BBVA | RESEARCH

Economic Outlook

Chile

Second Quarter 2013
Economic Analysis

- **The world economy continues to recover,** but with differences between the regions.
- **In Chile, growth will slow toward potential in 2013, at 5% y/y, with some moderation in domestic demand, particularly in investment.** We expect growth in 2014 to be 4.7% y/y.
- **Inflation kept below the Central Bank's tolerance range by transitory factors.** At the close of 2013 it should come in at 2.5% y/y, and within the target range in 2014.
- **The balance of domestic and external risks will extend the Central Bank's pause through the rest of 2013.** We expect a brief cycle of rises in the first half of 2014, given expectations that liquidity measures will begin to be withdrawn in developed economies.
- **The risks for the Chilean economy are related to adverse events in developed economies and effects on economic activity in important emerging markets such as China.** Domestic risks are associated with strong domestic demand putting pressure on medium-term inflation.

Index

Closing date: May 6, de 2013

1. Summary

Global growth continues its steady recovery, but more uneven prospects for the main economies are limiting possible improvement in 2013 and 2014.

In Chile, there are some signs of a slowdown in economic activity toward its long-term trend, but it is still early to decide whether they are only transitory elements. Overall, we estimate that GDP growth will be 5% y/y in 2013 and fall to 4.7% y/y in 2014, a quarterly rate in line with the potential growth of the Chilean economy.

Inflation continues below the target range due to factors we consider temporary, but they have made us adjust down our forecast for the close of 2013 to 2.5%. In the medium term, inflation in tradable goods should return to normal. As a result, headline inflation should move again toward levels closer to the Central Bank target.

In a context of domestic risks associated with a stronger economy and latent inflationary pressures, balanced by external risks that are still downside and could impact the global economy, the Central Bank will maintain its monetary policy rate for the rest of the year. For 2014, we expect a brief cycle of rises that should take the monetary policy rate to its neutral level in accordance with expectations factoring in a return to normal of external monetary conditions.

In the public sector, we anticipate the effects of lower growth, lower copper prices and greater inflation will balance out on the fiscal balance, leading to an effective deficit of 0.3% of GDP in 2013. For 2014, we forecast a similar deficit, which considers a renewed downward adjustment in the copper price, which will converge to its long-term level.

A significant aspect in this respect will be the current account, which we expect to record a deficit of 3.8% of GDP in 2013, with the copper price only marginally down to an average of USD 3.45 per pound. Most of the increased deficit will therefore come from a reduction in the trade surplus. In 2014, another adjustment in the copper price to an average US 3.26 per pound for the year will continue to expand the current-account deficit to 4.2% of GDP.

The risks in this baseline scenario come, as has usually been the case recently, from two sides. Domestic risks of higher growth and increased inflationary pressures have gained ground recently compared with external risks associated with Europe and its impact on growth in the emerging world. In particular, as we have seen at the start of the year, the impact on China and on commodity prices has become more important.

2. A more varied global scenario

Global growth continues its steady recovery, but the very different prospects for the developed economies are halting the strength of improvement in GDP in 2013 and 2014. Quarterly global GDP growth, estimated at 0.7% by BBVA Research at the start of 2013, will have been slightly over 0.6% in the last quarter of 2012, but available indicators point to a growing dispersion of activity, particularly between the most developed economies, where the euro zone is once more lagging behind the U.S. and even Japan. Emerging economies will continue to underpin global growth. Overall, the rate of global growth in 2013 is expected to be at 3.3%, only 0.1 points above the figure estimated for 2012 (Chart 1). In 2014, the rate will be close to 4%, although the risks continue to be downside.

In the Euro Zone, the recovery has been delayed until 2014, despite the role of the ECB as a firewall for financial tensions, aided by the boost provided to banking union. The ECB has been surprisingly effective as guarantor of the euro against shocks such as the disordered bailout of Cyprus, the political situation in Italy and the ruling by the Portuguese Constitutional Court. As a result, the markets and financial tensions have only reacted to these events to a limited extent (Chart 2). On the negative side, economic indicators show a **general cyclical weakness beyond the European periphery, which justifies the ECB's recent interest-rate cut.**

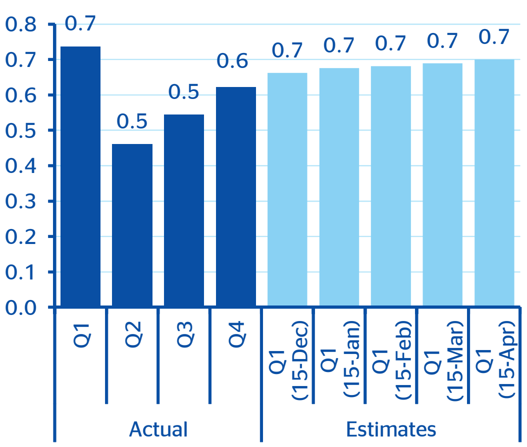
This is a positive measure, although it is unlikely in itself to reduce the financial fragmentation that is already having less impact on sovereign issuers and even large corporations, but is continuing to affect households and companies due to **the uneven operation of the banking channel.** The conditions of credit supply in the area as a whole continue to tighten while demand for credit is falling in peripheral countries. More is needed than the extension in the liquidity line for banks at least until 2014; measures currently being studied have to be implemented to boost finance for business, with the participation of institutions such as the European Investment Bank.

In this context, our scenario includes a downward revision of growth for the euro zone. We estimate GDP will fall by 0.1% in 2013 and rise 1% in 2014, 0.4 and 0.3 points, respectively, below the figure forecast in our January publication. In any event, the risks continue to have a downside bias. A key point is that Germany must not remain the only source of growth in the area thanks to its easy access to finance, high level of competitiveness and greater exposure to the best performing sources of global demand.

An additional consequence of the weakness of the European cycle is the growing debate on the appropriate level of fiscal consolidation. A path that achieves a credible timetable for cutting the deficit without leading to a short-term growth deterioration that makes useless the adjustment effort. The European Commission's support for the postponement of the public deficit targets in some European countries is in line with the idea of stressing the quality and composition of the fiscal adjustment and emphasizing structural reforms above short-term objectives. **What is Europe missing?** More determined progress towards banking union, shifting the debate on deficit targets to structural measures, and a firmer commitment to the reforms in the peripheral countries.

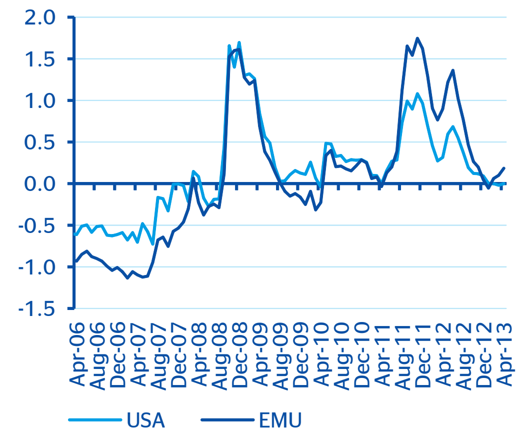
In the U.S., the strength of private demand is sustaining growth prospects despite the brake of fiscal adjustment. Uncertainty regarding fiscal policy in the short term has receded in terms of scenarios that included the closure of government offices (although without undertaking credible long-term fiscal consolidation measures). The elimination of some tax breaks and the entry into force of expenditure cuts have not triggered alarms in the financial markets (Chart 2), nor do they appear finally to have provided a substantial brake on private expenditure, thanks to **monetary expansion that is maintaining very favorable financing conditions** and is contributing to the improvement of income and wealth. Thus it is reasonable to maintain growth prospects for 2013 at 1.8%, despite the downward surprise of public demand in the GDP figures for the last two quarters.

Chart 1
Global growth based on BBVA-GAIN (% q/q)



Source: BBVA Research

Chart 2
BBVA Financial Tension Indicator



Source: BBVA Research

The Chinese economy has lost steam in the first quarter of 2013, with a negative surprise of weak investment, despite the greater strength of foreign demand and growth remaining in line with the government's target of 7.5% for 2013. The measures implemented to limit domestic financial fragility appear to have contributed to the slowdown. However, the change in the growth model towards a greater weight of consumption continues. With inflation also lower than expected, there is less pressure for making monetary conditions tougher, so authorities have room for maneuver given their commitment to sustainable growth for achieving the announced growth target. That is why our growth forecast for China remains unaltered at 8% for 2013 and 2014.

The path of sustained monetary expansion, which the Central Bank of Japan has now joined, involves challenging problems. The idea that investors looking for returns should move to more risky assets may favor valuations in some markets that are a long way from their long-term fundamentals, which could lead to disordered adjustments when the stimuli are withdrawn. This risk is growing because of the lack of coordination between the central banks with quantitative expansion policies, each of them looking to its respective domestic anchored inflation targets and sustainable growth. In the case of emerging economies, although for now they are supporting the major capital inflows well, it is essential to maintain vigilance over the domestic excesses this could generate.

3. Chile: Growth of 5.0% in 2013, close to potential

There are some signs of a slowdown in economic activity toward its long-term trend, but it is still early to decide whether they are only temporary elements

Economic activity has continued strong at the start of the year, still driven by the strength of domestic demand in both private consumption and investment. However, manufacturing and industrial activity has slowed its expansion. As a result, the gap that has existed in recent years between supply and demand in the economy has widened slightly. The situation has been reflected in the external deficit and may lead to inflationary pressures in the medium term. These points will be dealt with in more detail below.

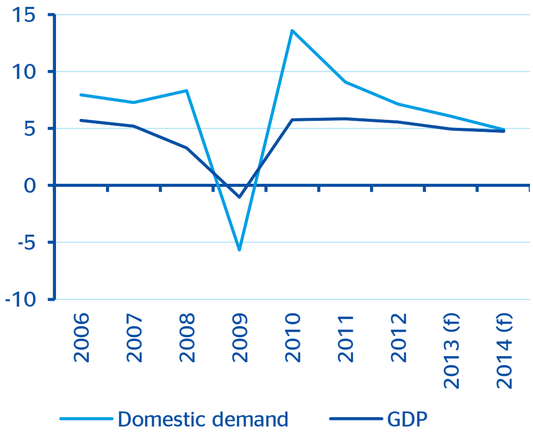
Following the acceleration of most of the indicators in 4Q12, there was some moderation at the start of this year, particularly linked to supply sectors, while domestic demand has slowed more gradually. Although there is some debate about whether the economy is showing signs of overheating, we consider that the incipient economic slowdown is easing this possibility. It is, though, a risk that should be monitored, particularly because part of the slowdown in expansion is the result of effects linked to fewer working days compared with 2012, which could be a one-off event. With respect to forecasts for the year, the estimated GDP growth has been adjusted slightly up from 4.8% y/y to 5% y/y, based on expansion in private consumption, which is slowing only marginally to 5.8% y/y, while investment should reduce its growth more abruptly to 7% y/y, largely due to the high base of comparison for investment in machinery and equipment in the second half of 2012. As a result, domestic demand will continue to grow faster than GDP, at a rate of 6.1% y/y (Chart 3).

Behind these figures lies a labor market that should create jobs at a rate of 1%, more moderate than in previous years, but it will continue to support a positive increase in real wages. On the investment front, investment linked to the mining and energy sector will continue to play a major role, together with strong residential investment (Chart 4).

In the external sector, exports will pick up on the low growth posted in 2012 to 3.3% y/y, with copper and non-copper exports growing at similar rates. However, it is important to point out that imports will grow at a faster pace of 5.9% y/y, maintaining the external sector's net negative contribution to GDP growth over the year.

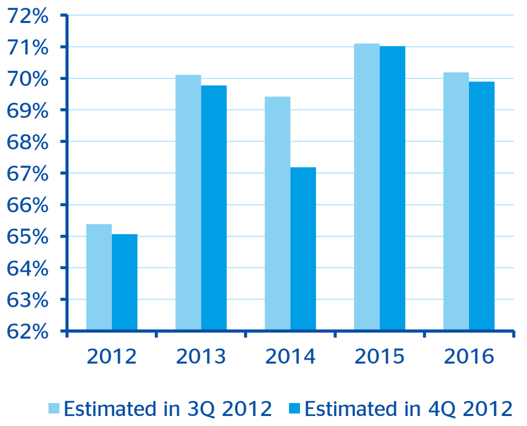
In the longer term, we estimate GDP growth in 2014 of 4.7% y/y, rising to 5% y/y in the following years. This assumes a quarterly rate of growth in line with the economy's potential, based on investment at around 25% of GDP and growth in productivity slightly down on current figures.

Chart 3
Domestic demand and GDP (y/y % change)



Source: Central Bank of Chile and BBVA Research

Chart 4
Investment plans in mining and energy (% of total)



Source: Corporación de Bienes de Capital

4. Inflation remains low, but will return to the target range at the close of the year

Inflation is still below the target range due to temporary factors that are leading to a downward adjustment of the forecast for the close of 2013 to 2.5%. However, it will be within the tolerance range and converge toward target in 2014

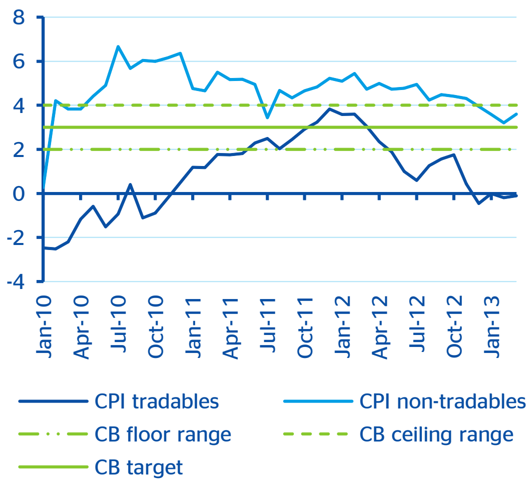
Short-term inflationary volatility has continued into the present, while the different measures of inflation have remained well below the Central Bank's target range.

With respect to volatility, the monthly figures have continued to be influenced by shocks that have been assessed as transitory. They mainly include downward adjustments in electricity tariffs, the transfer to domestic prices of price changes in fuels on the international markets, the trend for a significantly stronger exchange rate and normal food price volatility. Overall, it is estimated that these factors will ease in the medium term, so they should not affect the expected upward trend in inflation.

An additional factor has been the continued low levels of both headline and core inflation. Annual inflation closed the first quarter of 2013 at 1.5%, under the Central Bank's lower range of tolerance, while the core measure, not including food and energy, was 1.1% y/y. By categories, there was continued divergence between the inflation in tradable goods, which stands at -0.1% y/y, and non-tradable goods inflation, at 3.6% y/y; although the latter has moderated recently, it clearly reflects the lack of slack with which the economy is operating. However, the monthly variation shows a recovery that supports expectations of a steady convergence of the different measures to the inflation target of 3%. As a result, at the close of the year, inflation will close at 2.5% y/y, under the 2.8% y/y forecast in the previous report, which incorporates the cut in stamp duty from 0.4% to 0.2% starting in September that year (Chart 5).

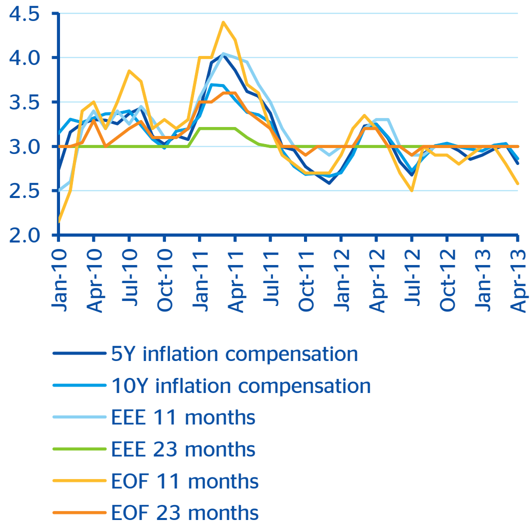
An important aspect to review is the behavior of analysts' inflation expectations and those implicit in financial prices over recent months. The survey of expectations published by the Central Bank has kept both one-year and two-year expectations anchored at 3%, which supports the diagnosis that temporary shocks lie behind the current low level of real inflation. Surveys of financial operators have been adjusted for the short term, with inflation expectations at 2.6% for the first 12 months forecast and anchored at 3% in the longer term. However, there is some downward adjustment in the implied inflation compensation in nominal and real bond yields in the longer term, which are at around 2.8% for 5 and 10 years (Chart 6).

Chart 5
Inflation measures (y/y % change)



Source: Central Bank of Chile and the National Institute of Statistics

Chart 6
Inflation expectations and inflation compensation (%)



Source: Central Bank of Chile and BBVA Research

5. Neutral monetary policy only for 2013... rises in 2014

Monetary policy will continue on hold for the rest of the year, given the imbalance between internal and external risks. In 2014, we expect a brief cycle of rises that should take the monetary policy rate to its neutral level, in accordance with expectations factoring in a return to normal of external monetary conditions

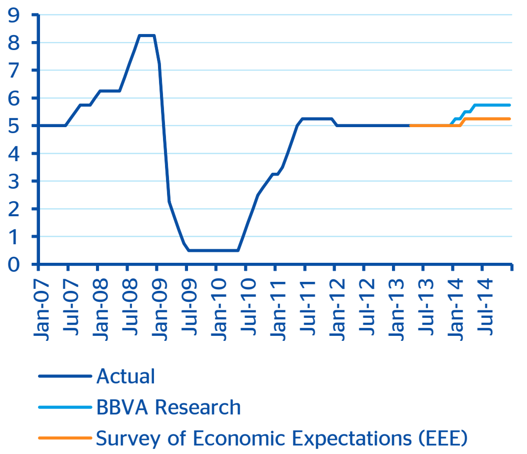
Although the first quarter of the year showed a slight slowdown in economic activity, part of this is due to the calendar effect which will not recur in the coming months. The growing importance of domestic risks over recent months has not receded, but despite this the Central Bank's analysis has resumed a neutral tone, after being somewhat more restrictive in the first quarter of 2013. In the medium term it will be important to decide whether what we are seeing is part of a gradual cyclical slowdown in line with expectations, or only a one-off slowdown, which would again support more restrictive signals from the Central Bank.

Recently external factors have tended to be the main driver offsetting the inclination of monetary policy toward neutrality. Although risks have lessened, there are still financial risks in Europe, risks of slowdown in China (and the impact on commodity prices and the exchange rate) and fiscal noise, now more moderate, from the U.S.

An important point in the economic policy dilemma faced by the Central Bank has been the appreciation of the exchange rate and the level of freedom this leaves to increase interest rates if necessary. Overall, we consider that the dilemma will ease as the exchange rate moves off the floor it has reached, due to the expected drop in the copper price and its gradual adjustment to its long-term level.

Toward the close of the year, how markets begin to factor in the withdrawal of monetary stimulus in the U.S. will be important, and could generate some volatility in the emerging markets. In fact, we have already seen reactions on the local markets to external financial shocks in the first quarter. The stock market has been hovering at similar levels to the close of 2012, showing the effects of the volatility of investors' risk aversion. Fixed-income markets have reacted to the search for a safe haven, in part by reflecting the falls in external interest rates. This has maintained the yield curve flatter in recent months. Overall, as the Central Bank faces incipient signs of a withdrawal of monetary stimuli in developed economies, the monetary policy rate will move toward its neutral level of 5.75% with successive increases in the rate from January to May 2014. This is compatible with inflation on target and growth at around the potential (Chart 7 and 8).

Chart 7
Monetary policy rate (%)



Source: Central Bank of Chile and BBVA Research

Chart 8
Nominal long-term bond yield (%)

Source: Asociación de Bancos e Instituciones Financieras

Box 1. Monetary policy and external liquidity conditions

The tough measures adopted by the monetary authorities in developed economies over recent years, as a result of the significant problems in their financial systems, have generated a headache for their counterparts in emerging countries. Chile is no exception to this. Following a cycle bringing local liquidity back to normal conditions in the wake of the financial crisis in 2010, the Central Bank has opted for a neutral stance in the face of the recurrent episodes of external financial stress. However, there is an agreed diagnosis with respect to the pressure that current monetary policy has generated on capital inflows, the resulting deterioration in the external accounts and the risks of an unwanted scenario of overheating at local level, boosted by domestic demand that is growing continuously at a rate that is unsustainable in the long term (see Box 2). In this section we argue that this behavior constitutes a continued active stance by the monetary authorities in a context of ultra-expansive external liquidity conditions. This would rule out the idea that the Central Bank is handling monetary conditions by looking in the rear-view mirror, or those analyses that suggest the current external liquidity conditions would justify a lower level of the monetary policy rate (MPR), in particular due to its impact on the exchange rate. Despite this, it is clear that the role external liquidity plays in determining local reference rates (the MPR) will be conditioned by the level of openness and effective access to external financial markets. As the levels of foreign-currency funds in the Chilean financial system increase, measured as dollar deposits against total deposits, the Central Bank will tend to react less to external liquidity conditions. In the current conditions, this interpretation would rule out possible future cuts in the MPR in the light of fears of exacerbating risks of a more expansive cycle. Further, our results suggest that if the steady expected return to normal external liquidity conditions (withdrawal of quantitative liquidity measures) is also manifested in a lower level of external finance for the local banking system, the sensitivity or room for the MPR to react positively to these new conditions would increase, other things being equal. Although traditional literature includes external liquidity conditions through the exchange-rate channel, we believe that a variant approach based on a monetary aggregate also captures the effect of the current external liquidity conditions on the local credit channel.

Composition of bank funding in Chile under extreme international liquidity conditions

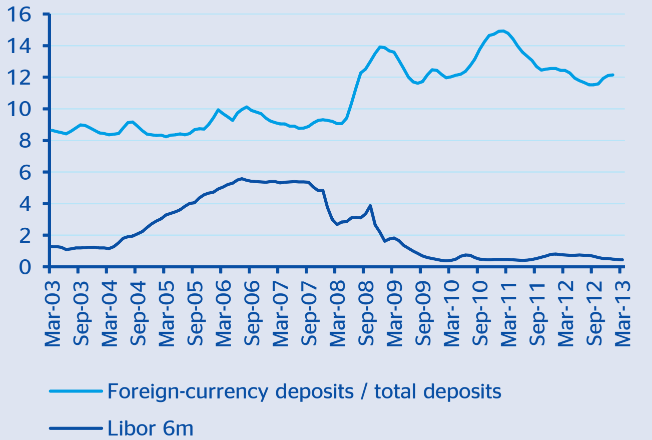
Since the start of the financial crisis and the Fed Fund cuts to all-time lows, there has been a change in Chile in the composition of the funding of the local banking system. This is no surprise in an economy such as Chile's, which has a high level of financial integration and financial openness. In particular, the dollar funding of the system, measured as a percentage of total deposits, increased from an average of around 8% to an average that stabilized at around 13% in recent years. Despite the volatility of the series, an initial glance allows us to infer that this would reflect the transfer of external liquidity conditions to the local economy. However, it could be argued that this shift in the composition of funding is due to an endogenous phenomenon, to be understood as a rational response by the current system to the spread between domestic and external rates. In fact, it is much cheaper today to obtain finance in dollars, even with the cost required by foreign-exchange risk hedging. This is reflected by a greater correlation starting in 2006 (Chart 9). It is precisely this element that we are attempting to isolate using a methodology that corrects the problem of endogeneity in the calculation.

In search for an extended Taylor Rule in a system of inflation targets, exchange-rate flexibility and financial openness

We have estimated an extended Taylor Rule taking a data series from 2003 to date. This time window allows us to include an institutional structure that best reflects an operational system of inflation targets, relative exchange-rate flexibility and financial openness. In particular, in addition to the traditional variables used to understand the behavior of the MPR, such as the gaps in capacity and unanchoring of long-term inflation expectations, we have used the 6-month LIBOR rate as a measure of the level of external conditions. By allowing for the composition of funding in the banking system and correcting the problems of simultaneity between variables, the sensitivity of the monetary policy rate to external short-term rates reaches nearly 30%. This correlation tends to be lower as the banking system shows greater exposure to external funding. Thus in a cycle of greater dollar funding of the banking system, the transfer of the monetary policy rate tends to lose its correlation to the movement of short-term external rates, other things being equal. This allows us to understand the cycle of monetary policy rate rises in 2010, and also rules out cuts in the rate under in current bank funding conditions (Chart 10) .

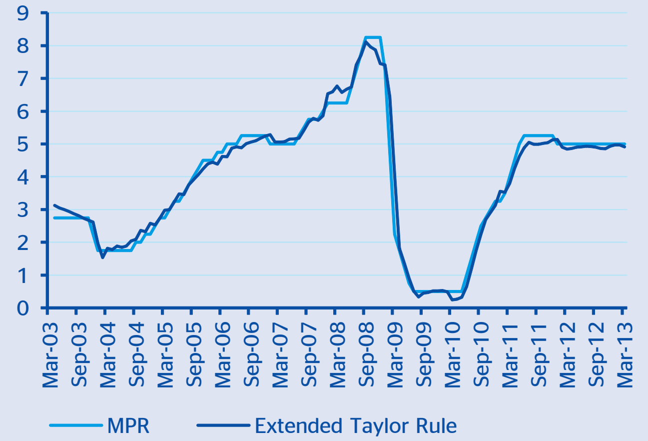
1: This analysis will be expanded in a forthcoming Economic Watch, which will present the different specifications and results of the estimates that support the conclusions included in this report.

Chart 9
Foreign-currency deposits and external interest rate (% of total, %)



Source: Central Bank of Chile and BBVA Research

Chart 10
Actual and estimated monetary policy rate (%)



Source: Central Bank of Chile and BBVA Research

6. Fiscal balance in line with a structural deficit of around 1%

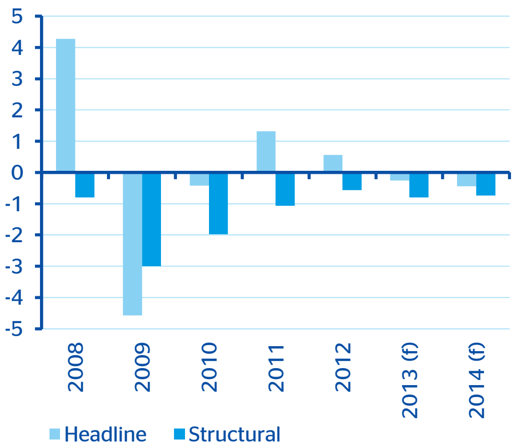
In 2013, we expect the effects of lower growth, lower copper prices and higher inflation to balance out and leave the fiscal deficit at 0.3% of GDP. In 2014 we expect a similar deficit, which takes into account another downward adjustment in the copper price

There was a fiscal surplus of 0.6% of GDP in 2013, influenced by the positive performance of the local economy, which was offset by lower inflation at the close of the year, and lower income from private and Codelco mining activity. Tax revenues increased in real terms by 1.3% y/y, with non-mining revenues up 7.1% y/y, while revenues from private mining fell by 14.2% y/y, and from Codelco even more, by 31.1% y/y. Expenditure increased in real terms by 4.7%, implying a marginal under-execution of the budget. The increase was supported basically by an increase in current expenditure of 5.5% y/y, while capital expenditure only increased by 1% y/y in 2012. Overall, there was a structural fiscal deficit of 0.6% of GDP, above the government's target of a deficit of 1% in 2013.

For 2013, we forecast a slight headline fiscal deficit of 0.3% of GDP, while the structural deficit will be close to 1% of GDP, without significant changes on the 2012 figures. However, the most important element to consider in the fiscal balance is the expected fall in the copper price, which will average at around USD 3.45 per pound, continuing under pressure from increased costs of private and Codelco mining production. The slowdown in activity will be slight, although it will be offset by a lower average inflation, which will lead to a real increase in revenues of around 2.8% y/y. Assuming an under-execution of the budget in line with historical standards, expenditure should increase by around 6.8% y/y (Chart 11).

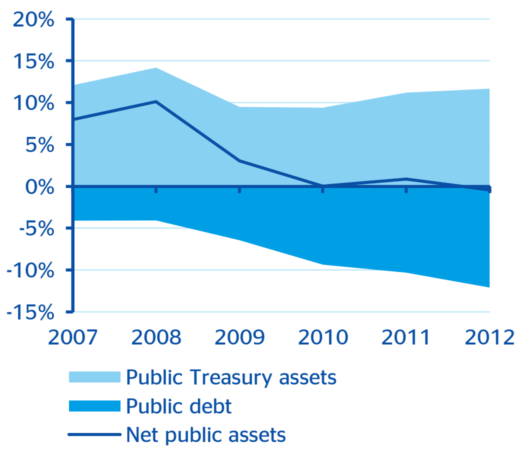
In terms of the composition of net assets in the public sector, those corresponding to the economic and social stabilization fund amount to USD 14,859 million, while the pension reserve fund stood at USD 5,829 million at the close of February 2013. If we consider that assets in the public treasury amount to USD 12,032 million, total fiscal resources are close to USD 32,720 million, some 12% of GDP. The public debt amounted to USD 32,423 million, so the net fiscal position is in virtual equilibrium. It is important to note that the future of sovereign funds, particularly those linked to the accumulation of funds from mining, will depend on the effective copper price continuing above the level defined as its long-term price, which is currently at USD 3.06 per pound. If confirmed at the next discussion of the committee of experts mid-way through this year, this continues to be under the average of USD 3.45 that we forecast for 2013. In 2014 we estimate an average price of USD 3.26 per pound, which still provides room for accumulation in the economic stability fund. The above depends on GDP growing at around its potential and inflation converging to the Central Bank target mid-way through 2014 (Chart 12).

Chart 11
Headline and structural fiscal balance (% of GDP)



Source: Budget Management (Ministry of Finance) and BBVA Research

Chart 12
Public assets and liabilities (% GDP)



Source: Budget Management (Ministry of Finance)

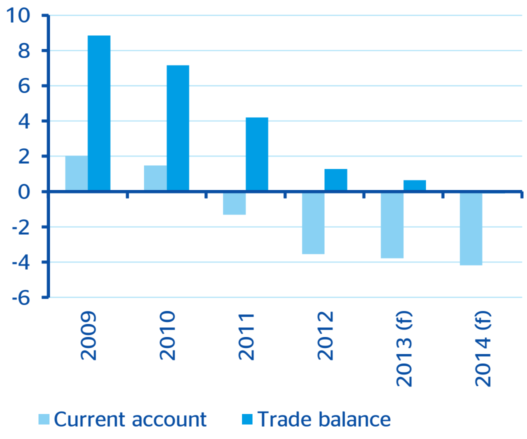
7. Balance of payments: slight deterioration, but still sustainable

A limited drop in the price of copper (from USD 3.6 to 3.45 per pound), offsetting the greater exported volume, would maintain the value of exports practically unchanged. Combined with imports rising as domestic demand strengthens, this would lead to a renewed fall in the trade surplus

In this scenario of a limited fall in the copper price (in fact, the price experienced a major adjustment following the release of China's growth figures in the first quarter, though this should be corrected in the upcoming months), total exports will be around USD 80.9 billion, 3.3% up on the figure for 2012. Boosted by the strength of domestic demand, imports will increase by 5.5% to USD 79 billion. Thus the trade balance will fall back for the third year in a row, from a surplus of USD 15.6 billion in 2010 to one of USD 1.9 billion in 2013. The income and current transfers accounts will not reflect substantial changes on 2012, so the current-account deficit will increase from 3.5% to 3.8% of GDP, basically due to the trade balance.

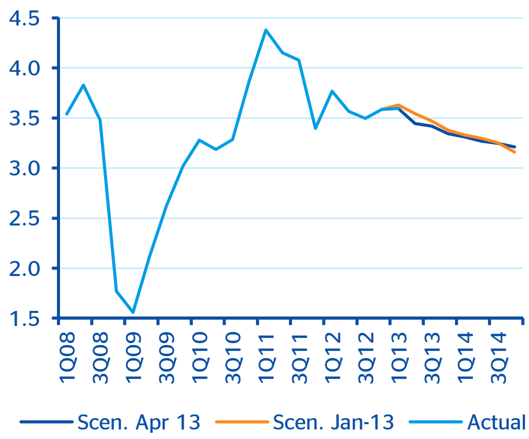
In 2014, imports will maintain their strength against exports, as in recent years, and as a result Chile will see its first trade deficit since 1998. The net aggregate effect of services, income and current transfers will result in a current-account deficit of 4.2% of GDP (USD 12.7 billion). This forecast involves an additional fall in the copper price, which will average USD 3.26 per pound in 2014 (Charts 13 and 14).

Chart 13
Trade and current-account balance (% GDP)



Source: Central Bank of Chile and BBVA Research

Chart 14
Forecast copper price (USD per pound, average)



Source: Chilean Copper Commission and BBVA Research

Just as in 2012, foreign direct investment (FDI) will be the main source of finance for these deficits, although an increase in foreign portfolio investment is also anticipated, together with foreign debt issues reflected in the other investments account. The sustainability of the expected deficits is reviewed in Box 2.

Box 2. Current account and debt stock

Over the last 3 years there has been a deterioration in the balance of payments, both with respect to the trade deficit and current-account deficit. This box reviews the sustainability of Chile's external accounts, both from the perspective of flows reflected in the balance of payments and in the external debt stock as a proportion of GDP and the contribution of international investment.

The sustainability of the balance of payments deficit turns basically on two aspects: one related to factors that explain the deterioration in the trade deficit, in other words, the strength of exports and imports; and the other to how the deficit is financed.

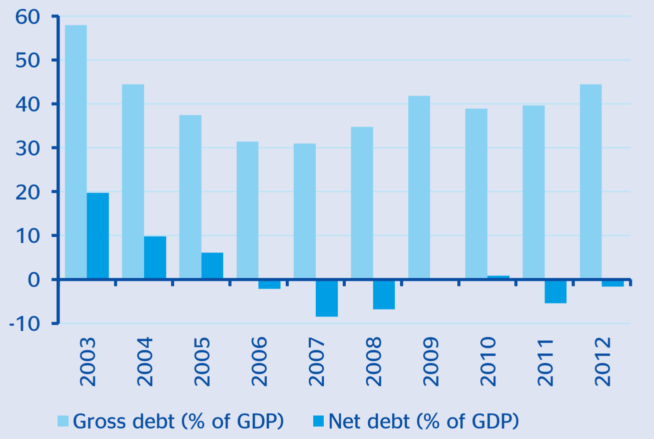
With respect to exports and imports, it is clear that the declining copper price has been key to the relative sluggishness of exports. The price averaged USD 4 per pound in 2011 and USD 3.6 in 2012, and is expected to converge to its equilibrium level of around USD 3 per pound in the medium term. The outlook for economic growth in the main markets for copper, and for a somewhat easier balance between supply and demand for the metal, together with the forecast of a relative strengthening of the real multilateral dollar exchange rate, all support our forecast for this price. In fact, following a steeper fall than normal in the first few months of the year, this forecast may even be considered optimistic. The steady recovery in the growth of the main economies and markets will also be a factor behind the slow growth in the value of exports other than copper.

On the imports side, the strength of domestic demand explains why imports should grow by more than two percentage points above exports in year-on-year terms this year and next. In any event, a significant part of this strength has been associated with the high levels of investment, in particular in tradable sectors such as mining. This factor has been and will be key if growth in exported volumes resulting from these investments is to offset the expected movements in both copper prices and imports, and should stabilize the deficit at around 4 percentage points of GDP in the medium term.

The deficit is expected to be financed mainly from foreign direct investment in both mining and energy projects linked to mining. The list of investment projects registered with the Capital Goods Corporation (CBC) reflects this composition of investment forecast for the next five years. It is interesting to highlight in this regard that the deficit is endogenous to the significant strength maintained by investment. That is why if these investments do not take place the deficit will not materialize. However, in this case there would be downward pressure on the exchange rate, given that it would imply expectations of lower foreign-currency inflows in the future. In contrast, if these investments do take place, they will be financed through FDI, which should also lead to an increase in export capacity in the medium term.

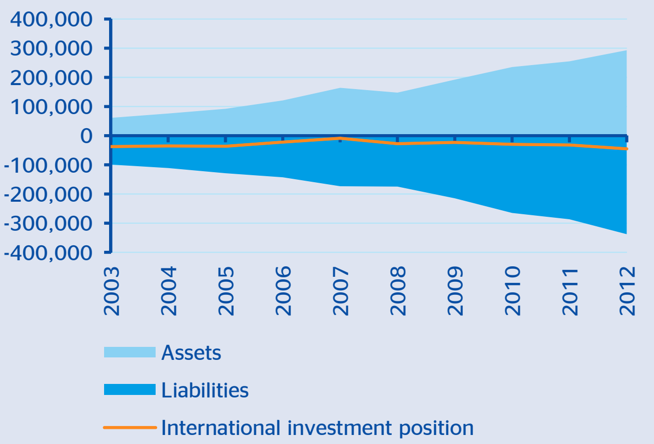
Gross foreign debt stock remained at around 40% of GDP between 2009 and 2011, and increased to 44.5% of GDP at the close of 2012, reflecting the deterioration in balance of payment flows. In net terms, between 2011 and 2012 the debt fell from 5.5% of GDP to barely 1.7%. In line with the above, the international investment position deteriorated by around 4 percentage points of GDP between the close of 2011 and 2012. Although there should be no problems in financing the current-account deficit in the medium term (the net foreign debt is very low, and the international investment position is in relative balance), a stabilization of the deficit at around 4% would lead to a gradual deterioration of the debt indicators and of the international investment position (Charts 15 and 16).

Chart 15
Gross and net foreign debt (% of GDP)



Source: Central Bank of Chile

Chart 16
International investment position (USD million)



Source: Central Bank of Chile

8. Domestic and external risks continue to be important

The most significant external risk is one associated with adverse shocks in developed economies, with a potential impact on economic activities in important emerging markets such as China

Despite the fact that the most significant source of external risk continues to be Europe, the probability of extreme scenarios being associated with it, as well as their potential impact, have continued to reduce. In particular, the estimated impact of this scenario on the U.S. and China has fallen, as explained in the first section of this report. In the case of Chile, the most significant channel of transmission of a crisis of this nature continues to be its potential effect on the terms of trade and export volumes, as any effect on confidence levels and domestic demand is considered limited.

The relevance of the external demand channel is clearly shown by the effect on the copper price of the recent Chinese growth figures for the first quarter of the year, which were only slightly below expectations. When the figures were released, the copper price fell by around 8% in a week. Although we consider that this was an overreaction, it is reasonable to expect an even greater and longer-term impact in the case of a significant slowdown in economic growth in China. Each cent by which copper falls in price is estimated to reduce the value of Chilean exports by around USD 120 million. The effect on the trade balance would be less marked, as there would also be falls in the prices of other, mainly imported, commodities such as energy. The fall in net external income would also moderate the adverse impact on the current account, but given that no significant slowdown is expected in domestic demand or imports, at the aggregate level there will be an increased current-account deficit, which is already relatively high in the baseline scenario.

In this scenario there would be a significant depreciation in the exchange rate, due to the effect of the lower copper price on the supply of dollars, and to the impact on expectations for a correction in the value of the peso as a result of the increased current-account deficit. Overall, although no very significant effect on domestic demand is anticipated, this would predominate over the effect of depreciation. As a result, inflation would fall and its return to the Central Bank target would take longer.

With respect to the effect on the fiscal balance, a fall of one cent in the copper price would lose around USD 50 million in revenue. Thus a fall of USD 35 cents (around 10%) over the year would lead to a drop of around USD 1,750 million in revenue. This factor alone, i.e. without taking into account the negative effects on economic growth and non-copper revenues, would mean moving from a fiscal balance to a deficit of over half a percentage point of GDP.

A fall of this size in the copper price would also have effects on the current account, as the direct effect on exports would be a drop of around USD 120 million for each cent that the average copper price falls, though this would be partly offset by lower profit remittances from private mining. In short, every cent that the average copper price falls has a net impact of USD 60 million. In other words, a fall of 10% in the average price would lead to a current-account deficit of over 4.5% of GDP this year.

With respect to economic growth, the ample fiscal and monetary room to implement countercyclical policies, and the positive fundamentals in the financial and corporate sector would limit the effect, so there would be a slowdown but in no case a recession.

On the domestic front, the main risk is once more that demand will not reduce its strength as anticipated in this baseline scenario. What is more, the data for the close of 2012 and the high-frequency data indicate that this risk has gathered force. Thus a scenario in which domestic demand continues strong could lead to inflation picking up, and a sudden brake on the speed of growth, rather than a gradual slow convergence to potential growth and the inflation target, as forecast in the baseline scenario.

9. Tables

Table 1
Annual macroeconomic forecasts

	2010	2011	2012	2013	2014
GDP (% y/y)	5.8	5.9	5.6	5.0	4.7
Inflation (% y/y, eop)	3.0	4.4	1.5	2.5	2.6
Exchange Rate (vs. USD, eop)	475	517	477	483	502
Interest Rate (%, eop)	3.3	5.3	5.0	5.0	5.8
Private Consumption (% y/y)	10.8	8.9	6.1	5.8	4.8
Government Consumption (% y/y)	4.6	3.0	4.2	4.7	4.9
Investment (% y/y)	12.2	14.7	12.3	7.0	6.1
Fiscal Balance (% GDP)	-0.4	1.3	0.6	-0.3	-0.4
Current Account (% GDP)	1.5	-1.3	-3.5	-3.8	-4.2

Source: BBVA Research

Table 2
Quarterly macroeconomic forecasts

	GDP (% y/y)	Inflation (% y/y, eop)	Exchange Rate (vs. USD, eop)	Interest Rate (%, eop)
Q1 11	9.8	3.4	479.7	4.0
Q2 11	5.8	3.4	469.4	5.3
Q3 11	3.2	3.3	483.7	5.3
Q4 11	5.0	4.4	517.2	5.3
Q1 12	5.1	3.8	485.4	5.0
Q2 12	5.7	2.6	505.6	5.0
Q3 12	5.8	2.8	475.0	5.0
Q4 12	5.7	1.5	477.1	5.0
Q1 13	4.8	1.5	472.5	5.0
Q2 13	5.0	2.0	468.8	5.0
Q3 13	5.1	2.0	474.4	5.0
Q4 13	4.9	2.5	482.9	5.0
Q1 14	4.2	2.7	491.0	5.5
Q2 14	4.6	2.8	496.3	5.8
Q3 14	5.2	2.5	499.6	5.8
Q4 14	4.9	2.6	501.8	5.8

Source: BBVA Research

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