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Chile Outlook

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Closing date: 07 July 2017

1. Editorial

Growth in the global economy is tending to stabilise at around 1% per quarter. This improvement, which is occurring particularly in the advanced economies, is being accompanied by a degree of rebalancing from the USA to Europe. The performance of emerging economies has been less positive and more varied, with a slower than expected emergence from the slowdown in Latin America. The tone in the financial markets has been upbeat, with volatility at historic lows in spite of persistent economic, political and geopolitical uncertainty, as well as the correction to expectations of a fiscal boost in the United States.

In terms of domestic economic growth, the risks detected in our previous report have materialised, and we have therefore revised our projection for this year down to 1.3%. Nevertheless, the conditions are in place to see growth closer to potential towards the end of this year and 2.4% growth in 2018.

Our baseline scenario envisages a depreciation of the peso over the projected horizon, due to cuts in the monetary policy rate and weak domestic activity figures in the short term, taking the currency closer to 690 pesos to the dollar at the end of the year. Any downgrade to the country's credit rating would drive the peso down and impact the stock market negatively. We also reaffirm our view that long-term interest rates will increase, exacerbated by changes to the contributors to the most risky pension funds: this has already started.

Factors affecting inflation include increasing slack in the economy and the strength of the peso, lower inflation for foodstuffs, particularly perishables, and the recent downward adjustment to oil prices. These factors have led us to reduce our projections for the coming months, and for the end of the year to 2.6% YoY. Furthermore, we consider that the balance of risks continues to be biased to the downside, particularly after June's inflation reading. This makes it highly likely that inflation will end the year closer to 2% than 3%. We have adjusted our 2018 forecast downwards slightly, to 2.8% YoY, mainly due to lower fuel prices.

The deflationary risks that have arisen recently are once again threatening the scenario set out by the Central Bank and weakening the anchoring of expectations. Re-anchoring these inflation expectations to the target range will require more decisive monetary policy action by the Issuing Institute, which may be more decisive than the consensus view. This is the only way of clearly signalling a commitment to price stability. Our scenario includes an additional cut of 25 basis points as the minimum dose of further monetary stimulus. Considering the lags in monetary policy, these cuts must happen as soon as possible, and no later than August, in our opinion.

We estimate that this year's fiscal deficit will once again undershoot the government's forecasts, as a consequence of higher than expected revenues. However, this does not change the critical shortage of funds affecting the public finances. Over the next year, whilst the extra funds arising from the final stage of the Tax Reform will enable spending to grow at a rate in excess of 4%. However, we believe that taking advantage of this situation to make more rapid

progress on fiscal consolidation would give an appropriate signal. We estimate that the the 2018 Budget should consider making between US$ 660 million and US$ 800 of unallocated funds available for the next government, which takes office in March. Between 2019-2021 the room for growth in spending consistent with convergence of the structural deficit to the target level will fall to an average rate of just 1.4% per year. This has reopened arguments about ways of bringing fresh funds into the government's coffers, through further tax reform.

The balance of risks continues to be weighted to the downside. A major risk is that the external stimulus from stronger growth in trading partners will generate less traction on the Chilean economy, due to structural factors stemming from the more challenging tax and labour climate generated by the reforms implemented over recent years. The insufficient depreciation of the peso and the results of the presidential elections also represent a risk to the macroeconomic scenario set out in this report. The risk of a downgrade of the sovereign-risk rating has increased significantly and we do not discount such a cut in the very near term.

The main external risk for Chile over the medium term continues to be the performance of the Chinese economy, although this has once again been mitigated to an extent. Finally, we still see a global risk of protectionist policies being fostered by Donald Trump, and the risk of more restrictive monetary policy by the Fed, which could shake international financial markets out of their unusual calm.

2. International context: Stable growth in 2017-18, but with downside risks

The world economy has been picking up in recent quarters and has approached growth rates of 1% QoQ, although it is trending towards stabilisation (Figure 2.1). In global terms the confidence figures are clearly positive, above all in the advanced economies, and seem to have become established at the higher end. World trade has recovered rapidly from the very weak levels in the middle of last year. All of this has also led to a rekindling of industrial activity and investment globally.

This positive dynamic is attributable to the prime factor behind expansion of late, namely the spur provided by economic policy in China, which have boosted its economy and led to a knock-on effect among other Asian countries, as well as the rest of the world economy. Other supports for the strong cyclical performance include: the extremely accommodative monetary policies of most advanced economies; fiscal policy that has recently been neutral or expansionary; and relatively moderate commodity prices. These factors have helped the global recovery, against a backdrop of calm in financial markets.

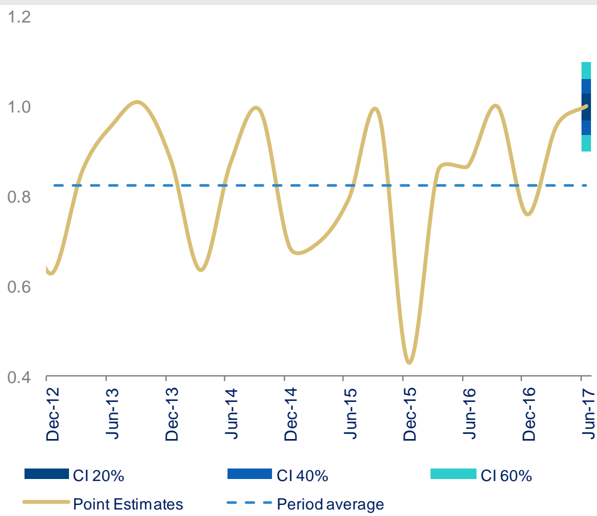
This improvement, which is occurring particularly in the advanced economies, is being accompanied by a degree of rebalancing from the USA to Europe. On the other hand, emerging economies have performed less promisingly and with more variation, with a slower than expected emergence from the slowdown in Latin America, in response to differing levels of dependence on commodity revenues.

The tone in financial markets has been upbeat, with volatility at historic lows in spite of persistent economic, political and geopolitical uncertainty, as well as the correction to expectations of a fiscal boost in the United States. This has meant that long-term interest rates have remained anchored, correcting some of the increases in previous quarters, while the appreciation of the dollar has stalled. The big question is whether the markets are being too lenient, particularly bearing in mind that the major central banks are making headway in the normalisation process. The tone of monetary policy is still accommodative, but in the last quarter additional steps have been taken in this process, in parallel with the improvement in the economy.

Our forecasts point to global growth remaining at 3.3% in 2017 and 3.4% in 2018. For China, we have revised growth upwards by around 0.2 pp in 2017-18, which would mean the authorities achieving their target of 6.5% in 2017, although we still predict a slowdown to 6% in 2018 (Figure 2.2). We have also revised our growth forecast upwards by three tenths of a percentage point in 2017, to 2%, based on exports and investment, with a slowdown in 2018 to 1.7%. In the opposite direction, we have revised our forecast for the USA down slightly, to 2.1% in 2017 and 2.2% in 2018, due to weaker than expected performance in the first quarter and the increased difficulty of approving expansionary fiscal measures and getting reforms through. In Latin America, weakening commodity prices this year and heightened domestic uncertainties in several countries have meant that reversing the slowdown is taking longer than had been

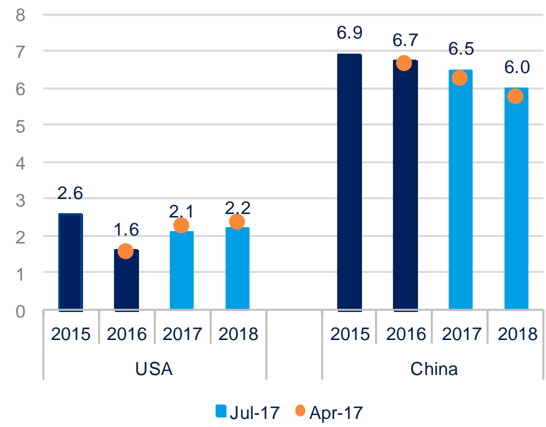
expected. These forecasts indicate that in the coming quarters emerging economies should make up ground on the advanced countries and China, which have spearheaded the recent upturn.

Figure 2.1 World GDP growth. Forecasts based on BBVA-GAIN (% QoQ)



Source: BBVA Research

Figure 2.2 GDP growth in the USA and China (%)



Source: BBVA Research

3. Chile: risks of a downturn in growth in 2017 materialising

The recovery will be less intense than expected this year, but the conditions are in place for better performance in 2018

In our February report, we forecast that the economy would grow at a similar pace to 2016 this year, with the market expecting a figure around 2%. In our report for the second quarter, we warned that risks were weighed to the downside and that this year could even be worse than the previous year. On this occasion, with the figures for the first quarter on the table and some information for the second quarter, we have decided to revise our growth projection to 1.3%, incorporating the risks we identified three months ago into our projection.

The slowdown observed at the end of 2016 sharpened at the start of this year, partly due to the effects of unemployment in Escondida, but also because the recovery in non-mining sectors was not robust. The economy ended 1Q17 with expansion of just 0.1% YoY, hamstrung by a two digit fall in mining, together with year-on-year falls in sectors as diverse as construction, business services and EGW[1]. Other sectors also slowed, such as transport, financial services, housing services and the public administration. However, there was stronger grown in fishing, trade and personal services.

Of the most dynamic sectors in 1Q17, trade and personal services also showed positive signs in the second quarter. The later are closely related to public education and health services, such that we see little room to maintain the growth rates from the first quarter, given the need for adjustment to government spending following a very dynamic first quarter.

From the expenditure point of view, the first quarter of the year was marked by higher growth in domestic demand, which was strongly influenced by a significant accumulation of inventories, which could be a signal of stronger expectations of demand. Private consumption grew at similar rates to the last three years, although with a clear acceleration in the durables goods, whilst government consumption revived following the halt in 4Q16, managing to avoid a technical recession. Investment contracted again, following a larger adjustment to the construction and other works component, partially offset by an increase in machinery and equipment. There was a sharp fall in exports, mainly explained by the effects of the paralysis at Escondida on copper deliveries (Figure 3.1).

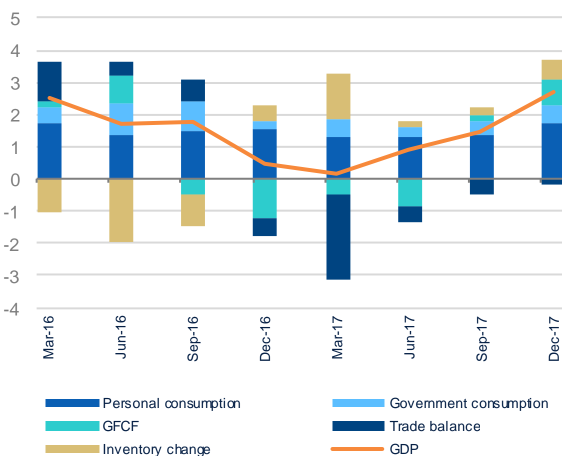
1: Electricity, Gas and Water.

The economy grew more slowly than expected in April and May, disappointing expectations. The market underestimated the effect of the three fewer working days on monthly growth in April, and overestimated the recovery capacity of Escondida following the paralysis in February and March. The sector figures published by the INE statistical institute led the market to revise its IMACEC economic activity indicator estimates upwards. However, the Central Bank noted the much larger fall in mining and, therefore, lower growth in aggregate activity.

At the sector level, an adjustment is taking place in the construction sector, which could last much of the year, with significant falls in activity indicators and job losses. However, retail trade is showing signs of greater dynamism, with a strong rebound in vehicle sales.

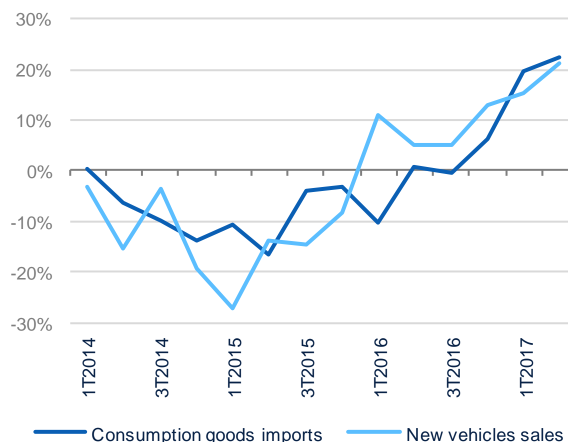
This better news from the private consumption side is supported by lower inflation, a lower exchange rate, making imported products cheaper, and a gradual recovery in confidence indicators. We have also seen solid growth in imports of consumer goods, which have benefited from the lower exchange rate and the restocking of inventories to meet demand, which is expected to be more robust in the coming months (Figure 3.2). There has been a slight rebound in confidence indicators for businesses and households. Whilst this is a positive development, they still remain below neutral levels.

Figure 3.1 Impact on annual GDP growth (percentage points)



Source: Central Bank of Chile and BBVA Research

Figure 3.2 Trade sector indicators (YoY change, quarterly average, %)



Source: Central Bank of Chile and BBVA Research

Going forward, we continue to expect a gradual recovery in GDP growth rates, although we are cautious about the speed of recovery, given the continuing sources of uncertainty. We estimate the ceiling for growth in 2Q17 to be around 1%, and project that the economy will grow at rates close to its potential (estimated to be between 2.5% and 3.0%) only in the final quarter of the year, when we expect to see more robust growth in private consumption and the first positive signs from investment.

We maintain our projection of 2.4% growth in 2018, slightly below market expectations and below the floor of the Central Bank's growth projection (2.5% to 3.5%). Our estimate considers that confidence indicators will reach neutral

levels during the first half of the coming year, and is consistent with higher growth among trading partners, the monetary stimulus passing through to consumer, commercial and mortgage lending rates, and a domestic outlook in which political uncertainty largely dissipates. Against this backdrop, we forecast that, in 2018, both private consumption and investment will grow at the fastest pace since 2013.

Public investment will provide greater support for growth in total investment in the coming year, but a recovery in private investment to positive growth rates is conditional on a recovery in the confidence of agents. With regard to non-tradable sectors, investment over the coming years is mainly dependent on the recovery in construction and new contributions by the energy sector, mainly through projects centring on non-conventional renewable energy (ERNC). Given scenarios of real depreciation of the peso and some return to historic patterns of growth in labour costs, as seen over recent years, a rebound in investment in non-mining tradable sectors would also be expected.

4. Long term interest rates on an upward path.

We continue to expect a steepening of the local yield curve

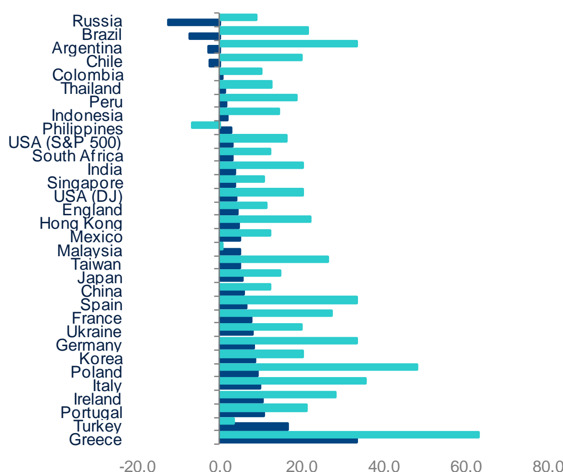
Uncertainty persists about how China's economy will evolve, although the recovery in the price of copper following the US Presidential elections has slightly improved the terms of trade. On the other hand, we believe that the continuing strength of the Chilean peso is preventing a faster adjustment process, since it discourages investment in tradable sectors, in an environment with low productivity.

Anticipating an economic recovery and/or a more benign scenario for the business environment with the change of government: the local stock market experienced a strong recovery. However, this has not continued in line with the vision we set out in our last report, where we stated that valuations would end up at the upper end of their ranges, consistent with fundamentals. In fact, it has been one of the worst performing stock markets in dollars over the last three months (Figures 4.1 and 4.2).

Real Exchange Rate (RER) remains at insufficient levels to provide robust support for investment in tradable goods

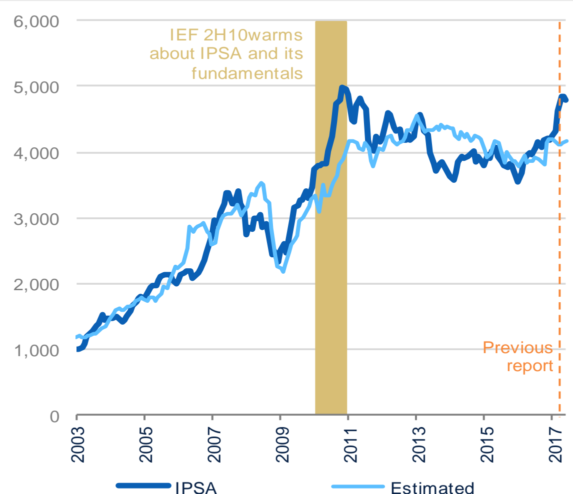
Despite the increase in the Fed's rate and news of a significant fiscal stimulus in the US, the peso has remained at between 655 and 665 to the dollar, although there has been some multilateral depreciation, which partially reversed in June (Figure 4.3). The lack of sufficient depreciation of the peso, despite weak economic data and cuts to the monetary policy rate (TPM), is explained by the renewed appetite of foreign investors for local assets, reflected in around US$ 1,300 million in carry trade transactions (Figure 4.4).

Figure 4.1 Global stock markets (USD, % change, 3 months and 1 year)



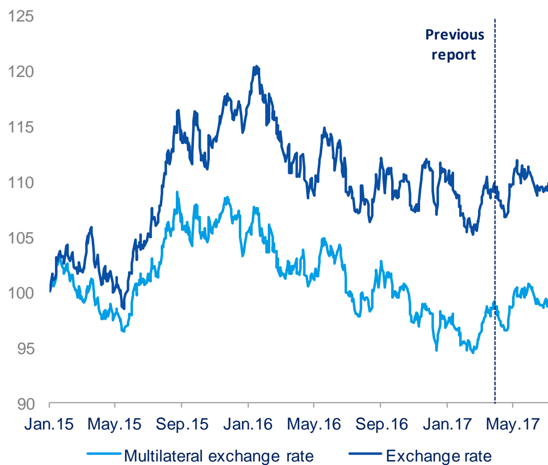
Source: Bloomberg and BBVA Research

Figure 4.2 Public Sector Accounting Standards Fundamentals Model*



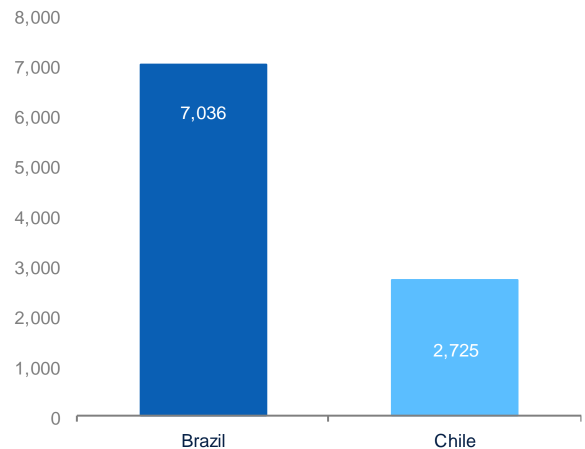
* Model of fundamentals, which includes as determining factors: The IMACEC Monthly Indicator of Economic Activity, copper prices and real long-term interest rates.
Source: Bloomberg and BBVA Research

Figure 4.3 Multilateral and Peso/US$ Exchange Rate (Index 2 Jan 2015 = 100)



Source: Central Bank of Chile and BBVA Research

Figure 4.4 Carry Trade Operations, Peso and Real* (Million US$)

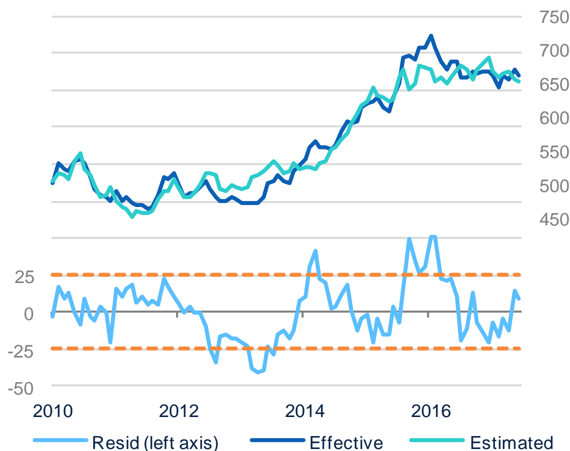


* Standardised contracts for Brazil for an amount of US$50,000. Observed increased between 12 May 2017 and 7 July 2017.
Source: Central Bank of Chile, BM&F Bovespa and BBVA Research

We reaffirm our view of increases in long-term interest rates, exacerbated by changes to contributors to the most risky pension funds: this has already started.

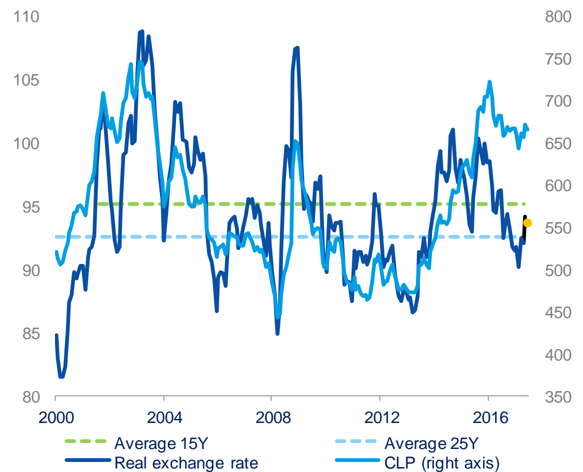
From our evaluation of nominal misalignment, we see no clear evidence of the peso being out of line with the level suggested by the terms of trade and other short-term factors (Figure 4.5). The real exchange rate is below its historical average, which we believe makes will make rapid reassignment of resources to export sectors more difficult (Figure 4.6). Monetary policy - which is certainly justified by the medium-term deflationary effects that this strengthening of the peso would entail and the weakness of the labour market - has started to take effect. Our baseline scenario envisages a depreciation of the peso over the projected horizon due to cuts in the monetary policy rate and weak domestic activity figures in the short term, taking the currency closer to 690 pesos at the end of the year.

Figure 4.5 Actual and estimated exchange rates (Peso/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 spread between Chile and the USA.
Source: Central Bank of Chile and BBVA Research

Figure 4.6 Real exchange rate, RER (average 1986 = 100)



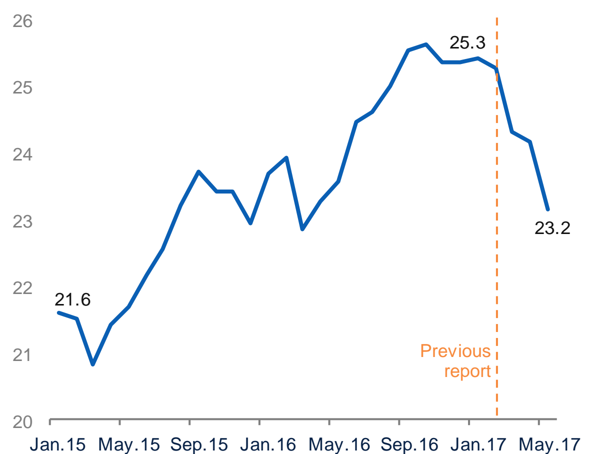
* Real exchange rate sampling point for June (93.6).
Source: Central Bank of Chile and BBVA Research

Benchmark local interest rates experienced a sharp rise following the US Presidential elections, but fell to historically low levels in mid-April (Figure 4.7). Of specific concern for long term interest rates is a reversal in the cautious performance of Pension Funds Administration contributors, and their movement to less risky funds for most of 2016 (Fund E). However, in light of recent improved yields, they could be gradually moving to riskier funds, as we anticipated in our previous report (Figure 4.8).

Figure 4.7 10-year nominal interest rates (percentage)

Source: Bloomberg and BBVA Research

Figure 4.8 Assets of Pension Funds Administrators in domestic sovereign bonds (percentage of total system assets)



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

5. Short-term deflationary risks weaken the anchoring of expectations

We have revised our inflation projection for December 2017 downwards to 2.6%

As we anticipated in our previous report, inflation has continued on its downward trend, approaching the floor of the Central Bank's tolerance range (2% YoY). Following repeated downward surprises over the previous months, in line with weak activity figures and contained underlying inflation, particularly of tradable goods affected by the strengthening of the peso, we have revised our inflation projection for December 2017 down to 2.6% YoY. This is supplemented by lower food inflation, particularly for perishables, and the recent downward adjustment in the oil price, which have led us to lower our projections for the coming months.

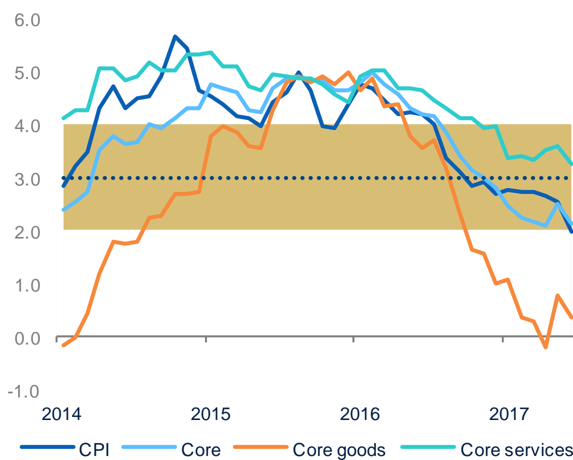
We also consider the balance of risks to continue to be weighted to the downside. The deflationary risks associated with a belated depreciation of the peso, together with monetary policy that does not consider a larger stimulus and the oil price remaining at current levels, outweigh the limited inflationary risks from higher volatility of external prices and a stronger rebound in domestic demand. A scenario is starting to take shape in which inflation becomes established at a level well below 2% YoY. This will make convergence on the target very difficult without a significant multilateral depreciation of the peso and a recovery in domestic demand. We have adjusted our 2018 projection downwards slightly to 2.8% YoY, due to lower fuel prices, but maintaining convergence on the 3% target over the medium term. However, without the upwards convergence of the oil price, our forecast for year-end 2018 would be 0.3 percentage points lower.

Part of the deflationary risks we flagged in our previous report have materialised

Core inflation, as measured by the CPI excluding food and energy (CPI EFE), has remained at the floor of, and at the margin below, the Central Bank's tolerance range. This is due to the strength of the peso and a lack of inflationary pressures, due to increased domestic weakness (Figure 5.1). The figures for May and June showed price dynamics to be very flat, with only a few products injecting inflation. This could mark the start of a period of falling inflation. Whilst the reading was positive in May (0.1% MoM), this was due to the ad hoc effects of two products, without which overall inflation and its core measures would have been zero or negative. This was confirmed by the June CPI, which showed a monthly change of -0.4%, taking the year-on-year inflation rate below the Central Bank's tolerance range (1.7% YoY). In addition, core measurements for both goods and services hit their lowest levels since this basket started to be used, and inflationary pressures eased. Should this trend continue it is very likely that year-on-year inflation will remain significantly below 2% in the coming months. This would be a significant surprise, not only for the market, but also for the last scenario set out by the Central Bank (Figure 5.2).

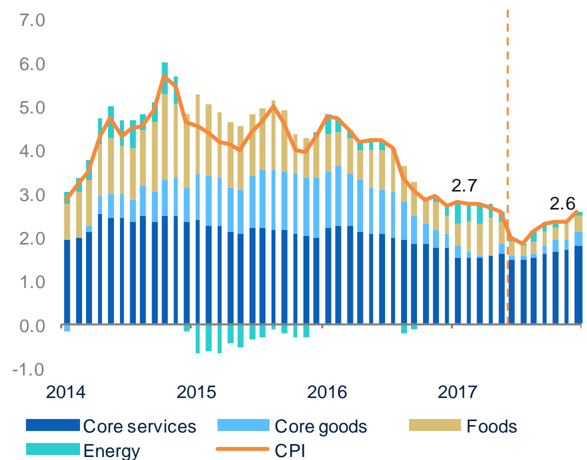
Whilst the most volatile components of the CPI basket, such as food and energy, have injected some inflation in the past few months, these are showing a significant slowdown, particularly with regard to international energy prices. On the food side, inflation for non-perishables remains contained, but the trend in perishables is worrying, as they continue reducing inflation by more than their historical seasonal rate. With regard to energy prices, there has been a downward adjustment in domestic petrol and diesel prices, in line with the lower international oil price and the appreciation of the peso against the dollar.

Figure 5.1 Annual inflation (%)



Source: INE and BBVA Research
EFE: CPI excluding food and energy.

Figure 5.2 Annual inflation forecast (%)



Source: INE and BBVA Research
EFE: CPI excluding food and energy.

The anchoring of expectations weakened again by deflationary surprises

In our baseline scenario, inflation stands at 2.6% YoY at year-end 2017 and 2.8% YoY at year-end 2018, slightly below the expectations of the market and the Central Bank's forecasts in its most recent Monetary Policy Report. Whilst the deflationary risks that have arisen recently are short term, they are once again threatening the scenario set out by the Central Bank and weakening the anchoring of expectations. In this regard, the expectations implicit in asset prices remain significantly below the target over the policy horizon. In fact, the most recent survey of financial agents (EOF) shows a decrease in expected inflation over two years (2.8% YoY): after seven months below 3%, this alerts us to an incipient decoupling of expectations. In the face of these risks, and after seeing the July CPI figures confirm that we are not just dealing with ad hoc effects, we consider it highly probable that the Central Bank will be open to a new 25 bp cut at its August meeting, which we regard as necessary.

However, if there is no rapid depreciation of the peso, together with further adjustments to the monetary policy rate and a rebound in oil prices, inflation will remain below the Central Bank's tolerance range for longer than estimated. This could lead the market to question the Central Bank's capacity to return inflation to its target.

6. Monetary policy: room for more stimulus

Contained inflationary pressures increase the pressure for the Central Bank to continue delivering monetary stimulus

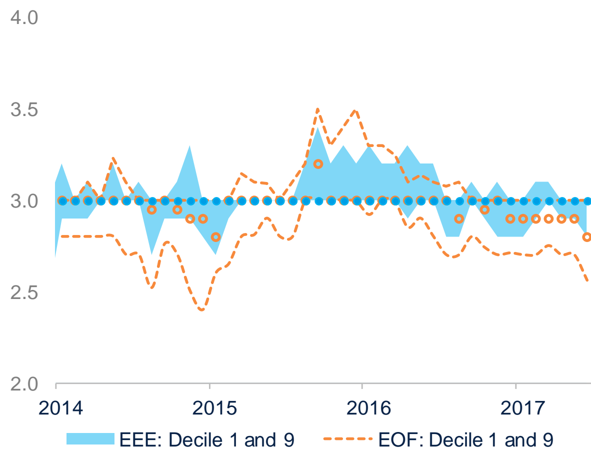
The Central Bank made decisive progress in the first few months of the year, cutting its monetary policy rate by 100 basis points in total: this took part of the market by surprise, as it was - somewhat inexplicably - not expecting this increased stimulus. The working assumption used in the baseline scenario in the most recent Monetary Policy Report was that the monetary policy rate would remain at 2.5% for a prolonged period. This idea was supported by a neutral bias in recent monetary policy decisions and was duly taken up by most analysts. However, asset prices and a minority of surveys now include the possibility of an additional cut this year.

We do not agree with the path for assets and inflation in the Monetary Policy Report's baseline scenario. We therefore consider that the monetary stimulus will be greater than that considered in the Report. Moreover, inflation is flagging and could fall well short of the Central Bank's 2.9% projection. Inflationary expectations have become decoupled and could drift further from the 3% target if short-term inflation readings remain weak and there are any downside surprises (Figure 6.1). In addition, we consider the pace of the economic recovery assumed in the Monetary Policy Report for the coming year to be optimistic.

With regard to expectations, the survey of financial agents for the second half of June considers that the monetary policy rate will remain at 2.5% over the coming months, although 27% of those asked expected this rate to be cut below this level in the following three months. Half of the respondents to the June survey also thought there would be no further cuts to the monetary policy rate over the following twelve months, while 24% of respondents forecast that the rate would be below 2.5% by year end (Figure 6.2). Likewise, short-term interest rates are weakly signalling the possibility of a further cut to the rate. All of this took place before the June CPI figures were released (-0.4% MoM), so it is highly probable that these trends will intensify.

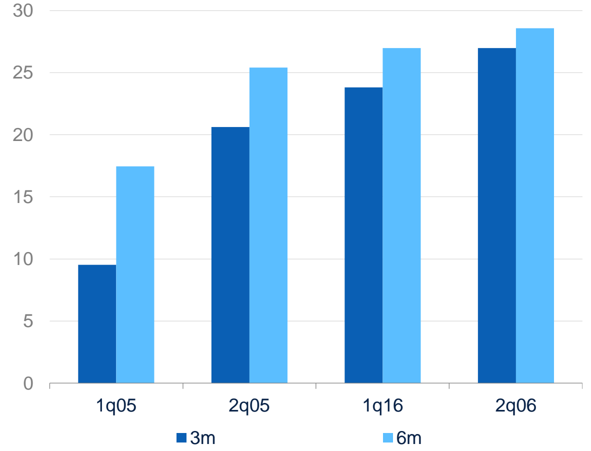
Re-anchoring these inflation expectations to the target range will require more decisive monetary policy action by the Central Bank, which may be more decisive than the consensus view. This is the only way of clearly signalling a commitment to price stability. Not reducing the monetary policy rate in this situation would be perceived as a signal of an excessively laid back attitude to scenarios in which inflation deviates below its target.

Figure 6.1 Survey expectations of inflation over two years (%)



Source: Central Bank and BBVA Research

Figure 6.2 Surveys of monetary policy rate expectations (% expecting monetary policy rate of less than 2.5%)



Source: Central Bank, Bloomberg and BBVA Research

Our scenario includes an additional cut of 25 basis points as the minimum dose of increased monetary stimulus, but we do not disregard the possibility of a larger stimulus. Considering the lags in monetary policy, these cuts must happen as soon as possible, and no later than August. We will have low interest rates for the rest of this year and most of next, with a gradual return to normal only starting towards the end of 2018, and the following year seeing normal growth and inflation conditions.

7. Fiscal policy: 2018 is the year for accelerating structural convergence

We forecast an effective fiscal deficit of 2.8% of GDP in 2017

The government will have published its updated forecasts for the current year when this Outlook is published. We do not expect the government's figures to show any significant variations from those in the Budget (an effective deficit of 3.3% of GDP and spending growth[2]: of 3.4%), based on the negative results of the 2017 Income Tax campaign (OR 2017) and weakening projections of economic activity, partly offset by higher copper prices.

As a result, we are adjusting our projection of the effective deficit for 2017 from 3.1% to 2.8% of GDP. This is because, firstly, it would not be the first time that the Treasury has estimated a worse deficit at this time of year than at year end (Figure 7.1). Rather than forecasting errors, we believe this to be a measure to contain expectations of higher spending. Our projection includes spending exceeding the budget in response to reconstruction costs for the fires in the south in early 2017. Thus, government spending will grow by 4.2% this year. With regard to revenues, the combination of higher copper prices and a stronger exchange rate compared to the September 2016 forecasts would generate net additional revenues of just US$200 million, combining the income of Codelco and the large private mining concerns. It should be borne in mind that there have been new ad hoc rebates to mining companies which will decrease total collections. On the other hand, certain temporary revenues should also be included, such as the reduced payment to the historic FUT (taxable profits fund) and the inflows to government coffers from borrowings related to the capitalisation of Codelco[3]. Finally, we yet again suspect a risk of the underestimation of the Government's non-tax revenues (see Table 7.1).

2018 will see the final additional stimulus from the Tax Reform taking effect

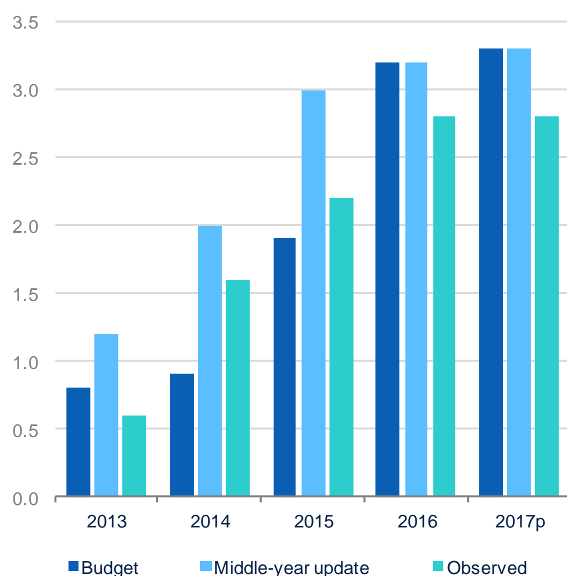
The Draft Budget for 2018 will start to be discussed shortly. As this will be prepared by one administration but implemented by another, politics will play a bigger role than usual. In previous years, debate has focused on the amount of unallocated funds. This time, the amount may be increased by a percentage of budgeted spending similar to previous periods. In the past, the amount of unallocated funds has fluctuated between 1.0% and 1.2% of GDP. If such a proportion is maintained, the 2018 Budget would include unallocated funds of between US$ 660 and US$ 800 million (Figure 7.2).

The final stimulus to tax revenues from the Tax Reform will be concentrated in 2018. The increase in the corporate income tax rate (from 24% to 25% or 25.5%, depending on whether the company applies the semi-integrated or

2: This increase is based on the new 2016 spending base, using the results for the end of December, and average inflation for the year of 3.0%.
3: For more details, refer to our April 2017 Fiscal Outlook.

attributed income regime) should impact tax collections, even though the results of the recent 2017 income tax campaign question the ultimate effects of this measure. Whatever the case, the change of regime - from one of 100% integration of companies and people vs. semi-integration, to which most companies will be subject - will inject new tax funds, one way or another. According to the Government's estimates when presenting the Tax Reform in 2014, the net fiscal impact of the measure will equal 0.34% of GDP, i.e. around US$800 million[4]. The Government Budget Department (Dipres) is likely to maintain a similar figure as its estimate of revenues for the coming year.

Figure 7.1 Official estimates of the effective deficit and the balance at the close (% of GDP)



p: BBVA Research projection for 2017 in the July update and at the close
Source: Government Budget Department, BBVA Research

Table 7.1 Changes in fiscal projections compared to the 2017 Budget

	Change	Effect (US$ million)
Higher revenues		**1300**
Non-mining tax		**200**
- Lower growth	-0.9 pp	-500
- Historic FUT	Profit to 30 April	670
- Other	Adjustments for execution to May	30
Codelco and mining tax		**200**
- Higher copper price	+ 35 cent	620
- Lower exchange rate	- $30	-150
- Rebates and others	Adjustments for execution in May	-270
Provisional	Adjustments for execution in May	**200**
Other revenue	For execution to May and revenues from capitalisation of Codelco	**700**
Higher spending	On reconstruction	**155**
Lower deficit		**1145**

Source: Government Budget Department, BBVA Research

This process will include re-estimation of structural parameters. Potential GDP growth was estimated at 3.2% and the benchmark copper price at US$2.56/lb for the previous budget period. Considering our projections and those of the market and the Central Bank, and being certain that the institutional changes adopted by the Committee of Experts, which provide the inputs for calculation of these variables, will retain the technical criteria used in the process, we assume a downward adjustment in trend GDP to 2.8%, with the benchmark copper price being maintained[5]. We also assume a target of convergence to structural balance at the rate of 0.25% of GDP.

All of the above leads us to forecast growth in public spending compatible with the 4.5% target, with a structural deficit of 1.2% of GDP and an effective deficit 2.8% of GDP (approximately US$7,750 million). Our assumptions are summarised in Table 7.2. Although the final effects of the Tax Reform mean that 2018 is the last year in which there is room for spending to grow by more than 4% whilst respecting convergence on structural balance, this is precisely the

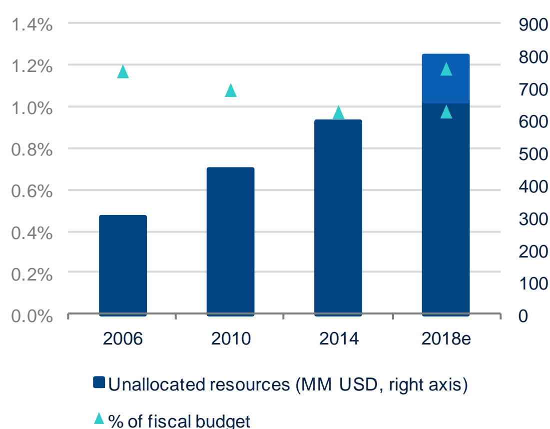
4: We say the impact is net because it discounts the lower collections resulting from the reduction in the highest marginal personal-income tax rate from 40% to 35%.
5: We performed a sensitivity analysis of our results with a slightly higher benchmark copper price of US$2.60/lb, with no significant change to the results.

year for making greater progress on reducing this deficit, making an even bigger statement about responsibility, particularly when a cut in the sovereign debt rating from the ratings agencies appears imminent.

New tax reform on the horizon: pro-growth or an increase in the tax burden?

We forecast average growth in spending of 1.4% in 2019-2021, in line with the assumptions for the structural parameters mentioned in the previous section and convergence on structural balance. With the limited room for new spending measures by a future administration now being evident, discussion of tax reform is back on the agenda.

Figure 7.2. Unallocated resources in the budget prior to the change of government



Source: Government Budget Department, BBVA Research

Table 7.2 Assumptions in the BBVA Research fiscal scenario

	2017	2018
Ref. copper price (USc/lb)	256	256
Trend GDP (change YoY)	2.8	2.8
Effective deficit (US$ million)	7,350	7,750
Effective deficit (% of GDP)	2.8	2.8
Structural deficit (% of GDP)	1.5	1.2
Growth in spending (change YoY)	4.2	4.5
Gross debt to Dec. (% of GDP)	24.6	26.9

Source: BBVA Research

Although there will be room for spending to grow by 4.5% in 2018, there will not be another year with similar scope to accelerate structural convergence for some time

The proposed alternatives for future tax changes appear to be heading in different directions, with no complete design existing. A “pro-growth” tax adjustment has been mentioned as the first option. This would involve focusing incentives on savings and investment, thus stimulating growth (effective and trend). This proposal is based on the assumption that the slowdown in activity and the fall in investment over recent years is largely due to the 2014 Tax Reform. The main risks to this approach reside in a potential overweighting of tax as a factor in the recent slowdown, or failure of such changes to achieve a substantial increase in expectations.

However, changes that increase the tax burden have also been mooted, perhaps by retaining the current tax rate on companies but adding new taxes to some industries or increasing personal tax rates. The assumption behind this approach is that the current tax rate for companies is not an excessive burden, and that there is room for a percentage of taxpayers - particularly those with the highest incomes - to make a larger contribution. The obvious risk is that higher tax burdens would prejudice collections for each tax, mainly through negative impact on growth and investment.

Whatever the case, the risks of the new administration not continuing convergence towards structural balance are high, particularly if the country's credit rating is downgraded this year. For the moment, the candidates have said they will maintain fiscal responsibility, but not whether the convergence target features in their plans.

8. Domestic economic and political risks remain

The balance of risks is slightly negative

Domestic monetary policy has taken a clear path toward delivering greater monetary stimulus than we believe is required to support the process of redirecting investment toward non-tradable sectors. Consequently, the risk of a late or inadequate response has faded somewhat. The slow depreciation of the peso should continue to be considered a risk, as we consider this essential to support the recovery of investment and competitiveness in export sectors for goods and services.

The presidential elections remain a risk. Despite the expectation of the presidential elections injecting a degree of uncertainty, political uncertainty has eased and stability improved, with a slight recovery in confidence. However, a close first-round result cannot be discounted. This would increase the probability of victory by candidates with programmes inclined towards less orthodox reforms, which could reverse the recovery in these indicators.

The slowdown bottomed out in the first quarter, but the second quarter was impacted by a number of temporary factors and some more fundamental factors, such as the limited dynamism of private investment. In this regard, the main risk is that the external stimulus from higher growth in trading partners and more fragmented global growth will generate less traction on the Chilean economy, due to structural factors stemming from the more challenging tax and labour climate generated by the reforms implemented over recent years.

The risk of a downgrade of the sovereign-risk rating has increased significantly. If these changes do materialise, there would be adverse consequences for funding costs, making any recovery even more difficult. And the damage to business confidence should not be ignored.

On the external front, the main risk to Chile in the medium term is still the performance of the Chinese economy, which could bring surprises, 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 financial channels as well as the real economy. This risk, although a factor in the last few reports, has lessened slightly.

We continue to view a tightening up of protectionist policies resulting from the new Donald Trump administration in the US as a global risk. It is difficult to estimate the effects, but there could be an impact on the dynamics of the external sector relevant to Chile. A more restrictive monetary policy on the part of the Fed, although risky from the viewpoint of external funding costs, would be positive for the currency, as we estimate that there is significant scope for peso depreciation without too much impact on inflation, given the slack in capacity and low inflation.

9. Tables

Table 9.1 Macroeconomic Forecasts

	2013	2014	2015	2016	2017	2018
GDP (% YoY)	4.0	1.9	2.3	1.6	1.3	2.4
Inflation (% YoY, eop)	3.0	4.6	4.4	2.7	2.6	2.8
Exchange rate (vs. USD, EOP)	529	613	704	667	685	665
Interest rates (%, eop)	4.5	3.0	3.5	3.5	2.25	2.75
Price of copper (US$/lb)	3.32	3.11	2.5	2.21	2.55	2.42
Private Consumption (% YoY)	4.6	2.7	2.0	2.4	2.2	3.1
Public Consumption (% YoY)	2.8	4.4	4.5	5.1	3.7	4.0
Investment (% YoY)	3.3	-4.8	-0.8	-0.8	-0.5	2.4
Tax Revenue (% GDP)	-0.6	-1.6	-2.1	-2.7	-2.8	-2.8
Current Account (% GDP)	-4.2	-1.7	-2.0	-1.4	-1.5	-2.0

Source: Central Bank and BBVA Research

Table 9.2 Quarterly Macroeconomic Forecasts

	GDP (% YoY)	Inflation (% YoY, eop)	Exchange rate (vs. USD, EOP)	Interest rate (%, EOP)
Q1 14	2.9	3.5	563.8	4.0
Q2 14	1.8	4.3	553.1	4.0
Q3 14	1.3	4.9	593.5	3.30
Q4 14	1.7	4.6	612.9	3.0
Q1 15	2.6	4.2	628.5	3.0
Q2 15	2.1	4.4	630	3.0
Q3 15	2.4	4.6	691.7	3.0
Q4 15	1.9	4.4	704.2	3.5
Q1 16	2.5	4.5	682.1	3.5
Q2 16	1.7	4.1	681.1	3.5
Q3 16	1.8	3.1	668.6	3.5
Q4 16	0.5	2.7	667.2	3.5
Q1 17	0.1	2.7	661.2	3.0
Q2 17	0.9	1.7	665.0	2.50
Q3 17	1.5	2.2	681.0	2.25
Q4 17	2.7	2.6	685.0	2.25
Q1 18	3.1	2.9	677.0	2.25
Q2 18	2.8	3.2	673.0	2.25
Q3 18	1.4	3.0	669.0	2.50
Q4 18	2.3	2.8	665.0	2.75

Source: Central Bank and BBVA Research

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