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Report on the Latin American economy. First half of 2017

20 April 2017

The Latin American economies face a highly complex outlook as a result of various factors, such as the fragility of the recovery in the advanced economies in the wake of the crisis, the tensions in re-balancing the Chinese economy and doubts over the extent of the pick-up in commodities prices. And adding to these has been the change of US Administration, with potential global implications owing to the expected change in the US economic policy stance.

Nonetheless, National Accounts data have shown a muted improvement in the region as a whole in the second half of 2016, assisted by the firmness of financial markets, the easing in monetary policies – against a backdrop of falling inflation – and the turnaround in commodities prices. The higher-frequency indicators point to a continuation of this improvement in the opening months of 2017. For 2017 as a whole, a moderate pick-up in growth across the region is expected, but one that is notably uneven from country to country, and with the balance of risks to growth remaining tilted to the downside.

Introduction

Although the financial markets have performed favourably over the past six-month period and this has, the odd episode of instability apart, been reflected in low levels of volatility, global economic developments have been marked by high uncertainty. The result of the US election last November, with potentially global implications owing to the expected change in economic policy stance, has joined other factors — such as the fragility of the recovery in the advanced economies in the wake of the crisis, the tensions in re-balancing the Chinese economy and doubts over the extent of the pick-up in commodities prices — to shape a highly complex economic outlook for Latin America in the medium term.

Over a closer horizon, global economic activity, especially in the advanced economies, tended to rise in the second half of 2016. In addition, the firmness of financial markets has provided for a pick-up in capital flows to the emerging economies (and particularly to Latin America) and an increase in bond issuance by these economies. These developments have checked the depreciation of their currencies, facilitating a reduction in domestic inflation and enabling a change in monetary policy stance, although the cuts in terms of real interest rates are still limited. Further, the turnaround in commodities prices in 2016 has enabled a partial recovery of the terms of trade.

Unsurprisingly, then, National Accounts data have shown a muted improvement in the region as a whole in the second half of the year. GDP growth, for the weighted average of the six main economies for which information is available[1], has risen from a quarter-on-quarter rate of -0.2% in the first half of the year to 0.1% in the second half. In year-on-year terms, the fall in activity has gradually lost momentum, from -1.0% in Q1 to -0.2% in Q4. The improvement has been fairly generalised with the exception of Brazil, whose GDP has fallen once again to a rate close to -1% in 2016 Q4.

The higher-frequency indicators point to a continuation of this improvement in the opening months of 2017, although it is still premature to conclude it is firming. The progress of the recovery in the short term is being underpinned not only by the aforementioned factors, but also by a progressive shift from net external demand to domestic demand, chiefly investment, while the increase in uncertainty (which is denting agents' confidence, especially in Mexico), the fiscal adjustments under way and the slackness of credit would appear to be counteracting this. In this setting, the consensus macroeconomic forecasts for the region's seven main economies as a whole (including Venezuela) suggest growth of 1.2% in 2017, following the fall of -0.7% estimated for 2016. In any event, this improvement, which has continued to be revised downwards in recent months, largely reflects the expected recovery in Brazil and Argentina (see Chart 1).

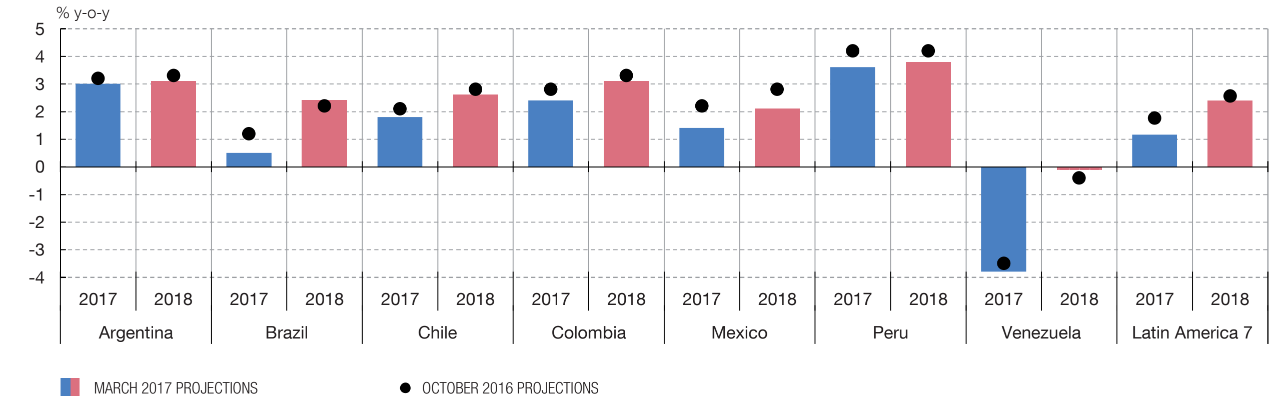
The balance of risks to growth remains tilted to the downside. Notable in the external domain are the risks arising from a possible abrupt tightening of global financial conditions, in the event that the normalisation of interest rates by the Federal Reserve were swifter than anticipated or that a change in global financial market sentiment were triggered by some other factor (including political events in some advanced economies). Moreover, although growth in the Chinese economy has stabilised recently, the widening in some imbalances and excessive corporate debt pose risks of a sharp adjustment over a lengthy

1 Brazil, Mexico, Argentina, Colombia, Chile and Peru.

GROWTH PROJECTIONS IN LATIN AMERICA

CHART 1

2017 AND 2018 GROWTH PROJECTIONS IN LATIN AMERICA



SOURCE: Latin American Consensus Forecasts.

horizon. On the domestic front, fiscal consolidation, the elections scheduled for 2017 and cases of corruption in various countries are further factors of uncertainty.

The first section of this report on the Latin American economy offers an overview of recent economic developments in the region. Thereafter, two dedicated sections offer an in-depth view of two specific matters. The first matter selected is the potential impact on the economies in the region — and in particular on Mexico — of the expected changes in US economic policies following Donald Trump's election as president. The second section tackles the recent adjustment in the Chilean economy in the face of a more unfavourable external environment and the challenges its economic policy must address.

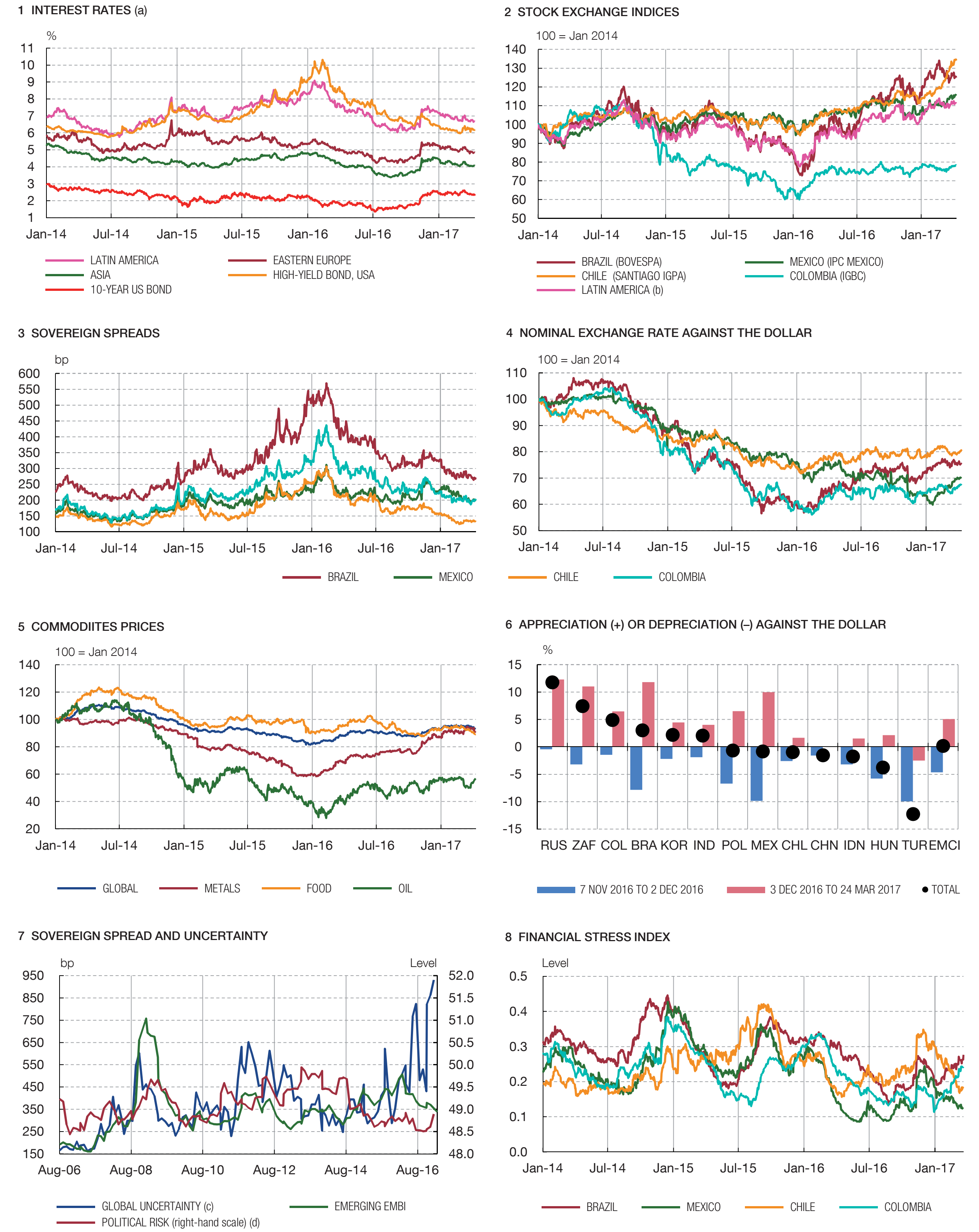
Recent developments in the Latin American economy

THE EXTERNAL ENVIRONMENT AND DEVELOPMENTS ON FINANCIAL MARKETS

The change in economic policy stance announced by the new US Administration, potentially with highly significant implications globally, has added a considerable measure of uncertainty to the international economic and financial context over the past six months. Notwithstanding, international financial markets — including emerging and, in particular, Latin American markets — have performed favourably, with low volatility levels, except at specific junctures. In parallel, the GDP data for 2016 Q4 highlighted the strengthening of activity in the advanced economies (as reflected in the upward revisions to growth forecasts for 2017) and in certain emerging economies, mainly in Asia, which was conducive to a moderate rise in international trade. Oil prices held stable over the final months of the period in question, after having trended upward in the first half of 2016, although they slid (by 10%) in the first week of March following the release of higher-than-expected inventories figures in the United States, having since recovered.

As from the summer and up to the presidential election in the United States, developments on emerging financial markets were characterised by a relatively positive firmness, with the odd exception such as Mexico and Turkey. The Republican candidate's unexpected victory unleashed a bout of global turbulence, which led to a heavy depreciation of the emerging economies' currencies, an increase in sovereign yields (see Chart 2), capital outflows (for a similar amount to those in May 2013) and the grinding to a halt of bond issues. However, as was the case after Brexit in June 2016, the duration of the episode was limited, meaning that by mid-December almost all the emerging markets regained their previous levels (Chart 2), with the exception of the currencies of certain countries more exposed to the new US trade and migration policies

INTEREST RATES, STOCK EXCHANGES, SPREADS, EXCHANGE RATES AND COMMODITY PRICES CHART 2
Percentage, indices and basis points



SOURCES: Datastream and JP Morgan.

a Latin American, Asian and Eastern European rates have been constructed by adding the US 10-year government bond yield and EMBI spreads
b MSCI Latin America index in local currency.
c Global GPU index.
d Simple average of EIU political risk indicators of 27 emerging economies.

(such as Mexico) and of some economies more dependent on external funding and subject to idiosyncratic geopolitical risks (Turkey).

The sound performance of the financial markets has stepped up in early 2017, in line with what was seen in other high-risk segments (see Chart 2). As a result, by late March, emerging stock markets stood 10% above their November 2016 level and their sovereign spreads were close to 40 bp down (having been at a low since May 2014). Moreover, in 2017 Q1 there were both debt- and equity-based capital inflows (essentially on the Asian markets), which virtually offset the outflows recorded in November last year (Chart 3). Finally, from January to March 2017, bond issues on international markets totalled $152 billion, a new historical high for a first quarter, thanks to sovereign placements, some of them by countries with a low credit rating. There are several reasons for this behaviour: the relative stability of oil prices at levels double those in early 2016; the rise in the price of metals to highs since mid-2014; and a search for yield against a background of still-very-low interest rates globally. Nonetheless, the situation is not free from risks, given that the vulnerabilities in the emerging economies have not diminished, and a decoupling is apparent between the risk premium of the emerging countries and the indicators of global uncertainty (which are at historical highs) and of idiosyncratic political risk (see Chart 2).

The Latin American financial markets were similarly affected by these trends. The positive tone prevailed until the US election, with the exception of Mexico, whose markets evidenced high volatility from mid-2016, stemming from the uncertainty over the electoral result and from the collapse of oil prices and its attendant effect on the financial position of PEMEX. Trump's victory prompted a temporary downturn in Latin American markets, acutely so in Mexico, where the peso depreciated by 11% in four days (see Chart 2), reaching an historical low on 19 January, and stock markets, CDS, the sovereign spread and long-term rates in local currency performed much more adversely than in the emerging economies.

As from December, the Latin American financial indicators have recovered and the indicators of financial stress, which had risen in the final stretch of 2016, have fallen once more since early 2017, reaching levels in some cases close to historical lows (see Chart 2). Since the beginning of this year, Latin American stock markets have risen 11.3%, notably so in Chile (12.4%) and Brazil (4.3%), on one hand, and in the case of the non-energy commodities companies (17.5%), on the other. Sovereign spreads have narrowed by close to 40 bp, somewhat more than in the emerging economies as a whole, owing to the marked declines in Peru, Chile and Brazil (60 bp; see Chart 2). Finally, Latin American currencies have appreciated since the start of the year by between 3% and 5%. The exception was once again the Mexican peso, which has appreciated by 19% since mid-January, underpinned by the measures adopted by the Mexican central bank, which has raised its policy rates on three consecutive occasions, intervened on foreign exchange markets and set in train a programme of foreign exchange hedges[2]; the new US Administration's lesser emphasis on protectionist talk has also helped the peso.

2 Foreign exchange swaps would be settled in national currency, meaning they should not affect reserves, and placed in weekly tenders of $1 billion each, distributed in terms of one, two, three, six, nine and 12 months, for a total maximum amount of $20 billion. The first swaps tender was held on 6 March, and there was greater demand for the shorter-dated terms, awarded at an exchange rate 0.1% up on the previous day's close. The one-year hedge was assigned as an exchange rate 4.3% down, but at a distance from the historical low of 19 January. These instruments were used by Brazil in 2002 and 2014, for a much greater amount (a maximum of $116 billion, $28 billion at present) and with a relatively high fiscal cost.

EXTERNAL CAPITAL FLOWS AND FINANCING
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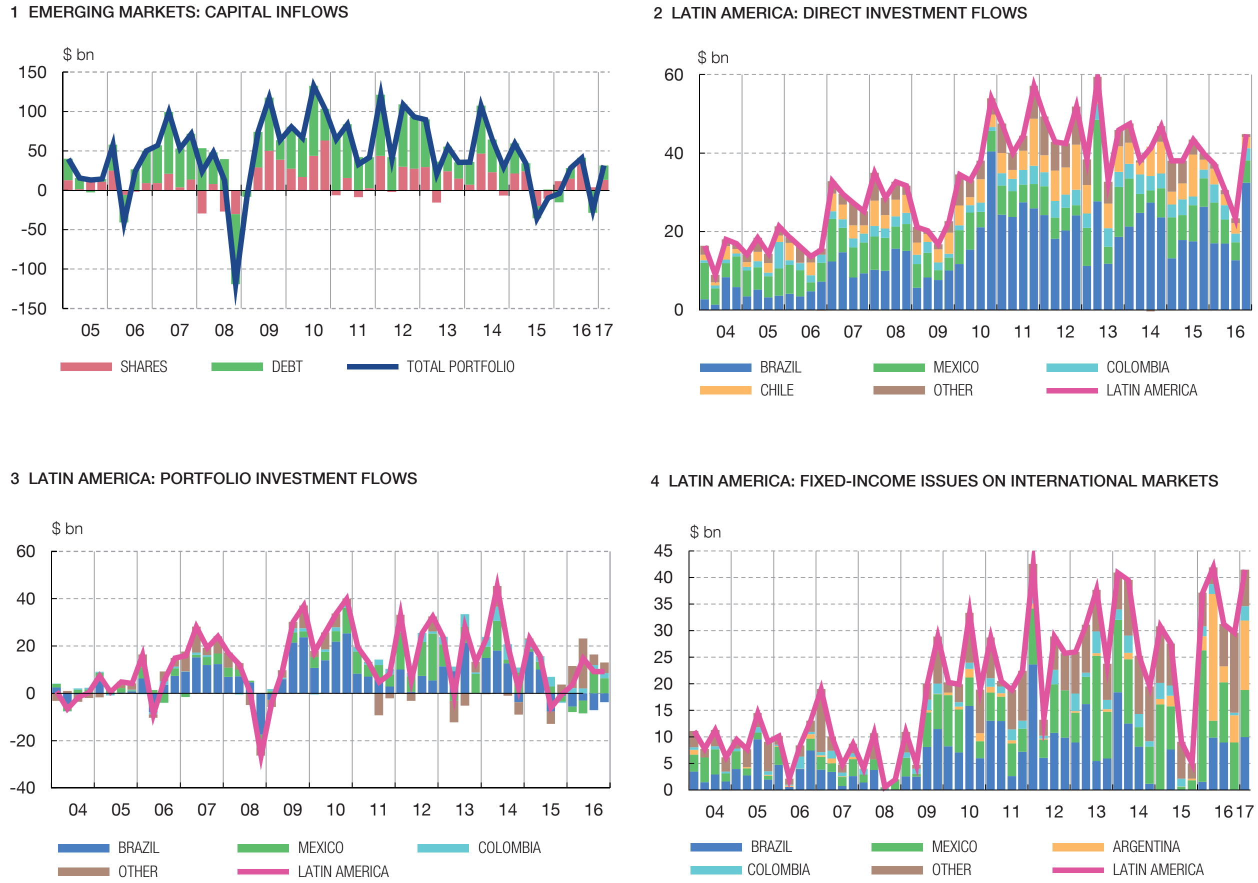
CHART 3



SOURCES: Datastream, Dealogic, IIF, JP Morgan, IMF and national statistics.

As discussed, following the decline in capital flows to the Latin American economies in the wake of Donald Trump's election, direct investment inflows rose substantially in late 2016, ending the quarter $4.8 billion up on the same quarter in 2015 (see Chart 3). Country by country, the increase in inflows into Brazil ($6.1 billion, especially in the services sector, and, thereunder, in distributive trade and financial activities) offset the decline observed in Mexico (-$1.5 billion, due to construction and services). Portfolio inflows stabilised in 2016 Q4 at levels close to the historical average ($9 billion), with a change in the geographical make-up, since in this case Brazil recorded capital outflows in the four quarters of the year (with the unwinding of non-residents' positions in the local debt markets) while in Mexico portfolio inflows picked up, initially owing to those targeted on money markets and subsequently to the increase in public-sector debt. Likewise, Argentina led bond issues in the region during the period analysed (see Chart 3), along with the state-owned oil corporations of Brazil and Mexico, meaning that 2016 marked a new all-time high in placements ($140 billion). Financial conditions scarcely changed in the period analysed, while euro-denominated placements fell to 12% of the total (17% in 2015). In 2017 Q1, placements totalled $41.5 billion, in a market dominated once more by sovereign issues (52% of the total).

ACTIVITY AND DEMAND

In the second half of 2016 all the region's countries, except Brazil and Venezuela, posted higher quarter-on-quarter GDP growth rates than in the first half of the year, marking what might prove a turning point from the previous trend. Year-on-year rates, however, were worse owing to the knock-on effect of the previous quarters, with the exception of Brazil, whose GDP improved from a year-on-year rate of -4.5% in the first half of the year to -2.7% in the second half, owing to the fact that the second half of 2015 had been particularly adverse. Among the other countries, the downturn in year-on-year growth rates was most significant in Argentina (falling from a rate of -1.5% to -2.9%), Colombia (whose growth dipped from 2.5% to 1.4%) and Chile (from 2.1% to 1.1%); Mexico (from 2.4% to 2.2%) and Peru (from 4.1% to 3.7%) decelerated only slightly. Overall, GDP for the aggregate of Brazil, Mexico, Argentina, Colombia, Chile and Peru turned up from -0.8% year-on-year in the first half to -0.4% in the second (see Table 1 and Chart 4).

Activity in Brazil in Q4 was disappointing. GDP contracted 0.9% in quarter-on-quarter terms, the worst figure in 2016 and the eighth consecutive quarter of declining activity. The contraction in Q4 was due to the poor export performance, especially in primary products (which fell by 20.5%), and to the sluggishness of domestic consumption and investment. In 2016 as a whole, GDP fell by 3.6%, very close to the negative decline of 3.8% the previous year.

Conversely, and despite negative year-on-year rates, Argentina emerged from recession in Q3, with quarter-on-quarter growth of 0.1%, which rose to 0.5% in Q4. Colombia posted its lowest year-on-year growth for 2016 in Q3, owing in part to a transport strike in July and August, and a substantial improvement was observed in Q4. In Chile, GDP fell in quarter-on-quarter terms (-0.4%) in Q4, owing to a strong fall-off in investment and in government consumption, after posting positive growth in Q3.

The quarter-on-quarter growth figures in Mexico and Peru were robust in the second half of the year. In Mexico's case, activity was sustained thanks to the sound performance of private consumption, with the data so far failing to reflect the possible negative impact of the change in the new US Administration's trade and migration policies. In Peru, activity was underpinned by the contribution of external demand, owing chiefly to the increase in exports, against a background of sharply declining government consumption.

At the aggregate level, the positive contribution of external demand to regional growth in 2016 was notable, as opposed to the sluggishness of domestic demand. Both investment and private consumption fell in the region as a whole, although the course of both components improved in the second half of the year and, above all, in Q4. The sluggishness of private consumption was accompanied by higher unemployment rates (see Chart 5) in all countries in the region, with the exception of Mexico, which explains the strength of its consumption.

Turning to the external imbalance, the Latin American countries corrected their current account deficit in 2016. The biggest adjustments were in Brazil, where the deficit shrank from 3.3% to 1.3% of GDP, in Colombia (from 6.4% to 4.4% of GDP) and in Peru (from 4.9% to 2.8% of GDP). Mexico (from 2.9% to 2.6% of GDP) and Chile (from 1.9% to 1.5% of GDP) also reduced their current account deficit, albeit to a lesser extent. These adjustments broadly reflected higher exports, in particular in those countries whose terms of trade improved owing to the pick-up in their export prices, assisted in some cases by the depreciation of their currencies against the dollar. Furthermore, the weakness of domestic demand also contributed to tempering significantly the buoyancy of imports.

The most recently updated indicators and the short-term forecasting models point to a favourable outlook in 2017 Q1 in Mexico, despite the uncertainty generated by the new US

LATIN AMERICA: MAIN ECONOMIC INDICATORS

TABLE 1

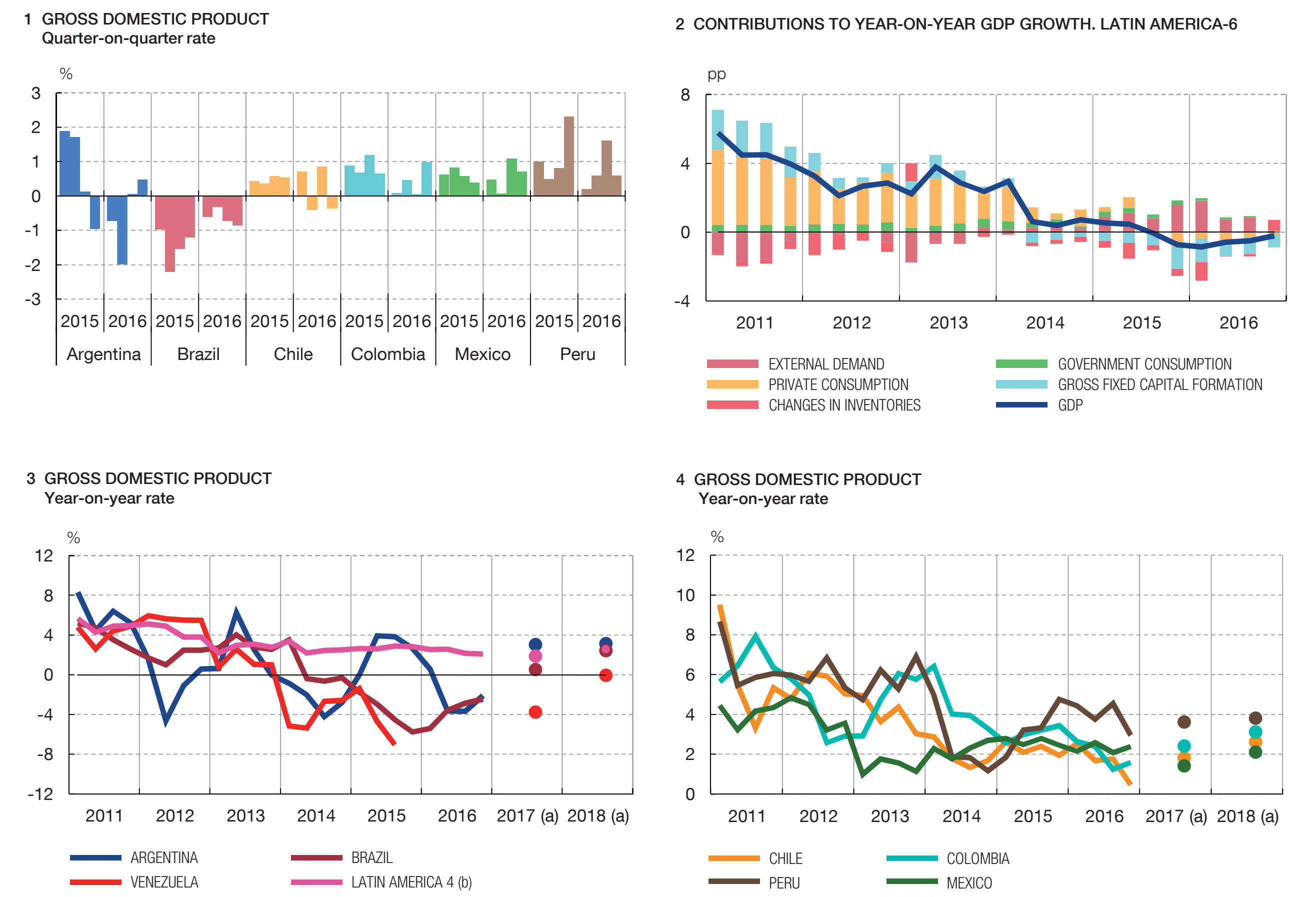
	2015	2016	2015				2016				2017
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	March
GDP (year-on-year rate)											
Latin America 6 (a)	0.0	-0.6	0.5	0.4	-0.1	-0.7	-1.0	-0.7	-0.5	-0.2	
Argentina	2.7	-2.3	0.0	3.9	3.8	2.7	0.6	-3.7	-3.7	-2.1	
Brazil	-3.8	-3.6	-1.8	-3.0	-4.5	-5.8	-5.4	-3.6	-2.9	-2.5	
Mexico	2.6	2.3	2.8	2.5	2.8	2.5	2.2	2.6	2.1	2.4	
Chile	2.3	1.6	2.6	2.1	2.4	1.9	2.5	1.7	1.8	0.5	
Colombia (b)	3.1	2.0	2.6	3.0	3.2	3.4	2.6	2.4	1.2	1.6	
Venezuela	—	—	-1.4	-4.7	-7.1	—	—	—	—	—	
Peru	3.3	3.9	1.9	3.2	3.3	4.8	4.4	3.8	4.5	3.0	
CPI (year-on-year rate)											
Latin America 5 (a)	6.1	6.1	5.4	5.8	6.2	6.6	6.8	6.3	6.0	5.2	4.7
Brazil	9.0	8.7	7.7	8.5	9.5	10.4	10.1	9.1	8.7	7.0	4.6
Mexico	2.7	2.8	3.1	2.9	2.6	2.3	2.7	2.6	2.8	3.2	5.4
Chile	4.3	3.8	4.4	4.2	4.8	4.1	4.6	4.2	3.5	2.8	2.7
Colombia	5.0	7.5	4.2	4.5	4.9	6.4	7.7	8.2	8.1	6.1	4.7
Venezuela	121.7	—	79.5	89.7	126.5	170.1	—	—	—	—	—
Peru	3.5	3.6	3.0	3.3	3.8	4.1	4.5	3.6	3.0	3.3	4.0
Budget balance (% of GDP) (c)											
Latin America 6 (a)	-5.7	-4.9	-4.5	-4.7	-5.1	-5.7	-5.1	-4.9	-4.8	-4.9	
Argentina	-3.9	-4.5	-3.1	-3.5	-3.6	-3.9	-3.2	-3.6	-3.6	-4.5	
Brazil	-9.1	-7.6	-6.7	-7.0	-8.0	-9.1	-8.3	-8.4	-7.9	-7.6	
Mexico	-3.4	-2.6	-3.3	-3.7	-3.3	-3.4	-3.1	-2.1	-2.2	-2.6	
Chile	-2.2	-2.7	-1.8	-2.0	-2.1	-2.2	-1.7	-1.8	-2.5	-2.7	
Colombia	-3.1	-3.8	-3.0	-2.5	-2.8	-3.1	-3.1	-3.2	-3.9	-3.8	
Peru	-2.9	-2.6	-1.0	-1.5	-2.1	-2.9	-3.2	-3.2	-3.2	-2.6	
Public debt (% of GDP)											
Latin America 6 (a)	50.2	—	46.8	47.5	49.2	49.7	51.1	51.9	53.4	—	
Argentina	35.3	—	38.1	38.0	38.7	35.3	38.8	41.8	44.7	—	
Brazil	65.5	69.6	59.5	60.7	63.6	65.5	66.3	67.5	69.9	69.6	
Mexico	46.2	50.9	43.5	43.9	45.6	46.2	48.0	48.1	49.3	50.9	
Chile	17.5	21.1	15.7	16.3	16.9	17.5	18.7	19.1	20.2	21.1	
Colombia	41.4	42.5	39.7	40.3	43.1	41.4	42.3	41.7	41.8	42.5	
Peru	23.3	23.8	19.9	19.9	21.1	23.3	22.8	22.2	22.7	23.8	
Current account balance (% of GDP) (c)											
Latin America-6 (a)			-3.3	-3.3	-3.5	-3.4	-3.0	-2.8	-2.5	-2.2	
Argentina	-2.7	-2.8	-1.3	-1.8	-2.2	-2.7	-2.7	-2.9	-2.8	-2.8	
Brazil	-3.3	-1.3	-4.3	-4.2	-4.0	-3.3	-2.5	-1.8	-1.4	-1.3	
Mexico	-2.9	-2.7	-2.1	-2.1	-2.6	-2.9	-3.0	-3.0	-3.0	-2.7	
Chile	-1.9	-1.4	-1.1	-1.1	-1.6	-1.9	-2.0	-2.2	-1.9	-1.4	
Colombia	-6.4	-4.4	-5.7	-6.0	-6.7	-6.4	-6.1	-5.7	-5.1	-4.4	
Venezuela	—	—	-1.2	-1.7	-2.1	—	—	—	—	—	
Peru	-4.9	-2.8	-4.6	-4.3	-4.8	-4.9	-4.6	-4.4	-3.7	-2.8	
External debt (% of GDP)											
Latin America 6 (a)	34.4	—	29.1	30.9	32.2	34.1	37.0	38.6	37.9	—	
Argentina	27.0	35.3	28.5	28.7	28.3	27.0	29.5	31.7	33.6	35.3	
Brazil	37.0	37.3	29.4	32.1	33.3	36.5	39.8	41.9	40.0	37.1	
Mexico	25.9	29.9	22.5	23.7	24.9	25.9	28.5	29.6	29.8	29.9	
Chile	64.2	—	57.8	59.2	62.8	64.1	66.8	68.4	67.4	—	
Colombia	37.9	42.5	29.2	31.2	34.7	37.8	40.9	42.7	42.0	42.3	
Venezuela	—	—	18.1	15.1	13.2	—	—	—	—	—	
Peru	38.1	38.2	34.8	34.7	37.0	38.1	39.5	39.1	39.0	38.2	

SOURCE: National statistics.

a Latin America-6: all the countries represented, except Venezuela. Latin America-5: all the countries represented, except Argentina and Venezuela
b Seasonally adjusted.
c Four-quarter moving average.

LATIN AMERICAN GDP
Year-on-year and quarter-on-quarter rates

CHART 4



SOURCES: Datastream and national statistics.

a Dots represent March 2017 forecast of the Latin American Consensus Forecasts for 2017 and 2018.
b Mexico, Chile, Colombia and Peru.

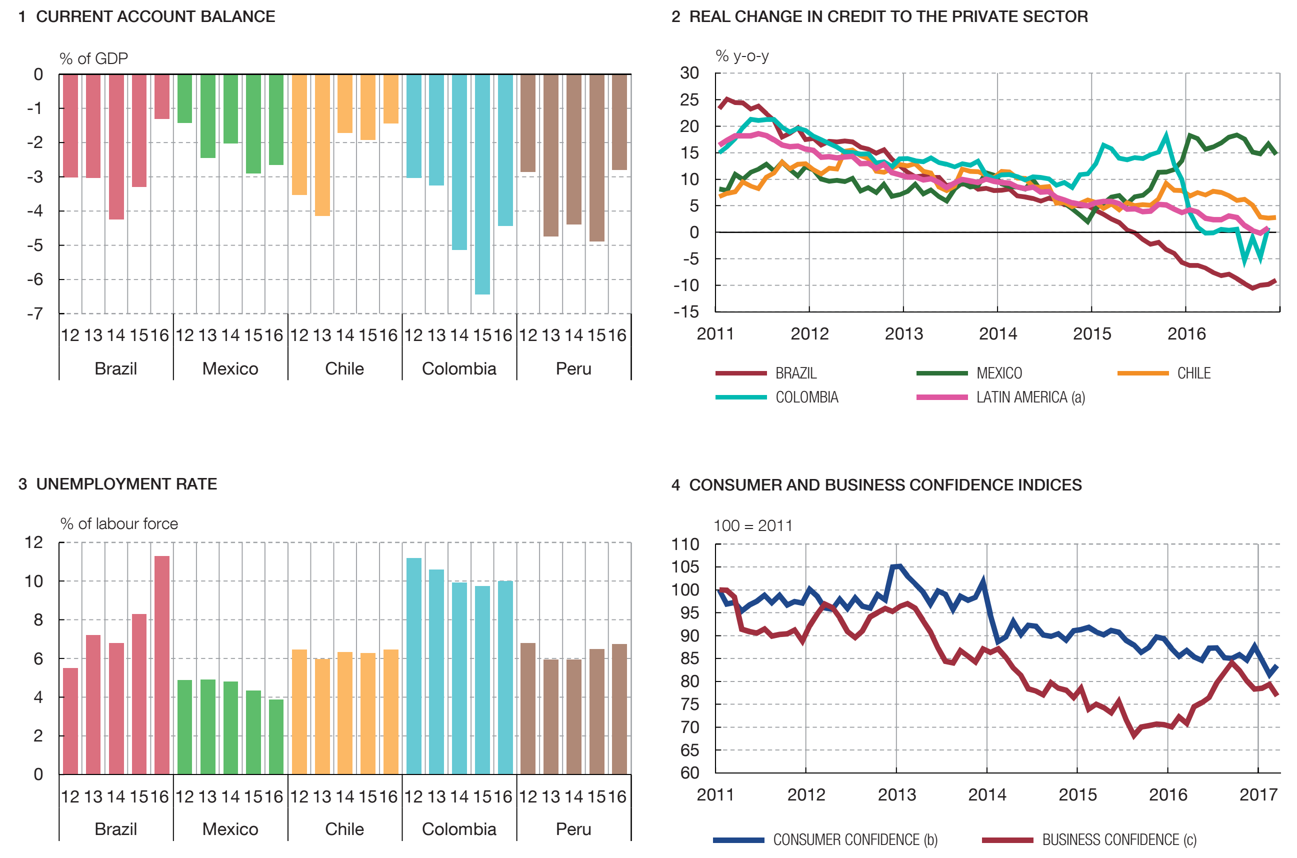
Administration's policies. Foreseeably, the depreciation of the Mexican peso will help stabilise the level of activity in the face of external shocks. In Brazil, the strong decline in GDP in 2016 Q4 was a negative surprise, which worsens growth expectations in early 2017. In Argentina, the indicators suggest that the exit from recession will firm and growth expectations are favourable. For Colombia and Chile there are signs of a higher level of activity in Q1, although in Chile the mining strikes might subtract several basis points from growth in this quarter. In Peru, expectations are favourable, although the cancellation of infrastructure projects and the consequences of the heavy rainfall in March because of the "Niño Costero" weather phenomenon may have a bearing on output.

INFLATION AND ECONOMIC POLICIES

Inflation developments in the region in the past six months have been characterised, with the odd exception, by a downward trend, although the pace of decline has differed notably from country to country. Average inflation in the five countries with inflation targeting regimes stood at 4.7% year-on-year in March, 1.4 pp less than in June last year, with a discernible narrowing of the differences across the countries (see Chart 6). The fall in inflation has been mainly due to the stabilisation of exchange rates following the heavy previous depreciations, to the sluggishness of demand and, in Brazil, to the path of regulated prices. The decline has been particularly sharp in Brazil and Colombia, where rates of 4.6% and 4.7% were recorded in March, respectively. In Peru and Chile inflation

EXTERNAL SECTOR,PRIVATE-SECTOR CREDIT, EMPLOYMENT AND CONFIDENCE INDICATORS

CHART 5



SOURCE: Datastream.

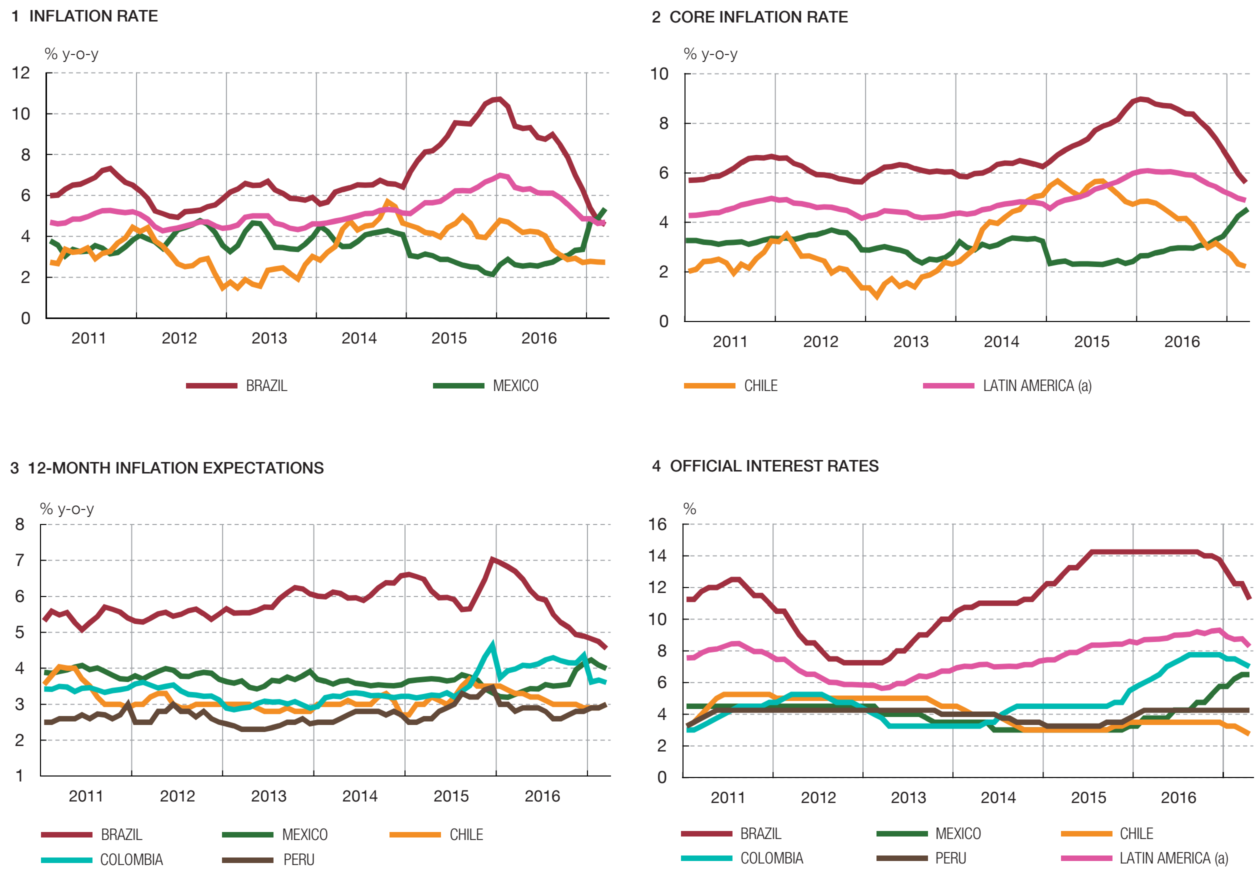
a Brazil, Chile, Colombia, Mexico and Peru.
b Argentina, Brazil, Chile, Mexico and Peru.
c Brazil, Chile, Mexico and Peru.

stood at 4% and 2.7%, respectively. Conversely, inflation rose significantly in Mexico, owing to the continuing effect of the depreciation and to the increase in petrol prices, partly associated with tax changes. In Argentina, the new official price index, which was first released in June 2016, increased on average by 1.5% per month in the second half of the year, so inflation fell yet again, albeit at a lower-than-expected pace.

As a result, monetary policies have progressively shifted to an easier stance, with the principal exception of Mexico. In Brazil, coinciding with the approval of the constitutional amendment to limit public spending growth, a cycle of cuts to the policy interest rate was launched, which began at the October meeting and which, so far, has entailed a 300 bp reduction (25 bp at the October and December meetings, 75 bp at those in January and February, and 100 bp in April) to 11.25% (see Chart 6). The market discounts further cuts insofar as inflation, which is now within its target range, continues to decline (see Table 2). The Colombian central bank lowered its policy interest rate by 25 bp at three of its four latest monetary policy meetings, placing it at 7%, against a background of weak demand and lower inflation, which is still above the upper threshold of its target band. Likewise, the Chilean central bank cut its official rate by 25 bp on three separate occasions, leaving it at 2.75%. In Chile, Colombia and Peru, where the central bank has not altered its policy interest rate since February 2016, further monetary easing is expected over the course of 2017.

INFLATION AND OFFICIAL INTEREST RATES
Year-on-year rates of change and percentage

CHART 6



SOURCES: Datastream.

a Aggregate of Brazil, Chile, Colombia, Mexico and Peru.

The situation in Mexico is radically different from that of the foregoing countries; following the pre-emptive tightening of monetary policy begun last June in the face of the sharp depreciation of the Mexican peso, the failure to correct the current deficit and the perception of a greater risk associated with the outcome of the US presidential election, the central bank decided on three further hikes of 50 bp and one of 25 bp in its policy rate over the last six months, placing it at 6.50%, in order to prevent second-round effects stemming from the depreciation of the peso and the hike in petrol prices. In Argentina, the pace of easing of monetary policy has slowed significantly in the second half of the year, given the downward stickiness of the rate of price rises and the difficulty in placing inflation in the central bank's target range (between 12% and 17% for 2017). Hence, after cutting the official interest rate by 200 bp between September 2016 and March 2017, the central bank raised it in April by 150 bp to 26.25%.

In the fiscal policy realm, and in line with previous years, both cyclical weakness and the choice of gradual fiscal consolidation strategies have limited progress in ongoing consolidation and the correction of fiscal balances has been modest (see Chart 7). Moreover, in certain cases, consolidation has been based on temporary measures, such as tax amnesties. In any event, it should be stressed that most countries have attained the (not always ambitious) fiscal targets set in the budgetary plans. Further, in some cases legislative reform has been introduced to contribute to fiscal sustainability in the

INFLATION
Year-on-year rates of change

TABLE 2

	2016			2017		2018
Country	Target	December	Fulfillment	March	Expectations (a)	Expectations (a)
Brazil	4,5 ± 2	6.3	Sí	4.6	4.3	4.4
Mexico	3 ± 1	3.4	Sí	5.4	5.4	3.9
Chile	3 ± 1	2.7	Sí	2.7	3.0	3.0
Colombia	3 ± 1	5.7	No	4.7	4.3	3.4
Peru	2 ± 1	3.2	No	4.0	2.9	2.6

SOURCES: National statistics and Consensus Forecasts.

a March 2017 Consensus Forecast for the end of the year.

medium term. An increase in or stabilisation of commodities prices, where appropriate, has — given that they are a significant source of public revenue– also helped alleviate public finances.

In Brazil, the constitutional amendment capping nominal public spending to the previous year's inflation over the next 20 years was finally approved in December. Moreover, the reform of pensions is in passage through Parliament, the approval of which is expected in the course of 2017. Given the medium and long-term public-spending-reduction drive to tackle the country's serious fiscal crisis, the Government appointed in May 2016 has opted for a gradual fiscal consolidation strategy in the short term. So far, in 2016 the primary deficit hit the target set by the Government (2.5% of GDP), underpinned by the extraordinary increase in revenue arising from the tax amnesty and by the slowdown in nominal spending at the end of the year. Although the deficit is expected to stabilise in the course of 2017 (on monthly information, it is estimated to have already fallen from 10% in June 2016 to 8.7% in January), the stock of debt will continue growing in the coming years. In Argentina, which has also opted for a gradualist strategy, headway in consolidation has been limited. The primary deficit stood at 4.6% of GDP in 2016, 0.2 pp below the Government's target, although without the revenue arising from the tax amnesty it would have stood at 6%. The gradual adjustment is forecast to continue in 2017 and the deficit target has been set at 4.2%. In Mexico, the fiscal adjustment remained under way, with the primary balance in 2016 standing at -0.2% of GDP, around 1 pp below the figure recorded in 2015. For 2017, the Government has set a primary surplus of 0.4% as a target.

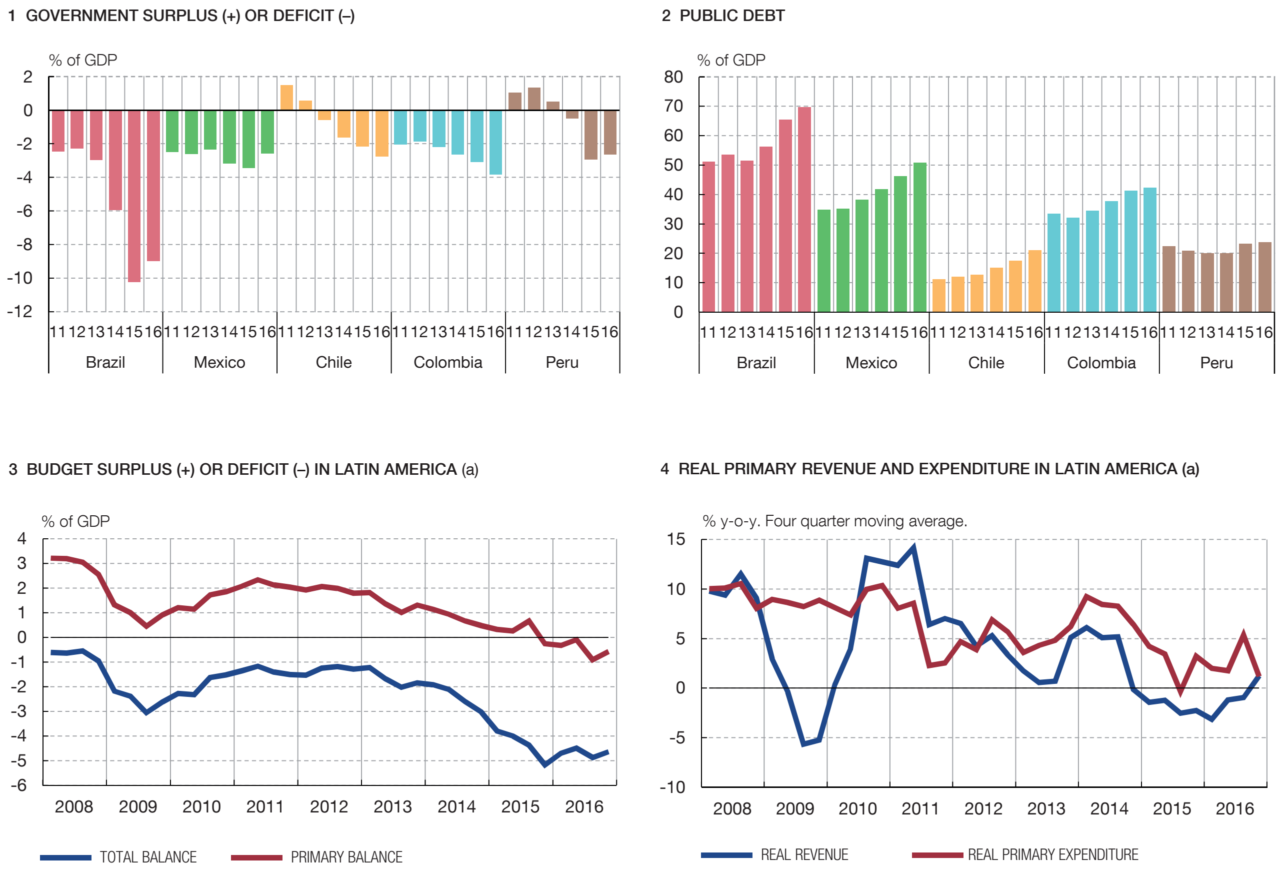
In Colombia, the Parliament approved a tax reform in December which raised the VAT rate from 16% to 19%, introduced a so-called "monotributo" (single tax) for individuals, lowered corporate income tax and entrenched more firmly the financial movements levy which it had introduced previously on a temporary basis. It is estimated this reform will raise tax takings by between 0.7% of GDP, in 2017, and 1.8 %, in 2022. Notwithstanding, the budget deficit rose by somewhat more than 0.5 pp, ending 2016 at 4%, chiefly owing to the decline in oil-related revenue. The end-2016 fiscal outcome in Chile, with a total deficit of 2.8% of GDP and a structural deficit of 1.6%, was better than expected. Finally, in Peru, the information available for 2016 suggests that the fiscal deficit will be below the Government target (3%); it is expected to improve this figure in 2017 with the introduction of a tax amnesty (in force during 2017) to declare assets abroad.

OUTLOOK

The outlook for the region points to a moderate recovery in growth (which, on consensus forecasts, would stand at 1.2% in 2017, following the 2016 figure of -0.7%), with marked

MAIN PUBLIC SECTOR FIGURES
Percentage of GDP and year-on-year change

CHART 7



SOURCES: Datastream.

a Aggregate of Brazil, Chile, Colombia, Mexico and Peru.

heterogeneity across the different countries (see Chart 1). In particular, the expected slowdown in activity in Mexico (whose growth would fall to 1.4% in 2017 from 2.3% last year), where a certain negative impact of the change in US economic policies is discounted, contrasts with the improvement projected for the South American countries. In this region, positive growth is expected in Brazil and Argentina (0.5% and 3.0%, respectively), following the declines in activity in 2016; in Colombia, Peru and, to a lesser extent, Chile, a gradual strengthening in activity is foreseen; and, in Venezuela, the recession will continue against a backdrop of deep-seated social and institutional crisis. As regards inflation, it is generally envisaged that there will be successful convergence on target ranges, although in Mexico's case, the return to the reference range may be delayed until the effects of the heavy depreciation and the rise in petrol prices have abated.

The balance of risks to growth remains tilted to the downside. Most notable on the external front are the swifter-than-expected tightening of US monetary policy, changes in investor sentiment in the current environment of high uncertainty, and difficulties in seeing through economic re-balancing in China. Domestically, the main risks are associated with the potential need to accelerate the pace of fiscal consolidation, with the uncertainty surrounding the scheduled elections and with the trying of certain cases of corruption.

The possible impact on Latin America of the expected changes in US economic policy

Based on the announcements made during the electoral campaign, Donald Trump's victory in the US presidential election last November may entail a substantial change in the US economic policy stance. The measures announced, if implemented, would have global consequences. Among the economies potentially most exposed to the shift are many in Latin America, which has significant trade, financial and migratory ties with the United States, turning in many cases on geographical proximity. Admittedly, there is still enormous uncertainty over the extent and depth with which the new president will put into practice the contents of this electoral programme, given the divisions in his party over some of the proposals. This section offers a review of the main measures under discussion and of the potential impact of some of them on the Latin American economies and, principally, on Mexico, which has closer ties.

As regards international trade, the new Administration has begun by abandoning the Trans-Pacific Strategic Economic Partnership Agreement (TPP) and has initiated talks with Mexico and Canada to amend the North American Free Trade Agreement (NAFTA). Furthermore, it has considered imposing tariffs on Chinese and Mexican imports (electoral proposals placed them at 45% and 35%, respectively) and the possibility of introducing a corporation tax that includes an at-border adjustment mechanism that penalises imports and exempts exports from the tax.

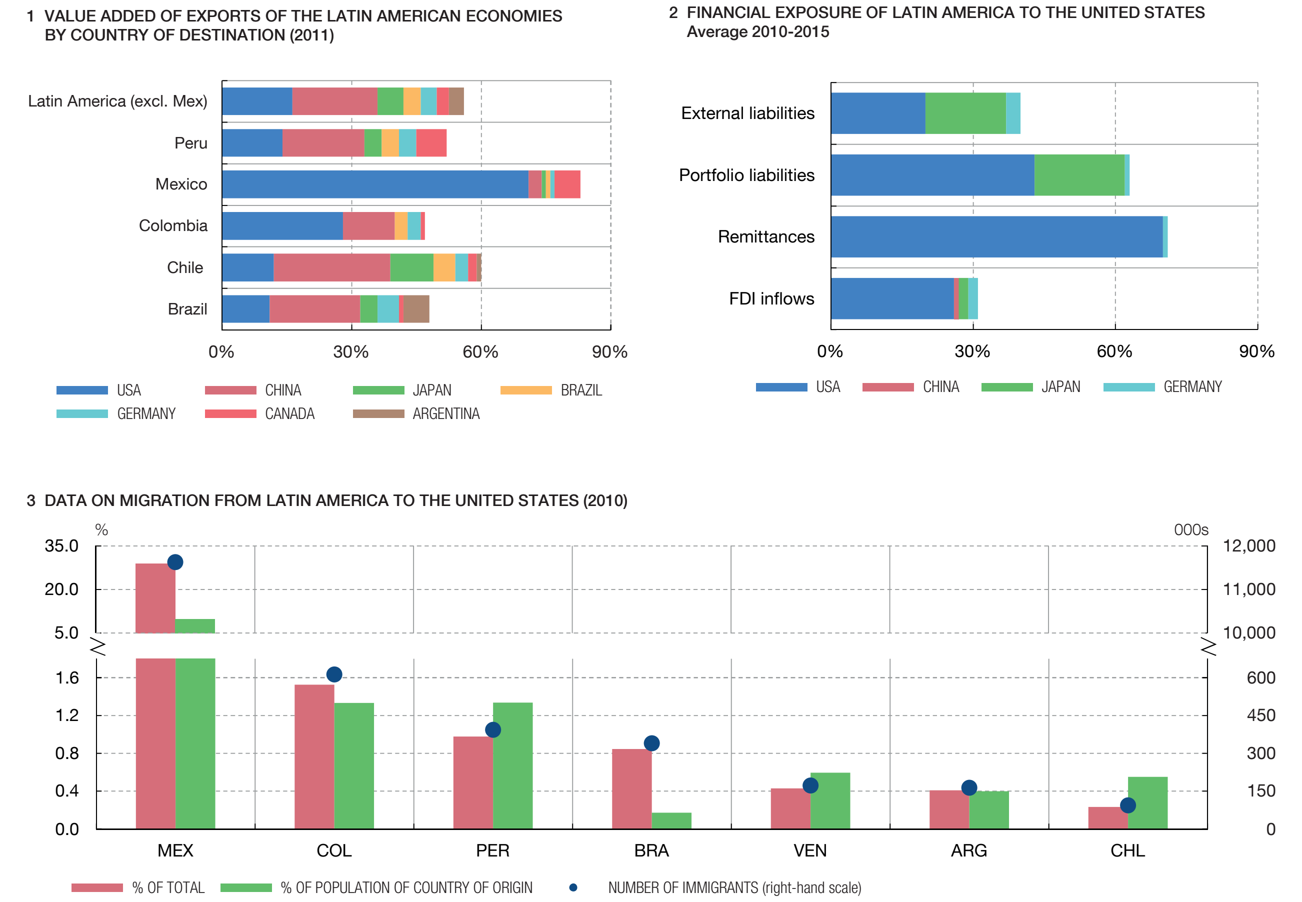
On migratory policy, several measures announced point to greater restrictions on incoming immigrants: the new president has already signed various executive decrees requesting funds for the construction of a wall on the border with Mexico (perhaps the best-known proposal of his electoral programme), the immediate expulsion of persons in an illegal situation and curbs on the entry of refugees and citizens from certain Muslim countries, although this latter measure has been suspended under a legal ruling. In the fiscal arena, a wide range of measures are at different stages of discussion, including most notably an aggressive reform of corporate income tax (including, among other things, a significant reduction in the tax rate), a cut in personal income tax (more pronounced for the higher bases), an infrastructure plan, an increase in defence spending and the possibility of compensatory cuts in other expenditure items. The expansionary nature of these fiscal measures, along with the fact that the output gap has already practically closed, potentially paves the way for the Federal Reserve to normalise its monetary policy stance more swiftly than announced. Indeed, recent months have seen the discounting of the policy interest rate rises expected by the markets, associated in part with the expected shift in the fiscal policy stance. Finally, with regard to financial regulation, there is the stated intention to repeal certain sections of the Dodd-Frank Act and a lesser willingness to coordinate regulation at the international level.

The lack of specifics offered for most of the measures mentioned hampers any rigorous assessment of their implications. This section selects some of the measures which, a priori, appear to be more likely to be implemented, and simulates their impact on the Latin American economies, conditional upon a certain specification of such measures.

In the trade domain, the United States has maintained very close links to some Latin American economies (Mexico and Cuba, for instance) since the late 19th century. These ties were extended to other countries in the region, markedly so during the two decades prior to the global financial crisis. As a result, the integration of these economies, especially Mexico and Colombia, into the US value chain reached particularly significant levels in this period (see Chart 8). After the financial crisis, the sectors and states with the greatest presence in these international value chains were those most affected by the recession,

TRADE, FINANCIAL AND MIGRATORY LINKS OF LATIN AMERICA WITH THE UNITED STATES

CHART 8



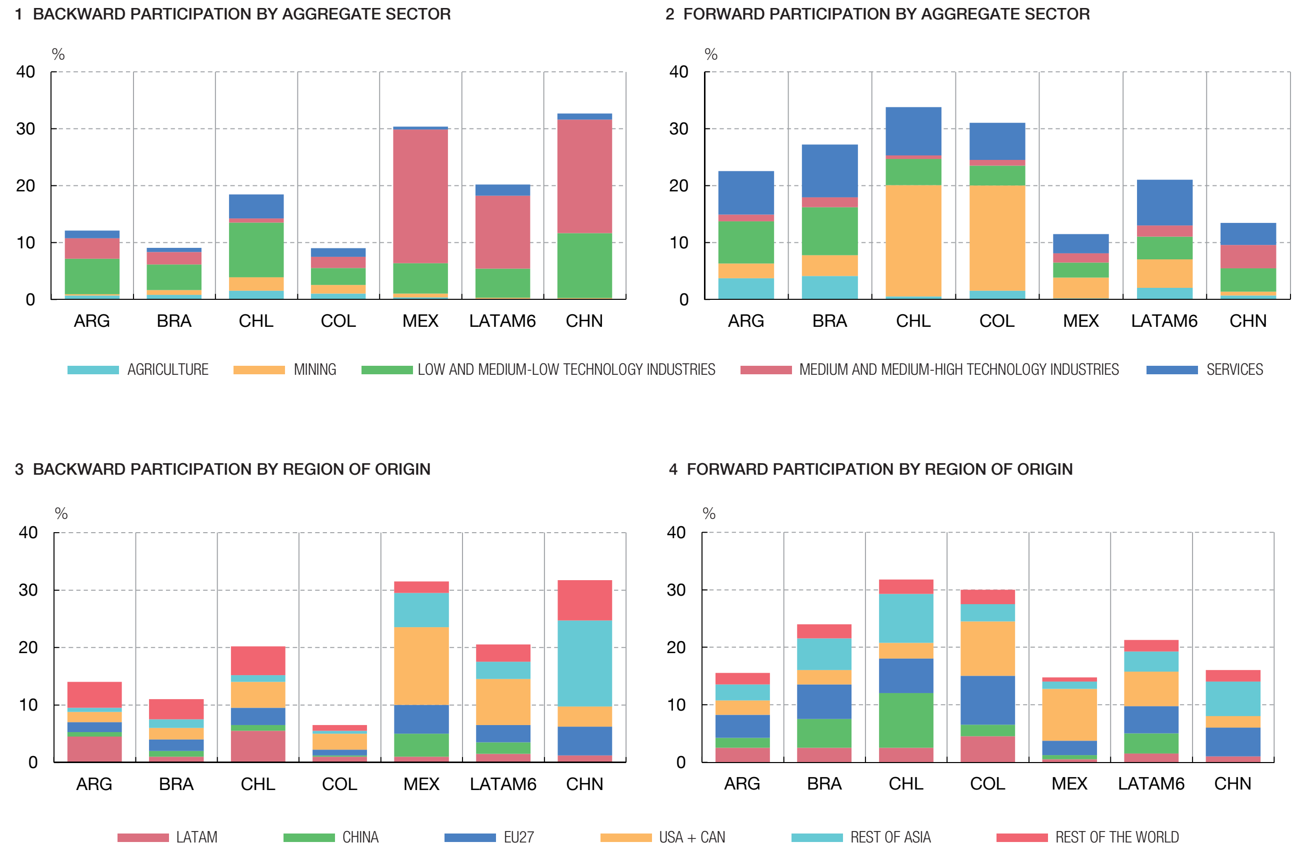
SOURCES: World Integrated Trade Statistics, BIS, IMF and World Bank.

but they also recovered more robustly afterwards. In this respect, recent studies[3] offer evidence that the increase in the global intensity of trade during the 2000-2008 period was due to a combination of two forces: the greater demand for goods with a high import content (consumer durables and equipment) and the continuous fragmentation of production at the international level. Since 2011, the fragmentation process has come to a halt and the demand for services (less trade-intensive than goods) has increased in relative terms, leading to less trade intensity.

The significance of regional value chains between the United States and Latin America can be analysed by calculating the share of value added originating in one region (United States or Latin America) in the exports of the other region. As can be seen in Chart 9, which breaks down the share of Latin America in global value chains by region and sector, this share is relatively high on average, but markedly uneven across countries and sectors; indeed, it is highly polarised. On one hand, exports from Mexico and Costa Rica incorporate most intensely value added generated in the United States, particularly in products of medium and high-technology sectors. On the other, the value-added provided from Latin America to US exports originates to a greater extent in Mexico and Colombia, in their capacity as suppliers of raw materials and services, respectively. These results

3 For further details see “An Anatomy of the Global Trade Slowdown based on the WIOD 2016 Release”, Timmer et al. (2016), GGDC Research Memorandum N. 162.

PARTICIPATION OF LATIN AMERICA IN GLOBAL VALUE CHAINS (2011) (a) CHART 9



SOURCE: OECD (Trade in Value Added and TiVA Database.

a The backward participation index is defined as the ratio of foreign value added in the gross exports of a country. The forward participation index is defined as the ratio of domestic value added incorporated into the exports of other countries.

underscore the high integration of Mexico and the United States in the production chains of numerous sectors.[4]

During his campaign, President Donald Trump announced his intention, if elected, to place restrictions on trade with the rest of the world, chiefly the countries with which the United States runs a trade deficit. The results of certain simulations conducted to quantify the possible impact of this type of measure[5] show that, under the scenario of a 35% increase in tariffs on goods imported from Mexico (and 45% in the case of China), in line with Trump's statements in the electoral campaign, and considering retaliation on a similar scale by both countries,[6] the impact on activity in Mexico would be most adverse, resulting in a cumulative reduction in growth of around 6 pp in the 2017-2020 period. Under an alternative scenario, encompassing a generalised rise in tariffs, placing them at the levels prevailing in the 1990s, the effect on the world economy would be most marked, resulting in a reduction in cumulative world growth of around 1 pp in the 2017-2020 period.

4 For example, according to data from the United States Trade Office, the states of Michigan and California accounted for around 87% of the trade deficit with Mexico in 2015 ($58 billion), since US imports of vehicles and car components from Mexico contain a significant proportion of inputs from the United States.

5 See the recent analytical article of the Banco de España, "Situation of and outlook for the world economy at the start of 2017" pp. 19-20. Available at: http://www.bde.es/bde/es/secciones/informes/

6 It should be stressed that these simulations omitted certain channels associated with a tariff shock.

FISCAL SCENARIO IN THE US (a) **TABLE 3**

	Year 1	Year 2	Year 3	Year 4
Fiscal scenario				
Fiscal revenue	-0.8	-1.7	-1.5	-0.8
Public spending	0.1	0.2	0.3	0.2
Change in fiscal balance	-0.9	-2.0	-1.9	-1.1

SOURCE: Banco de España derived from the Oxford Economics global macroeconomic model.

a Percentage of GDP.

To assess the effects of a more expansionary US fiscal policy on the Latin American economies, a series of simulations have been made with the Oxford Economics global macroeconomic model envisaging a fiscal scenario that is detailed in Table 3. What is involved is a "moderate" fiscal scenario, in line with the implementation of measures that the consensus among analysts considers to be most likely, and which is approximately equivalent to half of the amounts mentioned in the campaign by the new president; moreover, the scenario does not envisage the Republicans' proposal to introduce into corporate income tax an at-border adjustment mechanism that penalises imports and exempts exports from tax.[7] Specifically, the simulation incorporates the following elements: (i) a reduction in the corporate income tax rate; (ii) a reduction in personal income tax; and (iii) an infrastructure plan on a scale close to 0.3% of GDP per annum for the duration of the legislature. The simulation incorporates a monetary policy reaction to the fiscal expansion described, since inflation would climb, giving rise to a less gradual monetary normalisation path, around 300-400 bp above the baseline scenario.

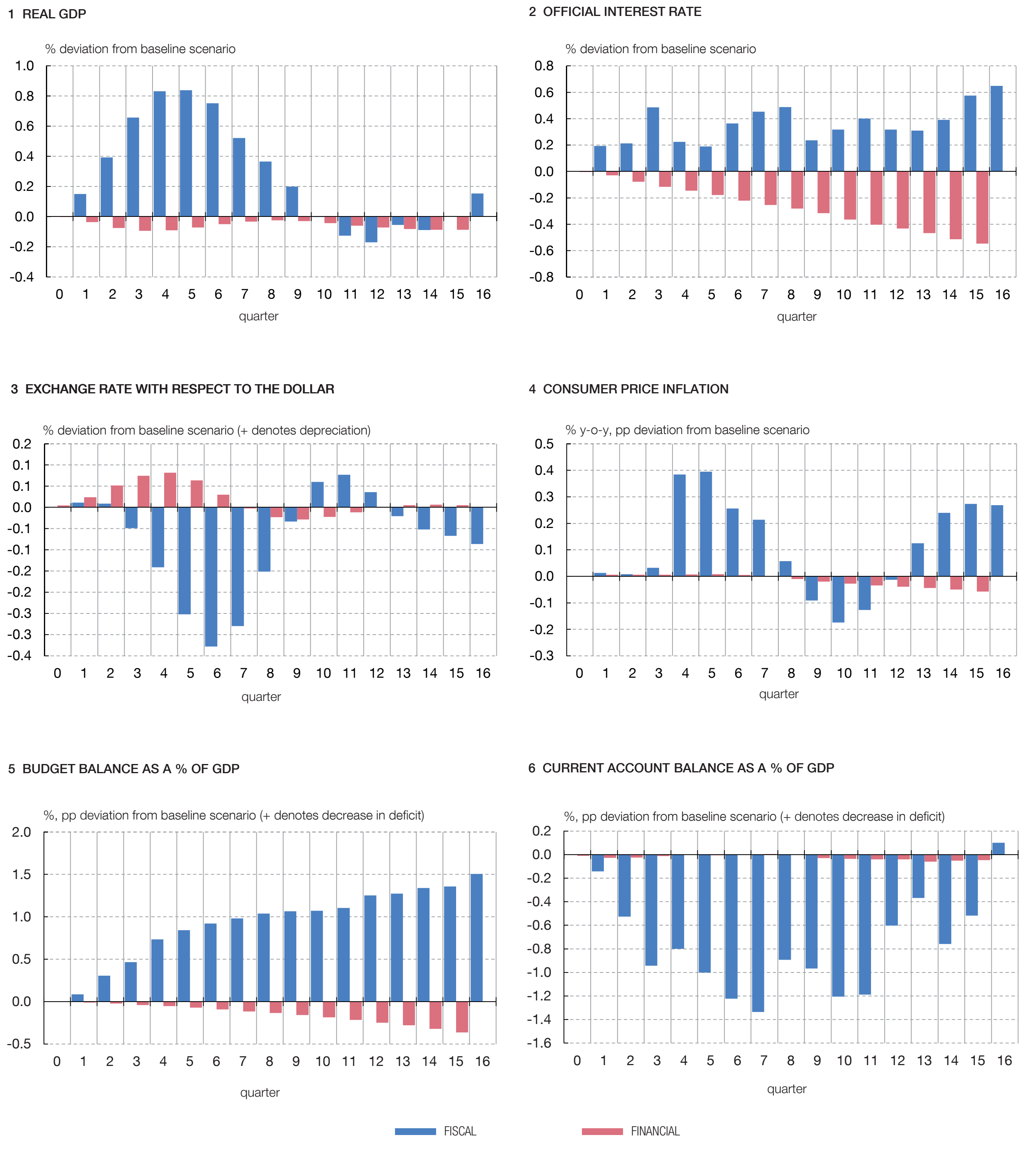
Chart 10 shows that the fiscal scenario considered would have a positive effect on the level of activity in Mexico. Specifically, growth of the Mexican economy would exceed baseline scenario growth by 0.3 pp on average until early 2020. This increase would be driven by higher business investment, private consumption and exports; however, the current account deficit would increase due to higher imports. Demand pressures would generate higher consumer price inflation, which would be nearly 0.3 pp above that of the baseline scenario despite the aggressive monetary policy response, which would raise interest rates above that of the baseline scenario in a range between 0.25 pp and 0.75 pp. The budget deficit would also deteriorate, by nearly 0.3 pp of GDP in 2020. Regarding the effects of this fiscal scenario on the other Latin American countries (see Table 4), despite the positive initial impact, the medium-term impact would be negative, particularly for Argentina and Brazil, mainly due to the tightening of the Federal Reserve's official rate.[8]

A portion of the rise in long-term interest rates in the United States seems to be due to market participants' expectations of a fiscal package like that mentioned above. Despite this, the term premium continues to stand at historically low levels. There is a possibility that other policies of the new Administration may raise the risk premium to more normal values, additionally pushing up long-term interest rates. In a setting of highly integrated

7 See Box 2 "The United States corporate income tax reform plan" of the Quarterly Report on the Spanish Economy, March 2017.

8 The results of these simulation exercises must be viewed with caution, since various factors could limit the size of the fiscal multipliers provided by the model.

IMPACT IN MEXICO OF US FISCAL AND FINANCIAL SHOCKS (a) CHART 10



SOURCE: Banco de España derived from the Oxford Economics global macroeconomic model.

a The fiscal scenario, described in detail in Table 3, comprises the following: (i) corporate income tax cuts; (ii) personal income tax cuts; and (iii) an infrastructure plan of a size near to 0.3% of GDP per year on average during the term of office. The simulation includes a less gradual monetary policy response of around 300- 400 bp above the baseline scenariol. The similation of the financial scenario envisages an increase of 100 bp in the term premia in the United States and Latin America up to end-2020.

EFFECTS OF THE US FISCAL AND FINANCIAL SCENARIO (a) — TABLE 4

Real GDP (b)	Year 1	Year 2	Year 3	Year 4
Fiscal scenario				
Argentina	0.10	0.53	-0.21	-0.03
Brazil	0.17	0.54	-0.07	-0.10
Chile	0.03	0.67	0.05	-0.01
Colombia	0.26	0.09	-0.03	-0.08
Financial scenario				
Argentina	-0.04	-0.06	-0.08	-0.11
Brazil	-0.01	-0.03	-0.04	-0.06
Chile	-0.03	-0.08	-0.10	-0.10
Colombia	0.00	-0.01	-0.01	-0.01

SOURCE: Banco de España derived from the Oxford Economics global macroeconomic model.

a The fiscal programme is assumed to exert an influence as from Q1 of the first year.
b Percentage deviation from the baseline scenario.

global financial markets in which the United States continues to be the largest world source and destination of foreign direct investment (FDI) flows and the source of sizeable portfolio and remittance flows, the main interest rates in the United States can flow through to the rest of the world and, even more so, to Latin American countries, particularly Mexico (see Chart 8). In the period 2010-2014, 40% of FDI inflows, 50% of portfolio flows and practically all remittance inflows (under particular scrutiny by the new Administration) in Mexico came from the United States. In the case of Chile, the percentage of FDI inflows and portfolio inflows coming from the United States was around 30% and 50%, respectively, of the total. To quantify the possible impact of shocks of this type, we simulated a 100 bp rise in term premia in the United States and in Latin America up to end-2020, for which we again used the *Oxford Economics* economic model.

Chart 10 shows that this scenario of higher term premia would have a slightly negative effect on Mexican production in the short term, since the potential depreciation of the peso would not offset the contraction in demand and the impact of higher borrowing costs on public finances. The impact on the GDP growth of the other Latin American countries would generally be slightly negative, being more marked in countries like Chile which are more dependent on portfolio flows from the United States (see Table 4).

Lastly, it should be noted that US immigration policies will foreseeably be reoriented to combine constraints on immigration with the expulsion of illegal immigrants. These measures would particularly affect Mexico, Central America and the Caribbean. In fact, according to World Bank statistics, in 2010 Mexican immigrants represented 29% of total immigrants in the United States and 9.8% of the population of Mexico, well above the figures for the other South American countries (see Chart 8). The possible reduction of emigration may have a positive effect on the working-age population and human capital of emigrant countries, although it would also negatively affect the receipt of remittances, which are usually a more stable source of funds than FDI or portfolio investment[9].

9 See Banco de España (2017): "Situation of and outlook for the world economy at the start of 2017", Banco de España, Economic Bulletin, March.

In short, the results of the simulation exercises suggest (although with the necessary cautions given the high uncertainty surrounding the measures and assumptions used in the analysis) that the change in the US economic policy scenario may have a significant potential impact on the region, particularly on Mexico. Although the expected fiscal stimulus may temporarily have a positive effect on the region's growth, the measures being considered by the new US Administration would foreseeably have a negative impact: at short term, owing to tighter financing conditions derived from a higher term premium due to fiscal expansion against a background of high public debt, but above all owing to increased trade protectionism and constraints on migrant flows, which would foreseeably have more lasting effects.

The recent adjustment of the Chilean economy and the current economic policy challenges

Since 2013 the Chilean economy has lost considerable momentum, mainly been due to the decline in terms of trade resulting from lower commodity prices and less buoyant external demand. These developments have particularly impacted the mining sector, vital for the Chilean economy because of the income it generates and the share of aggregate investment it represents. Meanwhile, the smaller increase in working-age population and the scant headway in productivity led to a downward revision of the growth capacity of the economy in the medium term. The economy was obliged to adapt to the new circumstances, and, although this was done without major disruptions, it has given rise to a situation of higher vulnerability, particularly in the fiscal arena. This section reviews the Chilean economic situation in this new setting and assesses the room for manoeuvre which economic policies have for addressing this situation.

The past decade was a boom period for the Chilean economy which allowed it to maintain twin (fiscal and external) surpluses, accumulate external assets in its sovereign funds and use macroeconomic policies countercyclically following the 2008 financial crisis. However, from 2011 Chile has been affected by the fall in the price of copper (down more than 50% between 2011 Q3 and 2016 Q1) and by the weaker external demand, basically from China, its main trading partner. This situation induced a contraction in aggregate demand and a loss of buoyancy in the economy. The mining sector grew much more slowly and even contracted in 2015 and 2016, as can be seen in Chart 11. Hence GDP growth fell from 6% in 2012 to an average of 2% in the four years from 2014 to 2017 (forecast), a poor performance unprecedented in the Chilean economy in the last 30 years. The main variable affected in this change of cycle was investment, which fell by 18% in real terms between 2012 and 2016, its share of GDP being reduced to 22% in 2016, down 5 pp from 2012. Although the economy's structural resilience allowed non-financial corporations to maintain their access to credit, activity in some sectors, such as construction, was also affected.

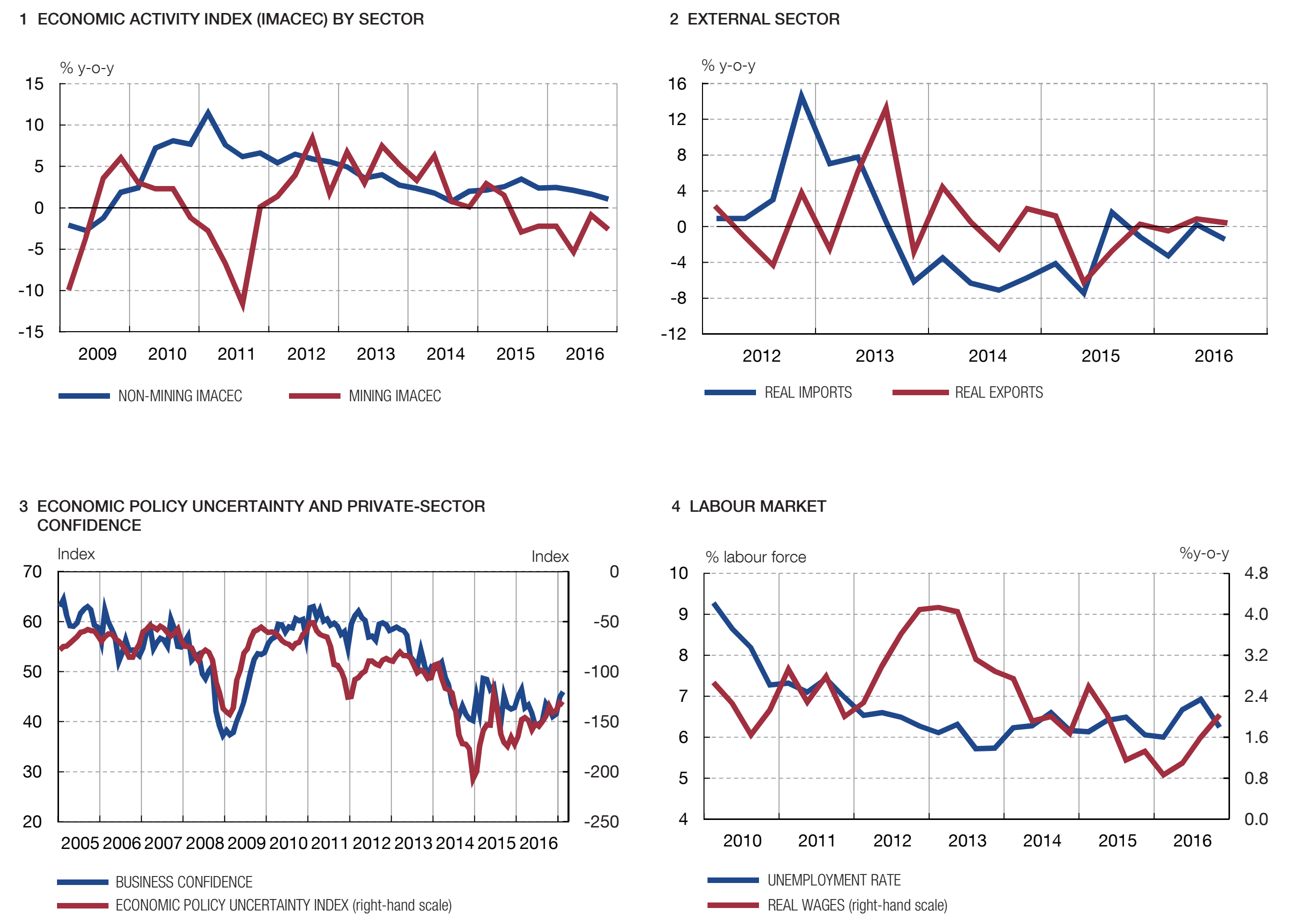
The lower capital accumulation, taken in conjunction with factors of a structural nature, such as slower growth of the working-age population and stagnation of factor productivity in the past decade, meant that potential growth was notably below that estimated before the crisis. Thus the trend GDP advisory committee[10] estimated the economy's potential growth to be 3%, down 2 pp from 2012 and 0.1 pp higher than the IMF estimate.

The change of cycle was rapidly reflected in the currency market. The copper price slump and the change in the financing conditions of the emerging economies — following the signs in mid-2013 that the Federal Reserve was beginning to consider reducing the

10 The structural fiscal balance policy of Chile requires an estimate of the economy's long-term revenue. For this purpose, in 2001 and 2002 two committees were set up which meet yearly to calculate the system's main parameters: the potential GDP of the economy and the long-term copper price.

INDICATORS OF THE CHILEAN ECONOMY

CHART 11



SOURCE: Datastream.

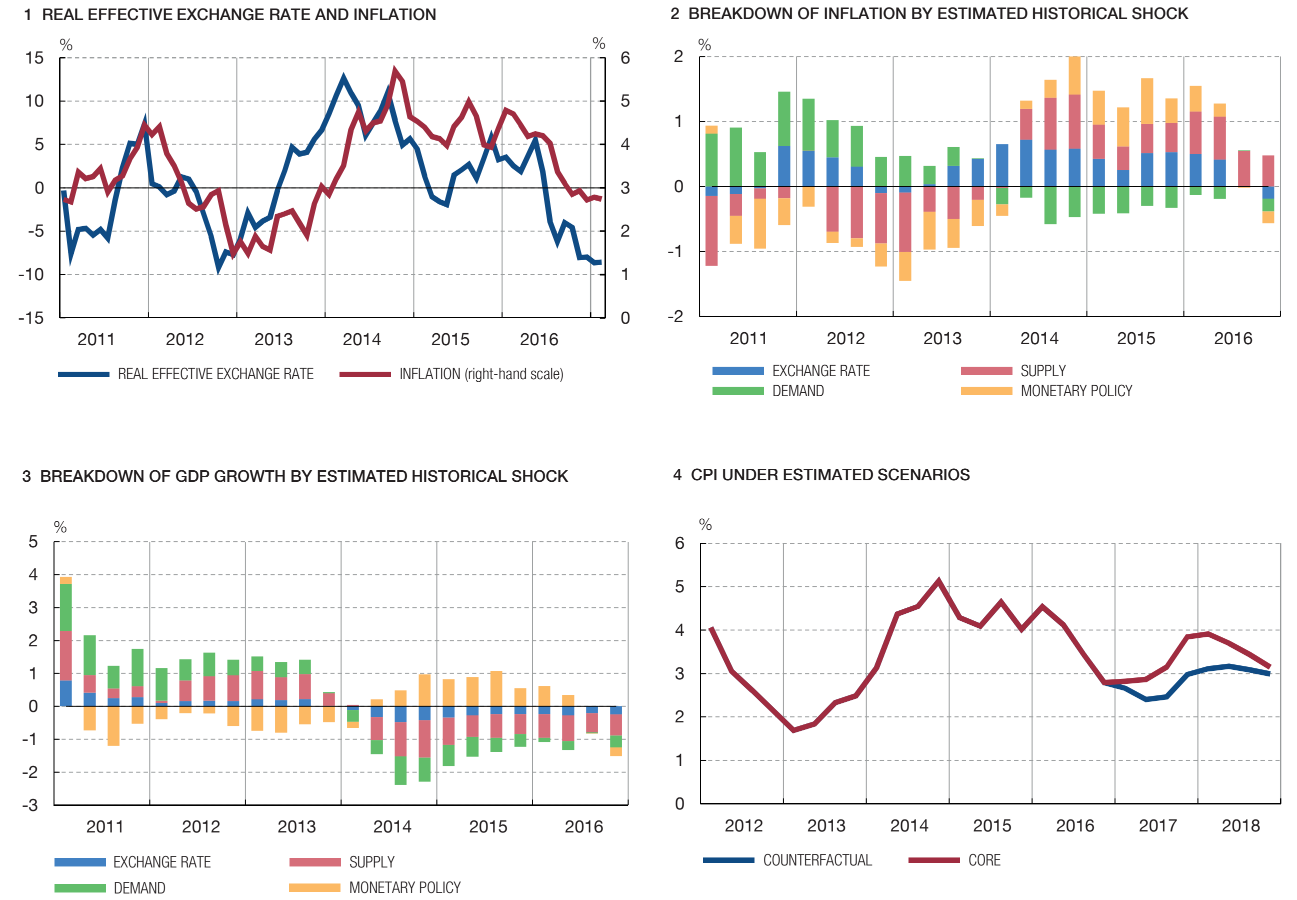
monthly volume of its asset purchases — led to a sharp depreciation of the peso, so the exchange rate acted as a variable in adjustment to the external shock. The competitiveness gains enabled Chile to maintain its exports against an unfavourable external backdrop and to replace a part of its imports by domestic production, as shown by Chart 11. As a result, the current account balance, which deteriorated notably in 2012 and 2013 to a deficit of 3.7% of GDP, recovered quickly and ended 2016 with a deficit of 1.4%.

The unfavourable external situation meant that the process of reform undertaken by the new government, which took office in 2014, commenced at a particularly delicate time from an economic standpoint. The objective was to address some of the main structural challenges to the Chilean economy, such as improving educational performance, in order to make the transition to more sustainable and all-inclusive economic growth. Although the main reforms (educational, fiscal and labour) were approved, their discussion and implementation led to heightened economic uncertainty reflected in a fall in private sector confidence indicators, as shown in Chart 11. This development impinged on the already-low investment rates, affecting growth negatively. By contrast, the favourable effects on growth of these reforms will become perceptible at medium term, when their ability to reduce the traditional bottlenecks in the Chilean economy becomes manifest.

Recently, activity has continued on a slowly advancing path, with growth of 1.6% in 2016. Against a background of falling investment, the key factor for growth has been

CHILE: REER, INFLATION AND BREAKDOWN OF GDP GROWTH AND OF INFLATION BY ESTIMATED HISTORICAL SHOCK

CHART 12



SOURCES: Datastream and Banco de España.

domestic consumption, driven by a rise in real wages and a favourable labour market performance. However, signs of exhaustion have been observed also on this front, such as the increase in unemployment to 7% in the first half of 2016 which, although it reversed in the second half of the year, did so with a significant contribution from self-employment.

In this setting, fiscal policy has been the main countercyclical tool used by the authorities and, as a consequence, the budget deficit increased to 2.8% of GDP in 2016. The net debt also increased and, although the figure still stands at a relatively low level, the public sector went from being a net international creditor to a net international debtor in 2016. Various sovereign debt rating agencies have assessed the Chilean sovereign debt outlook as negative for this reason, although the market risk indicators have performed favourably. In this situation, the government now envisages a fiscal consolidation plan to reduce the structural deficit by 0.25 pp each year.

Turning to prices, Chart 12 shows that the exchange rate depreciation induced an upturn in 2014 and 2015, raising inflation to 5% year-on-year, 1 pp above the upper bound of the monetary policy target range (target of 3%, with a tolerance margin of +/- 1 pp). This behaviour led to a slight increase in the official interest rate at end-2015, against a background in which the signs coming from activity augured a sharp deceleration and a negative output gap.

To analyse the impact of supply, demand, exchange rate and monetary policy shocks on the main Chilean macroeconomic variables, we used a structural BVAR model[11], the main results of which are set out in Chart 12. As can be seen, the adverse performance of domestic demand has led to a decrease in inflation in recent years, an effect masked between 2014 and 2016 by the impact of exchange rate depreciation on inflation. Once the exchange rate was stabilised, the decrease in inflation became apparent. In recent quarters, in response to the weak demand and exchange rate appreciation, inflation fell rapidly and has stood at a level below the central bank target since November. This led to a monetary policy response in the form of three cuts in the intervention rate, each of 25 bp, in January, March and April, reducing it to 2.75%. Activity reflected both shocks, as seen in Chart 12, and the lower structural growth of the economy, estimated at near 3%.

In the coming months, the main risk for monetary policy lies in the possibility that, in a setting of a stable or slightly appreciating exchange rate, inflation will stand below the target for a long period of time. In this respect, the aforementioned model was used to simulate a scenario consistent with a central bank monetary policy rate holding steady until end-2017, compatible with that expected by the analysts consulted in the March 2017 economic expectations survey. As a counterfactual scenario, we simulated one in which the central bank held its interest rate at the end-2016 level, namely 3.5%. Chart 12 shows that in the first scenario the monetary stimulus helps to keep inflation above the 3% target at end-2017, while in the counterfactual scenario inflation does not return to the target until 2018. The size of the impact of monetary policy on inflation is similar to that found in other studies for the Chilean economy, such as that of Parrado (2001).[12] In short, monetary policy would be decisive for stabilising inflation in a situation in which price growth departs from the central bank target.

The growth outlook for 2017 is for rates similar to those of 2016. Activity will be weaker in the first half of the year due to the carryover effect of the unfavourable performance in 2016 and to the impact of the mining sector strikes on exports. As these factors fade away, a recovery is expected late in the year which will allow the year to end with a growth rate close to 2% (the consensus forecast is 1.8%). For 2018, the commencement of a new stage following the presidential elections at year-end may bring improved confidence with a positive impact on the economic situation.

Turning to risks, it should be noted that the foreign currency indebtedness of private agents rose following the 2008-2009 crisis, fuelled by the lax financial conditions at international level, increasing their exposure to the balance sheet affects derived from the economic slowdown and the currency depreciation. However, the financial markets have performed favourably in recent months and corporate balance sheets reflect the prevalence of stable long-term sources of funds. This situation could change if financing conditions tighten for the Latin American economies (see preceding section). Similarly, fiscal accounts may deteriorate if the copper price, which recovered in 2016, falls again. Although the

11 The model, estimated using quarterly data, includes four endogenous variables (bilateral nominal exchange rate against the dollar, inflation rate, GDP and official interest rate) and two exogenous variables (external demand and copper price). The model includes a mean-adjustment to reflect the weaker long-term growth outlook explained in this section. The shocks to the endogenous variables are identified by a system of sign restrictions; see Forbes, K., Hjortsoe, I. and Nenova, T. (2015). "The shocks matter: improving our estimates of exchange rate pass-through". Bank of England External MPC unit Discussion Paper No. 43.

12 Parrado, E. (2001), "*Shocks Externos y Transmisión de la Política Monetaria en Chile*" Economía Chilena 4(3) 29-57

increase in structural expenditure in recent years has coincided with an increase in revenue from the fiscal reform approved in 2014, a worsening of the fiscal accounts or failure to meet the structural goals set in the fiscal rules could cause market tension and a deterioration of financing conditions.

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