
wriveras@bbva.com
+56 2 23931495

BBVA Research

Group Chief Economist
Jorge Sicilia Serrano

Macroeconomic Analysis
Rafael Doménech
r.domenech@bbva.com

Global Macroeconomic Scenarios
Miguel Jiménez
mjimenezg@bbva.com

Global Financial Markets
Sonsoles Castillo
s.castillo@bbva.com

Global Modelling & Long Term Analysis
Julián Cubero
juan.cubero@bbva.com

Innovation & Processes
Oscar de las Peñas
oscar.delaspenas@bbva.com

Financial Systems & Regulation
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Countries Coordination
Olga Cerqueira
olga.gouveia@bbva.com

Digital Regulation
Álvaro Martín
alvaro.martin@bbva.com

Regulation
María Abascal
maria.abascal@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Spain & Portugal
Miguel Cardoso
miguel.cardoso@bbva.com

United States of America
Nathaniel Karp
Nathaniel.Karp@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Turkey, China & Geopolitics
Álvaro Ortiz
alvaro.ortiz@bbva.com

Turkey
Álvaro Ortiz
alvaro.ortiz@bbva.com

Asia
Le Xia
le.xia@bbva.com

South America
Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Julio Pineda
juliocesar.pineda@bbva.com

CONTACT DETAILS: BBVA Research Chile. Avenida Costanera Sur 2710, Las Condes, .Santiago de Chile - bbvaresearch@bbva.com
www.bbvaresearch.com