# Economic Outlook

## Chile

First Quarter 2013
Economic Analysis

- **The global economy** improved in the last quarter as global financial tension continued to ease.
- **In Chile, the factors that have boosted domestic demand are expected to moderate,** so GDP growth should reach 4.8% in both 2013 and 2014.
- **We see little room for a further fall in the price of tradable goods,** so inflation is forecast to return to its target range mid-way through 2013 and close the year at 2.8% y/y.
- **We estimate that the Central Bank (BCCh) will maintain its pause in 2013,** given the virtual balance between internal and external risks, although it has been rather more cautious in its statements in recent months.
- **The risks for the Chilean economy continue to be associated to a disruptive episode in Europe,** though the various measures adopted by the economic authorities in developed and emerging economies have reduced the probability of this scenario. In contrast, the idiosyncratic risk of overheating has become more relevant.

# Index



Closing date: Februrary 8, 2013

# 1. Summary

The perception of the global economic scenario has improved over the last quarter with the steady fall in global financial tension, above all in Europe, and with the agreement to avoid the "fiscal cliff" in the U.S. Global growth is expected to pick up from 3.2% in 2012 to 3.6% in 2013 and 4.1% in 2014, practically the same estimate as three months ago.

In Chile, economic activity surprised with growth above what was anticipated throughout practically the whole of 2012. This strength was partly because the external situation was more benign than expected, but above all due to growing consumer and business confidence about the current and future economic outlook and its impact on domestic demand. Some moderation is expected in the factors that have driven domestic demand, while the forecast of weak growth in foreign demand remains in place, so GDP should reach 4.8% in both 2013 and 2014.

Inflation closed at 1.5% year-on-year in 2012, below our forecast of 2.3% three months ago. This was due to the moderating effect of the tradable component of the CPI, which in fact offset practically all the buoyancy of the price index of non-tradable goods. Looking forward, the relevant question is whether there is room for the prices of tradable goods to continue offsetting the strong prices expected for non-tradable goods. We see little room for a continued fall in imported inflation, so we estimate that in 2013 inflation will close at 2.8% y/y, and reach the target of 3% y/y in December 2014. However, the most significant idiosyncratic risk continues to be the strength of domestic demand and the resulting increasing pace of inflation.

Despite statements that have been somewhat more cautious in recent months in the context of a virtual balance between internal and external risks, we expect the Central Bank to continue with its pause in 2013 and maintain the monetary policy rate at 5%, then begin a brief cycle of rises toward neutral levels in the first quarter of 2014. These rises are coherent with expectations of an incipient return to normal conditions in international liquidity and an adjustment of the real policy rate, given the convergence of inflation with its target.

The public sector had a surplus of 0.6% of GDP in 2012, despite reduced revenues from copper, supported by increased revenues from income tax and VAT from other sources. For 2013 and 2014 we expect a slight effective public deficit of 0.2% and 0.6%, respectively. The worsening figures will mainly be the result of a reduced contribution from mining taxes, while expenditure will increase in line with GDP growth. In addition, public savings amount to over 11% of GDP, allowing a significant capacity to respond in the event of a possible external deterioration.

The upturn in the price of copper in the last quarter of 2012 led to the current-account deficit being lower than expected. In 2013, we expect the price of copper to fall less than anticipated three months ago. This will offset the greater strength of domestic demand and imports. As a result, the estimated current-account deficit for 2013 will be 3.7% of GDP, somewhat less than the 4.1% forecast three months ago. For 2014 we forecast a renewed increase in the deficit to 4.2% of GDP, although these levels are expected to be financed through FDI.

Although the outlook for local economic activity is positive, the risks for the Chilean economy continue to be associated with a disruptive episode in Europe. However, the various measures adopted by the economic authorities in developed and emerging economies have reduced the probability of this scenario occurring. In contrast, idiosyncratic risks, in particular risk of the local economy overheating, have gained in importance.

# 2. Global economic outlook improves

## The global economic outlook improved in the last quarter thanks to the continual decline in global financial tensions, especially in Europe, and the agreement avoiding the so-called "fiscal cliff" in the US

Confidence indicators have picked up across all major economic areas and data for output and spending continue to point to limited global growth. Europe has seen financial tensions ease for six months now, with markets gradually, albeit not fully, offering funding to financial and non-financial businesses in certain peripheral economies in the euro area.

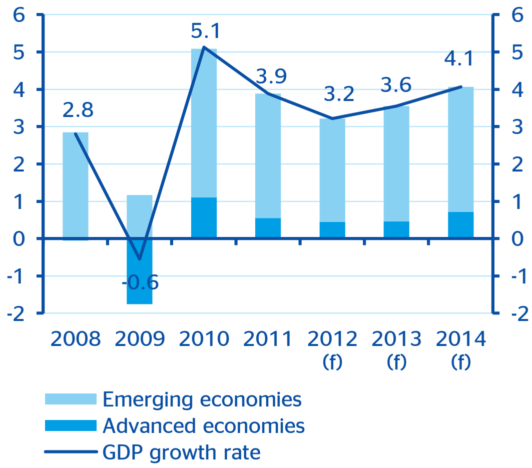
The mood in financial markets improved steadily in recent months thanks to three factors: (i) data show that China is not heading for a hard landing, as some analysts had expected; (ii) the US did not fall off the cliff and, in fact, its economy is withstanding uncertainty remarkably well; and (iii) Europe continued to progress towards a the banking union, reinforcing the commitment to preserve the euro.

Nonetheless, improvement in market perception does not make up for lack of improvement in fundamentals, and growth will remain weak in developed countries. Therefore, global growth is set to rise from 3.2% in 2012 to 3.6% in 2013 and 4.1% in 2014 - almost the same forecast as three months ago (Chart 1). In 2013, the downward revision of Brazilian growth and the unchanged scenario in the eurozone and the US should be offset by better forecasts for China, Mexico and some Latin American economies (Chart 2).

The recovery will only continue if the appropriate policies are implemented in the US and the eurozone. The US needs to do more than just soften the impact of imminent tax rises and should dispel any uncertainty surrounding debt repayment and how the burden of fiscal consolidation is to be shared. With respect to the eurozone, progress in governance, especially with respect to the banking union, must continue, both through additional agreements and the effective implementation of the agreements reached on banking supervision and resolution procedures.

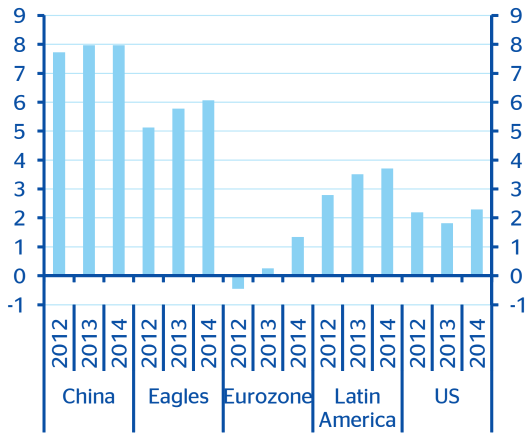
Although positive surprises are not out of the question, the uncertainty surrounding the global economic outlook looks set to remain high. Reduced global growth would be the consequence of increased financial tensions and a drop in confidence if doubts reappeared as to the European authorities' commitment to shore up the euro, which have been contained for now both thanks to the ECB's statement last July and the agreements reached between the countries in the eurozone in support of the single currency. If these tensions did emerge, new agreements on financial safeguards would be necessary and the recession in the eurozone would continue throughout 2013. The risk in the US would arise if the contagion arising from the European risk was added to the disagreements regarding fiscal consolidation or the debt ceiling. In that case, and with the support of emerging markets, the global GDP would range from 2.5% to 3% in 2013 and 2014. This risk scenario is less likely and the impact is lower than estimated three months ago. This is thanks to the progress that has been made in implementing policies in the most developed regions, and the resilience demonstrated by the emerging economies.

Chart 1
**World GDP growth rate**




Source: BBVA Research

Chart 2
**GDP growth rate**




(*) Eagles: Emerging and Growth-Leading Economies, emerging economies leading global growth. Included China, India, Brazil, Indonesia, Korea, Russia, Turkey, Mexico and Taiwan.
Source: BBVA Research

# 3. Chile: cruising speed growth in 2013

## Favorable terms of trade and high levels of confidence will maintain economic growth at around potential level

Throughout practically the whole of 2012 economic activity surprised with growth above what was anticipated at the start of last year. This positive performance was in part due to a more benign than expected external situation, but above all to growing consumer and business confidence with respect the current and future economic outlook. It is worth wondering in this respect why there was a general perception that domestic demand would inevitably be dragged down by weak foreign demand and result in a slowdown in growth. There were mainly two reasons: first, the experience of 2009, when the impact on confidence and domestic demand was much greater than expected; and second, even without a fall in confidence, the closing of the output gap led to an anticipation that inflation would gather pace if the strength of domestic demand was maintained, and this would eventually have a negative impact on confidence levels.

What in fact happened was that the expected deterioration in the confidence of economic agents did not occur. In the case of businesses, the Monthly Business Confidence Index (IMCE) remained at fairly high optimistic levels throughout the year, and even the components most closely linked to the foreign environment, such as manufacturing industry and mining, remained above 50 points. In the case of consumers, the Index of Economic Perception (IPEC) closed December 2012 with seven consecutive months above 50 points and reached its highest level since 2006 (Chart 3).

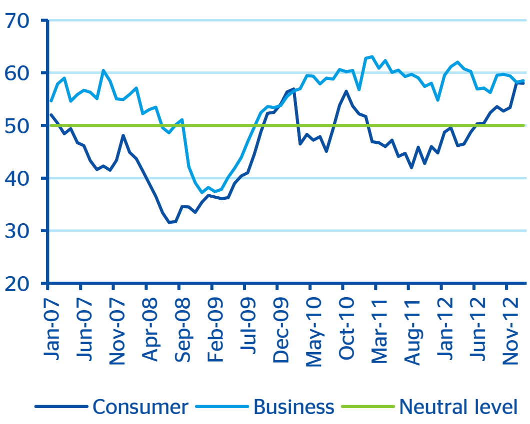
This high level of optimism was one of the factors that explained the strong growth in domestic demand, which hit 7.1% in 2012, under the 9.5% of 2011, but still above what had been expected. The other determining factor was the behavior of the terms of trade, mainly due to the copper price being at an average USD 3.6 per pound, down 10% on the average for 2011 but also above expectations, and at the expected long-term price level for this metal. Thus expectations and terms of trade were key for consumption, and in particular investment, remaining more buoyant than expected. They more than offset the negative impact of net exports on GDP growth, which fell back to 5.6% in 2012 from the figure of 6% in 2011, but still 0.6 pp above our estimate last October, and also still above potential.

It is interesting to note that, in line with the strength of demand, the sectors that grew most were those least dependent on the conditions of foreign demand and with fewer supply-side restrictions, such as retail trade and communications, or those that are intensive consumers of local products, such as construction.

With respect to the labor market, the rate of growth of employment and the labor force fell as anticipated. In a situation of virtual full employment there was practically no room for these variables to repeat the average growth levels of 5.1% and 3.8% respectively observed in 2011. In fact, employment growth dropped to an average of 2% and the labor force to 1.2%; as a result, the average unemployment rate fell by 0.7 percentage points from 7.1% in 2011 to 6.4% in 2012. One of the main implications of this tightening labor market was the behavior of wages, which in nominal terms closed the year with growth of around 6.5%, or around 4% in real terms.

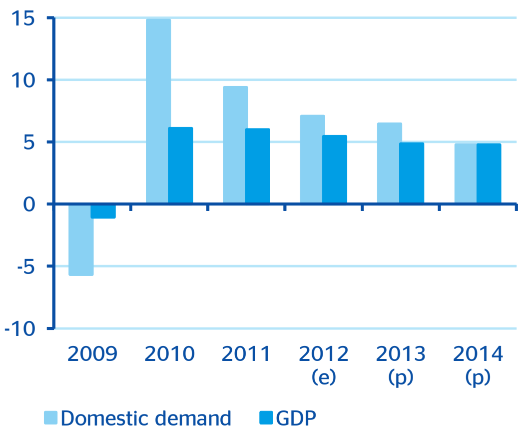
Credit increased its average annual growth by a percentage point on the figure for 2011 to 14.7%. This implies a significant rise if we consider that inflation was around 3 percentage points down in 2012. The breakdown of this positive performance is in line with investment growing more than consumption, leading to corporate lending expanding more than loans to individuals. Commercial lending increased its rate of growth from 12.4% in 2011 to 16.3% in 2012. In contrast, both consumer finance and residential mortgage loans reduced their annual average growth from 2011 to 2012, from 16.6% to 14.7% respectively in the case of consumer finance and from 12.3% to 11.8% in the case of mortgages.

Chart 3
**Business and consumer expectations**




Source: Adimark and Icare

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

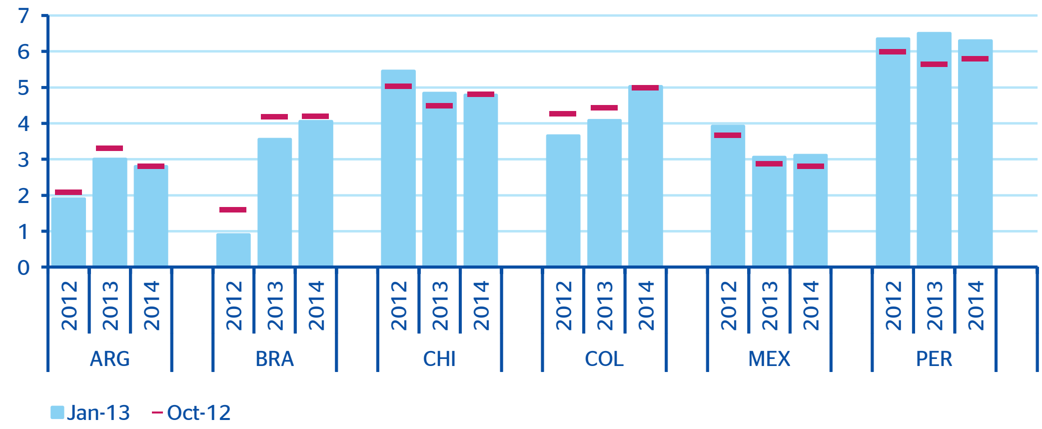



Source: BCCh and BBVA Research

## After three years of above-potential growth, excess capacity will have disappeared and the economy will grow at around potential in 2013-2014

In 2012 GDP grew by 5.6%, the third consecutive year of growth above the potential for the Chilean economy, estimated at around 5%. According to our estimates, this means that the GDP gap (the difference between the actual and potential GDP as a percentage of the potential) will be around 0.5% at the close of 2012, which would make it difficult for the economy to grow above potential for the fourth consecutive year. Some moderation is expected in the factors that have been behind the strength of domestic demand, while the forecast of weak growth in the rest of the world and the negative contribution of foreign demand remains in place, so GDP should grow by 4.8% in both 2013 and 2014 (Chart 4). As a result, the Chilean economy will this year post the second biggest growth in the region, second only to Peru (Chart 5).

Chart 5
GDP of Latam economies 2012-2014 (y/y % change)




Source: BBVA Research

In the case of private consumption, convergence to an average growth close to the economy's potential can be explained by the effect of a moderation in growth of the total wage bill and the steady increase in inflation on consumer expectations. In the case of investment, the growth of the machinery and equipment component is expected finally to return to normal while investment in construction moderates. In the case of construction, this is in line with the slowdown of in the issue of residential and commercial construction permits (see the Real Estate Watch 2012 report). There will also be some negative effect from the fall in the price of copper, which will drop from an average USD 3.61 per pound in 2012 to USD 3.51 and 3.26 per pound in 2013 and 2014, respectively (see Box 1).

The relative strength of domestic demand with respect to foreign demand in 2013 and 2014 will be key to the non-tradable sectors remaining more buoyant than tradable ones. In the case of mining, and in particular copper, the information available points to a delay in the execution of projects for increasing production capacity. In terms of manufacturing, we estimate that it will maintain growth at below the rest of the economy, and continue to show the effects of weak foreign demand. With respect to the sectors linked to domestic demand, the retail trade and services will continue to grow faster than the rest, although they will slow steadily due to the convergence of economic activity to a sustainable rate and a weaker labor market.

Finally, in this growth scenario at around potential in 2013 and 2014, the situation of virtual full employment will limit employment growth to that of the labor force, so it can be expected that both variables will grow at around 1% and the average unemployment rate will remain at 6.4%. Credit will steadily converge to an average nominal rate just above 10%, i.e. above the nominal growth estimated for domestic demand. This reflects that there is room for more financial penetration in Chile.

## Box 1. The outlook for the copper price

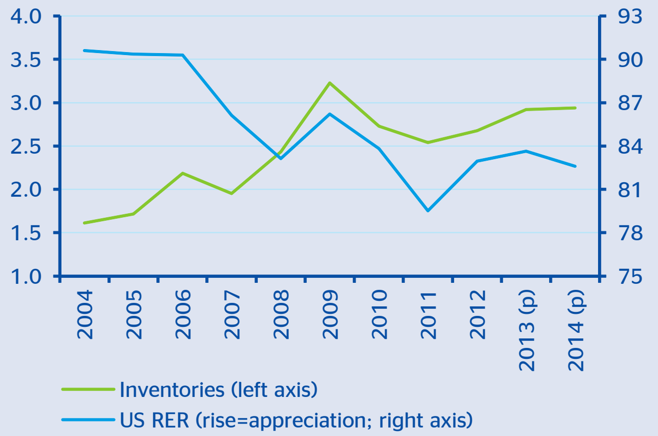
In 2012, the price of copper fell from an average of USD 4 per pound in 2011 to USD 3.61 per pound. The main reason for this was a steady global depreciation in the dollar; the balance between supply and demand remained narrow with respect to historical averages, with total inventories at under 3 weeks of consumption (Chart 6).

This year, the price of copper is expected to fall only marginally to an average of USD 3.51 per pound. This means an upward adjustment with respect to our prior forecast in the fourth quarter of 2012 of USD 3.15 per pound (Chart 7). This correction assumes that the tight balance between supply and demand currently observed in the market will be maintained, as a result of the postponement of new projects and low growth of supply from active projects that will reach only 2.8% y/y. On the demand side, expectations remain relatively stable, with expected growth of 1.5% y/y, once more headed up by the boost from China, which will increase its demand by 6% y/y. Meanwhile, the copper price will remain high, supported by expectations of a weaker dollar in multilateral terms in the medium term. Linked to this point, one cannot rule out the positive effect of the lower probability currently assigned to risk scenarios at a global level. This will favor investment flows to higher risk assets, including the commodity markets.

With respect to longer-term expectations, we continue to expect convergence of the copper price toward its equilibrium level, which we put at a range of between USD 2.8 - 2.9 per pound. The steady adjustment toward this level is the result of stable growth in the global demand for copper, while supply is showing signs of recovery, leading to a situation with relatively more slack. At the same time, the dollar is considered to be essentially stable at a global level. It is worth pointing out that this level of convergence is higher than the historical average of the real price of copper in the period 1980-2002, which reached USD 1.6 per pound, prior to the entry of China as a significant economic player. Since 2003, the real price of copper has averaged USD 3 per pound. We estimate that the composition of demand for the metal will remain relatively stable over the next few years, and validate an equilibrium price higher than the historical average. This represents a moderate upturn in supply in an environment of higher production costs due to reductions in the ore grades and higher energy costs.

Chart 6

**Copper inventories and US RER (weeks of consumption; 1973=100)**




Source: Cochilco, US Federal Reserve and BBVA Research

Chart 7

**Comparison of forecasts of the copper price (USD per pound)**


Source: Cochilco and BBVA Research

# 4. Inflation back on target

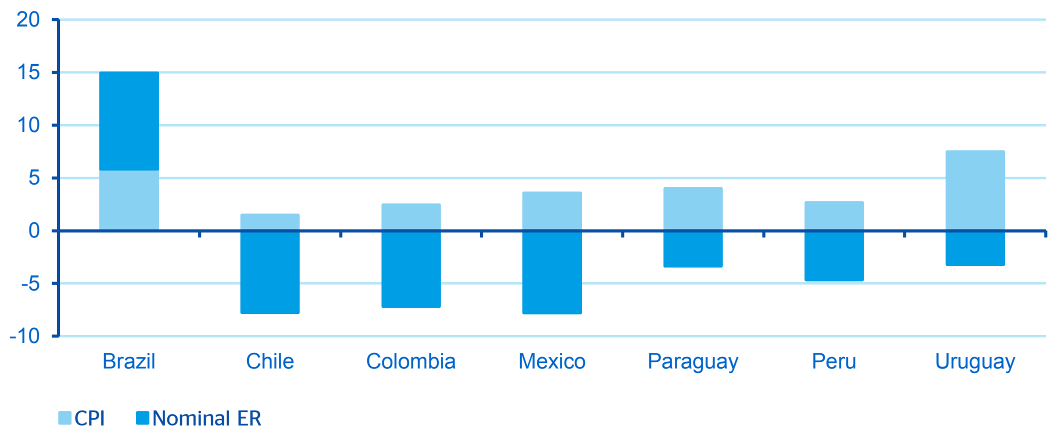
## Factors behind the low figure for 2012 will not recur in 2013, and inflation will return to its target range mid-way through 2013

Inflation closed at 1.5% year-on-year in 2012, under our forecast of 2.3% three months ago. In fact, two reports back, in the Chile Economic Outlook for the third quarter of 2012 published in August, the section on inflation was called "The Inflation Puzzle", referring to the paradox of a cumulative inflation of barely 0.4% through July, despite an estimated positive output gap that revealed the lack of excess capacity. The solution to this puzzle, as we explained at the time, was the moderating effect of the tradable component of the CPI, which accounts for around 60% of the consumer basket. It practically cancelled out the strength of the price index of non-tradable goods, which did reflect the cyclical situation of the economy.

But as well as explaining the paradox of low inflation, we had to assess whether the behavior of prices in the first seven months of the year could be extrapolated to the last five. The conclusion was that it was not very probable that the appreciation of the exchange rate and the fall in international inflation could continue. In fact, the expectation was for an upturn of energy and food commodity prices, which were factors behind the sluggish prices of tradable goods.

As we now know, this prediction proved only partially correct, as although there was no further appreciation of the peso as between the close of 2011 and the first quarter of 2012, the exchange rate remained essentially stable and even appreciated marginally in around the last quarter of the year. It is worth mentioning that Chile not only posted the lowest annual inflation in 2012, but also one of the biggest currency gains in the region (Chart 8). In addition, no upturn was observed in commodity prices; on the contrary, there was a downward adjustment in fuels, due to a reduction in geopolitical risk premiums. As a result, inflation in tradable goods closed the year at -0.5% y/y, offsetting the increase of 3.9% y/y in non-tradable goods (Chart 9).

Chart 8
**Inflation and exchange movements (y/y % change)**

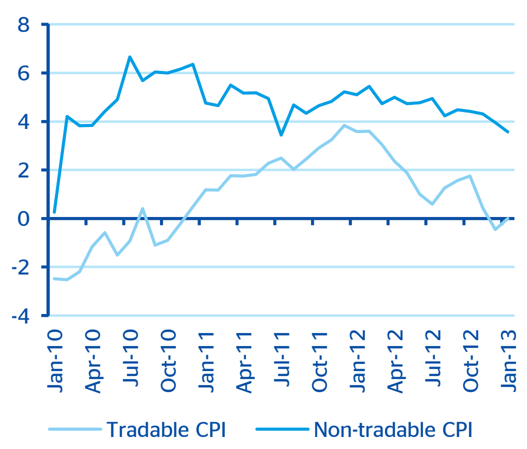



Source: BBVA Research, based on information from central banks and local statistical offices

Other hypotheses have been suggested to explain this low inflation in 2012, such as the effect of productivity gains or the compression of profit margins. These hypotheses conflict with the fact that low inflation is observed in the tradable component of the basket, in other words the goods whose prices are determined internationally; so productivity gains at a local level should not be relevant, unless they are productivity gains in the commercialization chain. The same could be said with relation to the compression of profit margins, which would also have to occur in the commercialization chain on arrival in the country; otherwise, we would simply be talking about a lower imported inflation.

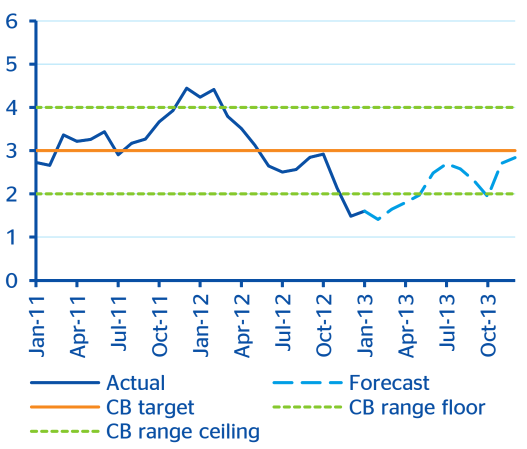
Looking toward the future, the relevant question is once more therefore whether there is room for the prices of tradable goods to continue offsetting the expected strength of non-tradable goods. Unless there is an adverse scenario at the international level, we see little room for a continued decline in imported inflation, while the exchange rate is expected to depreciate slightly in the medium term (see Box 2). Overall, the floor of the Central Bank's range (2%) should be reached at around mid-2013, and inflation is expected to close 2013 at 2.8%. The figure for the close of 2014 should be close to the target of 3% y/y. Nevertheless, as was pointed out in the last report on risk scenarios, the most important idiosyncratic risk is maintenance of the strength of domestic demand and the resulting acceleration in inflation (Chart 10).

Chart 9
**Price index by category (y/y % change)**




Source: National Institute of Statistics

Chart 10
**Total inflation (y/y % change)**




Source: BCCh, INE and BBVA Research

# 5. Monetary policy still on pause despite everything

## Although the Central Bank has been rather more vigilant in its statements over recent months, due to growing domestic risks, we estimate that monetary policy will remain on pause in 2013, and begin a brief cycle of reference rate rises towards neutral levels early in the first quarter of 2014

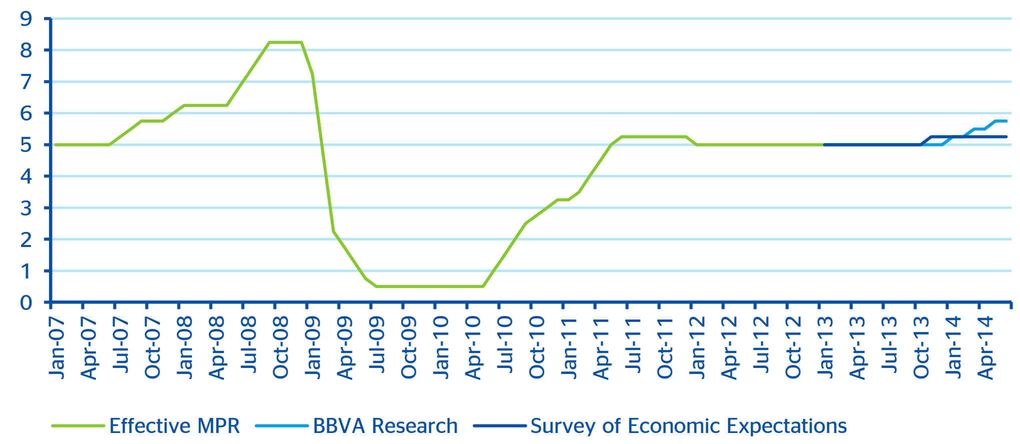
Over recent months, the figures for local economic activity have continued to surprise upwards. In principle this reflects a greater use of installed capacity and a rise in inflationary pressures. However, prices (at least in the aggregate) have not responded to the movements in the output-gap, as they have incorporated temporary falls in international commodity prices, mainly fuels and food. They have also been affected by the fall in the exchange rate. In fact, the exchange rate has been key for long-term inflationary expectations to remain anchored at the Central Bank target. However, the risks of a tight labor market and domestic demand that shows no clear signs of a slowdown will continue latent, and add a note of caution to the conduct of monetary policy. This will increase the risk of an acceleration of domestic prices beyond their desired levels in the medium term, with a potential decoupling of inflationary expectations.

In addition, but still on the domestic front, the current-account deficit is still an additional concern for the Central Bank, mainly due to the possible cumulative effects over financial stability goals. Despite this concern, we estimate that other policies apart from the monetary have to be considered to tackle these risks, as the Board of the Central Bank has already made clear in the latest meeting minutes (see Box 2).

Finally, risks have eased on the external front. Although the probability of an adverse effect in the U.S. and Europe remains latent, it has diminished compared with previous months. However, it is still the most significant risk, which counterbalances a somewhat more restrictive stance on the part of the Central Bank, as also reflected in the minutes of the latest monetary policy meeting.

In this context of virtual balance between internal and external risks, we expect the Central Bank to continue with its pause in 2013 and maintain the monetary policy rate at 5%, and then begin a brief cycle of rises toward neutral levels in the first quarter of 2014. These rises are coherent with expectations of an incipient return to normal international liquidity conditions and an adjustment of the real policy rate, given the convergence of inflation towards the target (Chart 11).

Chart 11
**Monetary policy interest rate (%)**




Source: BCCh and BBVA Research

## Box 2. To float or not to float

The recent appreciation of the currencies of emerging countries has led some of these economies to apply measures to halt this trend. In countries such as Brazil, Peru, Colombia, Russia, Korea and Israel, measures have been applied ranging from direct purchases on the foreign-exchange market to capital controls that aim to remove incentives for capital to enter these economies. However, other economies such as Chile and Mexico have remained within a free-floating exchange rate scheme, leaving open the option of interventions only if there is a significant misalignment of the exchange rate with respect to its long-term fundamentals.

### The real exchange rate and the factors behind its movements in the last decade

In the specific case of Chile, the Central Bank has focused its attention on movements in the real exchange rate (RER). This measure takes into account the relative competitiveness of the Chilean economy with respect to its main trading partners. In this way, the normal analysis includes both nominal exchange-rate movements and the inflation differentials between the main trading partners and Chile. Thus although the peso-dollar parity plays an important role, it is not the only relevant variable in the analysis.

The factors behind the movements of the RER include the terms of trade, which are largely influenced by the performance of the copper price, as well as the ratio of public expenditure to GDP and Chile's productivity relative to the rest of the economies. A number of studies have estimated the sensitivity of the real exchange rate to these variables. Based on their movements in the last decade, it is possible to analyze the role of the different factors in the trend toward appreciation shown by the RER.

One of the most relevant factors has been the increase in the terms of trade, which have doubled in the last decade, driven mainly by the major increase in the copper price (Chart 12). Although the pressure on the appreciation of the RER exercised by increased public expenditure has been mentioned, given that much of this expenditure is on non-tradable goods, in fact its size has not changed significantly. Thus the ratio of public expenditure to GDP was around 21% 10 years ago, while in 2012 it stood at 22%, although it had dropped to levels of close to 17% before the 2008-09 financial crisis. Finally, the improved productivity of the Chilean economy with respect to the developed economies has generated a trend for the RER to appreciate. One reflection of this improved relative performance is the strong GDP per capita growth in Chile compared with other economies, above all developed ones.

As a result, the RER has appreciated by around 18% over the last decade and currently stands at 7% below the average for the last 10 years and 5% below the average for the last 5 years.

Even though there are structural factors behind the trend for exchange-rate appreciation, the Central Bank has intervened in the market twice in recent years. It is worth reviewing the reason for these interventions and what could trigger new measures in this direction.

### The real exchange rate and interventions in 2008 and 2011

Both in the intervention in April 2008 and that of January 2011, the Central Bank stated that the objective was to carry out a program of international reserve accumulation that could be used as insurance against possible adverse external scenarios. The foreign-currency purchasing programs amounted to USD 8 billion in 2008 and USD 12 billion in 2011. As a result, the ratio of reserves to GDP amounted to 17%, a level that is comparable with that of other economies of a similar structure to Chile.

Another argument for the interventions would be a temporary misalignment of the long-term exchange-rate fundamentals, so the intervention would aim to moderate an overreaction by the RER. It is worth pointing out that this measure did not try to achieve a predetermined level of exchange.

Currently, the RER is at levels similar to those of before the interventions mentioned above, and it is worth wondering whether this corresponds to a temporary misalignment, or rather a more structural trend. To a large extent, this is what any new intervention in the foreign-exchange markets will depend on.

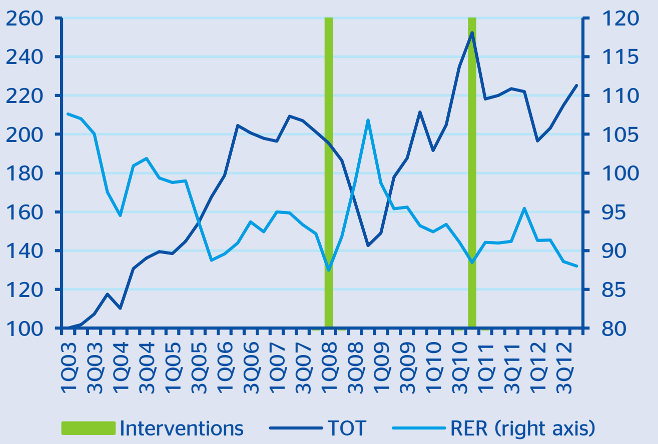
### The economic background to exchange-rate behavior

We can also review what factors explain the recent appreciation of the exchange rate in Chile from a broader point of view. We can also determine to some extent whether it is a temporary or permanent phenomenon. Considering that in the short term the exchange rate depends on real factors, such as terms of trade, but also on financial factors, its movements can be assessed in the light of a set of relevant variables. Thus the copper price, the differential of domestic and external interest rates together with the perception of risk by investors are natural candidates for assessing the short-term movements of the exchange rate. In terms of these parameters, an intervention may be motivated by a temporary and significant deviation of one of these factors. At the same time, if a significant part of the appreciation did not accord with these factors, it would send a signal of a possible exchange-rate misalignment, which could also trigger an intervention.

Currently, in considering the higher price of copper, the high differential of interest rates in favor of the peso and greater appetite for risk by investors, the rate can be seen to be somewhat below the estimated value according to its fundamentals, although the amount appears moderate in a historical perspective. In addition, various forecasts, including those of the Central Bank, suggest these fundamentals are not significantly deviated from their medium and long-term levels. Although the possibility of foreign-exchange intervention has been the subject of debate recently, we consider that at least one of the conditions above has to be met to motivate the application of this measure. In other words, a significant deviation of the fundamentals with respect to their long-term levels, or rather a rapid trend to appreciation that accumulates a significant decoupling in the variable (Chart 13).

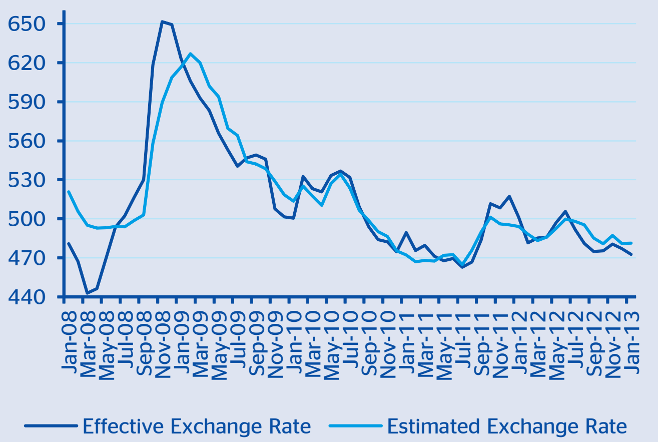
Finally, it should not be forgotten that various estimates reflect the limited effectiveness of reserve accumulation in maintaining a more depreciated exchange rate in the medium and long term. In addition to this, there are the high costs of the measure, given the need to sterilize the monetary impact of foreign currency purchases through the emission of local-currency bonds at an interest rate far above that obtained from investment in international reserves.

Chart 12
**Terms of trade and the real exchange rate (1Q03=100; 1986=100)**




Source: Central Bank of Chile and BBVA Research

Chart 13
**Estimate for exchange rate based on real and financial factors (COP/USD)**




Source: BBVA Research, based on information from Cochilco and BCCh

# 6. The strength of the economy leads to an improved fiscal result

## Despite lower revenues from copper, the public sector had a surplus of 0.6% of GDP in 2012, as a result of increased receipts from income tax and VAT from other sources. For 2013 and 2014 we estimate a slight effective public deficit of 0.2% and 0.6% of GDP, respectively, due to lower receipts from mining taxes

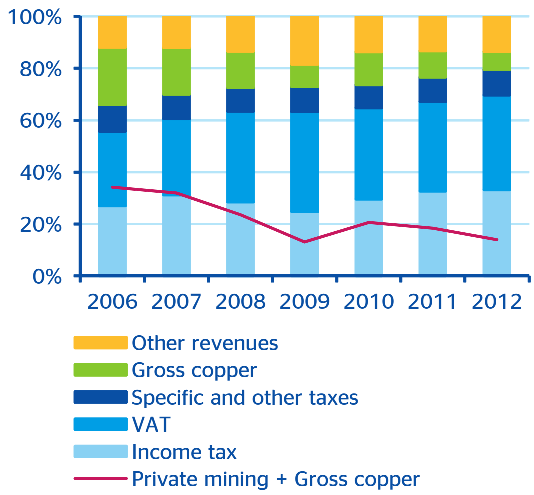
In 2012 Treasury estimates for the year put the effective public sector surplus at 0.6% of GDP, equivalent to USD 1,493 million, slightly above our estimate one quarter ago of 0.5% of GDP. This is the result of revenues of USD 58,845 million (a real rise of 1.3% y/y), where lower than expected receipts from copper (both Codelco and private mining) were more than offset by increased income tax and VAT receipts from other sources due to greater than expected growth of the economy in 2012, mainly boosted by the service sector (Chart 14). Fiscal spending amounted to USD 57,351 million (a real annual increase of 4.7%), equivalent to 21.8% of GDP. At the same time, budget execution was slightly under the agreed level for the period. As a result, both the greater tax revenues and the under execution of expenditure were key to the positive fiscal balance in 2012, and thus helped reduce (although only partially) the current pressure of internal expenditure on the balance of payments current account. Finally, it is important to highlight that the structural deficit fell by barely 0.6% of GDP, so the structural deficit target of 1% of GDP recently proposed by the current government for 2013 has been exceeded.

With respect to the position of assets, the public treasury closed 2012 with sovereign funds of USD 20,880 million, representing a nominal increase in dollars of 18.9% on the close of 2011. This was basically the result of contributions to the Economic and Social Stability Fund (FEES) and the Pension Reserve Fund (FRP) for a total of USD 2,890 million over the year. Other treasury assets (cash) fell slightly to USD 10,419 million (down 1.6% y/y), thus consolidating gross tax assets of USD 31,299 million (11.6% of GDP), above the accumulated amount at the close of 2008. This allowed an energetic fiscal policy response in the face of the international financial crisis. In accordance with the current fiscal responsibility rules as well as the effective surplus in 2012, we expect contributions to the FRP of at least 0.5% of GDP this year. The stock of gross public debt closed in 2012 at USD 31,880 million (11.9% GDP), an increase of USD 3,909 million compared with the accumulated stock at the close of 2011. This leaves the net debt position for the central government in virtual equilibrium (Chart 15).

Finally, for 2013 we estimate a slight effective public deficit of around 0.2% of the GDP estimated for this period. This is the result of a real increase in revenues of around 2% y/y, due to the expected greater tax receipts from non-mining taxpayers, as the revenues from the mining sector will remain stable, given our estimate for the average copper price of USD 3.5 per pound for the year (a slight fall on the 2012 average). Total real public expenditure will increase around 6% y/y, representing an under-execution of the budget law for 2013 in line with historical parameters.

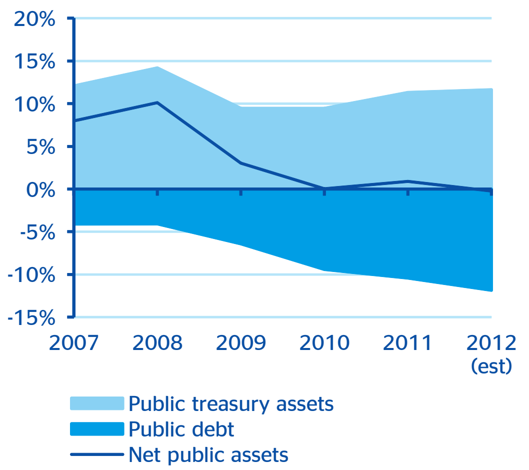
The fiscal forecast for 2014 is difficult because it will be the first year of a new presidential year, which could imply changes in the long-term management of the structural fiscal balance. Initially, we expect fiscal spending to increase in line with GDP growth and a slightly slower growth in revenues, particularly due to the lower average copper price. Thus the deficit will increase only moderately to 0.6% of GDP in 2014.

Chart 14
Breakdown of fiscal revenues (% of total)




Source: Budget Department

Chart 15
Net public treasury assets (% GDP)




Source: Budget Department

# 7. Balance of payments: better terms of trade will offset the increase in imports

## The upturn in the price of copper in the last quarter of 2012 led to the current-account deficit being lower than expected. The upward revision of the forecast copper price for 2013 would counter the greater strength of domestic demand and imports

The current-account deficit should close 2012 at 3.3% of GDP, somewhat better than the 3.6% estimated three months ago. This improvement can be mainly explained by the upturn in the copper price toward the end of the year, and with a somewhat lesser impact, the downward adjustment in fuel prices over the same period. As a result, the trade surplus is estimated at around USD 4.2 billion, a major fall on the surplus of USD 10.8 billion in 2011.

The current-account deficit will be almost entirely financed through foreign direct investment (FDI). It is worth pointing out that the FDI by non-residents amounted to USD 28,150 million, or around 11% of GDP. FDI from Chileans abroad amounted to USD 19,700 million, around 7% of GDP. In net terms, therefore, FDI is very similar to the current-account deficit estimated for 2012. However, it is important to highlight that there were net portfolio outflows of around 1.5 points of GDP, somewhat higher than the debt registered in the “Other investment” item. Finally, international reserves closed the year at USD 41.6 billion, practically the same figure as at the close of 2011 (USD 42 billion). This is consistent with the strategy of a floating exchange rate, although down in terms of GDP from 16.9% to 15.7%.

For 2013 and 2014 we expect a reduction of copper exports in line with the expected fall in the average price of the metal (see Box 1). Nevertheless, an increase in the value of other exports will mean that in the aggregate exports will increase at an average rate of 2.5% over the year. However, the higher average annual increase estimated for imports of 5.6% will result in a renewed fall in the trade surplus in 2013 to around USD 2.4 billion, and the first trade deficit in more than a decade, of USD 350 million in 2014. As a result, the current-account deficit estimated for 2013 will be 3.7% of GDP, somewhat down on the 4.1% forecast three months ago. For 2014 the forecast is for another increase in the deficit to 4.2% of GDP, although these levels are expected to be financed with FDI and assume the convergence in the price of copper to its long-term value. Thus this forecast does not differ substantially from an estimate of the current-account deficit at trend prices.

# 8. Domestic risks take the leading role

Despite the positive outlook for local economic activity, the risks for the Chilean economy continue to be associated with a possible disruptive episode in Europe, with global consequences manifested in falls in asset values, prices and levels of activity. However, the various fiscal and monetary measures adopted by the economic authorities in developed and emerging economies have reduced the possibility of an adverse scenario of this type.

Our current risk scenario includes not only a reduced probability of a negative event in Europe, but also a lower-level shock than considered in previous reports. Thus the main transmission mechanism of this risk event would be via a negative wealth shock on the local economy. This shock would generate a fall in the terms of trade and a global rise in the dollar (lower copper price), with negative results on consumer and business confidence, and on domestic demand. At the same time, the lower utilization of installed capacity would put downward pressure on domestic prices. In this scenario, a greater deterioration in the current account continues to be effective with respect to the current levels of deficit. However, the additional deterioration would be temporary. The monetary policy and fiscal response would be expansive, but not to the extent included in our previous risk scenario. In addition, the lower rate of aggregate economic activity, the fall in copper prices and the implementation of fiscal stimuli would all put downward pressure on the effective balance of the public sector.

In contrast with the above, idiosyncratic risks, in particular risk of the local economy overheating, have become more significant. With the information available, the probability of an event of this type has increased. Economic activity has once more picked up pace toward an above-potential rate, at least in the short term, while inflation has remained low due to temporary effects. Thus if the expected slowdown in domestic demand did not occur, we could anticipate an acceleration in inflation, in particular given the limited spare capacity, which would result in a decoupling of inflationary expectations. At the same time, the balance of payments deficit would increase given the strength of imports. In this scenario, the monetary policy response would be to bring forward the cycle of rises in the reference rate.

# 9. Tablas

Table 1
Macroeconomic forecast annual

| | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|
| GDP (% y/y) | 6.1 | 6.0 | 5.6 | 4.8 | 4.8 |
| Inflation (% y/y, eop) | 3.0 | 4.4 | 1.5 | 2.8 | 3.0 |
| Exchange Rate (vs. USD, eop) | 475 | 517 | 477 | 483 | 502 |
| Interest Rate (%, eop) | 3.3 | 5.3 | 5.0 | 5.0 | 5.8 |
| Private Consumption (% y/y) | 10.0 | 8.8 | 6.6 | 6.1 | 5.5 |
| Government Consumption (% y/y) | 3.9 | 3.9 | 3.4 | 4.7 | 4.9 |
| Investment (% y/y) | 14.3 | 17.6 | 9.9 | 8.2 | 6.5 |
| Fiscal Balance (% GDP) | -0.4 | 1.3 | 0.6 | -0.2 | -0.6 |
| Current Account (% GDP) | 1.5 | -1.3 | -3.3 | -3.7 | -4.2 |

Source: BBVA Research

Table 2
Macroeconomic Forecast Quarterly

| | GDP (% y/y) | Inflation (% y/y, eop) | Exchange Rate (vs. USD, eop) | Interest Rate (%, eop) |
|---|---|---|---|---|
| Q1 11 | 9.9 | 3.4 | 480 | 4.00 |
| Q2 11 | 6.3 | 3.4 | 469 | 5.25 |
| Q3 11 | 3.7 | 3.3 | 484 | 5.25 |
| Q4 11 | 4.5 | 4.4 | 517 | 5.25 |
| Q1 12 | 5.2 | 3.8 | 485 | 5.00 |
| Q2 12 | 5.7 | 2.6 | 506 | 5.00 |
| Q3 12 | 5.7 | 2.8 | 475 | 5.00 |
| Q4 12 | 5.6 | 1.5 | 477 | 5.00 |
| Q1 13 | 4.9 | 1.7 | 472 | 5.00 |
| Q2 13 | 4.7 | 2.5 | 469 | 5.00 |
| Q3 13 | 4.7 | 2.3 | 474 | 5.00 |
| Q4 13 | 4.8 | 2.8 | 483 | 5.00 |
| Q1 14 | 4.7 | 2.7 | 491 | 5.50 |
| Q2 14 | 4.5 | 2.7 | 496 | 5.75 |
| Q3 14 | 5.2 | 2.8 | 500 | 5.75 |
| Q4 14 | 4.7 | 3.0 | 502 | 5.75 |

Source: BBVA Research

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