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Chile Economic Watch

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Economic Analysis

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Fiscal policy: more expansive than expected

- **The trends parameters and the target which will frame the structural balance policy over the next few years will be the most restrictive since the beginning of the rule.** Both the copper price and trending GDP will have to be adapted downwards from now on. This, plus the reduction in the structural deficit to 0% of GDP in 2018, leaves the current administration – at least in terms of these parameters – in a tighter scenario than their predecessors enjoyed.
- **However, partly as a consequence of the above, the tax reform will directly inject more revenue, which will not only raise spending but also its YoY growth.** We estimate that public spending will grow on average between 7% and 8% over the 2015-18 period. The 2015 expansion will be around 11% in real terms. In the final year, the size of the state sector could be as much as 25% of GDP, close to 8pp over its 2006 level.
- **Everything in the medium-term fiscal scenario combines in pointing to put pressure to the upside on interest rates.** Higher spending growth, successive effective balance deficits, greater need for public borrowing and closing off a private borrowing valve (FUT). All in the same direction, meaning pressure to the upside on interest rates.
- **The exchange rate will not experience pressures to depreciate from fiscal factors in 2015 because of the huge expansion in public spending.** We see depreciation pressures on the peso continuing to a large degree throughout 2014, reaching around USDCLP 570 in forthcoming months.
- **The loss of dynamism in private consumption seen recently will continue to be pushed by rises in unemployment.** However, in 2015 we will have buffers linked to the beginning of transfers to lower-income households (with greater marginal propensity to consumption) coming from resources allocated to education, making room for expenditure on consumer goods.

Expenditure will increase by 6.6% in real terms in 2014, in a macroeconomic scenario which is very different from the one used to prepare the Budgetary Law in September 2013. The slowdown in activity and the lower copper price will cause disposable fiscal income to contract this year, so the effective balance deficit should be around 1.7% of GDP, instead of 0.9% of GDP as per the Budget. However, GDP and effective copper price results do not influence structural revenues, which are estimated based on trends parameters. On the contrary, greater inflation and the higher exchange rate make this level of income rise. So, if the level of spending approved in the law is maintained, the structural deficit will be 0.8%, and growth in spending will be 5.5% in real terms. In a scenario maintaining the deficit target as 1% of GDP, real increase in spending will be 6.6% (Table 1).

Table 1
Breakdown of effective and structural balance

CLP Mn	2014 Finance Ministery(a)	2014 BBVA Research (b)	(a) - (b) [mm de USD]	Main reason for the difference:
Disposable income	**30,840,787**	**29,712,127**	**-1,979**	
Tax revenue	**24,931,494**	**24,358,870**	**-1,004**	
Income tax large mining corporations	1,151,627	1,006,525	-254	*Lower copper price*
Income tax remaining contributors	8,502,901	8,329,486	-304	*Lower activity level*
VAT	12,326,848	11,950,649	-660	*Lower domestic demand*
Specific products	2,108,953	2,119,460	18	*Similar level*
Rest	841,165	806,049	-62	*Similar level*
Tax reform	0	146,701	257	*Tax reform (TR) introduced in 4Q13*
Codelco	**1,643,935**	**752,459**	**-1,563**	*Lower copper price and capitalisation at USD 1.2bn.*[1]
Rest	**4,265,358**	**4,600,798**	**588**	*Greater execution*
Structural Revenues	**30,829,660**	**31,112,532**	**496**	*Higher exchange rate and TR*
Total expenditure	**32,240,551**	**32,240,551**	**0**	*Assuming 100% execution*
Cash balance	**-1,399,764**	**-2,528,424**	**-1,979**	
% of GDP	**-0.9%**	**-1.7%**	**-0.8%**	
Structural balance	**-1,410,891**	**-1,128,019**	**496**	
% of GDP	**-1.0%**	**-0.8%**	**0.2%**	

Note: Both 2014 columns were converted into USD using the exchange rate estimated by BBVA Research
Source: BBVA Research

[1] The projection assumes that Codelco's capitalisation translates into lower transfers from the company to the Government Revenue. Another option would be to use resources from the Economic and Social Stability Fund (FEES), as a government authority mentioned recently, in which case company transfers would be larger by US$ 1.2bn than those used in this production, increasing structural revenue and room for spending this year by the same amount.

From this year onwards there will be additional revenue thanks to the tax reform, but less than half of what was projected by the Inland Revenue/Dipres. Although the projection estimates that over the course of 2014 the introduction of this law will result in higher revenues representing 0.29% of GDP, we estimate a longer than expected passage through parliament, as well as less revenue due to less effective anti-evasion policy: we believe that the tax intake in 2014 will only increase by around +0.1% of GDP.

For the first time, we expect a drop in the trends parameters (long-term copper price and trending GDP) and an increasingly more restrictive target. In terms of what is going to happen with fiscal policy over the next few years, the authority concerned has committed to converging to a structural balance by 2018. On this issue, we believe that the main benchmark parameters for estimating the structural income level, that is, the long-term copper price and trending GDP, are going to register drops in forthcoming years, starting as soon as 2014, for the 2015 Budget. Given the market situation of copper worldwide, it is very difficult to keep USD3.04 a pound (lb), the current reference price level. By contrast, we expect a price that gradually converges to its long-term levels, which we estimate at USD2.80/lb, so that the benchmark price ought to trend toward that price in coming years. Equally, growth rates lead us to expect a trending GDP of between 4% and 4.5% instead of 4.8% to 5%. If this scenario materialises, we would see something that has not occurred since the rule was introduced: falls in the trends parameters and an increasingly restrictive target (Table 2).

Table 2
Projection of the main reference variables in calculating structural balance

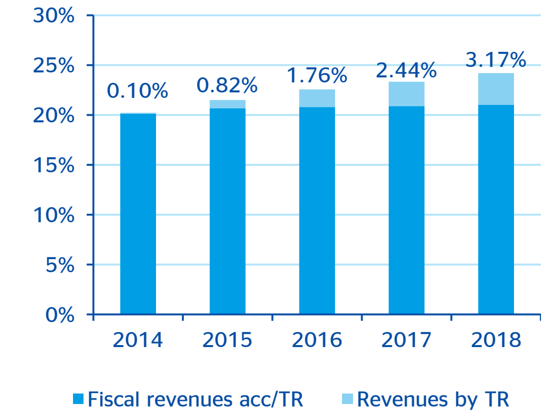
	2015	2016	2017	2018
Trending GDP (Var. YoY)	4.5	4.5	4.5	4.5
Long-term copper price (USDc/lb)	300	295	290	285
Structural Balance Target (% of GDP)	-0.8	-0.5	-0.3	0.0

Source: BBVA Research

Although the above might deliver an adverse climate for fiscal policy in the medium term, the tax reform now comes into play, changing the panorama completely. If the greater revenues estimated by the Finance Ministry materialise (Figure 1), there will be an increase in both effective and structural income. The latter are those which set the level of spending so, although they are affected by the conditions explained in the paragraph above, the tax reform more than compensate the falls in the benchmark parameters. This will raise average spending growth over the next few years to a range of between 7% and 8%, with a significant increase in 2015, when the increased revenue from the reform[2] (Figure 2) starts to really kick in. However, this will be a transitory phenomenon which will only last until the tax reform becomes fully effective. Once this happens, spending growth will return to being determined mainly by trending GDP growth and the changes in long-term copper price, settling again at between 4% and 5% in real terms YoY.

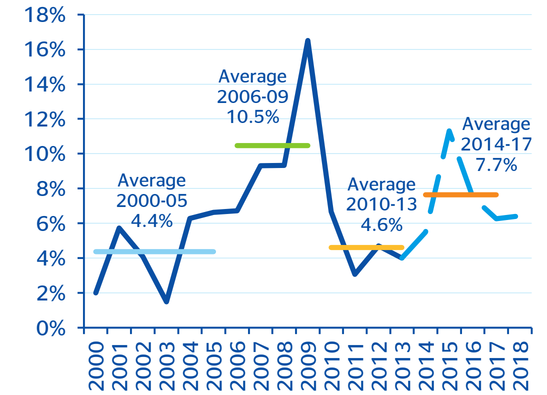
2: According to our estimates, the sharp increase in spending is also explained by the capitalisation to Codelco, which we assume to be USD1.2bn for 2014, but which will not be repeated in 2015. On the assumption of a similar capitalisation for next year, growth in spending would be 9.5% YoY.

Figure 1
Effective fiscal income as % of GDP 2014-18



Source: BBVA Research

Figure 2
Public spending growth and averages over the 2000-18 period



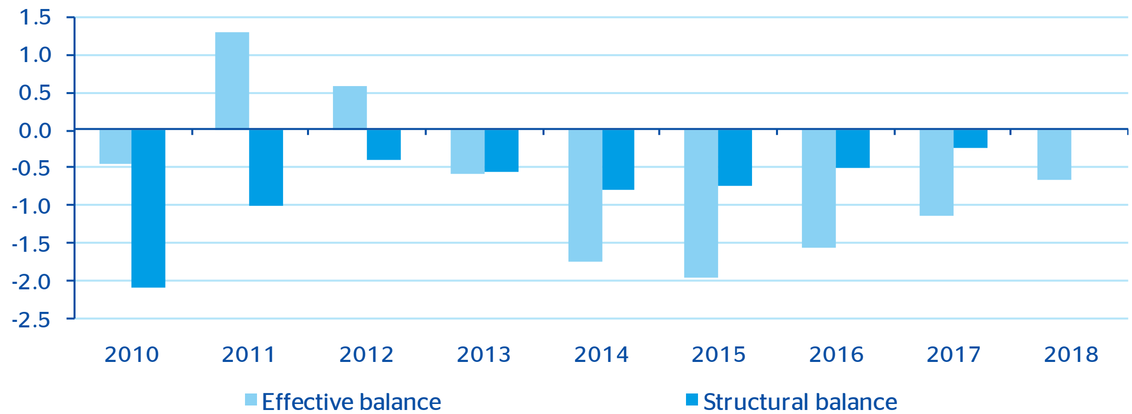
Source: State Budget Dept and BBVA Research

The possibility of the figures to stay in the low part of the average expected spending growth range, it is only because of the risks in some measures' ability to collect revenue. For example, given the debate that it has provoked, we think it unlikely that the increase in tax on alcoholic and non-alcoholic beverages will be passed. A 0.5% of GDP reduction in evasion and elusion also seems too strict to be achievable. The above, added to eventual changes in behaviour on the part of contributors not covered in the reform calculations, makes us see total revenue of 3% of GDP as having a bias to the downside.

If less revenue materialises than expected in the tax reform, the structural deficit target or the education reform (or both) will be partly affected. In this area, our view is that there are two important points once the reform has been approved: 1) having a mechanism for monitoring the tax reform, an Accountability Report which records whether the revenue collection goals have been reached; 2) focusing attention on the way in which resources are spent, that is, how the education reform is introduced, in order to see the real impact on long-term growth resulting from both reforms.

In summary, even though the tax reform will not collect 3% of GDP once it is operative, average spending growth will be higher than in earlier years. This, together with benchmark parameters closer to their effective levels and a structural deficit target that will only be reached in 2018, translates into a course of effective fiscal deficits over the next few years which will need to be explained in detail to foreign investors (Figure 3).

Figure 3
Effective and structural balances 2010-18 (% of GDP)



Source: State Budget Dept, BBVA Research

Therefore, all the elements are in position for upward pressure on sovereign interest rates: higher government expenditure, successive effective deficits which will push the Government into higher levels of debt, and the elimination of the FUT, which shuts off a source of borrowing and forces those who use it to seek resources from the financial market.

Finally, the rate of exchange, due to fiscal factors, will not feel depreciatory trends in 2015. We continue to expect heavy depreciatory pressure on the peso in 2014, with targets of around USD/CLP570 over the next few months. The slackness of private spending we have seen recently will continue to be driven by increased unemployment. However, in 2015 we will have buffers linked to the introduction of transfers to lower-income households (with greater marginal propensity to consume) coming from resources earmarked for education.

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