BBVA | RESEARCH

Economic Outlook

Chile

Third Quarter 2012
Economic Analysis

- **Global growth should recover gradually in 2013** as European and U.S. authorities reduce existing uncertainty.
- **In Chile, we revise our GDP growth forecast slightly upward for 2012,** from 4.2% to 4.4%, due to stronger than expected economic activity during the first half of the year.
- **Economic activity will slow down in the second half of the year, and for 2013** we lowered our forecast from 4.7% to 4.5%, due to a less favorable external enviroment.
- **Inflation should reach 2.3% at the end of 2012,** but in the context of marked contrast in the performance of the prices of tradable and non-tradable goods.
- **Monetary policy: no room for interest rate cuts,** and in pause until early 2014.
- **External risks have become more pronounced, although Chile is in a good position to face an increase in financial tensions in Europe.** The risk of inflationary pressures due to overheating of economic activity has been mitigated.

Index

Closing date: August 8, 2012

1. Overview

The global growth forecast has been revised slightly downward, to 3.4% in 2012 and 3.7% in 2013. The revision is based on the financial tensions in Europe and the slowdown, somewhat more intense than expected three months ago, especially in the largest emerging markets like China, India or Brazil. This global scenario presupposes that the necessary political agreements will be reached for making progress in the institutional development of the European monetary union and also for avoiding the automatic fiscal adjustment in the U.S.

Economic activity in Chile has shown no signs of contagion from the unravelling of the external environment, with GDP growth of 5.5% y/y in the first half of the year. Strong economic activity in the first half of the year would offset the effect of the slowdown in the second half on the annual results, and we are adjusting the growth forecast from 4.2% to 4.4% for 2012.

In 2013, however, the absence of excess capacity and the more adverse external environment determine a downward adjustment in the forecast, from the 4.7% forecast in May to 4.5%. By demand components, a rapid slowdown of investment is anticipated, which would average 7.5% between 2012 and 2013. For total consumption, an average growth of around 5% is forecast for the same period. In the aggregate, domestic demand, after growing approximately at twice the rate of GDP on average between 2010 and 2011, would grow slightly above GDP between 2012 and 2013.

For the second half of 2012 and in 2013, a decline in the current account is forecast, due mainly to weaker foreign demand, which would negatively impact the terms of trade and slow down growth of exported volumes. In annual terms, the current account balance would drop from -1.3% of GDP in 2011 to -2.9% in 2012 and 2013.

One of the biggest economic surprises in 2012 on the domestic front has been the performance of inflation. In July, the 12-month inflation rate dropped to 2.5%, which notably differs from our forecasts and those of the market made a few months ago. This result is explained mainly by the performance of the prices of tradable goods and some one-off adjustments, two phenomena that will not recur in the second half of the year. Thus, an upturn in inflation is forecast, with inflation standing at 2.3% y/y in December. In 2013 inflation would close at 3,0% y/y.

When considering the main factors that guide the Central Bank's monetary policy decisions, the arguments seem to support the neutral stance followed in recent months. Despite the downward surprises in the inflation levels, the evolution of the prices of non-tradable goods, which is associated directly with the strong performance of the domestic economy, continues to show rates well above the ceiling of the Central Bank's tolerance range. On the other hand, the exchange rate, after rising due to the intensification of international financial tensions has returned to levels seen previously. For the upcoming months we expect a moderate depreciation, closing the year at $ 492 per dollar.

A slight real increase in fiscal revenue, above the expected increase in expenditure, will determine a surplus of 0.6% of GDP in 2012. However, this corresponds to an upward adjustment in relation to the fiscal balance we estimated in May, given a relatively better performance of the economy in the first half of the year. As for the structural balance, we estimated that a deficit of 1.3% of GDP would be reached for 2012, somewhat higher than the -1.1% recorded last year.

The main risk factor will continue be to the possibility of a decline in the external environment, particularly in Europe, but also in the U.S. Instead, the idiosyncratic risk of overheating is losing steam. Nevertheless, Chile is in a good position to face an increase in financial tensions in Europe.

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2. External environment: a slowdown that may deepen unless decisive economic policy action is taken

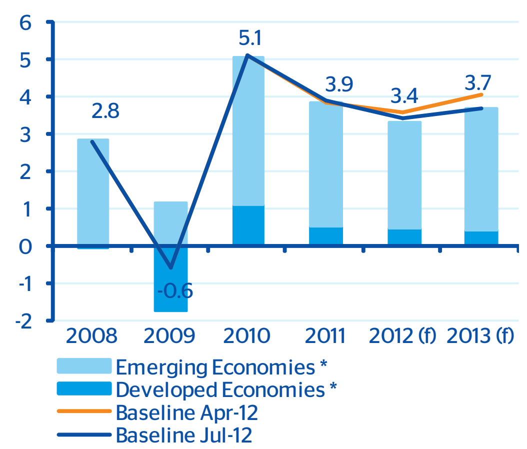
Global growth will improve only if key economic policy measures are fully implemented in time

After the deterioration in global economic conditions in the first part of 2012, our current scenario that still envisages a slight economic rebound in 2013 is very dependent on economic-policy issues. Our global GDP growth forecast stands at around 3.5% in 2012-13 (Chart 1), but relies on the assumption that necessary policy measures are implemented in time to avoid a financial mess in Europe, an automatic fiscal adjustment in the US in 2013, and help reach higher growth rates in emerging economies. However, if economic policies fail to achieve their goals, the slowdown now in place since 2011 is likely to intensify in 2012 and 2013. That could leave 2013 global GDP growth at its slowest pace in 30 years (except for the 2009 recession).

At a summit in June, the eurozone leaders reached agreements in the right direction to reinforce the currency union: single bank supervision in the euro area, far-reaching plans covering banking and fiscal issues, and growth-supporting measures. However, financial-aid mechanisms that have been approved to ensure financial stability in the eurozone (i.e., EFSF&ESM) must be used in their full capabilities as soon as possible to avoid a financial "accident." This is the only way to make sure that those economies currently struggling to access financial markets have the chance to implement fiscal-consolidation plans and structural reforms. This should include the involvement of the ECB.

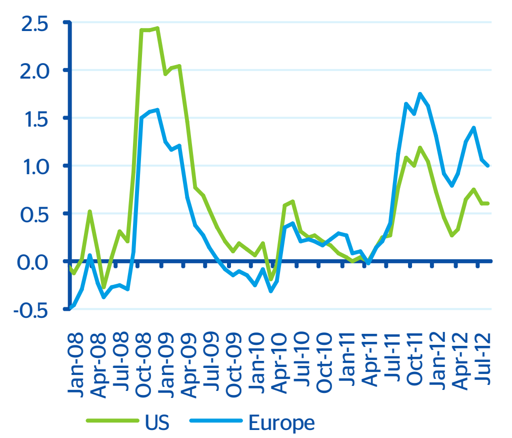
In the US, there must be an agreement to prevent that automatic spending-cut measures and the expiration of tax cuts come into force at the beginning of 2013. This "fiscal cliff" would not solve long-term sustainability of the country's public finances and, if all measures materialized, they would push the US economy back into recession in 2013. As the presidential campaign makes any kind of agreement difficult until the election, the surrounding uncertainty over the outcome of this process is likely to play a key role in shaping the economic and financial outlook as we move towards the end of the year.

Chart 1
Global GDP growth (%) to pick up in 2013



(*) Growth contributions
Source: BBVA Research

Chart 2
BBVA Financial Stress Index



Source: BBVA Research

Meanwhile, in emerging economies with room for policy stimulus, measures are needed to prop up domestic demand so that the effects of the external slowdown are mitigated. Additionally, volatility of capital inflows could increase due to the ebbs and flows of the eurozone crisis and, on the other hand, flows related to a new round of quantitative easing the US Fed is likely to embark on.

Failure to dovetail sovereignty transfer with debt mutualisation at the rhythm that markets demand drags the euro crisis out

The main uncertainty over the current economic scenario is whether the efforts that the eurozone countries will have to make to reinforce its governance will be preceded by a further deterioration in its financial situation. If this were the case, we think that it will produce massive interventions from EU mechanisms to eventually assure the financial stability of the eurozone. The decisions already taken, if implemented forcefully could suffice, but that requires that the measures approved at the end of June are implemented quickly, and also the effective use of the European stabilization mechanisms (first the EFSF and later the ESM) for intervening the markets.

All in all we have revised downwards our previous forecast for the eurozone due to continued financial stress (Chart 2) and ongoing deterioration in global economic confidence. This scenario implies a period of stagnation in the eurozone in 2012- 13. Despite this revision, in our view, the balance of risks continues to be tilted to the downside, given the likelihood that approved measures are introduced too slowly due to domestic-policy considerations in some countries. If that were to happen, then the risk of a recession in Europe in 2013 would be relevant, especially in countries such as Spain and Italy.

Eurozone countries have to solve the liquidity squeeze on some markets. Those constraints are a consequence of market participants assigning some chance that a euro break-up may occur. Euro countries are unable to dovetail the transfer of fiscal and banking sovereignty with effective mechanisms of reduction of imbalances at the rhythm that markets demand. As long as this situation continues, the risk of a euro break-up is fuelling the fragmentation of financial flows across the eurozone and impeding funding access for those economies with a net debt position with the rest of the zone. A fast implementation of financial-aid mechanisms and their reinforcement in terms of size and access to ECB's funding are key factors to eliminate the risk of a eurozone break up. However, in our opinion this extreme outcome is a tail risk; sooner or later, the measures needed to set up common institutions for banking supervision, deposit guarantee and banking resolution will be approved. Although there is political will to reinforce European currency-union institutions and governance, the implementation of appropriate measures are lagging behind. In the end, those measures will imply a transfer of national sovereignty to the European institutions and, at the end of the process, some form of liability sharing (debt mutualisation). That will also happen as for the fiscal policy, for example in the form of national consolidation plans having to be submitted to European institutions. If the challenges ahead are met satisfactorily, global growth could gradually increase during 2H12.

In the case of the US, the downward revision to our outlook for 2012 and beyond has been driven by a combination of disappointing growth figures in 1H12 and the impact of a high financial stress coming from the euro area.

As for Asia, growth in the first half of the year slowed in China more than expected. In line with the weaker global outlook, we have accordingly revised our projections for 2012-13 down. Nevertheless, monetary and fiscal measures to support growth should lead to a pickup, with growth in 2013 rising to 8.3%, a half percentage point higher than in 2012. Elsewhere in the Asia region there is also room for policy stimulus to support growth. But there are downside risks, including a more severe worsening of external demand and a continued slowdown in China, exacerbated by ongoing domestic financial fragilities.

2. Chile: growth with no signs of contagion

In the second quarter of the year, growth was above the figure forecast in May

Economic activity in Chile has continued to show signs of resilience to the decline of the external environment, with GDP growth of 5.4% y/y in the second quarter, one percentage point above our May forecast for that quarter. As explained below, one central determining factor of this strong performance in the first half of the year has been the improved expectations of employers and consumers, which has also entailed a very moderate downward correction in domestic demand, particularly in consumption, and a leveraged growth mainly in sectors geared to the domestic market.

The apparently zero impact of the international scenario on economic activity would be explained largely by the trend in economic expectations. On the one hand, the Index of Economic Perception (IPEC), which measures consumer confidence, recorded increases over the last three months, and after 16 months marked by pessimism showed positive expectations in Chilean households in June. On the other hand, the Monthly Business Confidence Indicator (IMCE) has remained above 60 points since February 2012, with the Manufacturing, Mining, Retail and Construction subindexes significantly above 50 points, the threshold between an optimistic (more than 50 points) and a pessimistic (less than 50 points) balance[1]. However, we cannot rule out that domestic factors have more than offset the foreseeable negative impact on external deterioration expectations (Chart 3).

One of the factors to be highlighted due to its beneficial impact on expectations is the good performance of the labor market, which is usually a lagging indicator of the performance of economic activity. Thus, in the April-June rolling quarter, the unemployment rate reached 6.6%, the same level recorded at the close of 2011, as a result of the rise in employment, which does not reflect the destruction of jobs typical of this time of the year for seasonal reasons. One implication of this good performance of the labor market –and the fact that the unemployment rate remains at full employment levels– is the strong growth of wages, which translates into a significant expansion of the wage bill.

Another factor that explains the improvement in expectations, particularly of consumers, is the downtrend in inflation. This, as we will see later, is also a benign side effect of the less dynamic external environment.

These factors, employment dynamism and wages, explain both the evolution of the various GDP demand components and the relative speed of growth in the various productive sectors. Although the demand composition for the second quarter is not yet available, a downward adjustment in the consumption growth rate is anticipated, somewhat lower than for investment. This would also be consistent with the fact that the sectors that have driven GDP growth are more closely linked to domestic demand, such as retail sales. As for foreign demand, a reversal of the positive impact observed in the first quarter –which had not been seen since 2009– is anticipated.

In the second quarter and in 2013, domestic and external economic fundamentals would explain a certain flagging in growth

The activity data to June continues to reflect a significant contrast in the performance of the sectors, depending on the relative importance of domestic and foreign demand. Thus, manufacturing output barely grew 1.1% y/y in June, while retail sales –supported by a calendar effect, but which would not essentially change the essence of the contrast by eliminating this effect– grew 8.9% y/y.

1: The IPEC is prepared by the company Adimark. The IMCE is prepared by Icare and the Adolfo Ibañez University. The methodological description of these diffusion indexes can be found on www.adimark.com and www.icare.com, respectively.

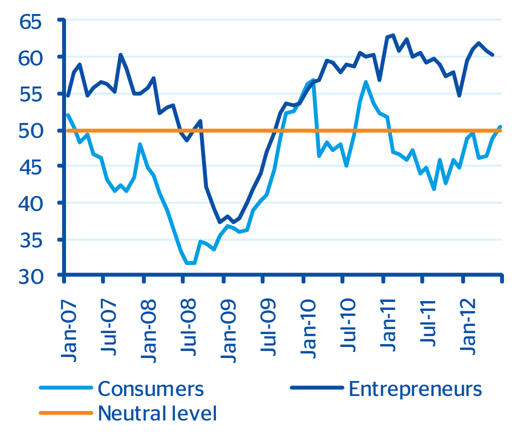
The scenario of external growth moderation, which would in part explain the slowdown in the industrial sector and other sectors more geared to foreign demand such as mining, should continue to affect the performance of these sectors in the short and medium term. As for the sectors mostly linked to domestic demand, such as trade and other services, some weakening in the fundamentals that have been determinant in their recent dynamism is also anticipated. Although the unemployment rate will remain at full employment levels, the closing of gaps in the labor market will being about a major slowdown in the employment growth rate (to 2.0% y/y), which will converge with the speed of the labor force growth, estimated at 1.5% y/y for 2012. Likewise, a moderate reduction in wage growth and higher inflation is anticipated.

The delayed effect of the normalization of monetary policy and a fiscal expansion with an essentially neutral tone should continue to reflect lower dynamism of domestic demand. This should lead to a slowdown of activity toward the second half of 2012.

Nevertheless, the strong dynamism seen in the first half of the year should offset the effect of the slowdown in the second half in the annual result, and we adjust the growth forecast from 4.2% to 4.4% for 2012. In 2013, however, the absence of excess capacity and a more adverse external environment determine a downward adjustment in the forecast, from the 4.7% forecast in May to 4.5% (Chart 4).

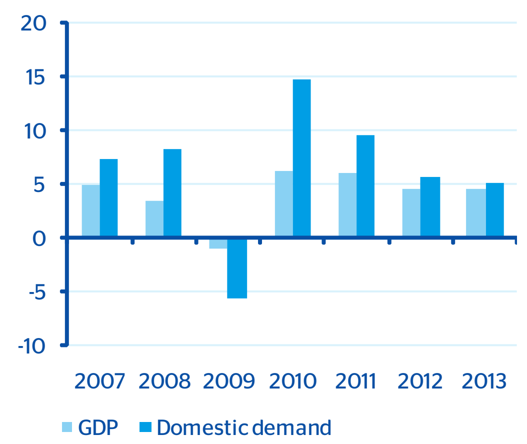
As for the performance of the demand components, the patterns anticipated in our May report are maintained in essence. On the one hand, a fast slowdown in investment is anticipated, from a growth of 17.9% in 2011 to an average growth of 7.5% between 2012 and 2013, with a marked slowdown in the case of investment in machinery and equipment, and a very limited reduction in the component related to investment in both residential and commercial buildings. On the other hand, and average growth of around 5% is forecast for total consumption in the same period. Finally, average inventory accumulation would account for around one percentage point of GDP. In the aggregate, domestic demand, after growing at approximately twice the rate of GDP on average between 2010 and 2011, would grow slightly more between 2012 and 2013.

Chart 3
Consumer and business confidence index (response balance, points)



Source: Adimark and Icare

Chart 4
GDP and domestic demand growth (y/y % change)



Source: Central Bank of Chile and BBVA Research

Credit growth rate would decrease moderately in line with supply and demand factors

While the performance of total credit has been in line with the evolution of aggregate demand, its disaggregation in corporate, consumer and mortgage lending reflects the evolution in its components, with some dispersal responses related to changes in other determinants of credit supply and demand[2].

2: The discussion uses as reference information the credit data published by the Superintendency of Banking and other financial institutions (ABIF), which excludes the accounting effect of the equity changes of Corpbanca.

In the case of consumer lending, between December 2011 and June 2012 a slowdown of more than 3 percentage points in the annualized growth rate has been observed, which has to do basically with supply factors, as suggested by the Central Bank's latest Bank Lending Survey. The evolution of these conditions may have been influenced by a preventive behavior by some financial institutions, related to the perception of a higher likelihood of an adverse external scenario, or to regulatory changes implemented or under discussion relating to household debt. In any event, no significant additional adjustments are anticipated in consumer lending in the short term, while in the medium term a convergence with an average nominal growth somewhat higher than for nominal private consumption is forecast, given the room for financial and banking deepening in Chile.

Commercial lending to companies has remained essentially stable in the first half of the year. However, a more pronounced slowdown is anticipated in the second half of the year and in 2013, due mainly to the reduction in the investment growth rate, particularly investment in machinery and equipment, following the acceleration that involved the recomposition of assets after the financial turmoil and the February 2010 earthquake. However, favorable supply (relatively low interest rates) and demand (high levels of household income and employment) conditions, as well as the recent increases in the price of property, should determine an upturn in mortgage lending in 2012 and 2013.

Current account deficit would be financed mainly through direct investment

In the first quarter of 2012, the current account deficit reached US$346 million, a significant improvement compared to the deficits recorded in the last two quarters of 2011, which averaged just over US$2,000 million. However, the evolution of the prices of the main commodities exported and imported contributed to this improvement, since the price of copper increased over the price of oil in this first quarter compared to the previous one, which together with the greater relative importance of copper for Chile's external transactions was relevant in the result. For the second quarter, the prices of both commodities have recorded major downward corrections, and despite the fact that the correction of the oil price has been more pronounced, the relative importance of copper has once again determined a reduction in the trade balance surplus[3].

For the second half of the year, a greater decline in the current account is forecast, due to a weaker foreign demand, which would negatively impact the terms of trade and slow down growth of exported volumes. In the case of the terms of trade, the decline would be due mainly to the effect of copper prices lower than those observed in the first half of the year (the price of a pound of copper would fall from an average of US$3,7 in the first half of 2012 to US$3.4 in 2Q12). In the case of the volumes, real growth in imports is forecast to be higher than in exports. In annual terms, the current account balance would drop from -1.3% of GDP in 2011 to -2.9% in 2012 and 2013.

As for the composition of financing of this deficit in 2012, there would be major changes in relation to 2011, as stated in our previous report. In 2011, the current account deficit was financed through portfolio inflows, mainly from pension funds, also with direct investment, and with other investments like bond placements abroad and the acquisition of equity instruments by foreign investors. These inflows were offset with the accumulation of reserves for over US$14 billion, part of which were made within the framework of the reserve accumulation program for US$12 billion implemented by the Central Bank throughout the year. Zero reserve accumulation is forecast for 2012, with financing coming mainly from direct investment, since there would be some reversal of the capital outflows made by the pension funds in the first quarter, and the levels of bond issues abroad seen the previous year would not be observed.

3: The current account data and the detail of the balance of payments for the second quarter are published on August 23.

Box 1. Terms of trade in perspective

Terms of trade will decline in 2012-13, largely by the convergence of the copper price to its long-term level

In the last months we have seen a major downward adjustment in commodity prices, in part as a result of the deterioration of the expectations of growth of the main developed and emerging economies, along with the effects of some financial contagion from the European debt crisis.

In this regard it is important to assess the recent performance of the terms of trade, which have accumulated an increase of 90% since 2003, considering the degree of openness of the Chilean economy. This has been due to a great extent to the high price of copper, which given its relative weight has more than offset the increase in the prices of other commodities like oil and fuels, together with decreases or very limited increases in the prices of other imported goods.

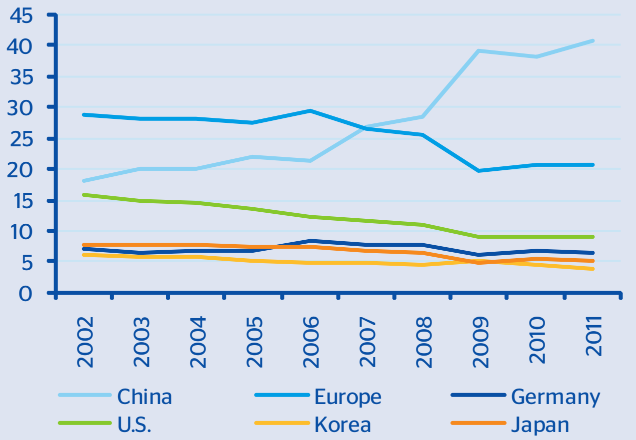
However, for this year we estimate that the terms of trade will fall around 6% y/y, while for 2013 we anticipate another drop, although much more moderate, of approximately 1% y/y. This is very much in line with a nominal copper price that should reach long-term levels of US$2.9 a pound. After reaching an average of US$3.5 in 2012, we expect the price of copper to average US$3.2 a pound in 2013, and then stabilize at its long-term level. This factor, combined with some recovery of the price of fuels in the long term, explains nearly the whole adjustment expected in the terms of trade.

One of the key variables for this decrease is lower growth of demand in the long term, as a result of a likely slowdown in the case of China, the main copper consumer, as it reaches a higher level of per capita income, while other significant emerging economies maintain a moderate rate of growth. Supply growth is also expected due to new projects and the expansion of projects in operation, which lead to expect an increase in the inventories, instead of the fall seen in recent years (Chart 5).

In terms of financial factors, we estimate that the dollar will reverse part of its appreciation triggered by flight-to-quality movements in the medium and long term. The expected real depreciation should support the price of commodities, given that the emerging markets are gaining ground in global demand for commodites and their currencies are being appreciated, which boosts greater relative demand for commodities (Chart 6).

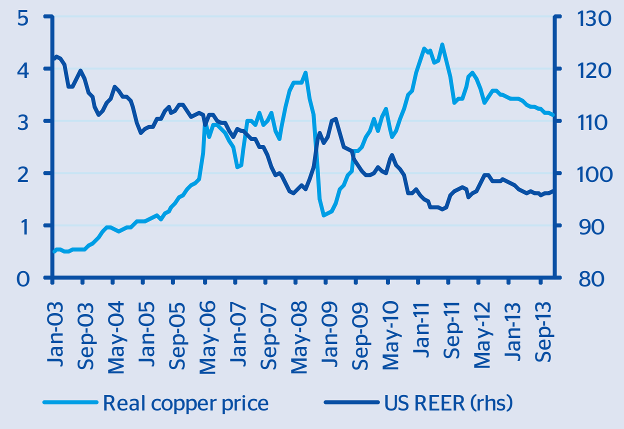
In the baseline scenario, it is assumed that convergence of the price of commodities toward their long-term level takes place gradually, which means that adjustments are also made to the volumes of exports and imports in response to the change in relative prices. Thus, the current account tends to stabilize in what we estimate to be a sustainable deficit level, near 3% of GDP. However, it is important to note that in the event of external shocks that negatively affect the price of commodities, particularly of copper, a more significant increase in the current account can be expected, at least in the short term.

Chart 5
Copper consumption (% of global consumption)



Source: World Bureau of Metal Statistics and BBVA Research

Chart 6
Real copper price and US REER (USD as of 2011; local currencies vs dollar, 2010=100)



Source: BBVA Research, BIS and Chilean Copper Commission (Cochilco)

3. The puzzle of inflation

Despite the closing of gaps and the strong dynamism of wages, the inflation accumulated in the first half of the year is barely 0.4%.

One of the biggest economic surprises in 2012 on the domestic front has been the performance of inflation. In addition to the low level accumulated in the first half of the year, in June the 12-month inflation dropped below the Central Bank's target to 2.5%, which notably differs from our forecasts and those of the market made a few months ago.

Last April, the Central Bank's Survey of Economic Expectations anticipated that inflation at the close of the year would be 3.5% y/y, the same level as the one forecast by the Central Bank's Monetary Policy Report in March, and slightly above our own forecast (3.4%). These expectations were supported not only by recent monthly inflation records, which except in March had been systematically above the estimates, but also by cyclical conditions of the Chilean economy which clearly suggested at least that annualized inflation would be kept at current levels, around the forecast for the end of year at the time.

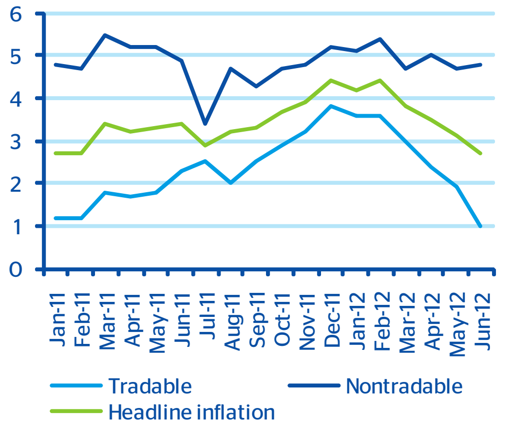
The breakdown of inflation into its tradable and non-tradable components enables this puzzle to be solved. Indeed, the prices of non-tradable goods have increased 4.9% y/y by July, in line with what can be expected in an economy with no excess capacity, with tensions in the labor market and with labor costs increasing in nominal terms around 7% y/y, more than twice the speed of inflation. However, non-tradable goods have a weighting of approximately half the basket of consumer goods used to estimate the CPI. The other half consists of tradable goods (capable of being imported), and the dynamics of these prices has been very different in recent months, since in June 2012, the tradable good price index reached an inflation of 0,6% y/y.

The performance of the prices of tradable and non-tradable goods has to do precisely with the difference in the economic cycle in Chile and in its main trading partners. The lower dynamism of the prices of tradable goods is explained by the lower imported inflation -from both developed countries and emerging markets- and by an exchange rate that is more appreciated compared to its level in late 2011 and early 2012. Additionally, although there has been some downward effect in the correction of regulated prices, such as electricity rates, this effect would only have moderated the increase in the non-tradable component of the economy. Likewise, although there has been a relevant effect in the adjustment of fuel prices, this has only be seen in June, since previously its impact had been positive. Thus, a less specific explanation, such as the aforementioned cases, has to do with the limited (and in some cases negative) inflation of tradable goods, which is reflected in items as diverse as clothing and footwear, technological products, fuels and some processed foods.

What can we expect in the future from the behavior of these two large price categories? As for tradable goods, an important component for which we do not expect the downward adjustment to be repeated, but rather an upward correction, is commodities, both fuels and food, due to the effects of the drought in the U.S. In manufactured goods with higher added value, the downward trend is not expected to continue, in part because an essentially stable exchange rate is forecast. In the case of non-tradable goods, we anticipate some inflationary pressures to continue due to the absence of excess capacity and a labor market that will remain subject to tensions. In the aggregate, some upturn of inflation is forecast in the second half of the year, with inflation in December standing at 2.3% y/y (Charts 7 and 8).

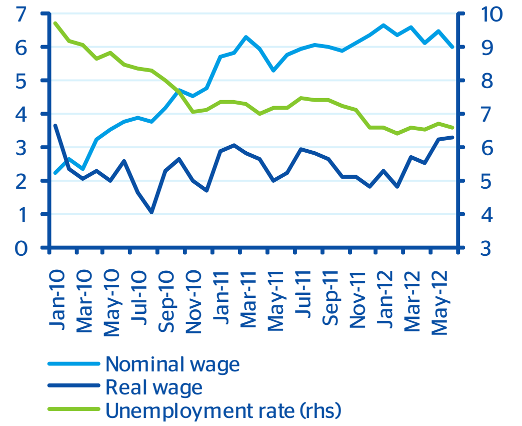
However, the downward trend in global growth could determine lower prices of imported goods, in particular of fuels and food. In this case, inflation could close 2012 slightly below the floor of the Central Bank's band. For 2013, we maintain the inflation forecast in the middle of Central Bank's target, 3%, with a downward trend related to the external scenario.

Chart 7
Inflation of tradable and non-tradable goods (y/y % change)



Source: National Institute of Statistics

Chart 8
Labor market indicators (y/y % change, percentage)



Source: National Institute of Statistics

4. Monetary policy on hold

The external uncertainty and the cyclical situation of the Chilean economy will lead to a prolonged pause in monetary policy, despite the fall in inflation

This year we have seen how the expectations on the evolution of monetary policy have gone from pointing to less expansiveness as a result of high inflation figures and strong growth, to awaiting interest rate cuts in the second half of the year, mainly in response to downward surprises in inflation, although the deterioration of the external scenario has also played a role in this adjustment.

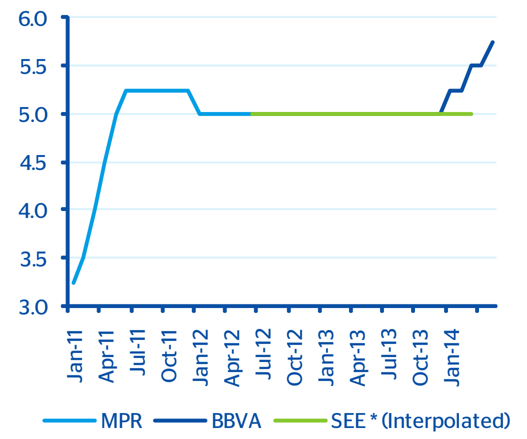
However, when considering the main factors that guide the Central Bank's monetary policy decisions, the arguments seem to support a more neutral stance, even in the medium term. Despite the downward surprises in the inflation figures, these can be explained largely by the performance of tradable good prices in a situation of appreciated exchange rates and falls in the prices of fuels in the international markets. In contrast, the evolution of the prices of non-tradable goods, which is associated directly with the strong performance of the domestic economy, continues to show rates well above the ceiling of the Central Bank's tolerance range. What is more, the forecasts suggest that these prices will continue to see upward pressures owing to the tightness of the labor market, the rises in wages and a lower than expected slowdown of domestic demand in the first half of the year. Therefore, as long as the inflation forecasts remain in line with the 3% target in the policy horizon, a neutral monetary policy stance is likely to be maintained (Chart 9).

As for the risks shown by this baseline scenario, a significant decline in the expectations of domestic inflation and growth, triggered by a deterioration in global economic conditions and a greater contagion, distort the monetary policy expectations downward. However, materialization of these risks an a higher level of contagion is required in order to justify cuts in the monetary policy rate. In particular, an unanchoring in expectations on long-term inflation could trigger a reaction in the Central Bank policy.

On the horizon the exchange rate remains essentially stable

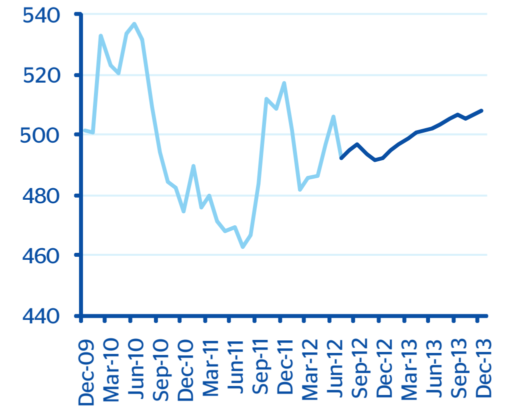
Local financial markets have shown moderate contagion from external financial turmoil. In particular, the exchange rate, supported by a moderate increase in risk premiums, is currently at a level similar to the one existing before the resurgence of the debt crisis in Europe last May, after a transitory depreciation, although at lower levels than during the turmoil episodes in 3Q11. In the future, we estimate that with some short-term volatility, the exchange rate should remain at levels similar to current ones, conditional on a gradual improvement of the external environment. In the medium-term, we anticipate a slight depreciation of the Chilean peso, explain mostly by a gradual reduction of the copper price to its long-term level (Chart 10).

Chart 9
Monetary Policy Rate (%)



(*) Survey of economic expectations
Source: Central Bank of Chile and BBVA Research

Chart 10
Nominal exchange rate, (pesos per dollar)



Source: Central Bank of Chile and BBVA Research

5. Improved fiscal balance despite the adjustment in the price of copper

The fiscal surplus would reach 0.6%, since despite the drop in the price of copper it remains above its long-term price

In the second quarter of the year, the degree of progress of the 2012 fiscal budget reached 43.7%, slightly higher than during the same period last year, which reached 42.1%. This involves an increase in the central government's expenditure of 5.9% y/y, compounded by a 5.5% y/y increase in current expenditure, and capital expenditure grew 8.2% y/y. Our estimate for the year points to a slight underspending of the budget, which would lead to real growth of expenditure of around 5% y/y.

As for revenue, real growth in the first half of the year was 2.9% y/y, explained by a drop in tax collection from private mining and Codelco, two items that decreased significantly as a result of the lower price of copper, which averaged US$3.67 a pound during the period, compared to an average of US$4.26 a pound in the first half of 2011. However, tax collection from other taxpayers increased 10.6% y/y in the period, which reflects in part strong economic activity in the last two quarters. A relatively lower price of copper for the second half of the year, combined with the expected slowdown in activity, would lead to annual real growth of revenue of around 1.7% y/y.

The combination of a slight real increase in revenue and the expected increase in expenditure leads to the lower surplus expected for 2012 (0.6% of GDP), compared to the 1.3% of GDP recorded in 2011.

However, this corresponds to an upward adjustment in relation to the fiscal balance we forecast in May, given a relatively better performance of the economy in the first half of the year.

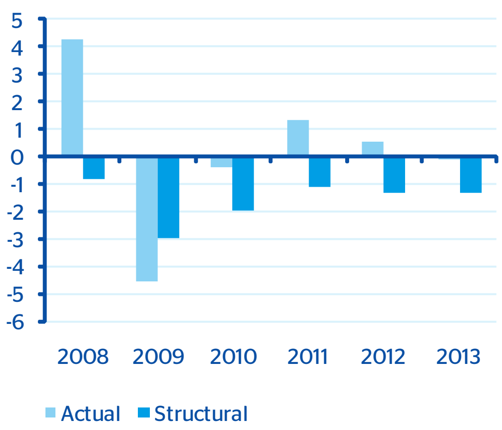
As for the structural balance, we estimated that a deficit of 1.3% of GDP would be reached for 2012, somewhat higher than the 1.1% deficit recorded last year (Chart 11).

For 2013, the budget discussions would consider the government's target of converging toward a structural deficit of 1% of GDP in the medium term, marginal adjustments to the economy's potential growth of around 5% in annual terms, and the long-term reference price of copper, which currently stands at US$3.02 a pound. Our estimate is that the price of copper should fall in the long-term to a nominal level of around US$2.9 per pound, in line with the current estimate of the experts committee convened by the Ministry of Finance.

However, it is important to point out that the aforementioned calculations do not take into account the effect of the tax reform proposed by the government last May and which is currently being amended by the government in order to secure the required support in Congress. However, the estimates of its impact on collection continue to be around US$700-1,000 million a year, equivalent to around 0.4% of GDP, a rather marginal adjustment for the purposes of achieving a necessary convergence toward a balanced structural fiscal balance in the long term, especially if a commitment has already been made to spend this additional revenue permanently.

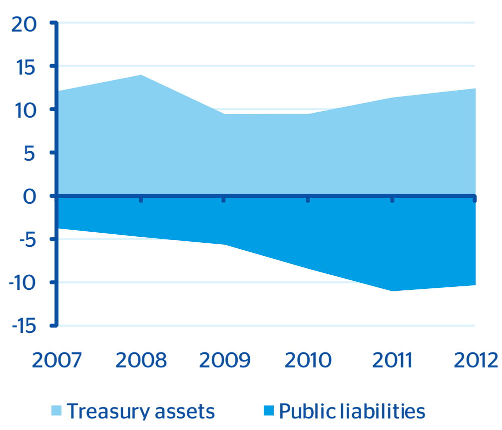
Finally, in terms of the government's net financial position, the sovereign fund that only includes copper surpluses reached in 2Q12 nearly US$14,800 million, while the funds accumulated in the Pensions Reserve Fund amounted to US$5,600 million, and the funds available in the Public Treasury stood at US$13,400 million. This involves public sector savings of around 13% of GDP, this even increases its net creditor position, since public debt is around 10.5% of GDP (Chart 12).

Chart 11
Fiscal balance (% of GDP)



Source: National Budget Office and BBVA Research

Chart 12
Public sector assets and liabilities (% of GDP)



Source: National Budget Office and BBVA Research

6. Upward external risks and downward domestic risks

External risks have heightened and now represent the main threat to the baseline scenario. Nevertheless, Chile is in a good position to face an increase in financial tensions in Europe. The idiosyncratic risk of inflationary pressures due to overheating of economic activity has been mitigated

It is clear that in this case the risk balance is tilting toward the factors of the external economic environment. Growing financial tensions in the developed world, mainly in the euro zone, but also in the U.S., combined with a greater contraction of economic activity at global level, would impact our economy through both real and financial channels.

The main impact of an adverse external event on Chile would be the drop in the price of copper and, to a lesser extent, in the quantities of exported mineral. Although confidence and domestic demand would drop, this situation would not be as serious as the one seen during the past crisis. This lower impact would be explained by the implementation of expansionary policies, mainly monetary policy, since the policy rate is around its neutral level. The downward adjustment of the monetary policy rate by the Central Bank would be significant, although less so than the 2009 adjustment. As for fiscal policy, although the government has resources to implement a countercyclical fiscal package, fiscal policy is not expected to play a major role in the face of an adverse external event, since the fiscal surplus is lower than in 2008 –a less favorable starting point– and the 2009 and 2010 fiscal stimulus packages have not been completely withdrawn from fiscal spending.

Although the greater global risk aversion could reduce external financing, its impact would be limited. In the event of an international credit squeeze, as happened in the previous crisis, the Central Bank would establish credit facilities in pesos and in dollars to face this situation, which would once again be temporary. International reserves of around 40 billion dollars would support this strategy.

Even though sovereign risk would increase, it is expected to be limited. In addition, the public sector's financing needs would be moderate and perfectly fundable with the fiscal savings in sovereign funds. In this regard, the private sector's financing needs could be met to a great extent by the local market, as happened in the previous crisis, with the resources accumulated in pension funds once again playing a relevant role.

As regards idiosyncratic risks, the likelihood of significant inflationary pressures caused by the overheating of economic activity has been lessened in recent months. Low inflation in the prices of tradable goods, as a result of lower international prices and the appreciation of the exchange rate, have contributed to moderate inflationary pressures. However, it is important to mention that should the external baseline scenario occur, we cannot rule out the possibility that the maintenance of high dynamism of domestic demand may generate relevant inflationary pressures, in particular if we consider that inflation in non-tradable goods is still at a high level.

8. Tables

Table 1
Macroeconomic forecast annual

	2009	2010	2011	2012	2013
GDP (% y/y)	-1.0	6.1	6.0	4.4	4.5
Inflation (% y/y, eop)	-1.4	3.0	4.4	2.3	3.0
Exchange Rate (vs. USD, eop)	502	475	517	492	508
Interest Rate (%, eop)	0.5	3.3	5.3	5.0	5.0
Private Consumption (% y/y)	0.9	10.4	9.0	5.1	4.8
Government Consumption (% y/y)	7.5	3.3	4.0	4.0	4.8
Investment (% y/y)	-15.9	18.8	15.7	7.7	7.3
Fiscal Balance (% GDP)	-4.6	-0.3	1.4	0.6	-0.1
Current Account (% GDP)	2.0	1.5	-1.3	-2.9	-2.9

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	2.9	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	6.8	3.0	475	3.25
Q1 11	9.7	3.4	480	4.00
Q2 11	6.0	3.4	469	5.25
Q3 11	3.9	3.3	484	5.25
Q4 11	4.8	4.4	517	5.25
Q1 12	5.6	3.8	485	5.00
Q2 12	5.4	2.6	506	5.00
Q3 12	3.9	2.5	497	5.00
Q4 12	3.0	2.3	492	5.00
Q1 13	4.5	2.2	499	5.00
Q2 13	4.5	3.1	502	5.00
Q3 13	4.5	3.3	507	5.00
Q4 13	4.4	3.0	508	5.00

Source: BBVA Research

DISCLAIMER

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