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BBVA Group Research
Department

Economic Watch

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Economic Analysis

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2012 budget shows little progress in reducing structural deficit

- **The 2012 fiscal budget approved by Congress leads to an effective deficit of 0.4% and a structural deficit of 1.5% of GDP**

  This compares with the effective surplus of 1.2% and the structural deficit of 1.6% of GDP estimated by the government in 2011. One reason for concern is the little progress made in reducing the structural deficit to 1% of GDP in 2014, when a new government takes over.

- **The budget is based on the assumption of a favorable economic scenario**

  The budget was prepared based on the assumption that the Chilean economy would slow down in line with its long-term potential, and under a relatively stable foreign scenario.

- **An increased structural deficit leaves less room for a fiscal stimulus**

  If global conditions deteriorate and domestic demand declines, the government could implement an expansive fiscal policy but, because it is starting from a significant structural deficit, it has less room for maneuver than in 2008.

- **Without major effects in the short term, although in the medium-term it would put pressure on the exchange rate and interest rates**

  In the short term, because of the slowdown expected for the rest of domestic demand, public spending dynamics would not generate greater inflationary pressures, while debt issuance would be similar to this year's, with limited effect on interest rates. However, maintaining a structural deficit would put pressure on the appreciation of the exchange rate and result in somewhat higher interest rates in the medium term.

Budget and fiscal policy outlook

In line with most market forecasts, at the time the public sector budget for 2012 was prepared, the internal economic scenario pointed to a slowdown in economic activity toward its long-term potential, while the external scenario would tend to stabilize, partly dispelling market uncertainty. In this regard, both the exchange rate and the price of copper considered are within the optimistic range of current analyst forecasts.

In addition, the budget envisages a 1.4% year-on-year drop in total real revenue, due to the lower price of copper for 2012 versus 2011, which should be partly offset by the higher taxes to be paid by private mining companies at the start of 2012. Other revenue items increase slightly, in line with the moderation in economic activity growth. Real expenditure would grow by 5.3% year-on-year compared to the adjusted budget for 2011, which we believe is consistent with a slight under-spending this year.

Following the extended discussion of the budget in Congress, at aggregate level this would imply a higher deficit (nearly US$150 million more), around 0.1% of GDP. The only two items that were not approved by Congress correspond to the Education Fund (US$4,000 million) and the amendment that enabled US$1,100 million to be used by CORFO, preventing its investment in financial instruments. Thus, the 2012 fiscal budget approved implies an effective deficit of 0.4% and a structural deficit of 1.5% of GDP. This represents a significant decline compared to the 1.2% effective surplus estimated by the government for this year, and practically no progress in reducing the structural deficit in relation to the 1.6% forecast by the government for 2011. Thus, the greater fiscal adjustment effort aimed at bringing the deficit down to the 1.0% target would concentrate in 2013 and 2014, something that will be difficult to achieve due to the political cycle, since presidential elections will be held in late 2013.

However, these figures are in line with our latest estimates, which point to an effective deficit of 0.3% of GDP and a structural deficit of 1.4% of GDP for 2012, considering a copper price and economic growth somewhat lower than the assumptions used by the government, but a higher exchange rate.

Convergence with a sustainable structural balance

The government plans to cut the structural deficit to 1% of GDP in 2014. As we have mentioned earlier, this target does not seem to be very ambitious, as in practice it implies that ¾ of the 2008-2009 fiscal stimulus has become permanent, thus limiting the chance of applying counter-cyclical policies should the international situation deteriorate. Thus, it is not surprising that the debate on a tax reform to increase revenue should be so intense.

Moreover, if revenue from copper falls in the future, a greater expenditure adjustment or even taxes would be required to return to structural fiscal balance.

How much room for maneuver does this budget leave in the event of an adverse scenario?

The likelihood of a more adverse external scenario has increased lately, whereby the Chilean economy could be affected to a significant extent, although not as badly as in 2009. Under this scenario, fiscal policy could apply an additional stimulus, as in 2009, when the stimulus package reached US$4,000 million (2.8% of GDP) and the structural surplus target was changed.

In terms of available resources, the Economic and Social Stabilization Fund (FEES) and the Public Treasury's liquid assets would reach nearly US$24,000 million in December 2011, which compares with the nearly US$23,000 million available at the end of 2008, before the Lehman Brothers event.

However, before the 2009 crisis, the level of public spending relative to GDP was kept below 20%, in nominal terms. As a result of the fiscal stimulus package applied that year, spending reached 24% of GDP, at level at which it has remained for the last two years. If a new economic policy response were necessary in the face of a renewed international crisis, spending as a proportion of GDP would increase again and require additional adjustments in the coming periods. In the medium term, a tax hike would be almost inevitable, since the structural deficit would most likely deteriorate by 2% or more of GDP, which without adjustments to expenditure or other sources of revenue would lead to an increase in the tax burden.

An additional decline in fiscal revenue in the face of lower domestic demand and a drop in the price of copper would make it advisable to use monetary policy to tackle an adverse scenario, given the greater flexibility and room for maneuver that currently being near the neutral interest rate level implies.

Public spending would put pressure on the exchange rate

The budget approved for 2012 does not envisage a withdrawal of the fiscal stimulus next year and, according to the 2012 Public Finance Report, such a withdrawal would only be gradual, given that the average real expenditure growth between 2013 and 2015 would be 3%, something which would need to be managed by the next government. Despite this, the expected moderation of domestic demand and some effect of the deterioration of the global scenario would ease inflationary pressures. On the other hand, we expect a recurrence of the issuance of public debt in pesos equivalent to US$6 billion seen in the last two years, and in foreign currency for US$500 million. Maintaining the coordination between the Treasury and the Central Bank as regards issues would result in a marginal impact on the interest rate structure.

However, maintaining a structural deficit in the medium term would imply constant pressure on the exchange rate, and upward pressures in long-term interest rates cannot be ruled out, especially if we consider that before the crisis the fiscal rule showed a surplus of 0.5% of GDP.

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