

# Economic Outlook

## Chile

First Quarter 2014  
Economic Analysis

- **The global economic cycle strengthened in the last few months of 2013.** The challenge of keeping the balance in world growth is transferring to emerging economies, particularly China.
- **Recent financial tensions do not alter our growth forecasts of the emerging economies as a whole,** but placed a limited downside risk.
- **For Chile in 2014, we maintain our 4% GDP growth forecasts** and cuts in the MPR towards 4%. Consistently, CPI inflation would rise to 2.6%.
- **The current account deficit in Chile no longer presents risks to sustainability,** in view of the visible slowdown in internal demand and the accelerated real and nominal exchange rate depreciation.

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# 1. Summary

The global economic cycle strengthened in the last few months of 2013. According to our estimates, global GDP accelerated in 4Q13 at rates close to 1% QoQ, leaving behind the moderation that started in 2012 and which reached its lowest point at the beginning of 2013 with growth of barely 0.5%.

The expected increase in global growth does not rule out the existence of downside risks to our forecasts. However, although these risks are far from having the same systemic nature as in the past, some events have appeared on the horizon, such as the recent drops in asset prices and EM exchange-rate depreciation.

US GDP growth has continued to accelerate throughout 2013, which at the end of the year has enabled the Fed to take the first steps in withdrawing monetary stimulus. In addition, in December an agreement was reached which represents an important step forward in eliminating uncertainty about government funding in 2014-2015, as well as reducing the fiscal adjustment initially forecast for this period.

During the last quarter the Chinese economy has demonstrated its duality, acting both as support for the global economy and a potential risk factor. On the one hand, the doubts existing at the beginning of the year about the sustainability of Chinese growth and the possibility of a hard landing have dissipated in the short term. The economy has recovered in the second half of 2013 and remains stable, although some of the most recent confidence and manufacturing activity outlook data have been lower than expected.

The market seemed to anticipate the start of tapering in the US, with stock exchange adjustments, increases in volatility and depreciations in emerging currencies. There have been no significant impacts as a result of the Fed's announcement. Long-term interest rates which experienced rises tracking foreign interest rates have suffered reversals as a result both of drops in foreign rates and cuts forecast for the MPR in Chile.

We predict an expansion of 4% in the 2014 GDP, backed by greater world growth, significant fiscal stimulus, normalisation in the stocks cycle and the effects of a lower MPR. However, if the risks to investment and, in the international arena, to the Chinese economy materialise, they could impact these forecasts to the downside.

The current account deficit is no longer an impediment in making cuts in the MPR, particularly in view of the peso's accelerated real and nominal depreciation, and the slowdown that is already evident in private consumption. What is more, in our base scenario we anticipate less dynamism in employment and salaries, with significant consequences for the expansion of consumption of durable goods.

Inflation presents balanced risks and we maintain our projection from our previous Economic Outlook report. We forecast that CPI inflation will finish at 2.6% YoY in 2014. There is no modification as a result of the inflationary shock of the peso's depreciation which will be compensated by the somewhat greater than expected slowdown in private consumption.

In this context, we forecast two additional cuts in Chile's MPR which we believe are consistent with the baseline scenario set out in this report. The first cut will materialise in February, while the second may occur as early as March. However, the timing of the second cut is more conditioned by external conditions and short-term figures, so may be postponed by a few months. Nevertheless, the MPR will then remain at 4% for the rest of 2014.

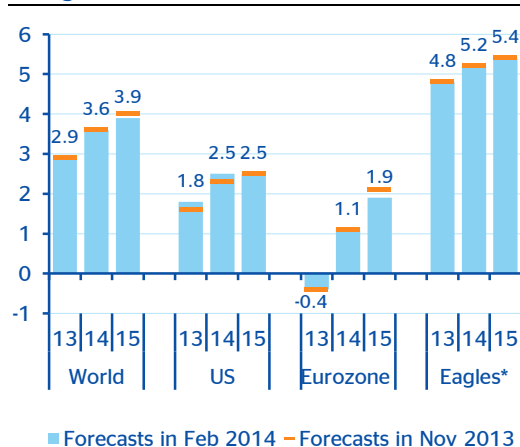
## 2. External Scenario: more growth and more balanced risks

### The global economic cycle is improving and we now have clarity on some economic policy uncertainties

The global economic cycle strengthened during the latter months of 2013. According to our estimates, during the second half of 2013, global GDP accelerated to 1% QoQ, leaving behind the moderation with its roots in 2012 and its low at the beginning of 2013, when growth was barely 0.5%. This improvement was driven by the acceleration of the developed economies – particularly the US, but also the eurozone, which started to see moderate growth. In the emerging markets, the situation is more diverse, but some of them (e.g. China) are posting relatively stable rates of growth.

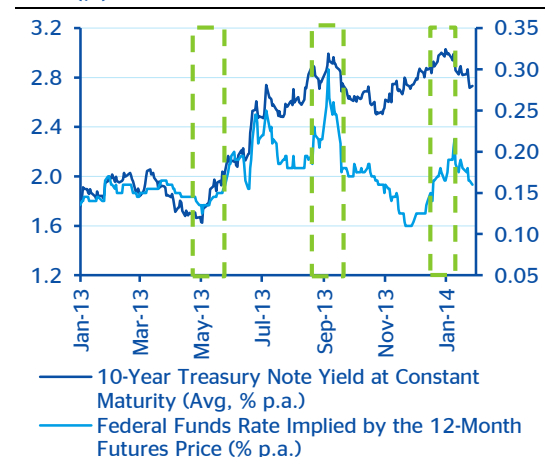
Our improved valuation of the global scenario is also the result of economic policy news flow, inasmuch as this helps to reduce uncertainty. First, the US reached a more far-reaching agreement on fiscal policy than we expected. Meanwhile, the improvement in activity allowed the Fed to start tapering its expansive monetary policy at the beginning of 2014. In Europe, further steps have been taken towards the construction of banking union, which together with the ECB's determination to keep risks under control, should eliminate the hobble represented by financial fragmentation. The global outlook would be clearer if it were not for the effect that the tapering is having on financial markets in the EMs, and which could eventually affect economic growth in some of the countries included in this category.

Chart 2.1  
GDP growth forecasts (%)



EAGLES is the group of emerging economies that will make the biggest contribution to global GDP in the next 10 years. The group comprises China, India, Indonesia, Brazil, Russia, Korea, Turkey, Mexico and Taiwan.  
Source: BBVA Research and IMF

Chart 2.2  
EU: Federal funds futures and long-term interest-rates (%)



Source: BBVA Research & Bloomberg

Thus, global GDP growth, which in 2013 had decelerated to 2.9%, will increase to 3.6% and 3.9% in 2014e and 2015e, respectively (Chart 2.1), practically the same as our forecasts three months ago. The expected increase in global growth does not detract from the existence of downside risks to our forecasts. Although these risks are a long way from having the systemic nature that they had in the past, some recent events such as the fall in asset prices and currency depreciation in EMs have made themselves felt.

## The US starts to unwind its monetary stimulus

US GDP growth has been accelerating through 2013, which by year-end allowed the Fed to take the first steps towards withdrawing monetary stimulus. Also, in December, an agreement was reached that represents an important step forwards in eliminating the uncertainty regarding the funding of the government's activity in 2014-15, as well as reducing the fiscal adjustment initially foreseen for that period.

The outlook for monetary policy has also clarified recently, in line with our expectations. As a consequence of an acceleration in activity with well-anchored inflation expectations, the Fed decided to start to taper its monthly purchases of financial securities. All in all, in the fourth quarter of 2014, the central bank will have stopped expanding its balance sheet. Our base scenario also assumes that the first increase in interest rates will take place in the second half of 2015, although the FED will continue to use its forward guidance to anchor interest-rate expectations. In fact, the Fed's efforts to explain its exit strategy have been relatively successful in avoiding episodes of volatility like we saw at the beginning of 2Q13. Both long-term interest rates and expectations regarding Fed funds remain at levels no higher than those seen during that period (Chart 2.2). This is significant because part of the US recovery was due to interest-rate sensitive sectors such as real estate.

In this context, we have revised upwards our forecast for US growth in 2014 to 2.5%, the same as our estimate for 2015 (Chart 2.1). This adjustment reflects both the strength of the US economy in the second half of 2013 and the additional momentum contributed by the reduced fiscal drain thanks to the agreement reached at the end of last year. Note that there are also upside risks to our forecast if the improvement in confidence results in additional corporate investment and hiring.

## The withdrawal of monetary stimulus in the US could cloud the outlook for some emerging economies

The change of direction in US monetary policy has, as usual, had a global impact. The emerging economies are being subjected to reduced capital inflows and currency depreciation, intensified in some cases by domestic events that have increased uncertainty regarding the management of their respective economic policies. In addition, there continues to be a differentiation between economies depending on their fundamentals: higher external deficits and more dependence on short-term and foreign-currency funding are associated with greater vulnerability to capital outflows and currency depreciation (Chart 2.3).

The recent tensions have not changed our growth forecasts for the EMs as a whole, but they do represent a significant downside risk. This risk is higher in the economies that have a higher weighting in global investment portfolios and that have the above-mentioned vulnerabilities: Turkey, Brazil, Indonesia and India in particular. The monetary tightening being introduced by some of these countries to control currency depreciation and inflation expectations will inevitably have a negative impact on growth. All in all, the diversity within the EM group means that our outlook remains favourable for some parts of South America, such as the Andean economies, emerging Asia and Mexico, some of which are benefiting from the cyclical momentum of the US economy (Chart 2.4).

## Growth in China remains at around 7.5%, but the vulnerabilities are more evident

The fourth quarter was a clear example of the duality of China's economy as both a support for the global economy and a potential risk factor. The uncertainty at the beginning of the year regarding the sustainability of its growth and the possibility of a hard landing dissipated in the short term. The economy has recovered in the second half of 2013 (Chart 2.4) and maintains a good tone, although some of the more recent data on confidence and expectations of manufacturing activity are once again below market expectations.

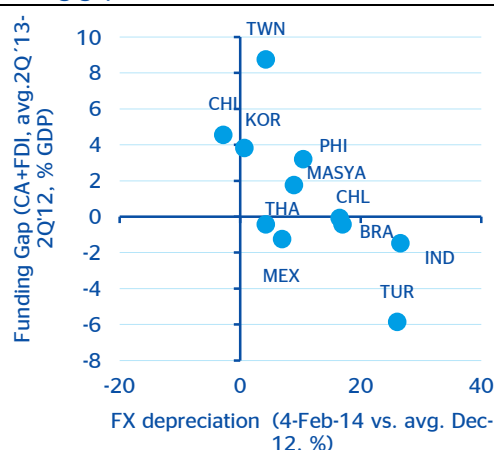
Fundamental changes in economic policy have also been announced. At the Third Plenum of the Chinese Communist Party, the authorities reiterated their commitment to maintaining high rates of growth, while at the same time as proposing measures that will strengthen the role of the market in allocating resources and a rebalancing from a model of investment and exports towards increasing household consumption. These announcements are steps in the right direction, but their effectiveness will depend on their execution, and they are not without risk.

For example, as regards the financial sector, the authorities are continuing to demonstrate their commitment to tackle the current vulnerabilities, fundamentally linked to the rapid growth of credit. This is being reflected in liquidity tensions in the interbank market which are above all affecting the so-called shadow banking sector<sup>1</sup>, although the authorities have not managed to moderate the rate of growth in credit.

In any case, our 2014 and 2015 growth forecasts for China's economy remain unchanged (at 7.6% and 7.5% respectively), based on our confidence in the authorities' scope and ability to take action.

Chart 2.3

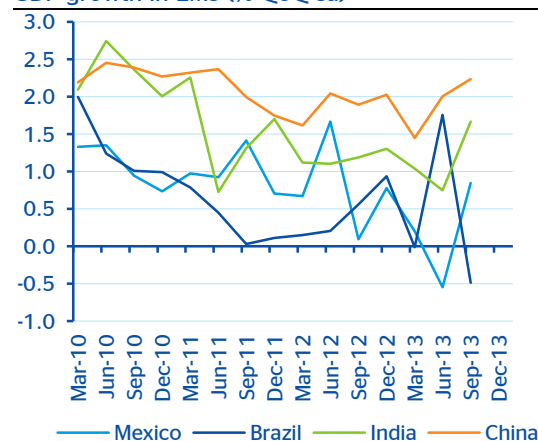
Exchange-rate depreciation (%) vs. external funding gap (CA + FDI, % GDP)



Source: BBVA Research and Haver Analytics

Chart 2.4

GDP growth in EMs (% QoQ sa)



Source: BBVA Research

## The gradual recovery in the eurozone continues, with the support of the ECB and with banking union in its sights

After starting the year in recession, the eurozone managed to sustain moderate expansion throughout the second half of the year, in line with our forecast. Thus if our expectations are confirmed, the fourth quarter data will indicate YoY growth of 0.4%, which although only slight, is its best since the end of 2011. The driver of this slight improvement was the prospect of an increasing role played by domestic demand and sustained improvement in financial conditions, favoured by the determination and commitment of the ECB with an expansionary monetary policy, although the engine of European growth in 2013 and 2014 was, and will continue to be, the export sector.

In any case, we cannot rule out periods of instability as we approach events that could alter the panorama of progress in banking union and of strengthening the monetary union in Europe in general. The events to watch in this context include the European Parliamentary elections, and news flow on the conditions and results of the stress test and asset quality review of the banking sector.

All in all, we reiterate our forecast for eurozone GDP growth at 1.1% for 2014. For 2015 we estimate 1.9%. However, given our projection of continued cyclical weakness, we are also maintaining as a risk event to our forecast horizon a scenario of significant deflation, although we assign a low probability to this risk.

<sup>1</sup>: The group of financial institutions and vehicles that fall outside the regulation of the banking system, but that carry out the same intermediary functions between the economic agents with surplus liquidity and those with insufficient savings to take consumption or investment decisions.

### 3. Local financial markets: minor impacts at the start of tapering

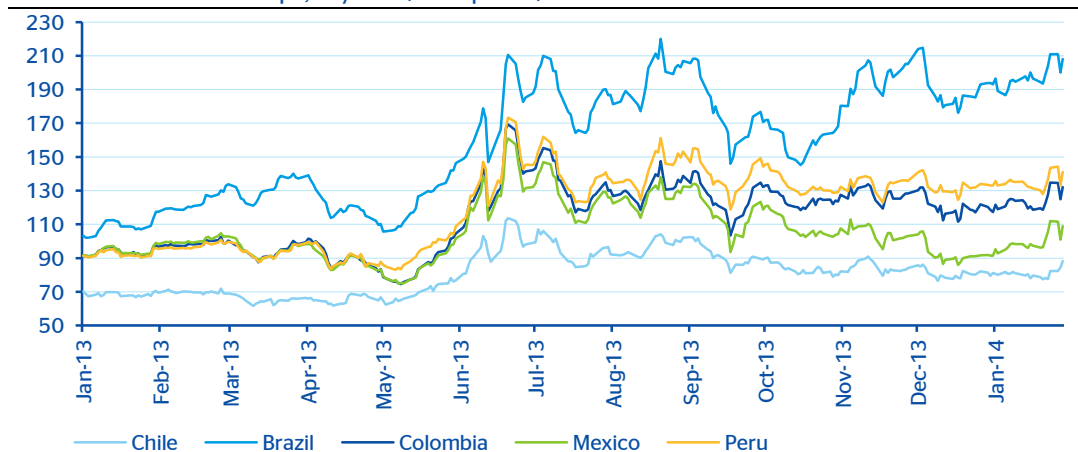
The market appeared to anticipate the start of tapering in the USA with adjustments in stock prices, rising volatility and depreciation of emerging currencies. Thus, once the Fed's announcement materialised, no significant impact has been seen. Long-term interest rates rose in line with external rates, but they have reversed since, which adds to the planned cuts recently announced for the monetary policy rate (MPR) in Chile.

As explained in our Outlook 4Q13, news of tapering in the USA caused significant impacts in global financial markets, in a scenario in which the majority view of the cyclical position was highly unfavourable for emerging economies in general.

In recent months, country risk (measured in terms of credit default swaps or CDSs) has been further punished in both Chile and other Andean economies. Chilean CDSs have stabilised at around 90 basis points, although increases above this level cannot be ruled out if short-term economic figures strengthen the conviction that growth will be markedly below potential in 2014. In this financial context, we should differentiate the case of Brazil, which has had a persistent rise in its CDS since mid-December (Chart 3.1), from the rest of Latin America.

Chart 3.1

#### Latam Credit Default Swaps, 5 years (basis points)

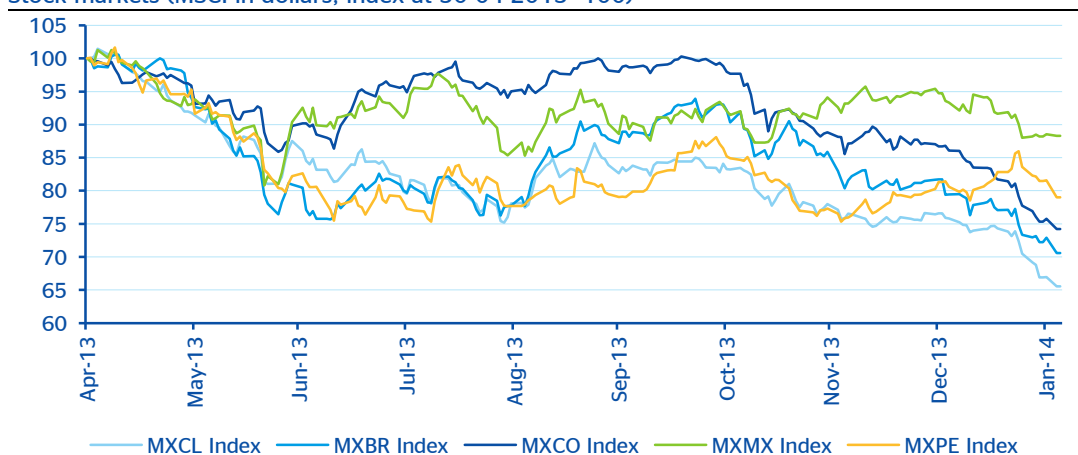


Source: Bloomberg, BBVA Research

Overall, the main Chilean stock market indicator has continued to move in step with peers in the region in dollar terms, despite elections and business uncertainty associated with the tax reform announced by the new government (Chart 3.2).

Chart 3.2

Stock markets (MSCI in dollars, index at 30-04-2013=100)



Source: Bloomberg, BBVA Research

Foreign and institutional investors continue to show scant appetite for local equities, a situation confirmed by the low volumes traded on the stock exchange. Thus, Chile's main exchange carried out transactions worth USD45.8bn in 2013, a fall of 1% compared to the volume of business recorded in 2012. Furthermore, the pension funds (AFPs) and mutual funds made continual net sales of Chilean shares in the second half of 2013, so that local equities dropped from 13.7% of the total assets managed by pension funds in June 2013 to 11.5% in December 2013.

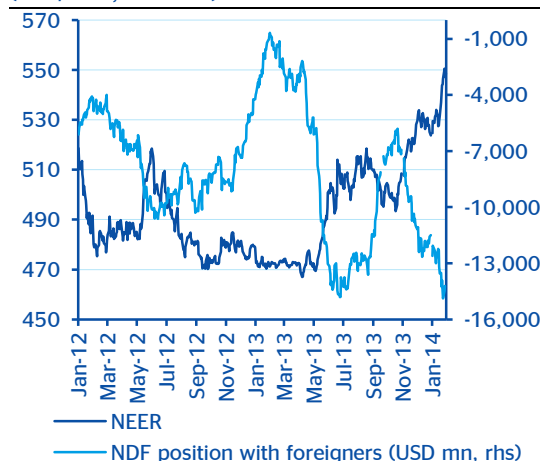
In response to the slowdown in the economy, we have seen cuts in the monetary policy rate in line with our medium-term base scenario. The need for further cuts in the coming months is supported by reported business activity below consensus expectations, which have offset the carry trade conducted by non-residents, arbitraging interest rates using derivative instruments (Chart 3.3). These financial assets have been caught up by the multilateral appreciation of the US dollar linked to tapering, significantly raising peso-dollar parity, although largely in line with other currencies in the region (Chart 3.4).

The exchange rate is in fact now above the level that could be explained by the fundamentals. There is, therefore, a temporary element in the depreciation of the peso seen since the beginning of the year, consisting of the neutralisation of carry trade positions and general concern about certain emerging economies. To the extent that markets see Chile as a relatively solid economy, and as the Federal Reserve's tapering strategy settles into pace, we may see some stabilisation or even a slight appreciation. However, any such developments would take place within the context of nominal and real depreciation processes under way during the first part of the year.



Chart 3.3

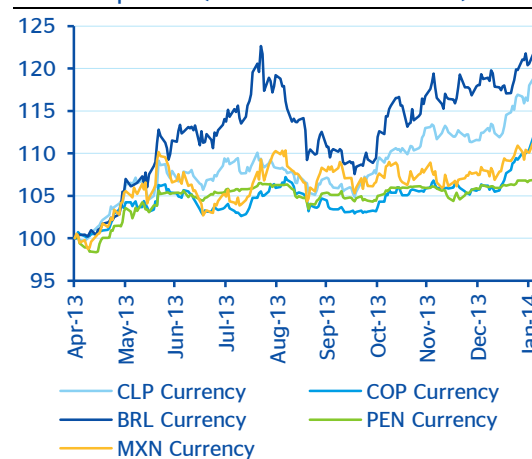
Nominal exchange rate and Carry trade  
(CLP/USD, USD mn)



Source: Central Bank of Chile, BBVA Research

Chart 3.4

US dollar parities (Index 30-04-2013=100)

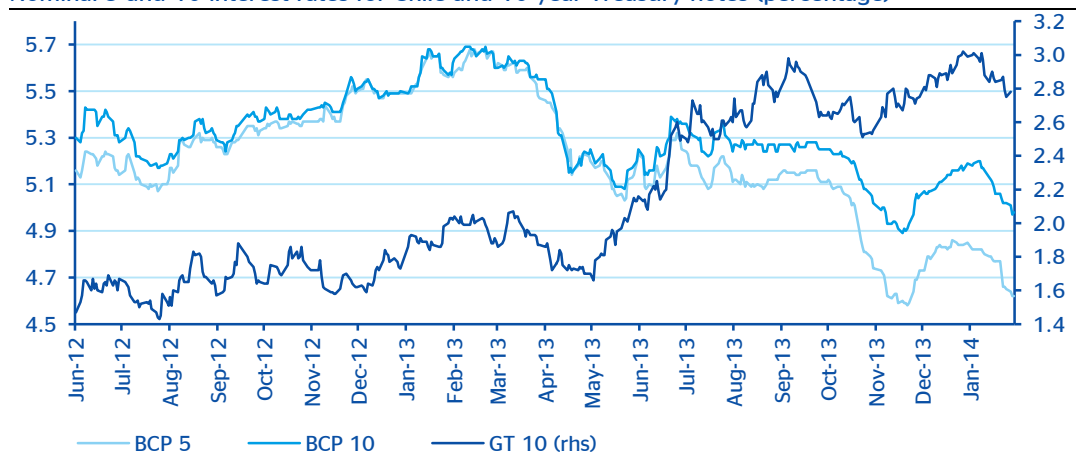


Source: Bloomberg, BBVA Research

Long-term interest rates rose sharply between mid-November and the end of December 2013, accompanying the upward movement of US Treasury bonds. The fall in US Treasury bonds since the beginning of 2014 combined with sharper-than-expected cuts in the Chilean monetary policy rate have resulted in falls of between 30 and 20 basis points on 5- and 10-year peso-denominated sovereign debt between the end of December 2013 and the first week of February 2014 (Chart 3.5).

Chart 3.5

Nominal 5 and 10 interest rates for Chile and 10-year Treasury notes (percentage)



Source: Chilean Association of Banks and Financial Institutions, Federal Reserve Bank of St. Louis, BBVA Research

A further element restraining upward movement in the interest rates charged on Chilean sovereign debt, at least temporarily, is the relative dearth in the supply of debt instruments issued by the Central Bank of Chile. In a move that is almost without historical precedent, the institution has opted not to issue sovereign debt with terms of more than one year. This has left the supply of sovereign instruments in the hands of the Treasury, which has delivered a debt plan which gives preference to nominal instruments over UFs, the latter indexed to inflation (Table 3.1).

Table 3.1

**Supply of sovereign debt instruments**

	2012	2013	2014
<b>Total supply in CLP and UF (USD mn)</b>			
Treasury	5,704	4,112	6,007
Central Bank	3,968	3,471	-
<b>Ratios (percent)</b>			
CB/Treasury	70	84	0
CB/Total	41	46	0
CLP/UF	54	63	120
CLP/UF CB	89	76	-
CLP/UF Treasury	37	53	120

Source: Central Bank of Chile, BBVA Research

The new composition of sovereign debt is in line with the authority's, endeavours to nominalise debt, contain transfers of foreign interest rate rises, and increase the transmission of cuts in the monetary policy rate to the medium- and long-term part of the yield curve.

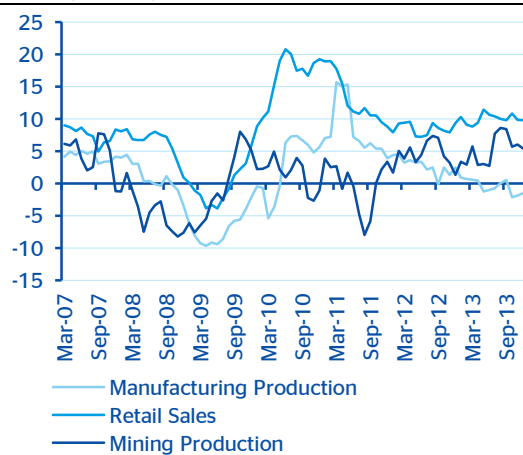
## 4. Chile: picking up speed in 2014 with GDP growth of 4%. Growth around potential in 2015

**GDP growth in 2014 will be based on faster world growth, a significant fiscal fillip, normalisation of the inventory cycle and the effects of cuts in the Monetary Policy Rate. The materialisation of investment risks and international risks affecting the Chinese economy could have a downward impact on these forecasts**

The economy grew at a rate of 4.0% in 2013, in line with the average for the published Monthly Economic Activity Index (Imacec), reflecting a very weak expansion of 2.7% YoY in the fourth quarter. At the sector level, growth last year was led by retailing and mining, but their dynamic results were offset by manufacturing and the weak performance of other sectors, basically comprising investment-related services (Chart 4.1).

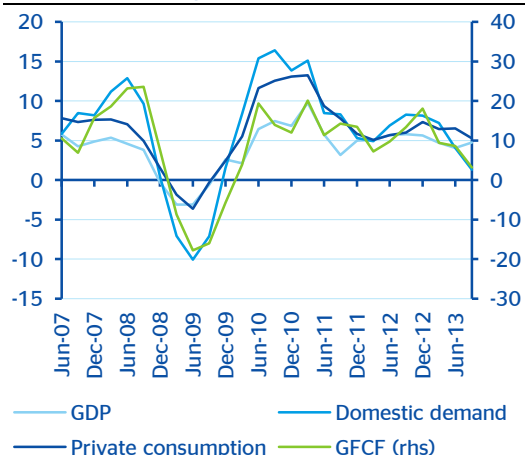
Domestic demand grew at 4.4% in 2013 according to our estimates, helping to close the gap with GDP reported in prior years. This result was negatively affected by the significant reduction in inventories in the second and third quarters, a phenomenon explained principally by the increase in mining exports, which was not repeated in 4Q13 according to our estimates (see Box 1). Declining investment in machinery and equipment also affected the growth of domestic demand, which slowed sharply in 3Q13 and, according to our estimates, actually contracted in 4Q13. Aside from the high basis for comparison associated with the imports of transportation equipment towards the end of 2012, this contraction clearly reflects the effects on the economy of the end of the mining investment cycle. Investment in construction has also slowed, and we estimate that it was around 4.7% at the end of 2013. Private consumer spending slowed, but only gradually, supported by a low rate of unemployment, rising wages and consumer optimism. We estimate that this spending component grew by 5.5% in 2013 (Chart 4.2).

Chart 4.1  
Indicators by sector (% YoY change, quarterly moving average)



Source: Central Bank of Chile, BBVA Research

Chart 4.2  
Domestic demand, consumption, investment and GDP (% YoY change)



Source: Central Bank of Chile, BBVA Research

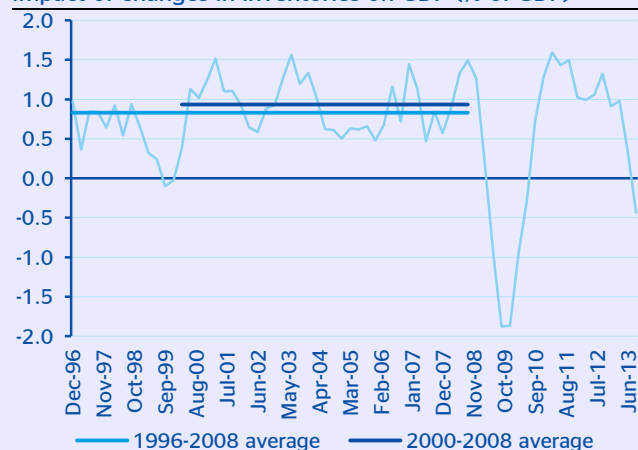
## Box 1. Inventories will contribute to growth in 2014

### The reduction in mining inventories did not continue in 4Q13

The economy saw a very significant reduction in inventories in the second and third quarters of 2013. The change in inventories produced an impact of -0.4% on GDP in 3Q13, compared to an average of between +0.8% and +0.9% before the crisis of 2008-09 (Chart B.1.1). From a forecasting standpoint, it seems clear that the behaviour of inventories is cyclical and that the accumulation of inventories as a percentage of GDP in the medium term should tend towards a positive figure. In this light, the events of 2Q13 and 3Q13 are a temporary phenomenon.

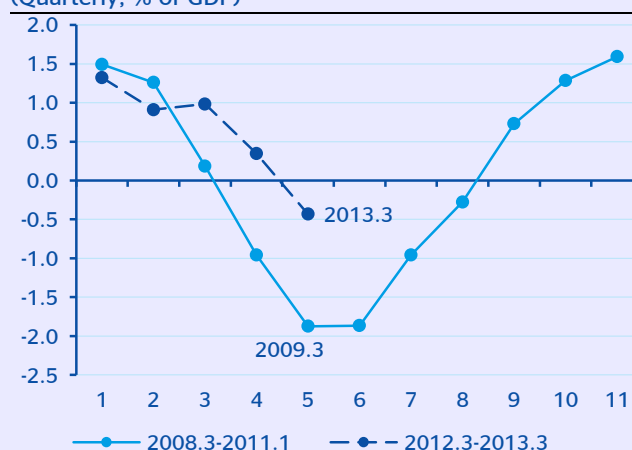
To find a similar reduction in inventories to that seen last year, we need to go back to the period 2008-09, although the present reduction is less intense (Chart B.1.2) and has different causes. Indeed, the inventory cycle of 2008-09 was mainly the result of a deterioration in the outlook for demand brought about by the expected impact of the international crisis on the economy<sup>2</sup>.

Chart B.1.1  
Impact of changes in inventories on GDP (% of GDP)



Source: Central Bank of Chile and BBVA Research

Chart B.1.2  
Impact of changes in inventories on GDP 2009-13  
(Quarterly, % of GDP)



Source: Central Bank of Chile and BBVA Research

One fundamental difference between the reduction in inventories seen in 2009 and 2013 is that the effect was almost completely offset (and explained) in last year's case by an increase in mining exports (Chart B.1.3), which grew significantly in the two quarters of inventory reduction. In this period, the increase in mining output was not sufficient to meet the increase in shipments abroad, and the difference therefore had to be made up by reducing inventories. This phenomenon was a response to a spike in demand for copper in China, which was also reflected in the decline in metal inventories in the world's stock markets.

Chart B.1.4 shows the surprising increase in copper shipments in the second and third quarters of 2013. This begs the question of whether this export growth continued in 4Q13, and the proxy for the volume of exports shown in the same chart in fact suggests that the pace of copper exports was not maintained. In this light, we should not see any further fall in inventories, at least due to this factor, when the National Accounts for 4Q13 are published.

2: In measuring the contribution of investment in inventories to GDP growth, we may observe that the negative contribution in 2009 was almost completely reversed in 2010. However, this component of GDP made a neutral contribution to annual growth in 2011-12.

Chart B.1.3

**Contribution to GDP growth (percentage points)**

Source: Central Bank of Chile, BBVA Research

Chart B.1.4

**Growth in copper exports (Percentage)**\*Difference between the Value and Price of exports  
Source: Central Bank of Chile, BBVA Research

In its Monetary Policy Report (IPoM) for December 2013, the Central Bank also argued that the process of inventory reduction is essentially a phenomenon related with the mining sector, and it also noted that a swift recovery in inventories could be one of the factors that would drive rapid convergence of growth in the economy towards the trend rates. How likely is this scenario? The next section of this box discusses the medium-term outlook for inventory accumulation.

### Outlook and impact on the macroeconomic scenario

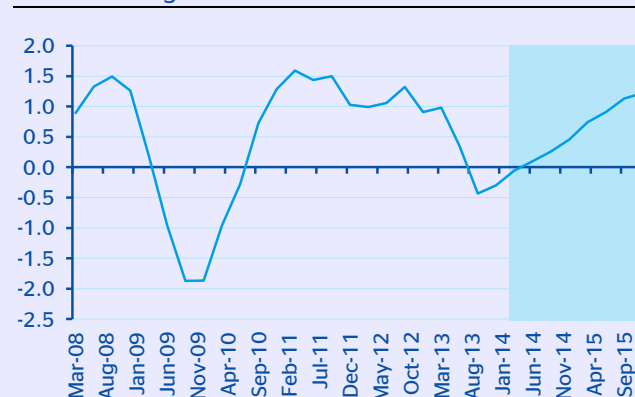
Now that the specific process affecting mining inventories has passed, the focus on the evolution of inventories should be placed on the other sectors of the economy and the usual factors determining this component of investment. One tool that is widely used

to track the evolution of inventories is the Monthly Business Confidence Index or IMCE, and we in fact have information from this index up to December 2013 with regard to business perceptions of the levels of inventories held. A direct reading of these indices suggests that inventories in mining are below the desired level and the historic average.

The empirical literature which seeks to explain the behaviour of inventories addresses the issue using two kinds of model<sup>3</sup>. The first comprise stable output models, in which firms seek to keep their output stable, regardless of the evolution of sales. As a result, inventories are counter-cyclical, which means they fall in periods of rising sales and accumulate in the deceleration phase of the cycle. The second kind is the inventory acceleration model. In these models, firms accumulate inventories when their outlook is one of strong demand, and vice versa. In this case, inventories behave pro-cyclically.

Based on the results for Chile, the second kind of model provides the closest fit with the actual data, which means that in our economy inventories tend to behave pro-cyclically and, therefore, their future evolution is key to the outlook for domestic demand (excluding inventories). On the basis of the forecasts contained in this Economic Outlook, Chart B.1.5 shows a projection of the change in inventories as a percentage of GDP over the coming quarters. As may be observed, our forecasts of growth in domestic demand and interest rates point to a gradual normalisation of inventories as a percentage of GDP over the course of 2014 to reach levels close to the historic averages in 2015.

Chart B.1.5

**Forecast change in inventories as a % of GDP**

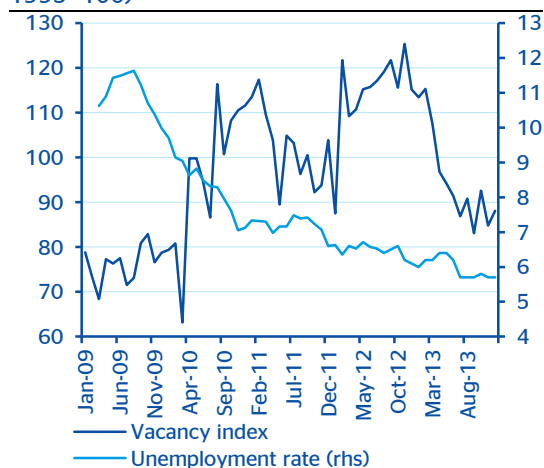
Source: Central Bank of Chile, BBVA Research

3: For further details, see Baeza, W. and R. Caputo (2005) "Estimación de Ecuaciones Trimestrales de Variación de Existencias". Revista Economía Chilena, Volume 8-Nº3. Central Bank of Chile.

We maintain our forecast of GDP growth for this year unchanged at 4.0%, but we expect domestic demand to grow by 4.5%, slightly above the forecast contained in our previous quarterly report. In the short term, we see a poor start to the year for growth, which will be in the range of 1.5% to 2.5% YoY in January, mainly due to the effects of the port strike on copper shipments. Together with the effects of this stoppage on agriculture, we see significant impacts on transport and services linked to international trade. Part of the effects of delays in shipment will be only temporary, and we expect a payback in the February's Imacec, if and when strike activity comes to an end.

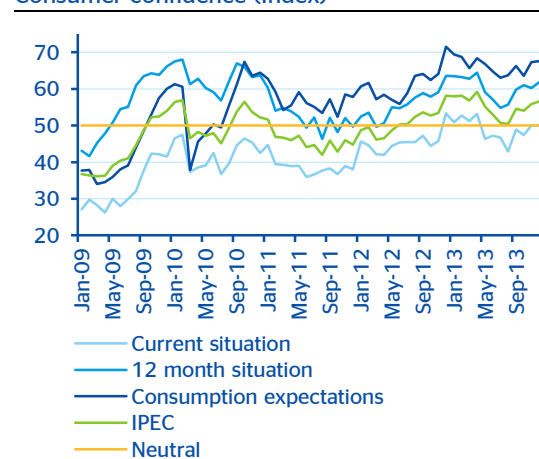
With regard to the spending components, we foresee an ongoing slowdown in private consumption this year with growth of 4.3%, as a consequence of the weakening in the labour market. This will be reflected in increases in the unemployment rate and smaller wage increases, which will have a negative impact on consumers' mood (Charts 4.3, 4.4 and 4.5). Meanwhile, currency depreciation has helped to contain both downward pressure on the prices of imported goods and price rises in the case of other goods, as private consumer spending was fuelled by falling prices of imported products in recent years. We do not believe that this will be a significant factor this year.

Chart 4.3  
**Unemployment and vacancy rates (Percentage, average seasonally adjusted weighted total index, 1995=100)**



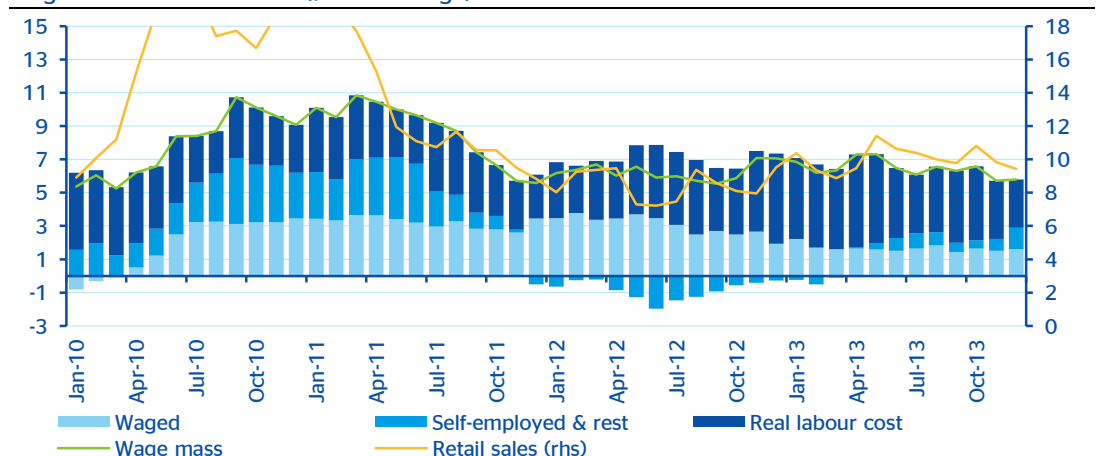
Source: INE, BBVA Research

Chart 4.4  
**Consumer confidence (Index)**



Source: Central Bank of Chile, BBVA Research

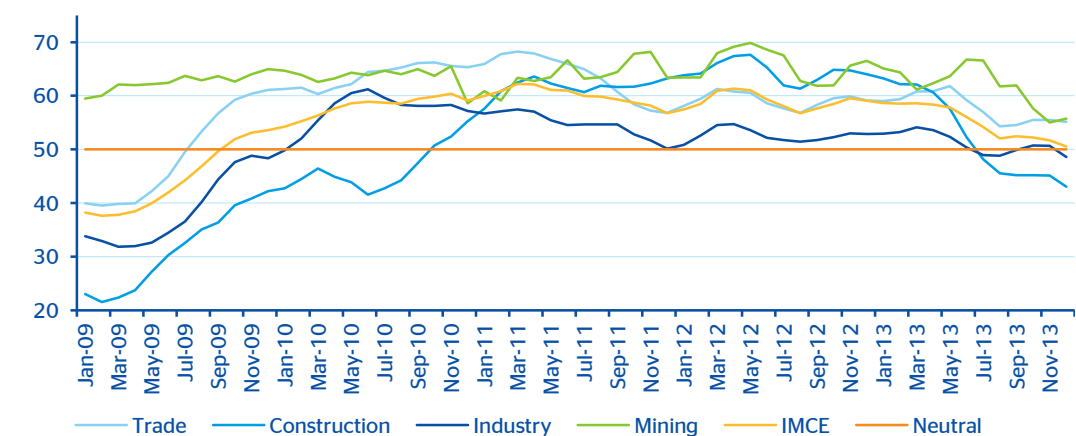
Chart 4.5  
**Wage mass and retail sales (% YoY change)\***



\*Annual change in the quarterly moving average  
Source: INE, BBVA Research

Investment is exposed to significant uncertainty in the forecast for this year. While the investment registry contains significant sums above the level of 2013, many of the projects concerned are at the preliminary study phase and, therefore, they will not necessarily get under way this year. It will therefore be key for the incoming government to announce the details of its tax reform, among other factors. In any event, we expect slower growth in construction this year and rising investment in machinery and equipment, mainly due to low comparison basis of this component in 2013. Considering that much of the investment in machinery and equipment consists of imported goods, the impact on GDP is considerably lower. Business confidence remains at neutral levels on aggregate, although this is because confidence in the mining sector is still at high levels and retail businesses also remain optimistic, offsetting the falling confidence in industry and construction, which are both in the pessimistic zone (Chart 4.6).

Chart 4.6

**Business outlook by sectors (quarterly moving average)\***

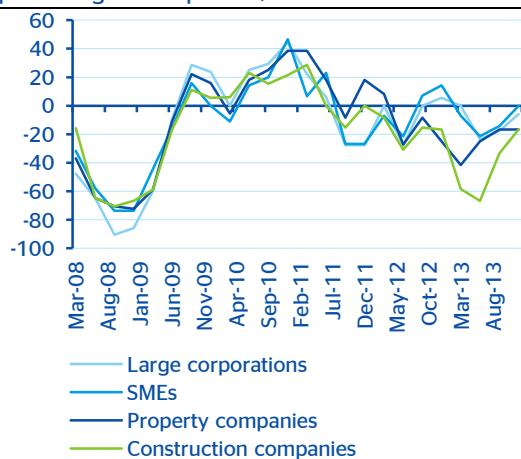
\*Annual change in the quarterly moving average  
Source: Central Bank of Chile, BBVA Research

One component of investment which played a key role last year was the change in inventories, a variable for which we foresee a gradual normalisation over the course of 2014, which will also contribute positively to GDP growth.

Meanwhile, the key financial conditions for investment and spending decisions, especially for durable goods, are currently being buffeted by opposing forces. On the one hand, bank lending conditions are becoming more restrictive (Charts 4.7 and 4.8), in anticipation of a scenario of weaker growth and a deteriorating job market, and on the other hand monetary policy is injecting stimuli into the economy in the form of cuts in the monetary policy rate which we estimate will total 100 basis points at the end of 1Q14 and the start of 2Q14.

Chart 4.7

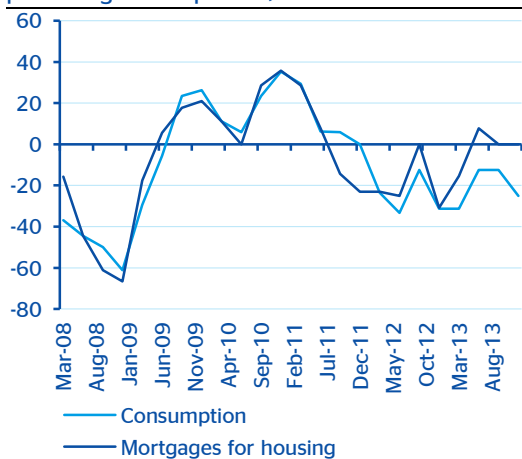
**Bank lending conditions to business (net percentage of responses)\***



\*Standards for Approval of Bank Loans to Businesses. Positive (negative) value less (more) restrictive.  
Source: Central Bank of Chile, BBVA Research

Chart 4.8

**Bank lending conditions to households (net percentage of responses)\***



\*Standards for Approval of Bank Loans to Businesses. Positive (negative) value less (more) restrictive.  
Source: Central Bank of Chile, BBVA Research

Meanwhile, we expect a significant fiscal stimulus in the form of public spending this year, as explained in more detail in the section on fiscal policy. We estimate that public spending will grow by more than 6%, representing the largest expansion since 2010, which should help, to some extent, to offset the deceleration in other components of domestic demand.

We foresee a positive impact from net exports on GDP growth, driven by recovery in the developed economies, particularly the USA and the Eurozone, and by the higher real exchange rate, which will make exporters more competitive (see Box 2). The main risk in this regard continues to be the Chilean economy's dependence on China, as the sustainability of growth is key to supporting demand for our export products. The Asian giant is currently exposed to downside risks, sounding a note of caution in relation to the outlook for copper prices and forecast export volumes for this year.

To end with a purely statistical but nonetheless important matter, the concentration of bad economic news in the latter part of last year implies that the economy should grow year-on-year without much difficulty, all else being equal, given the effect of the comparison basis during 4Q14. This is another reason why we continue to see our growth forecast for this year as feasible.

As of 2015, we forecast that GDP growth will settle around its estimated potential of 4.5% in the absence of external or internal shocks affecting the economy's rate of expansion. This higher growth will arise from a combination of the monetary stimulus injected between 2013 and 2014, a reduction in the uncertainties affecting investment in 2014, and a labour market in which job creation will grow in line with increases in the labour force and wages. This growth will be consistent with the inflation target and productivity growth.



## Box 2. Competitiveness of Chile's manufacturing exports

### The decline in manufacturing competitiveness over the last 5 years has been due to rising costs and the appreciation of the peso

Over the last five years, Chilean industry has in general strayed from the upward path of competitiveness gains observed since 2002. This decline has resulted mainly from the appreciation of the Chilean peso (in a context of multilateral depreciation of the dollar and favourable terms of trade associated with copper prices) and from rising labour and energy costs. However, we also see that these effects have been to some extent offset by lower borrowing costs (external, in particular) and by a deepening in the market of exchange-rate hedges.

In order to estimate the evolution of competitiveness in Chile, we have constructed indicators for industry as a whole and also for the different industrial sub-sectors<sup>4</sup>. The indicators are based on official figures from the unit value index of industrial exports (industrial IVUX measured in USD), the nominal exchange rate and our best estimate for an index of unit labour costs (ULC) in the sector concerned (for further details see the upcoming Economic Watch).

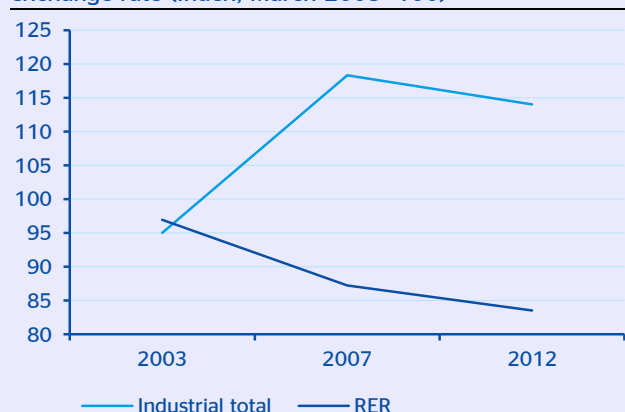
Our indicators suggest in aggregate terms that industry displayed an upward path of competitiveness gains in the period 2003-2007 (which we estimate to be around 24.6%), only to turn downwards again sometime around 2012 (fall of 3.7% in the period). In this context, industry has succeeded in raising its competitiveness by close to 20% in the period 2002-2012 according to our indicator, despite the difficulties encountered in the post-Lehman era. This is in striking contrast to the evolution of the multilateral real exchange rate (used as a measure of the economy's aggregate competitiveness), which appreciated by 10% over the period 2003-2007 and an additional 4.2% to 2012, making a fall of 13.8% for the period as a whole (Chart B.2.1).

In this context, the appreciation of the nominal exchange rate in recent years due to multilateral depreciation of the dollar would have been the key factor underlying the observed decline in competitiveness. In addition to the above, labour costs have risen sharply as a consequence of the change in the make-up of local growth, which ended by putting pressure on the use of domestic resources (Chart

B.2.2). This change was due to a major expansion of domestic demand, driving industries that are relatively intensive in their use of skilled labour. However, the change in the composition of growth, resulting in a significant expansion in both investment and consumer spending, conceals a wealth effect in terms of more favourable terms of trade resulting from high copper prices.

Chart B.2.1

#### Aggregate industrial competitiveness vs. multilateral real exchange rate (Index, March 2003=100)



Source: INE, Central Bank of Chile, BBVA Research

Chart B.2.2

#### Aggregate and industrial labour costs (% YoY change)



Source: INE, BBVA Research

4: The indicator used to measure competitiveness is based on the construction of a real exchange rate for the different sub-industries based on the following definition for the Competitiveness Index (IC):

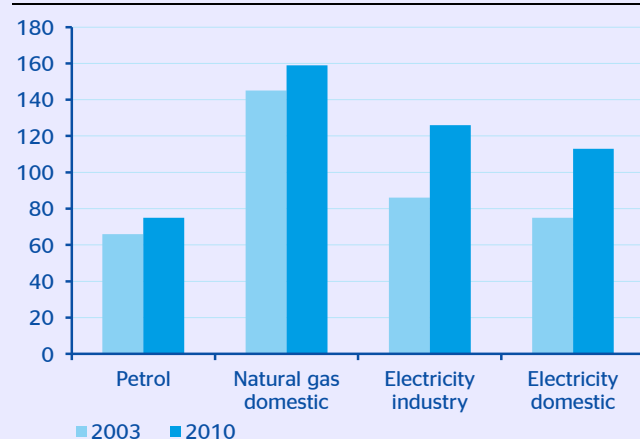
$$IC_i(t) = \frac{E(t) * IVUX_i(t)}{ULC_{Industry}(t)}$$

Where E is the nominal exchange rate. Seasonally adjusted quarterly series for industry IVUX and ULC. Further details in forthcoming Economic Watch.

While these factors can be related to transitory phenomena, a structural element also exists which compromises the outlook for industrial competitiveness over the next few years. This is the expected evolution of energy costs (Chart B.2.3). The energy sector has had difficulty in materialising investments in recent years, mainly as a consequence of environmental issues as a result of which numerous new projects have run aground in the courts.

Chart B.2.3

Energy prices in Chile (Dollars at market exchange rate, OECD median price index = 100)



Source: International Energy Agency, BBVA Research

The Chilean economy needs not only a relatively weaker peso, but also the continuation of a higher exchange rate over time. This would correct a significant part of the recent loss of competitiveness, leaving the reduction of energy costs as the real challenge

Finally, an alternative interpretation of the situation links a significant part of the loss of competitiveness to the bonanza in commodity prices, which placed the economy in a highly favourable cyclical position (i.e. excellent terms of trade), resulting in the appreciation of the peso, high investment and demand for labour in the mining industry, transferring the rise in labour costs to other non-conventional export sectors. However, we believe that this phenomenon (the so-called *Dutch disease*) is now coming to an end.

Regardless of the cause (whether global depreciation of the dollar due to the monetary cycle in the USA or appreciation of the Chilean peso because of a commodity-driven supercycle), we believe that investment may be expected to turn towards those sectors that have so far lagged behind as the decline in value in the Chilean peso becomes permanent and the investment cycle in the mining industry reaches maturity. In this regard, we understand that the Chilean economy needs not only a relatively weaker peso but also the continuation of a higher exchange rate over time. Hence, a significant part of the recent loss of competitiveness could be recovered and the challenge then would be to reduce energy costs while defending the progress made in logistics infrastructure in the light of the recent port strike (Table B.2.1).

Table B.2.1

Logistics performance, main competitors for Chilean industrial exports (Scores from 1 to 5)

	2007		2010		2012	
	Index	Ranking	Index	Ranking	Index	Ranking
Chile	3.25	31	3.09	48	3.17	38
Mexico	2.87	54	3.05	49	3.06	46
Argentina	2.98	44	3.10	47	3.05	48
Peru	2.77	58	2.80	66	2.94	59
Colombia	2.50	80	2.77	71	2.87	63
Latin America*	2.65		2.84		2.83	
South Africa	3.53	23	3.46	27	3.67	23
Canada	3.92	10	3.87	14	3.85	13
Australia	3.79	17	3.84	17	3.73	18
Norway	3.81	16	3.93	10	3.68	21
New Zealand	3.75	19	3.65	20	3.42	30
World	2.74		2.87		2.87	

\*Latin America reflects a simple average for Argentina, Bolivia, Brazil, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela. Note: The general score in the Logistics Performance Index reflects perceptions of a country's logistics based on the efficiency of the clearance process, the quality of trade and transport related infrastructure, ease of arranging competitively priced shipments, quality of logistics services, ability to track and trace shipments, and timeliness of shipments in reaching their destination within the scheduled delivery time. Scores vary between 1 and 5. A higher score represents better performance. The data are obtained from Logistics Performance Index surveys performed by the World Bank in association with academic and international institutions, private firms and individuals involved in international logistics. Source: World Bank, BBVA Research.

## 5. The current account reaches sustainable levels

### Contained external vulnerabilities in a *sell-off* scenario of emerging economies

In an international scenario in which questions have been raised about the vulnerability of some emerging economies, we see Chile in a strong position. Observing the composition of foreign debt, Residual Short-Term External Debt (RSTED) has increased, but it nevertheless represents a small proportion of Total External Debt. Thus, RSTED represented 40% of total debt in 2007 but has fallen to 33% in 2013. This indicates that much of the growth in foreign debt has a term of more than one year.

Observing liquidity indicators, it appears that the ratio of financial RSTED to dollar funds has recovered in the post-Lehman era, but only to levels similar to those of 2007 (Table 5.1). At the same time, some deterioration in solvency indicators may be observed since 2008, but once again they have recovered to levels below those of 2007. In this context, our evaluation is that the structure of foreign borrowing is healthy. From an international perspective, meanwhile, Chile's RSTED as a percentage of its international reserves remains at an intermediate level between the emerging economies with floating exchange rates and other smaller advanced economies. Furthermore, it was in fact Foreign Direct Investment that was mainly responsible for the sharp rise in foreign liabilities, together with the increase in the current account deficit post-Lehman, which has slowed significantly in recent quarters (see details in the next section).

Table 5.1  
**Solvency and foreign liquidity indicators**

	2007	2008	2009	2010	2011	2012	2013
(Billions of dollars)							
Total Foreign Debt	76	64	72	84	99	118	121
RSTED	30	28	26	30	40	40	40
(% of GDP)							
Stock of Foreign Assets	81	83	107	106	104	109	112
Stock of Foreign Liabilities	94	98	120	120	117	126	129
(% of total)							
<b>Structure of Foreign Liabilities</b>							
Foreign direct investment	55	58	60	61	60	61	61
Equity portfolio	7	5	7	8	7	8	9
Fixed income portfolio	4	6	6	8	10	10	11
Other	34	30	28	23	23	21	19
(Percentage)							
<b>Solvency</b>							
Total Foreign Debt / GDP	49	32	37	37	38	42	43
Total Foreign Debt / X	133	85	112	103	104	116	128
<b>Liquidity</b>							
Financial RSTED/ (NIR+SWF) (*)	55	45	51	55	53	56	57

(\*) Financial RSTED: excluding commercial loans and loans between companies due to foreign direct investment.  
Source: Central Bank of Chile, BBVA Research

One mitigating factor which should be mentioned with regard to external risks is the entry into force of the Single Funds Act. This law was enacted in November 2013 and it establishes a series of new incentives for foreign investors. In the case of investors who are not resident in Chile (foreign investors), a new tax of 10% on dividend distributions and capital gains obtained on public funds and mutual funds has been established to replace the Additional Tax. This law will probably come into force after the enactment of the necessary secondary legislation, which will establish a series of applicable regulations. The risk is that Chile may attract an inflow of foreign capital within the framework established in the Single Funds Act, but this will continue to be conditional on the absence of emerging economy *sell-off* risks associated with the external risks described in Section 9.

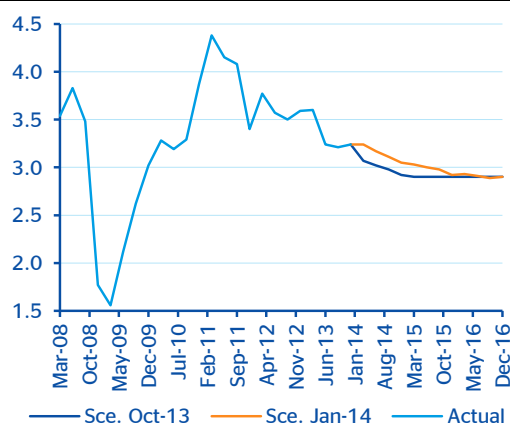
### The estimated current account deficit is revised downwards from 4.6% to 3.0% of GDP in 2014. We forecast a deficit of 2.8% of GDP in 2015. This correction is explained by the deceleration of domestic demand, mainly investment, and rising exports

We have significantly corrected our forecast of the current account deficit for both last year and this, which we now expect to shrink. This new assessment is based on the adjustment in the structure of growth, which reflects a smaller contribution from investment and an increase in exports. As a consequence, convergence towards sustainable levels, which we estimate at around 2%-3% of GDP, will accelerate over our forecast horizon. The inherent risks of depreciation have crystallised intensely, and the slowdown in domestic demand is more than obvious. Overall, these factors will help to remove any risks associated with current account sustainability.

Furthermore, we have made a small adjustment to the average price of copper for the period 2014-2015 (from USD3.00 to USD3.14 per pound in 2014, and from USD2.90 to USD2.98 per pound in 2015), which will provide additional support for the balance of trade. However, we maintain our estimate of convergence towards a price of USD2.90 per pound in the long run (Chart 5.1).

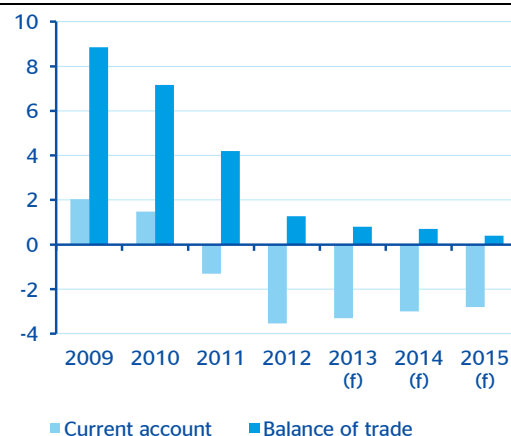
In this context, we forecast a current account deficit of 3.0% of GDP for 2014 (equal to USD8.2bn), significantly below the deficit of 4.6% of GDP forecast earlier, and we see a further reduction in the deficit to levels of around 2.8% of GDP in 2015 (Chart 5.2).

Chart 5.1  
Forecast copper price (US\$ per pound, average)



Source: Chilean Copper Commission, BBVA Research

Chart 5.2  
Trade balance and current account balance (% of GDP)



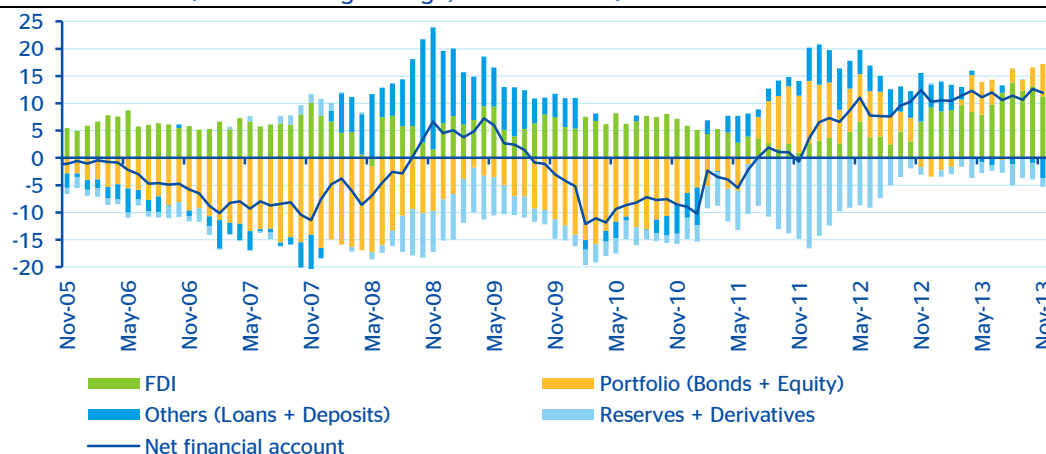
Source: Central Bank of Chile, BBVA Research

The current account deficit continues to be financed mainly by FDI. The impact of tapering consists of restrained portfolio outflows and limited effects on the cost of external borrowing. Meanwhile, the domestic cost of funding will be particularly sensitive to capital outflows from local institutions

Observing the figures in the financial account, we find that net financing has stabilised around an annual average of USD12bn with Foreign Direct Investment (FDI) as the principal source of funds (Chart 5.3). The evolution of funding via FDI will continue to be linked to the outlook for the country's growth, which means that it is particularly sensitive to the outlook for copper prices, given the high concentration of FDI in the mining sector, and in this light we expect it to converge gradually towards its long-run value.

Chart 5.3

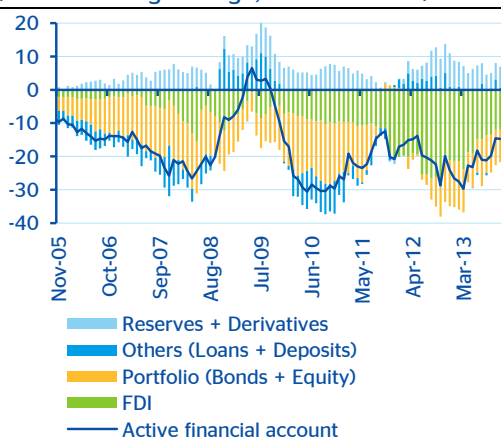
Financial account (annual moving average, billions of USD)



Source: Central Bank of Chile, BBVA Research

Nevertheless, a net outflow of USD1.7bn occurred in November 2013, mainly affecting portfolio investment (for USD2.6bn) and partially offset by FDI inflows of USD0.9bn. In this context, we anticipate a reduction in non-resident inflows (in November 2013, the annual moving average inflow displayed a fall of 17.8% with respect to the cumulative total for November 2012), which has so far been offset by smaller outflows of resident capital (Charts 5.4 and 5.5).

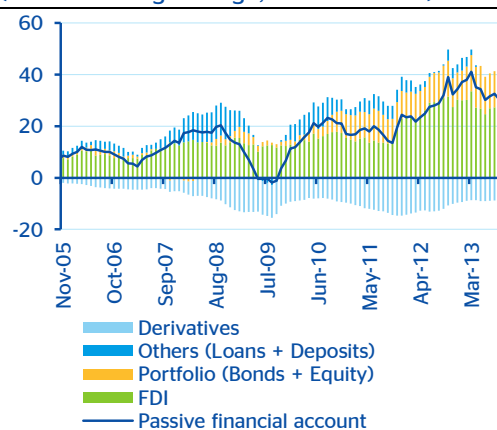
Chart 5.4

Financial account: Resident flow  
(annual moving average, billions of USD)\*

\*A positive (negative) balance implies an inflow (outflow) of resident capital

Source: Central Bank of Chile and BBVA Research

Chart 5.5

Financial account: Non-resident flow  
(annual moving average, billions of USD)\*

\*A positive (negative) balance implies an inflow (outflow) of non-resident capital

Source: Central Bank of Chile and BBVA Research

In a base scenario of orderly tapering, the pattern of smaller foreign portfolio inflows could continue in the long run, an effect that could only be contained by further depreciation of the currency. In this regard, we see the recent depreciation of the peso as healthy, because it is precisely this automatic adjustment mechanism which guarantees equilibrium in the balance of payments and, in particular, in short-term portfolio flows. In addition, we believe that the risk of contagion from other more vulnerable economies like Brazil should be taken into account.

Because of the above, it seems that the strategies of resident institutional investors will not only play a role in financing the investment needs of local firms but will also affect the cost of financing. A scenario including significant capital outflows on the part of institutional residents will put upward pressure on the cost of local borrowing, given that local institutional agents provide around 14% of bank funding sources.

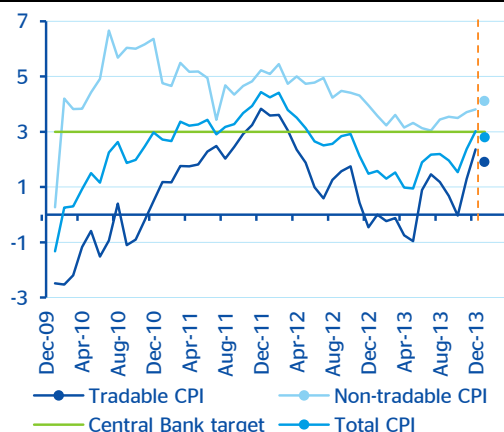
To conclude, we do not see any risks associated either with the deficit or with the way in which it is financed. However, it is foreseeable that the supply of funds will move abroad (in particular towards developed economies enjoying sustained recovery), while demand for financing, though somewhat lower given the slowdown in investment, could shift to the domestic economy. This structure for the direction of flows would generate greater pressure on local financial resources, inevitably driving up local financing costs, which would have to be offset by making limited cuts to the monetary policy rate in the baseline scenario.

## 6. Inflation will not come under significant pressure in 2014, converging toward the target of 3% in 2015

### **Inflation will stay moderate in 2014 due to widening capacity gaps, reduced pressure on wages, a limited transfer of exchange rate depreciation and low international inflation**

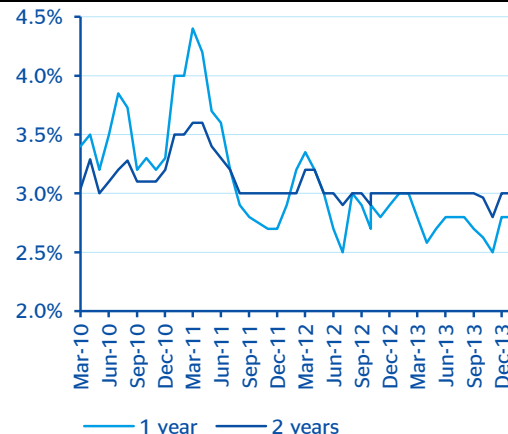
Inflation ended 2013 at a YoY rate of 3%, in line with the Central Bank's target but higher than expected by us, the market or indeed the Central Bank itself (Chart 6.1). Between November and December, the CPI registered a cumulative rise of one percentage point, as a consequence of shocks affecting specific prices, which combined with the impact of the rising exchange rate on the prices of imported goods and services. After the publication of the inflation rate for November and December, those inflationary expectations which had shown signs of downward pressure, resulting in surprise cuts in the monetary policy rate, again began to converge with the central bank target (Chart 6.2).

Chart 6.1  
Inflation measures\* (% YoY)



\*The dotted line marks the start of a new basket of goods 2013=100.  
Source: Central Bank of Chile, INE and BBVA Research

Chart 6.2  
Median inflation expectations, Financial Operators Survey (% YoY)



Source: Central Bank of Chile, BBVA Research

The low inflation registered in the early part of last year was largely due to the deflationary impact of tradable goods. This in turn echoed the low exchange rate, but also the methodological problems recognised in the calculation of the CPI, in particular with regard to the measurement of garments and footwear. However, this changed in the second half of the year with the depreciation of the peso and as a result of methodological changes made by the National Statistics Institute (INE) in the measurement of garments, which were reflected in a reduction in the deflationary impact of this item on the total CPI. As a result, the tradable goods CPI rose by 2.9 percentage points between June and December (Chart 6.3).

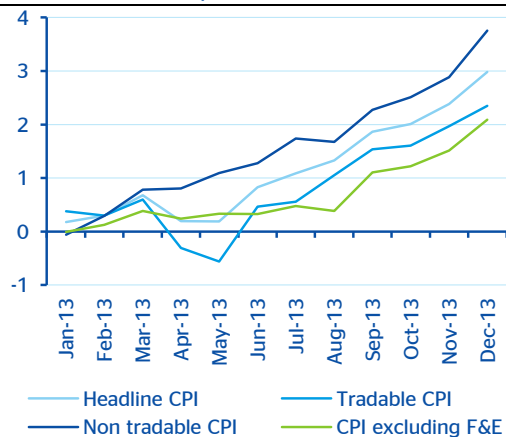
Another key aspect of inflation in 2013 was the rise in underlying inflation (CPI excluding food and energy) in the second half of the year. Until June, average monthly variations were close to zero, and twelve-month increases were below 1%, but in the second half of the year underlying inflation gathered pace, ending the year on 2.1% YoY. Though still in the lower part of the tolerance range for the inflation target, the increase in underlying inflation indicates that the rise in inflation in the second part of 2013 went beyond the usual volatility caused by food and energy prices in the total CPI, and it may reflect second-round effects and the recovery of margins.

The information available for the first two months of this year indicate that the CPI for January was driven by rising gasoline prices, new cars and lemons, although these increments were partially offset by falling prices for fruit and vegetables, garments and footwear. Increases in the prices of gasoline products and new cars will be offset in February by cuts in mobile telephony access charges, which came into force in late January and which we believe will shave almost one decimal point off the CPI for February and 0.25 percentage points off the annual inflation rate.

We do not see significant inflationary pressures for the rest of 2014, and we maintain our forecast of 2.6% YoY in December. While we will see increases in the year-on-year rate of inflation in the first half of the year due to the low basis for comparison, we estimate that inflation will fall below 3% in the second half of the year (Chart 6.4).

Chart 6.3

## Cumulative monthly inflation for 2013 (%)



Source: INE, BBVA Research

Chart 6.4

## CPI inflation and BBVA projections for 2014 (% YoY)\*



\*The dotted line marks the start of a new basket of goods 2013=100.

Source: INE, BBVA Research

Various factors support this view of inflation, including on the one hand the fact that the economy will continue to grow below its potential as domestic demand slows, and therefore inflationary pressures are not foreseeable from this quarter. In this regard, we anticipate a less tight labour market, in particular in view of the expected slowdown in investment, and a higher rate of unemployment and slack demand in the mining industry, which will result in an additional reduction in wage pressures.

On the other hand, we believe that the depreciation of the peso has probably already materialised, in line with the assumption made in our base scenario for the exchange rate, and although there will be some additional transfer to consumer prices over the next few months, any perceptions of a permanent fall in the value of the peso that may arise will do so in a context of a greater output gap. Finally, from an international standpoint, the outlook for the developed nations and for the Chinese economy suggests that imported inflation will be restrained this year, and some deflationary risks have even emerged. In the absence of unforeseen supply-side *shocks*, the most likely macroeconomic scenario is consistent with contained local inflation fluctuating around the monetary authority's target rate over the course of the year.

We forecast that inflation will converge on the central bank's target of 3% YoY in 2015. This forecast is consistent with projected GDP growth around the potential and with the conduct of monetary policy in 2013-2014, which will inject the necessary stimulus to meet the target. In this scenario, expectations of inflation will remain anchored to the target of 3% YoY, and no significant inflationary pressures will arise either in the labour market or from abroad, because international inflation will also be restrained and because the exchange rate will not undergo any significant adjustments.



## 7. Monetary policy: major monetary stimulus in the short term

**We maintain our forecast for a monetary policy rate of 4% with two cuts of 25 basis points, although cuts in the reference rate will be brought forward. One of these will be agreed at the meeting in February**

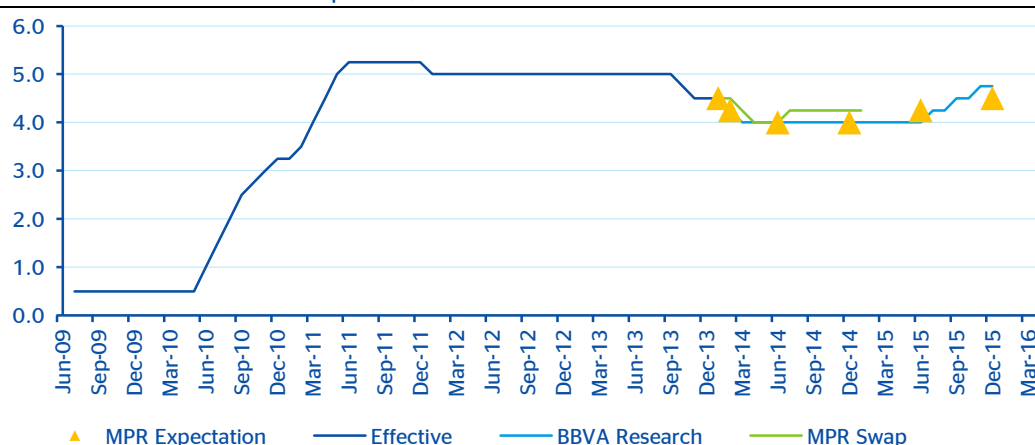
In order to comprehend the changes that have occurred in monetary policy in recent months, we may recall the Central Bank's baseline scenario, which was set out in its December Monetary Policy Report (IPoM). On this occasion, the Central Bank estimated that the economy would grow at a rate of around 4.25% (mid-point of the projection range) and that the monetary policy rate would reach 4.25% in a context of annual inflation of 2.5%.

The closing figures for 2013 challenged the Central Bank's baseline scenario in two ways. In the first place, business activity figures for the latter months of 2013 were weaker than expected, causing downward corrections in the outlook for growth this year, while inflation was higher than anticipated in November and December. The Central Bank reaction to this news was to recognise that the business and demand scenarios were weaker than had been assumed in the base scenario, and to treat the inflationary *shock* as temporary. In this context, and in the light of a scenario of low international inflation, the Central Bank maintained the monetary policy rate at the January meeting, but introduced an expansionary bias in its monetary policy, which was interpreted by the markets as showing that the reference rate would be below the 4.25% established in the latest IPoM.

As explained in the relevant sections, we have not made any changes to the base scenario presented three months ago in this Report, whether in terms of business activity or inflation at the end of the year, and on this basis we still expect the monetary policy rate to fall to 4%. However, we expect an larger overall monetary stimulus than we had assumed in November, because we believe that the Central Bank will bring forward cuts in the monetary policy rate (MPR) to 1Q14 (Chart 7.1).

Chart 7.1

Actual MPR and BBVA forecast (percent)



Source: Central Bank of Chile, Bloomberg, BBVA Research

Given the Central Bank's announcements, it is highly likely that a fresh cut of 25 basis points will be agreed at the February meeting. This additional cut could be made as soon as March, although we believe that this will depend on international developments, especially with regard

to the emerging economies and impacts on the Chilean economy. The evolution of the exchange rate will be especially relevant in this regard, because any additional depreciation of the peso could change the inflation scenario. Meanwhile, the short-term figures available to the Central Bank at that date (poor performance of the Imacec indicators for January and low CPI for February) would make March a likely candidate for a new cut in the MPR. If these forecasts materialise, a total cut of 100 basis points will have been made since the start of the expansionary monetary policy cycle, whose impact will be felt in the second half of this year given the usual lag in the effects of monetary policy measures.

Meanwhile, the actions taken by the Central Bank to generate a monetary stimulus that will allow inflation to converge on the target rate of 3% go beyond the two cuts in the monetary policy rate and the announcement of further cuts. Thus, we consider that the January announcement that no long-term debt instruments would be issued this year is intended to help restrain any increases in long-term interest rates in a context of gradually rising international interest rates.

Looking forward, it cannot be ruled out that further cuts will be made in the MPR in addition to those considered in our base scenario, but these would be conditional upon a further weakening of the economy and/or the crystallisation of any of the risks described in this Outlook Report, a scenario that we see as unlikely based on the information available to date.

Finally, we forecast that monetary policy will begin a gradual process of normalisation towards neutral levels (estimated at between 5.25% and 5.75%) in the course of 2015, to the extent that the economy converges on its potential growth rate and inflation stays around the Central Bank's target rate. A key factor will be the start of the process of raising interest rates in the USA, which we expect to begin in the second half of next year. In this regard, any eventual delay in the normalisation of monetary policy in the Chilean economy with regard to the USA could cause unwanted effects on capital flows and the exchange rate, which the Central Bank will need to consider in its decisions.

## 8. Fiscal policy: public spending set to grow above 6% in 2014

### **Significant under execution in Budget expenditures in 2013 and increased structural revenues due to the higher exchange rate will create room for growth in public spending above the rate of GDP growth in 2014**

If the macroeconomic scenario described in this Situation Report is considered instead of the scenario established in the Budget Act, effective tax revenues will be lower. Thus, our scenario assumes lower growth in GDP and domestic demand than the Finance Ministry, reducing tax revenues. The Central Bank and the consensus have recently shifted towards our forecast for growth in 2014, which means that the revenues projected by the government in this respect in October now look optimistic. However, the recent depreciation of the peso will significantly offset the negative impact of slower growth. Meanwhile, the revenues received by the Treasury in dollars, mainly consisting of transfers from private mining concerns and Codelco, will increase sharply. In this light, we estimate that the government's effective revenues for 2014 will be below the budgeted figure by just 0.1% of GDP (Table 8.1).

Table 8.1

**Differences in forecasts for variables affecting 2014 tax revenues**

	<b>Ministry of Finance</b>	<b>BBVA Research</b>
GDP (% YoY change)	4.9	4.0
Domestic demand (% YoY change)	5.4	4.5
Average inflation (%)	3.0	2.9
Average exchange rate (peso per dollar)	522	548
Average copper price (dollar cents per pound)	325	314
Effective reduction in revenues compared to Ministry of Finance forecast (% of GDP)	-	<b>0.1</b>

Source: Chilean Ministry of Finance, BBVA Research

The higher average exchange rate expected in 2014 will increase dollar-denominated tax revenues by more than USD800mn. Given the current situation of a depreciating peso and the authorities' determination to prevent additional upward pressure on long-term interest rates in a context of economic slowdown, we see room for the Treasury to decide on a financing mix based to a greater degree on the liquidation of dollars and less on debt issues. This could make it unnecessary to issue the total USD6bn in long-term debt announced at the beginning of the year.

Meanwhile, the incoming government, which will take the reins in March, is committed to a tax reform which, as planned, would increase tax revenues by USD8.2bn, or 3% of GDP. Though information on the details and implementation of this reform is still lacking, the measures expected to have the largest effect on tax receipts are mainly related to income taxes, and they would have an impact only in 2015 or 2016, depending on the specifics of the Act. The tax measures which might have an impact this year, such as the increase in stamp duties or the change in specific value added taxes, would raise tax revenues by considerably less than the total estimated effect.

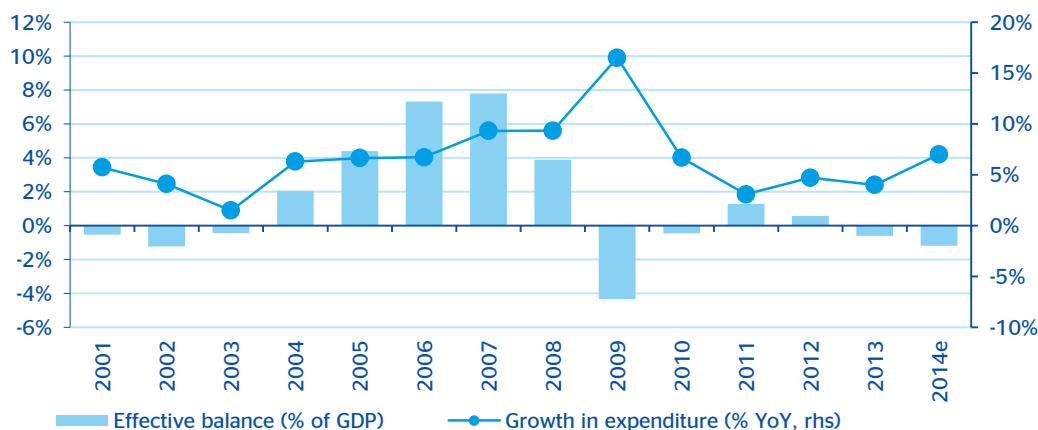
We may recall here that Chilean fiscal policy is guided by the rule of Structural Balance, according to which the cyclical changes in GDP and the copper price must not affect structural revenues, unlike inflation and the exchange rate, among other variables, that actually affects estimates of structural fiscal revenues. In view of these effects, we consider that structural revenues this year will be higher than budgeted by some 0.3% of GDP. Given the target of 1% of GDP for the structural deficit, these larger structural revenues allow more room for public spending.

Public spending grew by 4.0% in 2013 in real terms, significantly less than the 5.9% announced by the government in October of that year, and the expenditure approved in the Budget Act for the current year therefore implies a larger annual increment, given the lower basis for comparison.

Consequently, we expect total central government spending to grow by more than 6% this year, the largest such increase since 2010, due to both the smaller basis for comparison and the room for manoeuvre provided by the rise in structural revenues. However, this assumes 100% budget implementation and the absence of Codelco capitalisations. On this basis, the effective balance would be around -1.2% of GDP (Chart 8.1).

Chart 8.1

## Growth in spending and effective fiscal balance



Source: Chilean Ministry of Finance, BBVA Research

As explained on previous occasions, it is possible that the incoming government will choose not to meet the target of 1% of GDP for the structural deficit, a decision that would not be incompatible with the commitment to converge on a structural balance in 2018. If this turns out to be the case, growth in spending could be even greater in 2014.

Finally, another factor which might increase structural revenues this year, and consequently the room for spending, would be the introduction of methodological changes to measure the structural balance, as proposed by the Fiscal Council or implemented by the incoming government.

Looking forward to 2015, we expect public spending to continue to grow faster than GDP. However, a more precise forecast will depend on a series of factors which are still unknown. On the one hand, it is likely that the independent experts in charge of determining long-term parameters (copper price and potential GDP growth), will adjust their estimates downwards, which would allow less room for spending next year, all else being equal. We may recall, however, that the incoming government will announce a tax reform which will begin to generate additional revenues as of 2015, doing so with increasing intensity over the following two years, and this will also create room to raise spending above the level established by the benchmark parameters. Meanwhile, the incoming authority will have to define its approach to convergence with the structural balance, and we would not rule out a process including higher deficits in the early years and faster convergence towards the end of the period once the tax reform is in place. The possibility that the structural deficit may be relatively higher in the early years is another way in which the incoming government could provide itself with room for manoeuvre.

## 9. Risks: economic slowdown in China and a faster-than-expected fall in business expectations

**The current account deficit has narrowed significantly, mainly because of the deceleration in domestic demand. A larger-than-expected slowdown in China is the main external risk, together with the effect of tax reform on expectations**

The situation in the developed world has continued to stabilise, assisted by renewed commitments by the monetary authorities to provide support and macroeconomic successes. In particular, parts of Europe still face major economic challenges connected with tax consolidation and regulation of the banking system, although these will take place in a more benign financial atmosphere given the continued outbreaks of uncertainty and volatility. The developed world's exposure to monetary risks involves the need to calibrate the monetary stimuli needed on an appropriate basis to prevent unwanted deflationary effects. In this context, the crystallisation of deflationary risk would put pressure on local monetary policy. This is a situation which is not, however, inconsistent with the foreseeable change we anticipate for the TPM in the medium term.

Meanwhile, the risk of a hard landing for the Chinese economy has diminished, although there is still a danger of a sharper deceleration than assumed in our base scenario. Markedly lower growth linked to excessive corporate indebtedness could have consequences for the copper price. At the same time, it will need to restructure its growth sources further and to resolve certain vulnerabilities in the financial system. Finally, eventual additional restrictions on overcapacity in industry would also have a major impact on demand for copper. Overall, China remains the main external risk for the Chilean economy. An abrupt fall in the copper price beyond the decline assumed would affect the contribution of exports to growth, jobs directly and indirectly linked to the mining sector and the fiscal and external accounts, among other matters, and it could jeopardise net capital inflows and worsen the terms of the foreign borrowings which are crucial to Chile.

An idiosyncratic risk has emerged in Chile which was not fully visible in our last Situation Report. Following Michelle Bachelet's election victory in mid-December 2013, the new government will implement a tax reform, the main aspects of which were discussed in Box 1 of the 3Q13 Situation Report. Given that a significant part of tax receipts would come from the partial or total, gradual or immediate, elimination of the tax benefits allowed in the form of credits for retained earnings (FUT in the Chilean acronym), the potential impact on private investment has, unsurprisingly, become a source of uncertainty. Moreover, this has happened in a scenario of slowing investment in mining, which had enjoyed a historic boom in recent years ( "*A historic investment boom in Chile Economic Watch*"). In this context, the risk is that decisions affecting the implementation and timing of the tax reform, the details of which have still not been announced to date, will have a greater impact on investment than assumed in the base scenario.

## 10. Tables

Table 10.1

### Annual macroeconomic forecast

	2011	2012	2013	2014	2015
GDP (% YoY)	5.9	5.6	4.0	4.0	4.5
Inflation (% YoY, eop)	4.4	1.5	3.0	2.6	3.0
Exchange Rate (vs. USD, eop)	517	477	529	552	556
Interest Rate (% eop)	5.25	5.00	4.50	4.00	4.75
Private Consumption (% YoY)	8.9	6.1	5.5	4.3	6.3
Government Consumption (% YoY)	3.0	4.2	3.6	4.8	4.6
Investment (% YoY)	14.7	12.3	3.8	3.8	4.7
Fiscal Balance (% GDP)	1.3	0.6	-0.6	-1.2	-0.9
Current Account (% GDP)	-1.3	-3.5	-3.3	-3.0	-2.8

Source: BBVA Research

Table 10.2

### Quarterly macroeconomic forecast

	GDP (% YoY)	Inflation (% YoY, eop)	Exchange Rate (vs. USD, eop)	Interest Rate (%, eop)
Q1 12	5.1	3.8	485.4	5.00
Q2 12	5.7	2.7	505.6	5.00
Q3 12	5.8	2.8	475.0	5.00
Q4 12	5.7	1.5	477.1	5.00
Q1 13	4.7	1.5	472.5	5.00
Q2 13	4.0	1.9	502.9	5.00
Q3 13	4.7	2.0	504.6	5.00
Q4 13	2.7	3.0	529.5	4.50
Q1 14	3.1	2.8	554.0	4.00
Q2 14	3.9	2.9	542.0	4.00
Q3 14	4.1	2.8	549.0	4.00
Q4 14	4.7	2.6	552.0	4.00
Q1 15	4.8	2.7	551.6	4.00
Q2 15	4.3	2.8	553.2	4.00
Q3 15	4.4	2.9	554.8	4.50
Q4 15	4.6	3.0	556.1	4.75

Source: BBVA Research

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