Economic Outlook

Chile

Third Quarter 2013
Economic Analysis

- **The global economy is showing a cyclical weakening,** above all in emerging markets, and is facing more difficult financial conditions.
- **Growth in Chile has shown clear signs of slowing down with a GDP expansion that would reach 4.2% y/y in 2013.** In 2014, we estimate an expansion of 4.4% y/y, lower than expected three months ago.
- **The risk of an increase in the current account deficit has grown and represents the main risk in the medium term for the economy.** We forecast a 4.6% deficit in 2013 and an increase towards 5.1% of GDP by the end of 2014.
- **Inflation has been affected by temporary shocks.** The inflationary boost due to the devaluation of the peso, the increase in the price of fuels and the absence of transitory deflationary shocks makes us maintain an inflation forecast of 2.5% at close of 2013.
- **The Central Bank would reduce the Monetary Policy rate to 4.25%.** We do not currently consider bigger cuts consistent with the recovery in the inflationary trend, the high current account deficit and the still dynamic private consumption.

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Closing date: August 2, de 2013

1. Summary

The composition of global growth continues with significant levels of heterogeneity. The United States shows a slow but steady recovery, and the possible withdrawal of the non-conventional monetary stimulus is already being discussed. In Europe, fiscal adjustments have continued and growth would show a recovery in the second half of the year, but at a slower pace than in the USA. In China, the economic downturn is stabilizing and we expect that its contribution to global growth will be somewhat lower than estimated a few months ago. The financial credit terms have worsen for the emerging markets in the face of a contained reversion of capital flows, in response to the downturn in those economies and to the signs of withdrawal of the non-conventional monetary stimulus in the USA.

In Chile, economic activity has been more sluggish than anticipated, and our expectations of growth have been corrected from 5% to 4.2% for this year, and from 4.7% to 4.4% for the next year. In addition, due to the lower than expected growth in China for the 2013-2014 period, we have changed downward our expectations of the average price of copper for the following years. In particular, we expect an average price of around USD 3.24/pound this year and USD 2.95/pound next year (vs. USD 3.45/pound and USD 3.26/pound, respectively). The above, combined with the slowdown of the local economy, have depreciated the exchange rate significantly with respect to our initial forecast. In this context, we raise our expectations for the exchange rate towards closing figures of $514 and $524 per dollar for 2013 and 2014, respectively. We have also corrected our current account deficit forecast from 3.8% to 4.6% for 2013 and from 4.2% to 5.1% for 2014.

Inflation will start to recover following the disappearance of transitory deflationary shocks. After a first half of the year with inflation below the projections, the second half of the year will present a recovery in the inflationary trend that makes us maintain our inflation forecast for the closing of 2013 at 2.5%. The recent devaluation of the peso will support the convergence of inflation – particularly of tradables- to the center of the target range by mid-2014.

The Central Bank would reduce the monetary policy rate (MPR) to 4.25% at the most. These cuts would materialize in the coming months, and the rate would remain at that level for the whole of the first half of 2014. We do not consider additional cuts consistent with our base scenario, particularly in view of the worsening of the current account deficit, the increase in the inflationary trend and the still narrow labor market.

The public sector has continued with a high pace of budget execution from a historical point of view that will lead to an expansion of fiscal spending of around 7% at the close of 2013. Lower tax receipts associated with 2012 due to a reduction in collection from companies will lead to a bigger effective deficit estimated at 1% at the close of 2013. The structural deficit remains as initially budgeted at levels of 1% of GDP. Towards 2014, we expect our view of lower expansion of fiscal spending to be confirmed due to downward estimates for trend GDP and the long-term price of copper for 2014, which we estimate will decline to 4.8% and USD 2.9/pound, respectively. Thus, the deficit would reach a 0.7% of GDP in that period.

The risks in this baseline scenario come from two fronts, with intensities somewhat different from those forecast previously. On the one hand, domestic risks are associated with a somewhat lower growth as a result of a more significant downturn in private consumption. On the other hand, more significant declines in the price of copper are not to be ruled out if there is a bigger downturn in growth in China. In this latter case, a greater increase in the current account deficit may require curbing measures in the fiscal and monetary areas.

2. Global environment: Slowdown in China and uncertainty about the withdrawal of the monetary stimulus in the U.S.

The global economy is showing cyclical weakness, above all in emerging markets, and is facing more difficult financial conditions

The global economic situation is less favorable than it was three months ago, when we issued our previous growth forecasts. We have therefore revised down our global GDP growth outlook to 3.1% in 2013, 0.2 percentage points below the forecasts three months ago. For 2014, we maintain our expectations of continued expansion, in this case at 3.8%, 0.2 pp below the figure we forecast in the last quarter. At least two reasons lie behind this deterioration and the resulting revision of our forecasts. First, the emerging markets are experiencing a sharper slowdown than expected, reflected in a greater downward revision of its growth forecasts (Chart 1). Above all, they include more moderate growth in China, due to its global implications beyond Asia, for example on the South American economies. Second, there has been an unexpected event, at least at the time when it occurred: the tightening of financial conditions at global level. This increased stress has basically been the result of market reaction to the communication of the details given by the Fed of its steady reduction and subsequent reversion of the third round of its quantitative easing program.

Making the markets used to less liquidity: the greatest impact will be on emerging economies with bigger short-term financing needs

Although the reasons for this may be varied, most of the shift in financing conditions at global level took place in mid-May, with the details announced by the Fed of its plans to limit and then put an end to its program of monetary expansion. The Fed has also reaffirmed its commitment to maintaining interest rates very low for an extended period and, perhaps more importantly, the whole process is conditional on economic recovery: i.e. on the economy continuing at "cruising speed".

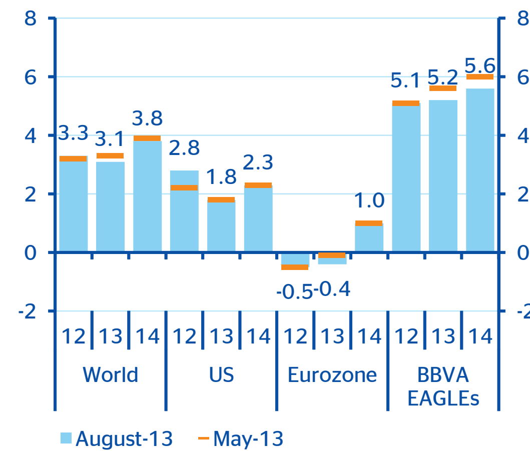
However, market reaction to this plan (even after being clarified in all its details) has been stronger than probably desired by the Fed. As can be seen in Chart 2, long-term interest rates increased by more than 100 basis points, while futures now discount the first rise in the monetary policy rate for the start of 2015, practically one year before expected two months ago. In our opinion, what is being seen on the financial markets is probably partly an over-reaction, as shown by recent downward moves in both long-term rates and expectations of shorter-term rates. Even so, the implementation of the mechanism has generated a process of restructuring of portfolios in the face of the end of abundant liquidity, and thus of extra demand for bonds that kept interest rates at exceptionally low levels. In our opinion, therefore, we are being faced with the start of a cycle of normalization of financial conditions, with higher interest rates and lower demand for risk assets.

Emerging markets have been most affected by the recent upsurge of financial stress. Currently the situation has clearly reversed the positive funding conditions prevailing previously, with capital outflows from emerging markets (Chart 3). As well as falls in the stock markets and bond prices, there has also been a general depreciation in their currencies.

There are various factors behind these major capital outflows. As well as an immediate anticipation of the new global liquidity scenario through a restructuring of portfolios, the cyclical weakness of some large emerging markets and the growing risk of a steeper slowdown in China are factors pointing in the same direction. Moreover, monetary expansion in Japan has done little to generate the expected capital flows to emerging markets in search of higher returns.

Overall, however, although the rate of capital outflow from emerging markets is very high, there are reasons for optimism. First, the most recent data on capital flows show more moderate outflows over recent weeks. Second, the profile of investors who have headed up the outflows is of a shorter-term investment horizon, compared with institutional investors with longer-term horizons. Finally, the portfolio reorganization has to take into account that if we are moving towards an environment of lower central-bank support for liquidity, this is because the global economic cycle is tending to improve. We should also not forget the fundamentals that emerging markets have constructed in terms of their policy certainty and comparative advantages against the most developed countries with respect to their solvency ratios.

Chart 1
GDP growth in the main regions



* EAGLEs: Emerging and Growth-Leading Economies. The group is made up of China, India, Indonesia, Brazil, Russia, Korea, Turkey, Mexico and Taiwan.
Source: BBVA Research

Chart 2
Yield on 10-year US public debt (%)

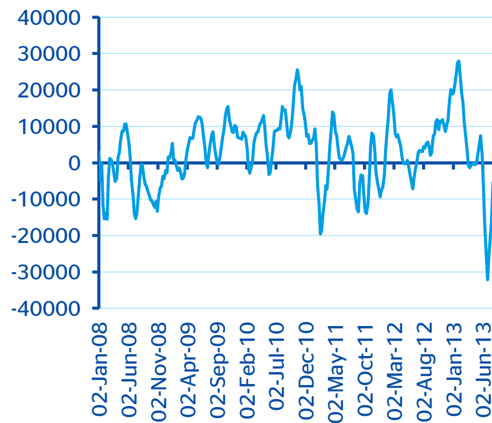
Source: BBVA Research and Bloomberg

Slowdown in China: sluggish external demand and steps to limit indebtedness and the scope of shadow banking

The recent tightening in the Chinese interbank lending market is an example of the side effects of the Chinese authorities' efforts to limit rapid credit growth, both in the official banking sector and the credit generated by the shadow banking, which is unregulated. The commitment of the authorities to achieve this goal has been made clear over recent months, as they have notably allowed a liquidity squeeze in the interbank system.

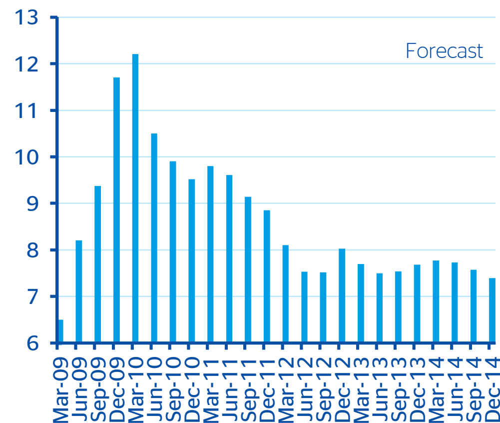
The baseline scenario is still one of a continued moderate slowdown (Chart 4). The measures taken to limit credit growth will act as a constraint to some extent, but even so, the Chinese authorities appear comfortable with the current GDP growth rates, as they are the result of changes that make for more sustainable (and quality) medium and long-term growth. Even so, we still consider that the government has room for maneuver if the growth slips below the official targets. The authorities have the instruments to prevent any accident to the financial system, at least in the short term, and we do not rule out new economic stimulus measures.

Chart 3
Capital flows to emerging markets (USD million, moving four-week average)



* Capital flows to fixed-income and equity.
Source: BBVA Research.y EPFR

Chart 4
China GDP growth (y/y %)



Source: BBVA Research and CEIC

More diversified global risk events, but with less potential impact

This highly likely global baseline scenario still has some uncertainty ranges somewhat more tilted to the downside than to the upside, but with no high probability of disruptive events that would prevent an outlook of, at least, sustained global growth in 2013 and 2014 near 2012 levels. This diagnosis is a sign of a return to normality in the economic landscape.

The downside risks that could once again delay global recovery (relatively less likely than on other occasions) would basically be the persistence of events that complicated the outlook last quarter to the point of generating additional tensions in the conditions for accessing finance and a decline in the confidence of the economic agents. This could be: i) a new, intense and continued fall in the price of risk-less assets like the U.S. Treasury bond as a result of a market less compliant with the wishes of the Federal Reserve; ii) a resurgence of doubts about the progress towards banking union and the "exceptional nature" of Greece; and iii) a sharper downturn in the Chinese economy amid its necessary process of economic rebalancing and adjustment of the size of its financial system. Although it is true that the authorities have room for maneuver to prevent "tail" events, the process of change faced by China is notable and requires extensive, ongoing and decisive reforms.

3. Chile: Growth for 2013-2014 is corrected downward to 4.2% and 4.4%, respectively

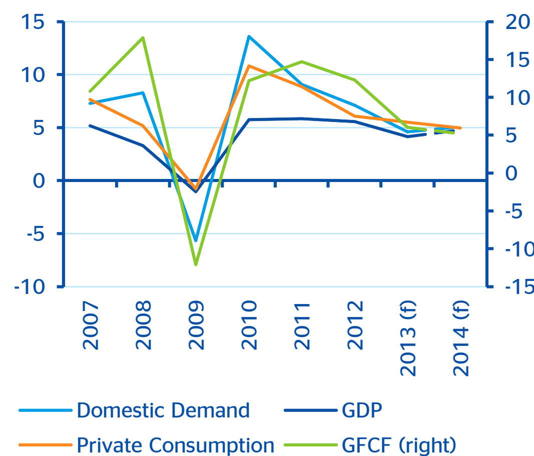
The incipient signs of an economic downturn seen during the first quarter in investment have also been detected in the manufacturing sector. However, private consumption and government spending are still showing a significant expansion pace

GDP in the first quarter of 2013 grew 4.1% in annual terms, while in the second quarter it would grow less than 4% annually. These figures were below our baseline scenario and explain a large part of the correction of GDP expansion from 5.0% to 4.2% for the close of 2013. As regards economic activity, the downturn in spending was due mainly to investment, although this component would show a recovery over the next few quarters with the completion of

mining and energy projects that have seen a slowdown in the engineering work related to support tasks (Chart 6). The level of imports of capital goods is down, although they continue to be high. Dynamic consumption continues to be supported by favorable labor conditions, with unemployment rates closer to their all-time low and personal income growing at high rates. Consumer confidence has seen marginal declines -somewhat higher in business confidence-, while the Bank Lending Survey shows more restrictive conditions in supply and demand, mainly in construction and real estate activities (Chart 7).

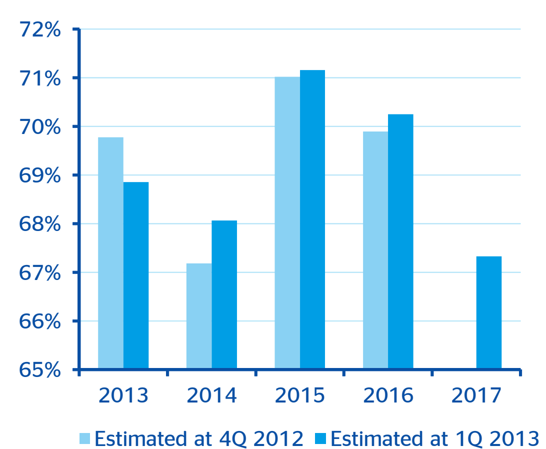
The manufacturing industrial activity has substantially moderated its expansion, mainly in sectors more linked to foreign demand, while the food sector continues to benefit from the persistent growth of basic consumer goods. In this context, supermarket sales continue to grow at a pace above their historical averages. Durable goods consumption also continues to be strong, particularly focused on cars and electronics.

Chart 5
Domestic demand: consumption, investment and GDP (y/y % change)



Source: BCCh and BBVA Research

Chart 6
Investment plans in mining and energy (% of total)



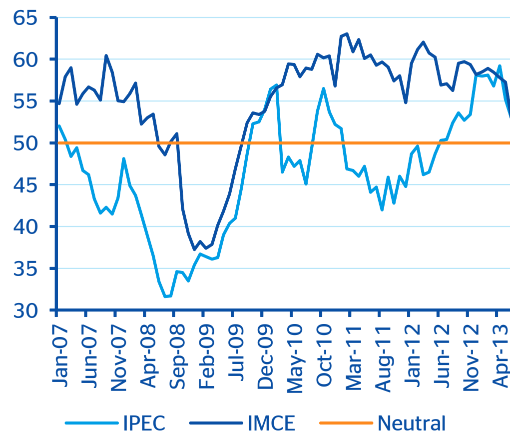
Source: Corporación de bienes de capital

After the acceleration of economic activity and spending in 4Q12, a moderation on the supply side has been observed that was to some extent attributed to the political announcements related to the tax reform (see Box 1). However, a large part of the slowdown is explained by phenomena linked to the flagging in the execution of scheduled mining projects and a less dynamic industrial sector. The discussion about the possible overheating that was maintained at the beginning of the year has given way to concerns about a bigger slowdown and the possible need for an additional monetary stimulus. Regarding forecasts for the year, the estimate for GDP growth is adjusted significantly from 5.0% y/y to 4.2% y/y, with a lower contribution from investment and private consumption, while investment would reduce its growth to 6.0% y/y (see Table 1 at the end of the document). However, domestic demand would bring its growth closer to GDP expansion, growing 5.3% y/y in 2013 (Chart 5).

The labor market has continued to create jobs, although in a counter-seasonal way. Job losses in agriculture and real estate have been offset by the creation of jobs in construction and the retail sector. However, the unemployment rate remains at levels that allow the labor market to be described as still narrow (6.2% in the April-June quarter), with real wages growing at a real annual rate of 5% (Chart 8).

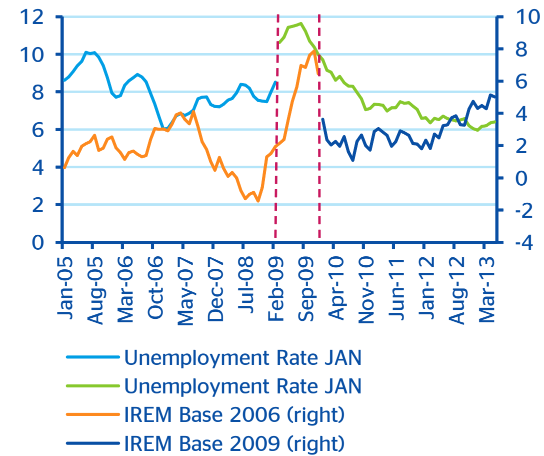
Regarding the foreign sector, exports would grow 2.7% y/y in 2013. Part of the slowing down in shipments seen in the first quarter was due to stoppages caused by strikes at ports in March, a situation that was quickly brought back to normal. However, imports would grow 5.7% y/y, with a negative contribution from the foreign sector to GDP growth, and increasing the current account deficit during this year.

Chart 7
Consumer and Business confidence (Index)



Source: BCCh and BBVA Research

Chart 8
Unemployment rate and real remuneration index (%, y/y % change)*



* The dotted line shows the start of the application of new base and methodology.
Source: National Institute of Statistics and BBVA Research

For 2014, we expect a slower convergence of growth towards the potential. This is the reason why we corrected GDP expansion downwards from 4.7% to 4.4%. Meanwhile, domestic demand will continue to slow down, with private consumption and investment growing 5.0% and 4.8%, respectively. This downturn, combined a weaker Chilean peso in real terms, will make imports lose strength and grow 4.4%. Lastly, toward 2014 exports will benefit from a more depreciated real exchange rate and greater global growth compared with 2013, expanding 4.5%.

Box 1. Announcements of tax reform

With presidential elections scheduled for November this year, it is worth looking at the tax programs of the candidates who have more chances of being elected. In particular, within the country's political spectrum, that envisages two big coalitions disputing the executive power, only the opposition to the current administration proposes substantial changes regarding taxes. This block, self-named Nueva Mayoría (New Majority) and led by Michelle Bachellet (MB), has included in its agenda changes to the tax system that, according to their calculations and under full operation, would make it possible to collect around 3% of GDP. Alianza por Chile (Alliance for Chile), that represents the incumbent block and at the statistical close of this report had not yet named its presidential candidate, would not present relevant proposals regarding taxes.

Thus, we will focus on how the proposal of candidate MB, who leads the surveys, expects to raise structural revenue for the treasury of around 3% of GDP. The latter are mainly focused on funding an educational reform and closing the government's current structural deficit. Below we describe in general terms the main elements behind the changes to the tax structure:

Income tax: In general terms, the proposal is based on a rebalancing of the tax burden, raising the tax rates for companies and reducing it for individuals. In this context, the first proposal that has generated debate is the elimination of the FUT (Tax Profit Fund), a mechanism that takes into account the profits made by companies but that have not been withdrawn by their owners, but rather reinvested within the company or alternately in some investment instrument in the financial system. Currently, the withdrawal of profits from the FUT pays the first-category tax for the 20%; however, in the consolidation of income and settlement of taxes for individuals (global complementary), they receive as a credit the tax paid by the companies in which they participate as owners. In

this sense, the current mechanism makes it possible to postpone the payment of taxes as long as those profits are reinvested, generating a support and incentive for investment. Additionally, under the FUT scheme, the companies would obtain a source of finance less costly than the alternative of resorting to the financial system. It is worth mentioning that the proposal for the elimination of the FUT would not be retroactive for companies that still have accumulated balances, but it would come into effect from the fourth year of government, when the companies would pay taxes on all the profits generated and not only on the ones they withdraw. Additionally, as regards income tax, the proposal includes a gradual increase in the tax paid by the companies (or first category) from the current 20% to 25%. Lastly, the reform envisages a reduction in the marginal rate of the people income tax for the upper band of income, reducing the current 40% to 35%. It is estimated that these measures will result in collection of around 1.92% of GDP.

Incentives for savings and investment: Given the negative effects that the elimination of the FUT could generate on investment, the reform incorporates a compensation mechanism of instant depreciation from the fourth year. In this way, the companies could discount from the tax base all the investments made in one year. Additionally, a tax exemption is included for capital gains by individuals who save in financial instruments, up to a maximum corresponding to the return of a risk-free asset. However, it is estimated that these measures will generate a reduction in tax revenue of around 0.21% of GDP.

Measures to support SMEs: Extend the base of companies that can pay taxes based on simplified accounting. For this, relaxing the requirement of sales below 5,000 UTM has been proposed for all those that obtain sales below 14,500 UTM. On the other hand, there is a proposal to eliminate simplified tax schemes, for example, the taxation of presumed income, among others, mechanisms that encourage the under-declaration of benefits. Lastly, in order to solve a liquidity problem that SMEs face when paying VAT, there are plans for the scheme to incorporate the interaction of SMEs as suppliers of big companies. In general, large companies pay their suppliers (not only SMEs) within 90 days, while the liquidity needs to pay VAT are every 30 days. Thus, as a measure to reduce the difference in the duration of short-term assets and liabilities in SMEs, large companies will be required to be responsible, in part, for the monthly VAT that small companies owe. It is estimated that these measures will generate a reduction in tax revenue of around 0.18% of GDP.

Corrective taxes and elimination of exemptions: As a measure to correct externalities, there are plans to encourage the purchase of fuel-efficient vehicles through a tax proportional to the cylinder capacity and differentiated according to the type of fuel used. Another measure is the elimination of the refund of the diesel-specific tax in the industrial sector (SMEs would be excluded from this amendment). There is also a proposal to change the current tax on alcoholic beverages with a specific one equivalent to 20 UTM for every 100 liters of pure alcohol. Along this same line, there are plans to replace the current cigarette tax (a fix amount) with a specific tax per quantity. Within two years, the stamp duty would be raised from the current 0.4% to 0.8%, while SMEs will continue to recover this tax by deducting it from the monthly VAT payment. Lastly, the proposal envisages the elimination of two tax exemptions, the first one related to the preferential treatment of the real estate sector in VAT taxation. For this, all real estate transactions among construction companies, real estate agencies and other intermediaries would be taxed prior to the sale to the end consumer. There are also plans to restrict the current special VAT credit for construction companies, limiting it to homes with prices under 2,000 UF only. The second one is related to the elimination of the tax exemption for private mutual funds (PMF). It is estimated that these measures will generate revenue of around 0.97% of GDP.

Lastly, the proposal envisages implementing stronger controls to reduce tax evasion and avoidance, giving more powers and resources to the Internal Revenue Service. Revenue of 0.51% of GDP is expected to be collected with this measure.

4. Current Account Deficit: The main medium-term risk

Despite the downward correction in private consumption growth, the current account deficit shows an increase of 4.6% of GDP at the close of 2013 and 5.1% at the end of 2014. That is based on a lower average copper price expected for this year (from USD 3.45 to USD 3.24 per pound). The current account deficit's sensitivity to the price of copper is significant, and in one year we estimate it at USD 60 million for each cent of a dollar reduction in the average price

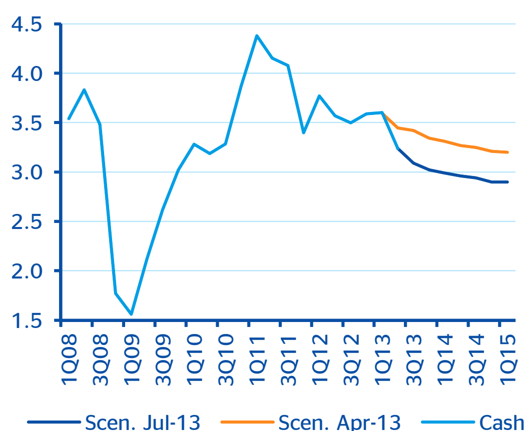
Some necessary adjustments have taken place in recent months to correct the increase in the current account deficit. In fact, the real exchange rate has depreciated in a context of a major decline in the price of copper (Chart 9). In addition, domestic demand has slowed down, which should contribute to reduce the deficit in the medium term. However, this risk becomes more relevant if the decline in the price of copper intensifies, foreign finance conditions get worse and private consumption remains dynamic.

In the first quarter, the balance-of-payments current account accumulated a negative balance of USD 1,690 million, equivalent to 4% of GDP in the last rolling year, and we forecast a current account deficit of 4.5% at the close of 2013. This deficit would increase towards 2014 due to a slower decline in consumption with respect to the available revenue, leaving the deficit at levels of 5.1% of GDP at the close of 2014 (Chart 10).

As to the financing of these growing deficits, as in 2012, foreign direct investment (FDI) would be the biggest source of flows, mainly in mining and in energy projects directly linked to that sector. The automatic adjustment of the current account deficit takes place through the revenue in the current account. Indeed, lower copper prices lead to lower revenue for the parent companies of foreign corporations that exploit the mineral. Our estimate is that considering such automatic adjustment, the current account deficit would increase by USD 60 million for each cent of a dollar reduction in the average price of copper, considering a 1-year period.

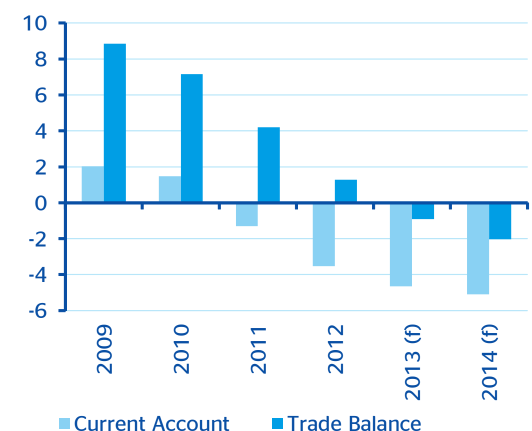
To conclude, the sustainability of the current account deficit is directly related to external inflation, long-term GDP and the level of international financial integration, measured as the net debtor position with respect to GDP. Our estimates regarding the sustainable level suggest that the Chilean economy could sustain a deficit of between 2% and 3% of GDP in the long term. Consequently, we consider that deficits like those seen recently and forecast in our baseline scenario are the main medium-term risk for the Chilean economy. Fiscal and monetary policy measures that allow a healthy convergence towards sustainable levels may be necessary in the coming quarters.

Chart 9
Copper price forecast (USD per pound, average)



Source: Chilean Copper Commission and BBVA Research

Chart 10
Trade and Current-account balance (% GDP)



Source: BCCh and BBVA Research

5. Inflation would recover in the absence of transitory deflationary shocks and the peso's devaluation

CPI inflation will show a strong rebound during the rest of 2013 supported by the recent devaluation, methodological adjustments by the National Institute of Statistics, the absence of transitory deflationary shocks and increases in the electricity rates. Consequently, we maintain our inflation forecast of 2.5% at the close of 2013 and 2.6% as of December 2014

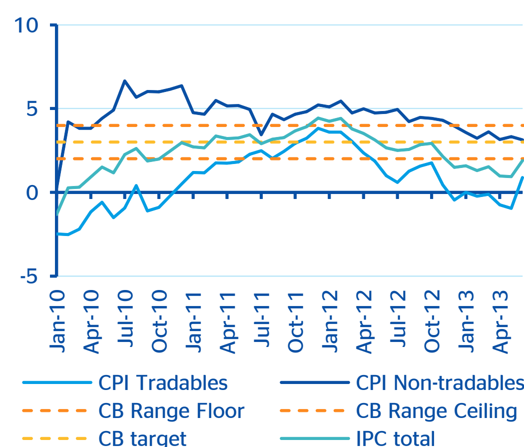
Inflation showed high volatility in the first half of the year in monthly terms, mainly impacted by electricity rates and other transitory shocks that led inflation to reach 1% in annual terms last May. In addition, the strengthening of the peso and the lower fuel prices seen during the first months reduced the inflationary concerns of the monetary authority.

In the above context, tradable goods inflation has been the main cause of the inflationary decline, which stood at 0.9% y/y in June, while non-tradable goods inflation remains in the center of the target range at 3,1% y/y, despite suffering the deflationary shocks of electricity rates (Chart 11). In any case, the underlying items excluding fresh food, regulated prices and indexed prices stand at levels below 1.3% y/y. We forecast that this favorable inflationary scenario will be impacted upward by the recent devaluation of the peso. Our estimates suggest that the inflationary transfer of the 7% of the peso's devaluation at the statistical close of this report will inject around 0.4% of inflation as of December 2013. However, we maintain our annual inflation forecast at 2.5% for 2013, somewhat higher than the figure reflected in the price of financial assets and analyst survey (Chart 12).

An aspect that also supports a better transfer of strong consumption to inflation is related to the methodological improvements in the CPI price basket. During the first half of the year, the National Institute of Statistics (NIS) announced revisions to the methodologies for measuring several products in the price basket. This methodological revision is part of the ongoing improvement processes undertaken by the institutes of statistics, and also takes advantage of the chance to incorporate the new Family Budget Survey which will be applied as of January 2014 (see Box 2).

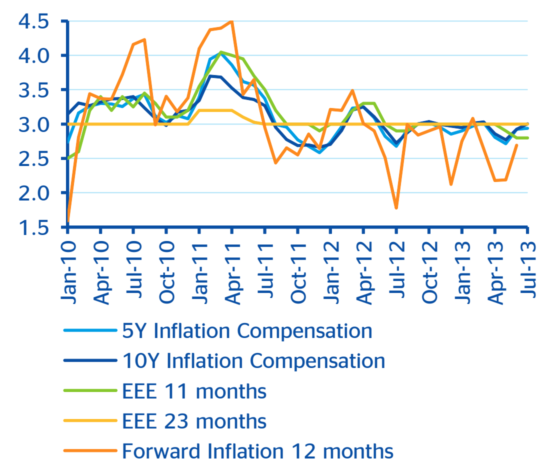
For 2014, inflation would converge with the target towards mid-year, although it would close with an increase of 2.6%. We are still considering a bigger contribution from the tradable component of CPI that would mostly include the transfer effects due to the devaluation of the exchange rate. In addition, the slowdown in economic activity would make it possible to relieve the underlying pressure of prices that is best included in the non-tradable component of the CPI basket.

Chart 11
Inflation measures (y/y % change)



Source: BCCh and National Institute of Statistics

Chart 12
Inflationary expectations, inflation compensation and inflation forwards (%)



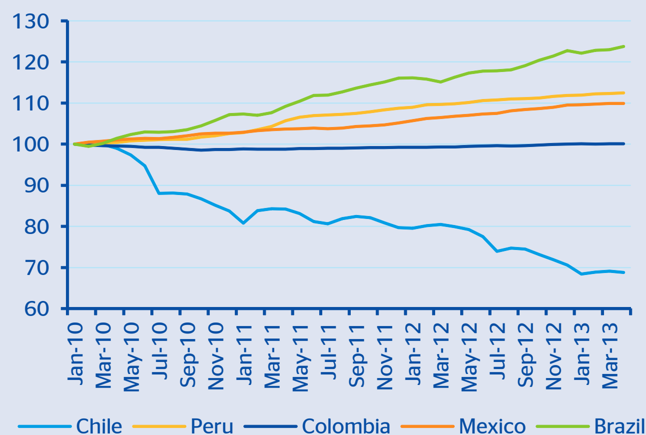
Source: BCCh and BBVA Research

Box 2. Methodological adjustments to the CPI

The National Institute of Statistics has undertaken a revision of the methodologies in order to correct the prices of several relevant products in the CPI basket. These improvements correspond to an ongoing process of methodological progress that takes place in all the statistical offices worldwide. After its application, a Consumer Price Index (CPI) in accordance with the best international practices is expected to be in place.

Clothing and footwear: This is one of the divisions whose methodology has been thoroughly revised by the National Institute of Statistics and the CPI Users Committee that was asked to participate in the revision process. The Committee held its first meeting at the National Institute of Statistics last May 7, where the current methodology for capturing prices was presented and the allocation methodologies for clothing used in France, Sweden, the United Kingdom and South Africa were shown. Problems such as the absence of application of quality adjustments for fashion were discussed. If the behavior of the clothing and footwear division is compared with other countries in Latin America, important differences can be seen. This has generated consensus with respect to the fact that the National Institute of Statistics is facing methodological challenges in this division (Chart 13).

Chart 13
Clothing: International comparison (Base January 2010=100)



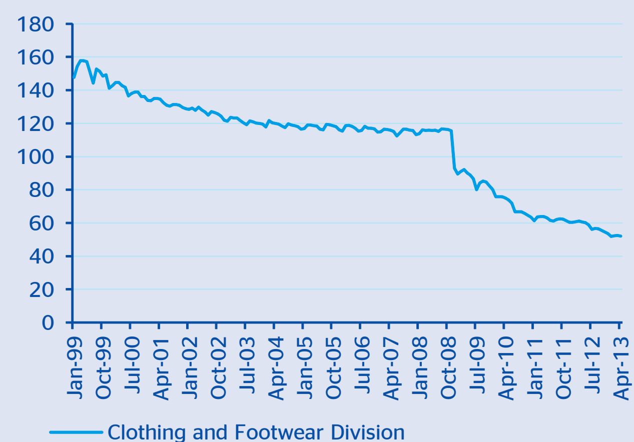
Source: National Institute of Statistics, DANE, INEI, INEGI, IBGE and BBVA Research

The methodological changes proposed involve providing the interviewers with clear and precise instructions regarding the product to be surveyed based on the most objective criteria possible. In addition, the time period is defined based on two large seasons of the year: Autumn-Winter from February to July and Spring-Summer from August to January. This criterion would be reinforced with the compilation of prices two months before and two months after each season, which would be subject to flexible representativeness.

The clothing and footwear division currently has a 5.21% share in the CPI basket. It is worth pointing out that in 2012 the division saw an 11.3% decline, concentrated mainly in the second quarter of the same year, registering an accumulated fall of 8.9% (Chart 14).

Lastly, these improvements will be implemented in the July CPI, published during the first days of August.

Chart 14
Prendas de vestir y calzado, cifras empalmadas (Base enero 2010=100)

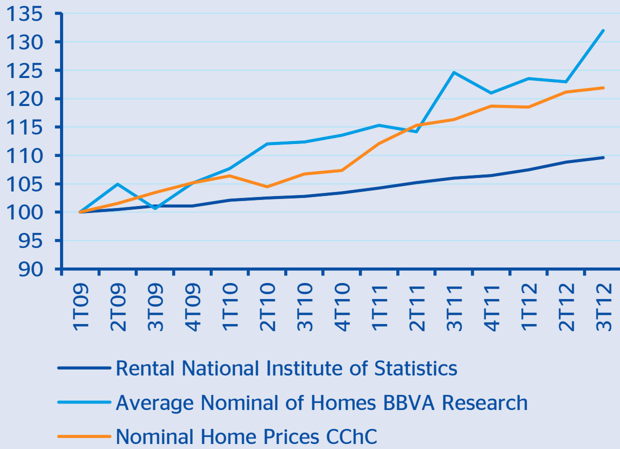


* The gray area corresponds to the start of the 2009 basket. The original series was considered for the connection up to December of that year.
Source: National Institute of Statistics and BBVA Research

Rental: The National Institute of Statistics and the Committee have detected the need to increase the size of the sample and to add to the measurement new rentals in the corresponding proportion. Under the current methodology, the values of rented homes are set by contract, so they differ from the market value for the same rental. The Rental product has a 3.87% share in the CPI basket and currently, in order to measure the effective rental through the survey, a random sample of homes that have declared the expense is considered.

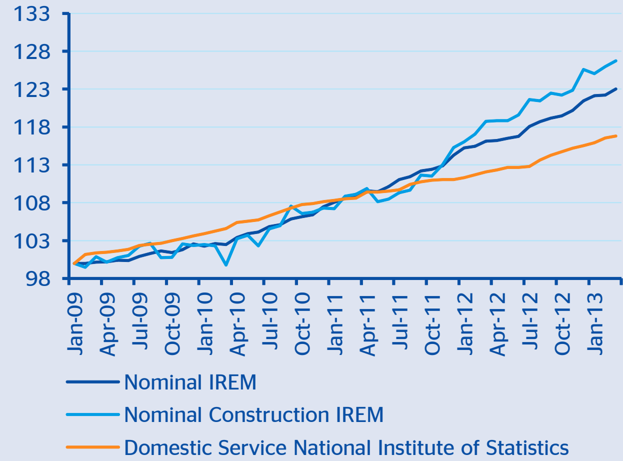
When conducting an analysis in nominal terms, the Rental has increased 10.5% from 2009 to 2012, while the value of the homes has increased 28% on average (Chart 15). Should Rental have had the same variation in the underlying asset, the gap would be approximately 0.7% monthly in that period. The proposals for methodological changes will be implemented as of January 2014, when the new basket starts being used.

Chart 15
Rental and home price changes
(Base January 2010=100)



Source: National Institute of Statistics, Chilean Construction Chamber (CCHC) and BBVA Research

Chart 16
Domestic service
(Base January 2010=100)



Source: National Institute of Statistics, BBVA Research

Domestic service: For this item, the National Institute of Statistics has stated that the methodology reflects well the variation of the index, and although it acknowledges the existence of the variance, it sees no signs of bias, so the adjustments will consist in increasing the sample size. Domestic service has a 2.26% share in the CPI basket and home surveys are conducted to measure its variation. However, it is possible to do a comparison with a labor-intensive service as the one seen in the Construction IREM. In nominal terms, from 2009 to 2012 the Domestic service index has grown 15.5%, while the Construction IREM and general IREM have grown 25.6% and 21.5%, respectively (Chart 16). The aforementioned proposal will be implemented in the base year 2013=100, i.e. from January 2014.

Insurance: The items that capture the prices of insurance would also be reviewed by the National Institute of Statistics in the light of the differences in their change with respect to the information collected from the financial agents that distribute and sell such insurance. Again, the adjustments would be implemented in January 2014.

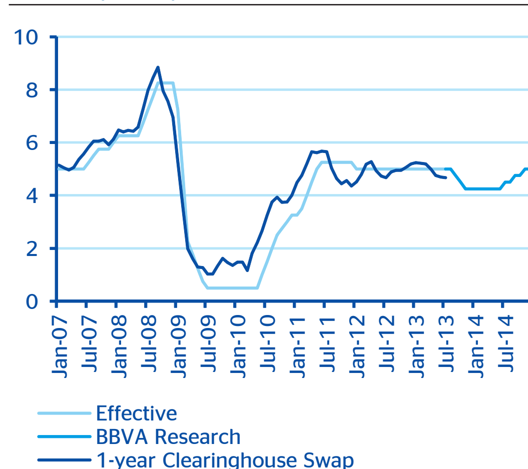
6. Monetary Policy with moderate cuts not beyond 4.25%

Monetary Policy has dealt with a balance of internal and external risks by maintaining the Monetary Policy Rate (MPR) at 5% since January 2012. Within out baseline scenario we have incorporated the bias towards a more pronounced monetary relaxing delivered by the monetary authority. However, we consider that the increase in the current account deficit, the recovery in the inflationary trend and the still persistent dynamic of consumption would leave room for cuts of no more than 75 bp. Towards 2014, and in particular in 3Q14, the contractive cycle would begin, closing the year at 5%

In its latest Monetary Policy Report (IPoM), the Central Bank delivered a scenario that considers 50 bp cuts, in line with private expectations at the time. The monetary policy meeting in July, prior to the statistical closing of this Outlook report, explicitly stated that the consolidation of the trends outlined in the last IPoM may require adjustments in the Monetary Policy Rate in the coming months. The price of the assets and the expectation surveys has internalized this message (Chart 17).

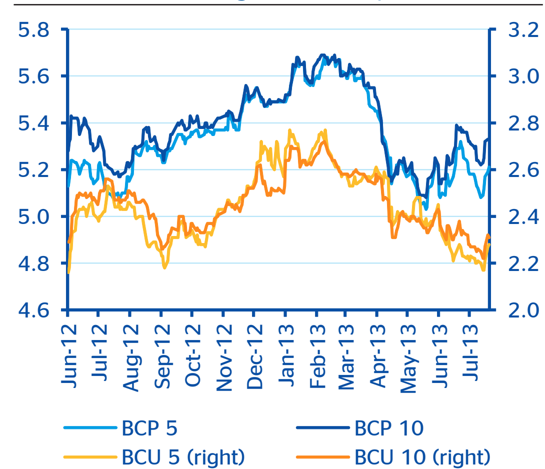
The Central Bank considers that the consumer confidence indicators and the more restrictive lending conditions would anticipate a slowdown in consumption. In addition, it considers that the current account deficit may tend to close in the medium term driven by the real devaluation of the peso and the lower dynamism of domestic demand. Our position is still agnostic regarding the need for more monetary stimulus, considering that the Monetary Policy Rate stands at the lower part of the estimates of a neutral MPR. However, we must acknowledge that the explicit intention of the Central Bank is to deliver more stimulus within the framework of fine tuning the monetary policy so as to narrow the distance with respect to the reference rates of other emerging markets, which has been an argument repeated in several of its statements (Charts 20).

Chart 17
Monetary Policy rate (%)



Source: BCCh and BBVA Research

Chart 18
Nominal and real long-term bond yield (%)



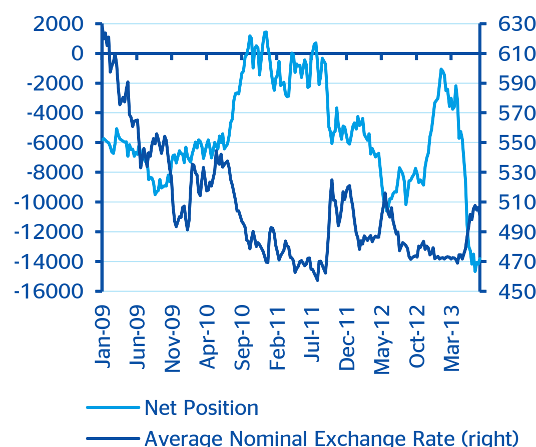
Source: Asociación de Bancos e Instituciones Financieras

In the above context, we modeled an MPR cut of no more than 75 bp in the policy horizon for the next 3 quarters that also supports our forecast of a 4.4% GDP expansion at the close of 2014. The beginning of the limited monetary easing cycle would start in September 2013, while the contractive cycle would start towards the third quarter of 2014, closing at 5%.

As we had anticipated in our Outlook report for 2Q13, the financial market has started to internalize the greater risk of withdrawal of the non-conventional monetary stimulus by the Fed. This phenomenon has occurred in a context of volatility, even though the upward impacts on the sovereign interest rates have been very moderate compared with other emerging markets, in part because of a message of the possible injection of monetary stimulus by the authority, and also because of the low internationalization of the sovereign debt compared with other emerging markets (Chart 18). In addition, we have observed appreciation impacts on the dollar at global level and capital outflows from emerging markets. In fact, in Chile we have seen capital outflows that sought to benefit from the interest rate spreads (carry trade) for approximately USD 10,000 million in the first half of the year (Chart 19). In addition, the local stock market has declined 14% in pesos and 21% in dollars since January 2013, influenced in part by portfolio capital outflows. Should there be an ordered scenario of withdrawal of the monetary stimulus in the United States during this second half of the year, justified by the consolidation of growth of that economy, together with a limited slowdown in local consumption, we consider that the Central Bank may reconsider its intention to cut the MPR or announce very moderate cuts.

Chart 19

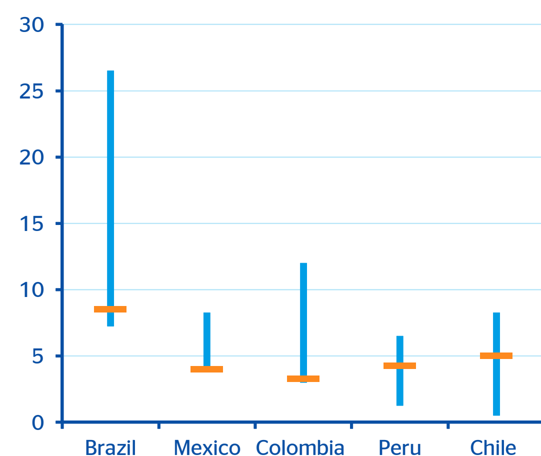
Carry trade and nominal exchange rate (Million USD, Pesos)



Source: BCCh, Haver and BBVA Research

Chart 20

Current Monetary Policy Rate in the region vs. historical range since 2001 (%)



Source: Haver and BBVA Research

7. Fiscal Policy: Spending is executed at a fast pace, with settlement of dollars and expansion that would end around 6% in real terms in December 2013

We forecast higher effective fiscal deficits for 2013 and 2014, reaching 1% and 0.7% of GDP, respectively. That is a result of lower tax revenue from mining and non-mining companies and a lower price of copper. The structural fiscal deficit would remain at 1% of GDP this year and the next one

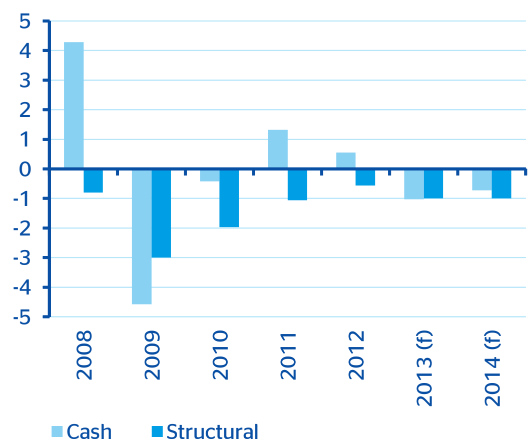
The fiscal balance reached a surplus of 0.6% of GDP in 2012 thanks to the good performance of private consumption and good results at a non-mining corporate level. In fact, revenue not related to mining increased 7% y/y, while the contribution from Codelco shrank 31% y/y.

In 2013, the Income Operation ended in April revealed a scenario with good receipts from items more linked to consumption, particularly VAT collection. However, unlike the previous year, taxation of non-mining companies was negatively impacted by lower profits, which are explained by the increase in the cost of labor, the increase in the cost of energy and the strengthening of the peso for those more linked to exports. This way, reported taxes shrank 17% y/y, leading our effective fiscal deficit forecast to be corrected from 0.3% of GDP to 1% of GDP at the close of 2013 (Chart 21).

In terms of budget execution, the state of the Central Government's operations as of June 2013 shows a real expansion of 6.8% y/y, with a revenue contraction of 5.6% y/y. The pace of fiscal execution is somewhat faster than that observed in previous years on the same date (Chart 22). In addition, there is the liquidation of dollars in May and June for approximately USD 4,200 million as a way to execute spending, leaving an estimated remainder of no more than USD 800 million according to our estimates.

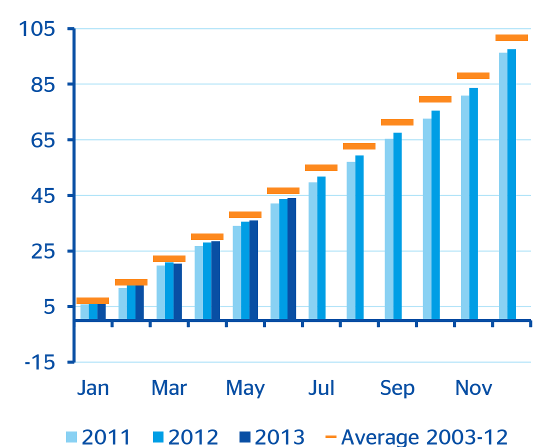
This scenario of lower revenue is explained by the aforementioned lower tax receipts. However, we expect spending to continue to grow strongly, consistent with an effective deficit of 1% of GDP, without missing the dual objective set by the Government 4 years ago. In fact, the Government suggested presenting an average real expansion of spending lower than GDP growth in the 4-year period, while respecting the structural fiscal deficit target of 1% of GDP. For 2013, this means that spending would not grow more than 6.7%, and the authority has already announced a real expansion of 5.9% as of December, a figure significantly higher than the forecast GDP expansion of 4.2%. Against this backdrop, fiscal spending will continue to contribute to the growth of domestic demand, but at a slower expansion pace during the second half of the year.

Chart 21
Effective and structural fiscal balance (% of GDP)



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

Chart 22
Government budget execution (%)



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

8. Balance of external and internal risks closely linked to the price of copper

The main risk is associated with a slowdown of the Chinese economy that has an impact on the price of copper. The impact on the external and fiscal balance would be significant, particularly if the convergence at lower levels in the price of the metal is abrupt

Despite the fact that Europe continues to be a source of external risk, the probability attached to extreme scenarios has continued to decrease. In the case of Chile, the most significant transmission channel for a crisis of this type continues to be its potential effect on the terms of trade and exported volumes.

After the widespread conviction that the Fed would gradually withdraw the non-conventional monetary stimulus in late 2013, which followed lower than expected growth figures in China in the first quarter, the price of copper fell significantly in relation to the levels seen in previous quarters. Against this backdrop, it is important to bear in mind the sensitivity of the fiscal balance and external accounts to the price of copper. We estimate that each cent by which the price of copper falls reduces the value of exports by around USD 120 million. The decrease in net revenue from abroad would mitigate the adverse impact on the current account and we estimate this figure at USD 60 million for each cent reduction in the price of copper.

As for the effect on the fiscal balance, a fall of one cent in the price of copper would involve around USD 50 million in lost revenue. Thus, a fall of 32 cents of a dollar over the year would lead to lower revenues of around USD 1,600 million. This factor alone would mean going from a situation of fiscal balance to a situation of deficit somewhat higher than half a percentage point of GDP.

In an adverse scenario, it is important to mention the significant fiscal and monetary room for implementing counter-cyclical policies, as well as the sound fundamentals of the financial and corporate sector. Taken together, they guarantee limited impacts on the economy.

Lastly, although the conditions for an adjustment of the current account deficit have started to take shape through the real devaluation of the peso and the slowdown of domestic demand, both have been relatively moderate so as to guarantee a convergence that allows preventive and/or extensive cuts to me made in the Monetary Policy Rate. Starting an expansive and/or significant monetary cycle in advance without seeing some dynamism in consumption with respect to the available revenue could lead to an increase in the current account deficit in an external scenario where the risks of additional falls in the price of the metal are still present.

9. Tables

Table 1
Annual macroeconomic forecasts

	2010	2011	2012	2013	2014
GDP (% y/y)	5.8	5.9	5.6	4.2	4.4
Inflation (% y/y, eop)	3.0	4.4	1.5	2.5	2.6
Exchange Rate (vs. USD, eop)	475	517	477	514	524
Interest Rate (%, eop)	3.3	5.3	5.0	4.3	5.0
Private Consumption (% y/y)	10.8	8.9	6.1	5.5	5.0
Government Consumption (% y/y)	4.6	3.0	4.2	4.1	4.9
Investment (% y/y)	12.2	14.7	12.3	6.0	4.8
Resultado Fiscal (% PIB)	-0.4	1.4	0.6	-1.0	-0.7
Cuenta Corriente (% PIB)	1.5	-1.3	-3.5	-4.6	-5.1

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	4.1	1.5	472.5	5.0
Q2 13	3.7	1.9	502.9	5.0
Q3 13	4.7	1.9	506.0	4.8
Q4 13	4.1	2.5	514.0	4.3
Q1 14	4.7	2.6	515.5	4.3
Q2 14	4.6	2.8	518.7	4.3
Q3 14	4.3	2.5	522.0	4.8
Q4 14	4.1	2.6	524.1	5.0

Source: BBVA Research

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