Economic Outlook

Chile

Fourth Quarter 2012
Economic Analysis

- **The global economy will improve slightly in 2013,** supported mainly by lower risk aversion due to measures taken by central banks, in particular the ECB.
- **In Chile, more moderate domestic demand will limit growth to 4.5% in 2013,** slightly below the country's growth potential, but still among the highest in the region.
- **Rising prices in tradable goods will push inflation up to 2.2% y/y at the close of 2012 and 3% y/y in December 2013.** However, the risks are biased upward.
- **We expect the Central Bank to maintain its pause in 2013** and to launch a short cycle of rises in the monetary policy rate in the first quarter of 2014.
- **The fiscal balance will remain at around equilibrium level,** while a slight deterioration is expected in the external balance, with a current-account deficit of 4.1% of GDP in 2013. The exchange rate will remain stable in the short term and register a moderate depreciation in 2013.

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Closing date: November 5, 2012

1.Summary

The global GDP is expected to grow steadily to 3.5% in 2013. This gradual rise is supported by lower risk aversion fostered by the measures taken by central banks, particularly the ECB.

In the first three quarters of 2012 economic growth in Chile was above the expectations suggested by a global environment of sluggish growth. The main driver of this growth has been domestic demand. Although a slowdown in the last quarter of the year is still expected, cumulative growth to date suggests revising upward the GDP growth forecast for 2012 from 4.4% to 5%.

More moderate domestic demand in 2013 will push growth down to 4.5%, under the country's estimated growth potential (around 5%). Despite this, Chile will be among the fastest growing countries in Latin America; in 2012 it was second only behind Peru in the region.

In the labor market a situation of virtually full employment was achieved in 2012, with an average unemployment rate of 6.5%. In 2013 the labor force is expected to increase at around the same rate as the population of an age to work, while employment will grow slightly above this figure. As a result, the rate of unemployment will average 6.5%, and labor cost pressures will remain.

The expected slowdown in consumption and more limited growth in employment and real wages should result in a slower rate of increase in consumer loans.

The moderating effect of tradable goods prices early in the year will not continue into the second half, and we expect year-on-year inflation to be 2.2% in December. In 2013, an upturn in fuel and food prices and continued inflationary pressure from non-tradable goods will push inflation to the target of 3%. However, the lack of spare capacity may amplify any supply shocks, so inflation risks have a clear upward bias.

We expect the Central Bank to maintain its pause in 2013 but to launch a brief cycle of rises in the monetary policy rate in the first quarter of 2014, in a global environment of generally looser monetary policies. This pause implies a relatively restrictive monetary policy stance; combined with a stronger exchange rate, it gives the Central Bank time to wait before returning the reference rate back to its neutral level. Unlike in other emerging economies, we do not expect any short-term macroprudential measures to be introduced in Chile.

Following a slight fiscal surplus in 2012, slower growth and a lower copper price will be the main factors behind a slight fiscal deterioration in 2013. With respect to the external accounts, the current account deficit will be at 3.6% of GDP in 2012, also due to the lower copper price and increased imports. In 2013 the deficit will increase to 4.1% of GDP, although it will be financed by foreign direct investment. The exchange rate will remain stable in the short term, while the expected movements in the copper price will trigger a slight depreciation in 2013.

The chance of an "accident" in Europe has reduced, but it continues to be the main global risk factor. At the domestic level, domestic demand is still very strong. This could lead to a faster deterioration in the balance of payments, a stronger depreciation in the exchange rate and higher inflation.

2 Global environment: bold actions by central banks make tail-risk scenarios less likely

Bold actions by central banks have clarified the global economic outlook but challenges remain for policy makers to avoid setbacks

The world economy is expected to continue its soft recovery with a GDP growth rate of 3.5% in 2013 (3.2% in 2012, 4.1% on average in 2010-12). **It is supported by lower risk aversion, following the influential decisions taken by central banks, especially the ECB.** However, three factors stand out among those that could make this outlook deteriorate significantly: first and foremost, troubles in Europe, if the euro break-up fears that loomed large during the first half of the year among market participants resurface; second, in the US, the still-hanging threat of the so-called fiscal cliff, i.e., a spending-cut and tax-hike package worth 4% of GDP due to come into effect at the beginning of 2013 that would push the US economy back into recession; third, a severe slowdown in the emerging economies, in particular in China and some commodity-oriented economies, if Chinese appetite for raw materials decreased.

Central bankers to the rescue; other policy makers should follow suit

Against a backdrop of high uncertainty and threats to the world economy, over the past months authorities across the world – in particular central bankers in the eurozone and the US – have taken significant steps forward. **Those bold measures have spared the world economy from a systemic event that would have been comparable with the financial developments of late 2008.** Both central banks have built a bridge to a new institutional environment in the case of Europe, and to a new fiscal pact in the US; these actions have paved the way for other policy makers to use their room for manoeuvre. However, the FED's actions are more open-ended than the ECB's due to different conditionality: strict fiscal fulfilment is compulsory in Europe, whereas labour market improvement is the objective in the US.

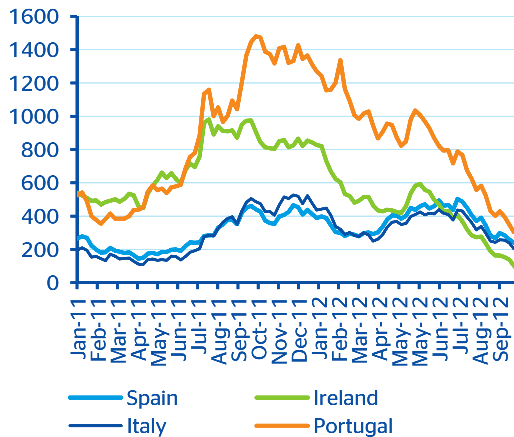
"… whatever it takes…"

In our **view, when the European Central Bank (ECB) President Mario Draghi announced the implementation of a new bond-purchase programme (Outright Monetary Transactions, or OMT) in late July, the institution took a decisive step to put an end to the debt crisis in Europe.** Under certain conditions (see our September ECB Watch for further details), the ECB could intervene in the secondary sovereign-debt markets. The ECB's move came after a eurozone summit in June where leaders reached some agreements to reinforce the currency union: a broad roadmap towards a single banking supervision, far-reaching plans covering fiscal issues and growth-supporting measures. The rationale behind the Draghi announcement is clear. Yields on some peripheral bonds are elevated because markets are partly pricing in eurozone break-up fears, compromising the ECB's mandate amid a severe financial fragmentation. Since that is "unacceptable," the ECB has committed itself to buy unlimited quantities of sovereign bonds of those countries that seek financial aid from Europe's funds (European Financial Stability Fund & European Stability Mechanism) with "strict and effective conditionality." **The existence of a lender of last resort under fiscal conditionality dispels fears of the reversibility of the euro in its current configuration.**

Under extreme market pressure and looming euro break-up fears, some action from European leaders and the ECB had long been expected. However, **the ECB move was more decisive than anticipated.** The OMT programme makes the ECB a credible backstop. As a consequence break-up fears are not justified and will continue to be so as long as this process continues. Tensions in

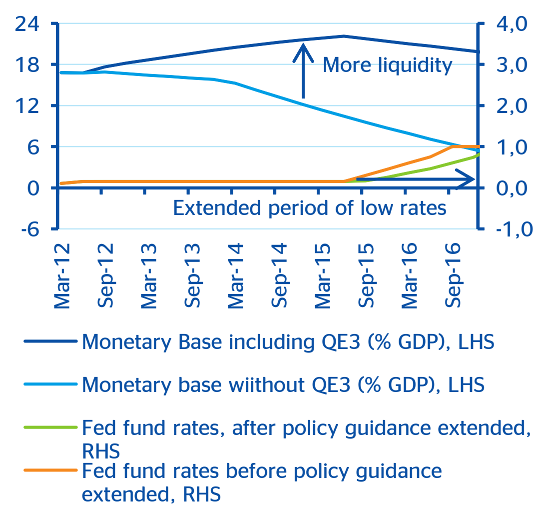
financial markets have eased significantly since June (Chart 1) and, in our view, the maintenance of this situation in spite of recent adverse market events is proof of its capacity to dispel doubts.

Chart 1
Financial Stress Index for eurozone countries[1]



Source: BBVA Research

Chart 2
QE3 and extended policy guidance



Source: BBVA Rresearch

Other elements have recently reinforced the currency union in Europe. First, **the permanent fund that will deal with any new bailout in the eurozone (the ESM) has been put in place,** after the German Constitutional Court backed Germany's involvement. Second, **the process for achieving a banking union in Europe (as set last June at a Eurogroup meeting) continues moving forward, although grinding slowly.** The implementation of a full banking union consists of four different elements: joint supervision, common regulation, a common body for banking resolution and a pan-European deposit-guarantee scheme. Given the scale of the task ahead, the full implementation is likely to be a long-lasting process. Yet European leaders agreed to set a calendar for banking supervision by January and more details are due to be agreed on at the Eurogroup meeting in December. In June they had agreed on direct banking recapitalization from the ESM, something that we deemed key in order to eliminate the risk emerging from the sovereign-banking feedback loop. However, there are other ways to reach the overriding goal of preventing regulatory ring-fencing and the goal of breaking the sovereign and bank risk that can be also explored. Certainly, the banking-union project needs to move forward fast.

At the end of the process, we think the eurozone will eventually come up with a full package that will reinforce its governance. As we have long argued, it should comprise a banking union, a fiscal union and a lender of last resort to prevent fragmentation. Progress has been made on all of these fronts. Probably that progress has not been ambitious enough to revert the current dynamic quickly. Yet, policy makers seem committed enough to the process and we think the worst of the crisis may, at last, be over. In the short term, the ECB's programme and the ESM support under fiscal conditionality creates a benchmark to deal with difficult funding situations in peripheral countries, allowing them to keep market access. At the same time, the proper implementation of the banking-union plans and further definition of the fiscal-union design will be a key factor to the long-term sustainability of the eurozone.

1: The BBVA Research Financial Stress Index (FSI) is a synthetic indicator that summarizes movements of: risk measures (5-year CDS, CDS of non-financial corporations and financial debt), volatility (stocks, interest rates and exchange rates) and liquidity stress (spread between interbank rate and free-risk asset at 3-months term).

"... as long as needed..."

With the US economy growing at low rates, the unemployment rate remaining persistently high and amid huge uncertainty in Europe, a pre-electoral gridlock over how to bring the whopping US deficit down was the last thing the US economy was in need of. Against this backdrop, the Fed did not hesitate. First, and in accordance with its "forward-guidance policy," the Fed announced that it intends to keep rates at its current low levels at least until mid-2015. Second, the Fed announced a new round of quantitative easing (QE) to support growth and employment recovery.

This further monetary loosening will be different from previous rounds. First, the Fed will purchase mortgage-backed securities (MBS) rather than Treasuries in an attempt to improve financial conditions for households. Second, the Fed will continue with this policy for a considerable period of time, even after the recovery strengthens and the labour market improves substantially; i.e., it will not give up buying MBS when growth starts picking up (see our US Fed Watch for further details).

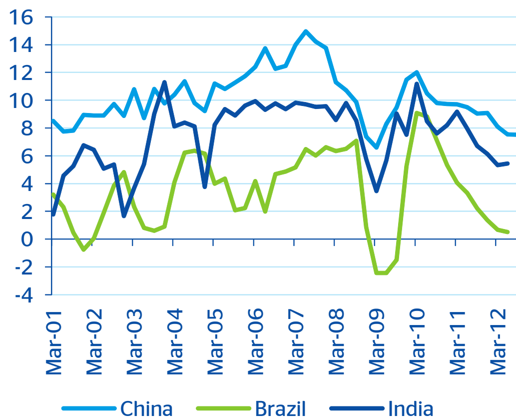
In our view, by embarking on QE3 and extending policy guidance, the Fed is buying insurance against the "fiscal cliff," but it is not a silver bullet if not accompanied by fiscal actions. In our baseline scenario, an agreement will be reached to avoid the complete package of automatic spending cuts and tax hikes from taking place. Yet we also expect some form of fiscal consolidation that will drag the economy down. With QE3 and policy guidance, the Fed does its part to give the economy the boost it needs to avoid slipping back into recession in 2013. In fact, according to our estimates, monetary loosening could contribute just a few tenths of a percentage point (pp) to GDP growth in 2013, but from 2014 onwards the effect will be more substantial. Regarding inflation, the impact will be small and delayed. However, it seems to us that the FED's tolerance to higher inflation will depend on growth and labour market improvement.

The potential effects of QE3 are not restricted to the US economy. As previous programmes showed, they prompt inflows to emerging economies, decreasing risk premia, and lowering funding costs in those countries, boosting the availability of credit, their growth rates and also their inflation. Our estimates show that QE3 (plus the Draghi effect) could have a lower impact than QE1 due to comparative evolution of risk premium and capital inflows in the emerging economies. In any case, that will depend on domestic-policy response to capital inflows.

Central bankers' responses are not enough to bring the global economy back to a firm expansion

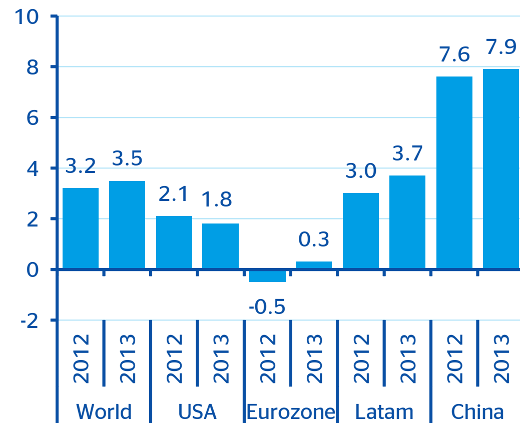
The world economy may have avoided decelerating to the slowest growth in the last 30 years (apart from the 2009 great recession) but the low growth environment continues. The advanced economies have been losing momentum since 2011 as one should expect given the current deleveraging environment. More recently the emerging economies have been hit too. In this regard, the trade channel has been intense in bringing exports and GDP growth down (Chart 3). Certainly that is the case in the three largest emerging economies. Brazil's economy almost stalled in the first half of the year; India's GDP grew by 5.3 and 5.5% y/y in the first and second quarter, respectively, the slowest pace since the beginning of 2009; and in the third quarter of the year the Chinese economy slowed to a rate of 7.4%, the lowest growth rate since 2009 although the most recent data points to a bottoming-out.

Chart 3
Emerging economies: GDP growth rate (% y/y)



Source: BBVA Research and Haver

Chart 4
GDP growth (% y/y)



Source: BBVA and Haver

However, **the actions that have been taken by central banks in the US and in the eurozone are partly dispelling some doubts and improving the outlook.** Under our baseline scenario, growth in the eurozone is likely to gain momentum entering 2013. Although the eurozone's GDP will decrease in 2012 (-0.5%), it will rebound slightly in 2013 (+0.3%). In the US, we have maintained our forecasts: growth will remain at around 2% in 2012 and 2013. The main downward revision in our October scenario corresponds to China (by -0.2 pp in 2012 and -0.4 pp in 2013), although its growth rate will remain close to 8% both years due to expected policy stimulus to compensate partially the slowdown it is experiencing. Other emerging economies will make up for this slack: the outlook for growth in Latin America is revised slightly upwards in 2013, when the region will grow by 3.7%, up from a 3% growth rate in 2012.

All in all, **the world economy is expected to continue undergoing a soft recovery with a GDP growth between 3% and 3.5%. Yet this scenario relies on several key assumptions,** in particular on whether European policy makers will deliver on their commitments. First, **this scenario assumes that the recent wrangling over financial supervision does not substantially affect June's agreements,** so the vicious link between sovereign and bank risk is broken and the monetary policy transmission, which in the eurozone is conducted mainly by banks, works again. Second, **we assume that the mechanism in place to eliminate the "convertibility risks" is activated in full if needed.** This will keep yields in peripheral economies contained, but substantial reductions will happen at the same time as Europe progresses in its new institutional arrangement and the commitments are fulfilled. **The ESM/ECB's intervention could be enough to bring Spanish and Italian yields back to levels consistent with the mid-term sustainability of the public debt,** and to levels that will make reforms have a long-lasting impact. This implies that both countries retain market access and investment-grade ratings and deliver on their fiscal commitments or are granted extensions to meet them (ideally in terms of their structural fiscal balances). On this issue, it should be considered the risk from negative feedback loops between fiscal adjustment and economic growth and also the possibility that negative fiscal multipliers may be higher than previously expected, at least in the short-term. Finally, in this scenario, Greece will continue being part of the euro, which will, in turn, require further support from Europe by additional funding and/or a longer period to fulfil fiscal conditionality. Based on past experience, too many things could still go wrong, but policy makers tend to find solutions to Europe's problems when crunch time approaches.

3. Chile: growth below potential in 2013

In 2012 the strength of domestic demand has offset the negative influence of net exports on growth; in 2013, more moderate growth in domestic demand will lead to below-potential growth

In the first three quarters of 2012 the economy grew above the expectations suggested by a global environment of sluggish growth. In fact, sectors geared to the domestic market (mainly retail trade, construction and communications) have been determinant in recent months. The uncertainty regarding the external environment has had a limited real effect, basically in tradable sectors, particularly manufacturing industry.

With respect to the components of domestic demand, both private consumption and investment continue strong, particularly in the case of consumption; investment slowed somewhat over the year.

Business and consumer expectations have been key to explain the growth in consumption and investment. After falling back in mid-2011 they have systematically been positive in the case of business and improved for consumers, entering optimistic territory over the last three months (Chart 5). This favorable trend in expectations is mainly a response to domestic factors: first, the strength of the labor market; and second, low inflation. Overall, both factors have led to a significant growth in real terms ofthe total wages bill. The strength of local demand has also been key in business expectations, particularly in sectors geared to the domestic market, such as construction. However, in the case of mining the high copper price has also been important, despite the fall compared with the average levels of 2011.

Domestic demand, which we expect to grow at 6.1% in 2012, more than offsets the negative contribution of net exports, so we have revised upwards the forecast GDP growth for 2012, from 4.4% in the July report to 5%.

The growth forecast for 2013 remains at 4.5%. The fact that growth will not reach its estimated potential of 5% is basically due to the moderation of domestic demand. Nevertheless, Chile will be among the fastest growing countries in the region in 2013 after being second only behind Peru in 2012 in South America (Chart 6).

With respect to the components of demand, there will be a slowdown in consumption due to slower growth in the total wages bill and an upturn in inflation, which we will deal with below. The slowdown in investment can be explained both by the return to normal of spending on machinery and equipment recorded in 2012, and by the effect on mining and energy projects of a copper price that fell back again in 2013 and is gradually returning to its long-term equilibrium level.

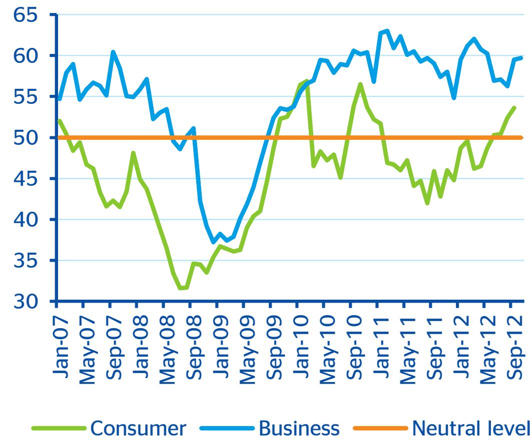
At the sector level, the non-tradable sectors (mainly retail trade and construction) will continue to be the most positive influence on growth, although this will moderate in the case of retail trade and maintain its pace in construction (see our report Real Estate Outlook Chile 2012). In contrast, the sectors geared more to the external market (mining, manufacturing and agriculture) will continue to reflect the weakness in demand in the rest of the world.

Full employment creates tension in the labor market

Despite the fact that in recent months the unemployment rate has fallen to a level considered full employment in Chile (in the moving quarter July-September it stood at 6.5%), annual employment is still growing faster than the labor force. The expected growth in employment in the final months of the year will lead to an average increase of 1.7% in 2012, following on a rise of 5.1% in 2011. Despite the slowdown, with a reduced rate of growth in the labor force (expected to be around 1%) the unemployment rate will end the year at 6.1%, leading to a fall in the annual average from 7.2% in 2011 to 6.5% in 2012.

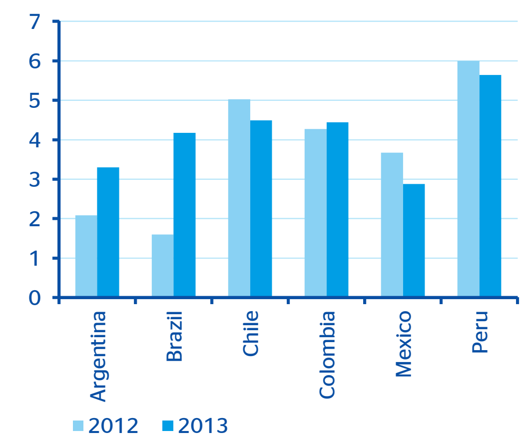
The tight labor market has meant that wages continue to rise at around 6% year-on-year, more than double the annual increase in inflation. No substantial changes in this situation are expected in 2013. In fact, the labor force is expected to increase at around the same rate as the working-age population, with employment rising slightly more. As a result, the rate of unemployment will average 6.5%, and the labor cost pressures will be maintained.

Chart 5
Indices of consumer and business confidence (positive - negative perceptions; 50=neutral)



Source: AdimarkGfK and ICARE

Chart 6
GDP growth of the main Latin American economies (y/y % change)



Source: BBVA Research

Box 1. The credit situation

Recent trends in corporate and household lending

Following the recovery after the global financial crisis begun in 2008, aggregate lending continued to grow strongly in 3Q12, although with signs of stabilization in its rate of expansion. The nominal average growth in credit was 16% y/y in the January-August period this year, based on the strength of lending to individuals and companies. Consumer finance has grown at around 16% y/y, while mortgage lending has done so at a rate of around 12% y/y. Corporate lending increased at a rate of 17% y/y. These rates of growth are in line with domestic demand, which has only shown moderate signs of a slowdown over the year. As a result, the macroeconomic fundamentals of demand for credit have remained very favorable.

In addition to the positive economic environment, average interest rates in the system for consumer finance and mortgage loans have risen only to a limited extent on the levels at the end of last year. However, consumer and commercial lending have begun to show signs of a slowdown in recent months, reflecting more restrictive market conditions, in particular in credit supply.

Favorable economic fundamentals keep household demand strong

Focusing the analysis on the situation of lending to 3Q12, on the credit demand side, individuals have continued to show a positive attitude in their intentions to take out new loans, which is in line with the favorable economic fundamentals experienced by households. A higher rate of formal employment, increases in real wages and positive prospects for the local economy in the medium and long term have boosted demand for credit. The survey of credit conditions prepared by the Central Bank shows that the net responses with respect to demand for consumer finance recovered in the third quarter, after dropping in 2Q12. Demand for mortgage loans has continued to show a positive level of net responses.

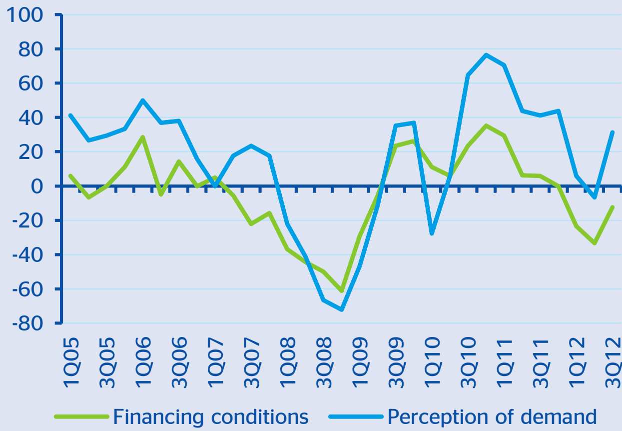
More restrictions on the supply side to granting loans

On the supply side, however, financial institutions once more showed a more restrictive net response in terms of credit conditions, continuing with a trend that began in the 1Q12 consumer finance survey. With respect mortgage lending, the result in 3Q12 was neutral, although the balance had been deteriorating since 3Q11. The main factors behind more restrictive credit conditions are associated with the customer portfolio risk and competition from other banks and financial institutions (Charts 7 and 8).

Medium-term outlook

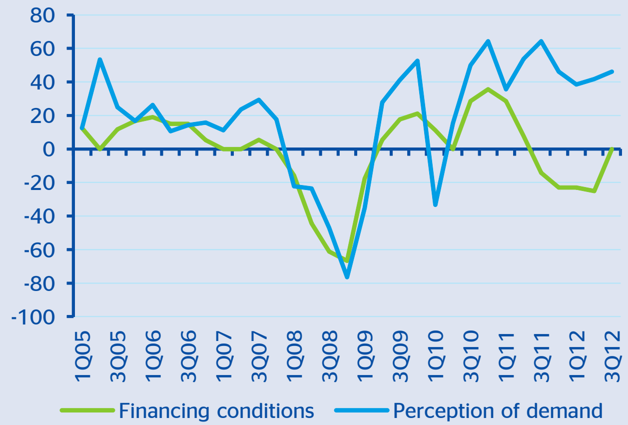
In the medium term, if the current credit conditions continue, the slowdown in consumption and a more limited expansion in employment and real wages should result in a slower rate of growth in consumer finance. Our forecast is that the nominal annual growth of consumer finance will converge to 11% in 2013. However, mortgage loans are expected to reach rates of close to 15% in 4Q13, largely because the real-estate sector is expected to remain strong in terms of volume and prices next year (Charts 9 and 10).

Chart 7
Approval standards and demand perception for consumer finance (net responses)



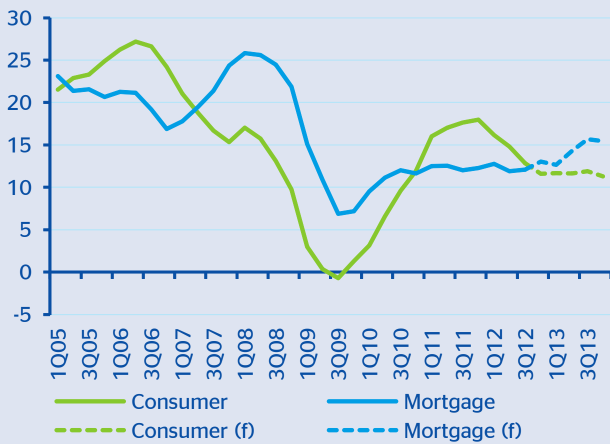
Source: Central Bank of Chile

Chart 8
Approval standards and demand perception for mortgage loans (net responses)



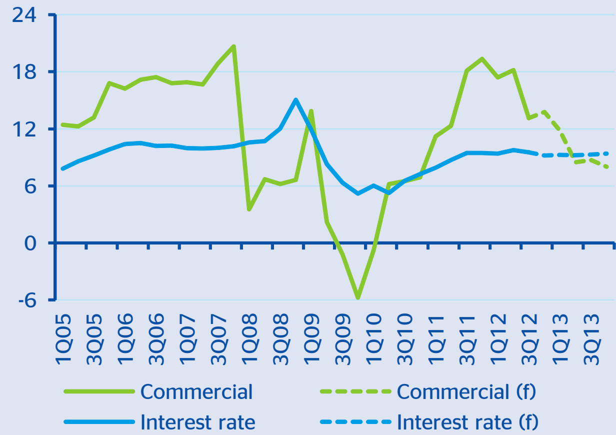
Source: Central Bank of Chile

Chart 9
Consumer and mortgage loans (y/y % change)



Source: Superintendency of Banks and Financial Institutions (SBIF) and BBVA Research

Chart 10
Corporate lending and interest rates (y/y % change)



Source: SBIF, Central Bank of Chile and BBVA Research

4. Inflation within target range

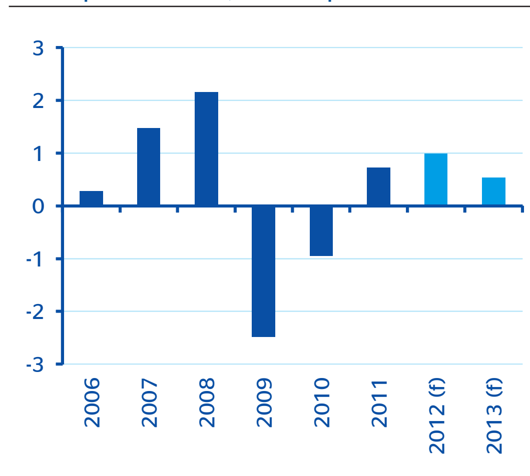
Turnaround in the tradable goods component of inflation explains the upturn at the close of 2012 and greater pressure in 2013

After cumulative inflation barely hitting 0.6% in the first eight months of the year, in September it increased by 0.8% m/m. Beyond seasonal factors explaining the high September figure, we consider that this result was a turnaround in the behavior of the headline CPI and its components. It is worth noting the change in the price index for tradable goods, which averaged a negative 0.2% m/m in the first seven months of the year, but reversed its trend over the last two months, recording an average of 0.9% m/m. The index of food prices, which averaged 0% m/m in the first half of the year jumped to 1.4% m/m in the third quarter.

For the last three months of the year we expect a high rate of volatility in inflation, associated with retroactive adjustments to the electricity fares and a strong downward correction of fuel prices, following their overreaction to expansionary monetary policies of the developed economies. The moderating effect of prices of tradable goods early on in the year will not be repeated in the second half, and we expect annualized inflation of 2.2% for December, slightly down on the 2.3% estimate in the July report.

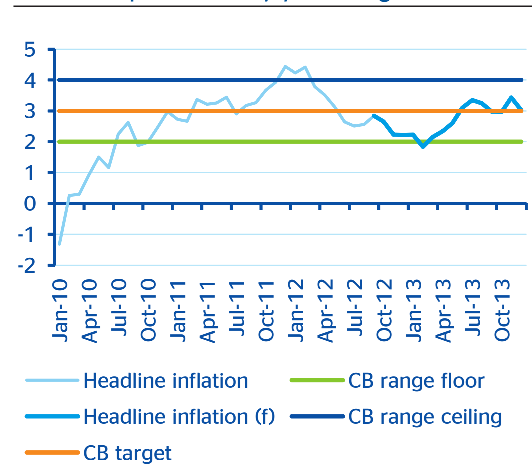
In 2013, we expect an upturn in fuel and food domestic prices related to the forecast growth in energy and food commodity prices, and a very steady depreciation in the exchange rate. These factors will maintain the upward trend in prices for tradable goods of the last two months. With respect to non-tradable goods, although moderation in demand and a GDP growth slightly below potential will reduce excess capacity utilization (defined as the gap between GDP and potential GDP), inflationary pressures in this component still remain (Chart 11). These factors will be exacerbated by persistent tension in the labor market. Although we anticipate inflation to be at the target of 3% at the close of 2013, the lack of spare capacity may amplify any supply shocks such as an increase in fuel or food prices on international markets. Inflation risks therefore have a clear upward bias (Chart 12).

Chart 11
Output gap (GDP - potential GDP, as % of potential GDP)



Source: BBVA Research

Chart 12
Consumer price index (y/y % change)



Source: National Bureau of Statistics and BBVA Research

5. The scenario for monetary policy continues ambiguous

Divergences in the cyclical situation of the economy in Chile and abroad will hold the policy rate at 5% until the close of 2013

Monetary policy has continued to operate in response to conflicting domestic and external factors over recent months. On the one hand, an analysis of local activity suggests moderation was not as strong as anticipated mid-way through the year, which would be a clear signal for a more restrictive monetary policy. On the other, the external slowdown has continued and the medium-term prospects have once more been adjusted downwards in the last quarter. The level of openness of our economy and the expected time lag with which the global slowdown will affect the domestic economy point in the other direction.

What has been the effect of this on effective inflation and the inflationary expectations of the agents? Inflation has returned to levels close to the Central Bank's target range, but core inflation continues near the floor of tolerance. With respect to the outlook, after an upturn in commodity prices, including food and fuel items, resulting from greater liquidity measures implemented by the main developed economies, some reversion is to be expected and has already been observed in some of these prices. However, the strength of local activity, the situation of virtual full employment in our economy and dynamism observed in labor costs, all introduce a note of caution with respect to future inflation. This is in line with the fact that the Central Bank has shown a more restrictive stance in the minutes of its last monetary policy meeting, which highlighted the tightness of the labor market and possible inflationary pressures if the strength of local activity continues. What is more, reduced turmoil abroad may heighten these pressures as the probability of an adverse risk scenario diminishes and the expectations of economic agents become more confident.

In addition, the growing current account deficit emerges as a relevant factor. Although it is largely financed from foreign direct investment, it reflects high levels of expenditure that may harbor upward pressures on the exchange rate and second-round implications for inflation.

In this context, we expect the Central Bank to maintain its pause in 2013 and to initiate a brief cycle of rises in the monetary policy rate in the first quarter of 2014, in an external environment with generally easier monetary policies. This pause implies a relatively more restrictive monetary policy in Chile, which together with a stronger exchange rate allows the Central Bank to wait before bringing back the reference rate to its neutral level (Chart 13).

It is also worth pointing out that BBVA Research has for some time considered that the most probable scenario would be for the pause to be maintained for a prolonged period. The market was until recently anticipating a cut in the rate, but has come closer to our view, and few analysts now anticipate cuts in the near horizon.

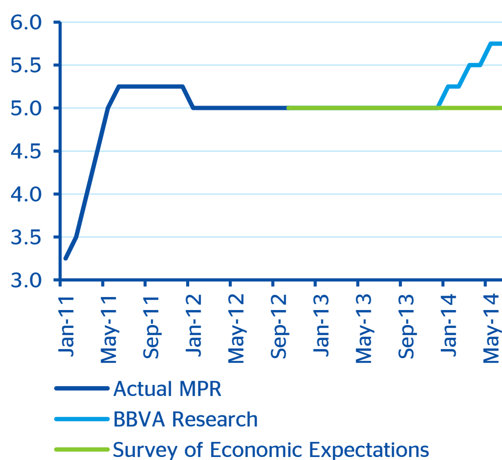
The effects of these expectations on monetary policy and the return to normal of interest rates lead us to consider that nominal yields will remain fairly flat, and begin to rise only in the medium and long term. The structure of real interest rates, which has been returning to normal as inflationary expectations have increased, will move in line with inflationary expectations that are well anchored at around the target.

Exchange rates have been influenced largely by the increased spread between domestic and external interest rates due to the effect of the new round of quantitative easing in the U.S. (QE3) and the measures announced by the European Central Bank. The latter triggered a rise in the price of copper to close to USD 3.7 per pound, far above expectations for the second part of the year. In this scenario, the exchange rate appreciated to levels of CLP 470 per dollar, 10% down on the close of 2011. Although some of these factors have been adjusted recently, the more favorable fundamentals corrected the exchange rate down. We expect it to close 2012 at

CLP 475 per dollar and 2013 at CLP 498 per dollar. In the longer-term, the exchange rate will depreciate steadily in line with the expected fall in the copper price. This fall will in turn be the result of fundamental factors that have to do with a steady increase in supply and a somewhat weaker demand due to the slowdown in the Chinese economy and the high level of copper inventories.

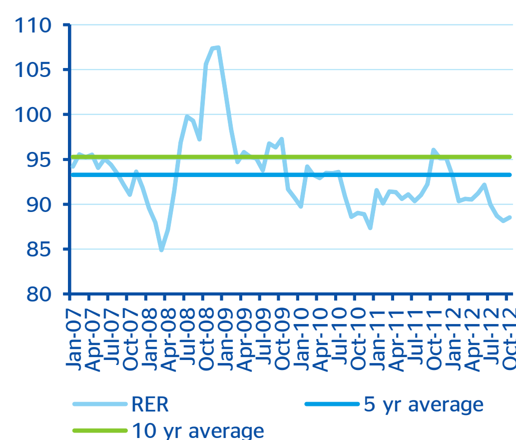
We therefore consider that the debate on the possibility of exchange-rate interventions by the Central Bank does not have sufficient basis in the current situation. Specifically, the advisability of a measure of this kind is limited, if we compare the costs of intervention, as measured by the spreads of the domestic and external interest rates implicit in sterilization, and the benefit of a partial and temporary depreciation of the exchange rate while the dollar loses value on international markets. At the same time, the real exchange rate still remains slightly above the levels that triggered previous intervention programs in the foreign-exchange market; and as we mentioned, the fundamentals are in favor of a higher real exchange rate (Chart 14). With respect to short-term macroprudential measures, similar to those applied by other emerging economies, we do not expect that restrictions will be introduced on capital flows; first, because there has been no substantial increase in portfolio inflows; and second, because it is not in line with the free floating policy followed in Chile. There will also be no increases in reserve requirements, as there is no evidence of asset price bubbles or of strong expansion in lending. If there is a sustained deviation of a more idiosyncratic nature of the Chilean peso against a relevant basket of currencies, the Central Bank could be expected to announce a program of scheduled reserve accumulation.

Chart 13
Monetary policy rate (%)



Source: Central Bank of Chile and BBVA Research

Chart 14
Real effective exchange rate (1986=100)



Source: Central Bank of Chile and BBVA Research

6. Fiscal balance at around equilibrium

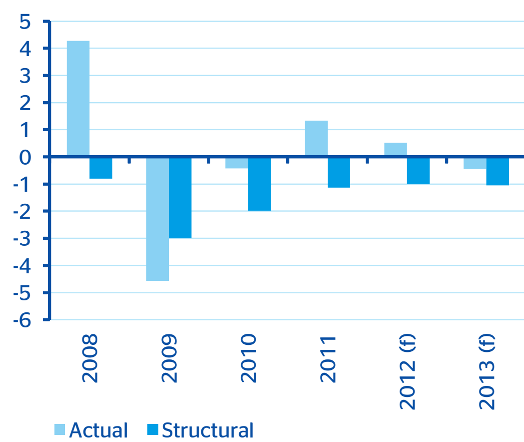
The price of copper and economic growth determine the fiscal surplus in 2012; in 2013, the fall in the price of the metal will be the main factor behind a slight deterioration

In 2012, higher revenues from taxes linked to economic activity will be partially offset by lower revenue from mining, given a copper price that we estimate will average USD 3.59 per pound over the period, compared with a level of USD 4.0 per pound in 2011. On the expenditure side, the budget approved for 2012 includes a growth in public expenditure of around 6% in real terms. We consider that the actual fiscal balance will be 0.5% of GDP for the year, somewhat better than the figure estimated by the government.

For 2013, we expect a deficit of 0.4% of GDP, due to the lower copper price (an average of USD 3.15 per pound, slower growth of domestic demand and output and a 5% increase in public spending in real terms (according to the budget law currently being debated in Congress). The structural deficit will reach 1% of GDP, in line with the advance made by the Executive on its target. It is worth highlighting that the advance announced for the structural deficit target reduces some of the pressures on the current-account deficit and on the appreciation in the exchange rate. However, the size of the foreign deficit and the essentially exogenous nature of the factors behind the exchange rate continue to limit the effectiveness of this tool, particularly given the reduced levels of freedom to make a greater fiscal adjustment (Chart 15).

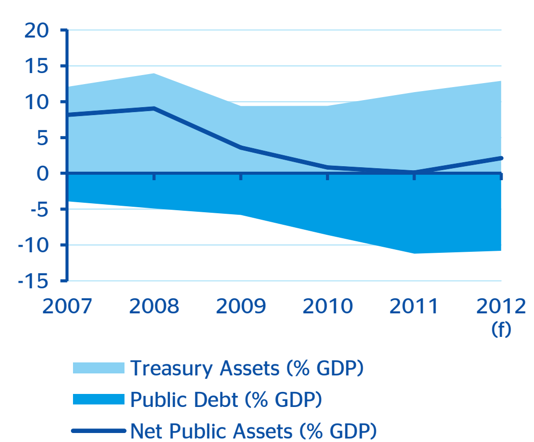
With respect to the public-sector's net position, Treasury funds and sovereign funds are currently close to USD 34 billion, around 13% of GDP. Given the level of public debt of 11.3% of GDP, this maintains the creditor net balance (Chart 16).

Chart 15
Fiscal balance (% of GDP)



Source: Budget Department and BBVA Research

Chart 16
Public sector assets and liabilities (% of GDP)



Source: Budget Department and BBVA Research

7. Deterioration in the current account, but still at sustainable levels

The current-account deficit will hit 3.6% in 2012, as the upward correction in the copper price from USD 3.55/lb to USD 3.59/lb, with respect to the previous scenario, will only partly offset increased imports due to higher domestic demand

Exports are expected to reach USD 79.3 billion in 2012, a fall of around 2.5% on the figure for 2011, due to a 10% drop in the price of copper, which will only partly be offset by the increased volumes of copper exports and the value of other exports. Meanwhile, imports will increase by around 6% to USD 74.9 billion. As a result, the trade surplus will fall from USD 10.8 billion to 4.4 billion. The lower trade surplus will be more than offset by the balance of payments deficit in the service and income accounts. As a result, the current-account deficit will be USD 9.7 billion (3.6% of GDP) in 2012.

It is interesting to note that the above implies a significant deterioration in the current account compared with the 1.3% of GDP in 2011. What is more, the quarterly figures for this indicator would have deteriorated steadily, and with the data available as of this date we estimate that

in the third quarter it will easily exceed 5% of GDP. This deficit will be mainly financed from foreign direct investment, which is expected to reach around USD 20 billion, higher than the figure of USD 17 billion in 2011. The net balance of foreign direct investment (discounting direct investment by residents in the rest of the world) will be close to the average of the last two years, at around USD 5.5 billion. The rest of the current account deficit will be financed by other investment. This implies a significant reduction in the contribution of portfolio investment compared with 2011.

The current account deficit is expected to rise in 2013 to 4.1% of GDP. This result can be explained by a forecast average copper price of USD 3.15 per pound, 12.5% down on the average forecast for 2012. In addition, fuel imports will increase in nearly USD 1 billion. Although the current-account deficit is once more expected to be mainly financed with foreign direct investment, the foreign deficit is reaching levels that increase vulnerability to falls in the copper price.

8. External and domestic risks

The likelihood of an accident in Europe has reduced, but it continues to be the main factor for global risk; at the domestic level, there is renewed risk of overheating

Although the main risk faced by the Chilean economy continues to be a significant deterioration in the European situation, recent progress made in addressing the crisis in the euro zone have led to a very significant drop in the perceived likelihood of this adverse scenario in Europe.

However, the main channels through which a negative situation in Europe could cause contagion to the U.S. and, in particular, China, continue to be the same in the case of Chile, i.e.: i) a deterioration in the terms of trade, led by a fall in the copper price; ii) a fall in the volume of exports, although lower than that expected for imports; and iii) a drop in business and consumer confidence. The improved scenario in Europe suggests that the extent of the above effects would be lower than that which occurred in the wake of Lehman Brothers.

Given this, the effects on the main macroeconomic variables would also be more limited. There would be a fall in GDP growth, although substantially below the fall of 2009, and in fact the economy would not enter recession. Inflation would react as expected in this context, with the deflationary effect of lower domestic demand prevailing over the inflationary effect of a major depreciation in the exchange rate. In all, inflation would be substantially below the base scenario, but not negative as occurred in 2009.

In terms of the foreign accounts, in the short term slowing imports would partially offset the fall in exports, although the fall in the copper price would lead to a swift deterioration of the current-account balance, which is already at worrying levels in the base scenario. In the medium term, the steady recovery in the terms of trade would serve as a buffer and allow a steady improvement in the current-account deficit.

Although there could be another international credit squeeze, as happened in the wake of the Lehman Brothers collapse, the Central Bank would establish credit facilities in pesos and dollars to address this situation, which would in any event be temporary. The level of international reserves, at close to USD 40 billion, would support this strategy, and exchange-rate flexibility would mean that the use of these reserves was very limited. The relatively high current level of interest rates would provide the Central Bank with ample room to apply a stimulus policy, although a reaction of the extent of 2009 would not be required.

In the case of fiscal policy, the lower levels of freedom with respect to the post-Lehman Brothers situation would determine a lower stimulus, despite the abundant reserves held in sovereign funds. The above, combined with lower revenues due to reduced domestic demand, would result in a bigger fiscal deficit, but financing requirements would also be easily covered by sovereign funds.

The most important idiosyncratic risk is once more that domestic demand is still very strong. This could lead to a deterioration in the balance of payments, a depreciation in the exchange rate and higher inflation.

9. Tables

Table 1
Macroeconomic forecast annual

	2009	2010	2011	2012	2013
GDP (% y/y)	-1.0	6.1	6.0	5.0	4.5
Inflation (% y/y, eop)	-1.4	3.0	4.4	2.2	3.0
Exchange Rate (vs. USD, eop)	502	475	517	475	498
Interest Rate (%, eop)	0.5	3.3	5.3	5.0	5.0
Private Consumption (% y/y)	-0.8	10.0	8.8	5.3	5.2
Government Consumption (% y/y)	9.2	3.9	3.9	4.1	4.7
Investment (% y/y)	-12.1	14.3	17.6	7.7	7.3
Fiscal Balance (% GDP)	-4.6	-0.4	1.3	0.5	-0.4
Current Account (% GDP)	2.0	1.5	-1.3	-3.6	-4.1

Source: BBVA Research

Table 2
Macroeconomic Forecast Quarterly

	GDP (% y/y)	Inflation (% y/y, eop)	Exchange Rate (vs. USD, eop)	Interest Rate (%, eop)
Q1 10	2.8	0.3	523	0.50
Q2 10	7.1	1.2	537	1.00
Q3 10	7.7	1.9	494	2.50
Q4 10	6.7	3.0	475	3.25
Q1 11	9.9	3.4	480	4.00
Q2 11	6.3	3.4	469	5.25
Q3 11	3.7	3.3	484	5.25
Q4 11	4.5	4.4	517	5.25
Q1 12	5.3	3.8	485	5.00
Q2 12	5.5	2.6	506	5.00
Q3 12	5.4	2.8	475	5.00
Q4 12	4.1	2.2	475	5.00
Q1 13	4.1	2.2	481	5.00
Q2 13	3.7	3.1	493	5.00
Q3 13	4.8	3.0	490	5.00
Q4 13	5.4	3.0	498	5.00

Fuente: BBVA Research

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