ESTUDIOS

2020 OUTLOOK

Economic outlook in a year of change

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Introduction

This year will be marked by the internal political process in response to the social upheaval. The most crucial thing will undoubtedly be the constitutional process. The plebiscite on the next 26th of April could begin a substantial transformation to the legal framework we have known for the last 40 years. Notwithstanding, the political discussion does not end there. The first elections for regional governors will be held during this year, which will mark the beginning of one of the most ambitious processes of political decentralisation that the country has had in recent decades.

In tandem, essential reforms are progressing through Congress, which will involve first-order economic impacts. The tax modernization project, launched in 2018, has evolved significantly: the government has rejected the reintegration of the income tax and introduced new taxes, which should moderately raise tax revenues. The reform of the pension system also seeks to significantly increase the compulsory contribution and will include a distribution component to those with the lowest pensions.

The magnitude of the social upheaval –which revealed levels of dissatisfaction beyond what was foreseen– and the violence that has come with it have significantly diminished confidence. This, along with the uncertainty that the constituent process will arouse, is expected to affect growth. However, greater certainty will be attained as milestones are fulfilled.

Meanwhile, after last year's sharp slowdown, the world is expected to regain some of its dynamism. Alongside an expansive fiscal policy and low interest rates, this will help restrict the impact of the domestic political scenario on local activity. Hereafter, the task of containing fiscal deficits will become particularly relevant to achieve the stabilisation of public debt in the medium term.

This document issued by Banco Santander's Studies Department offers our vision over the economic situation of Chile and the World, and the outlook for this year. With it, we seek to contribute to the assessment and public debate regarding the challenges we must face to continue moving towards the country's progress.

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Santander

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EXECUTIVE SUMMARY

The year 2019 was marked by the advances and setbacks in the commercial dispute between China and the United States, the slowdown in the world's economy and the social conflict in our country.

Trade tensions reached their peak in May when the United States announced new tariffs and China retaliated with further restrictions. However, the situation eased towards the end of the year when an agreement prevented some of these measures from taking effect. Despite this, the slowdown in global trade since mid-2018, along with the uncertainty over the dispute between these two countries, more restricted financial conditions at the beginning of the year, and domestic political problems in several countries caused global economic activity to lose momentum. Thus, the world expanded by around 2.9%, its lowest record since 2009.

Although the slowdown was widespread, the moderation experienced by emerging economies was the most significant. The United States maintained an important dynamism that allowed it to complete its longest period of expansion ever recorded. Meanwhile, China decreased its growth down to 6.1%. The slowdown of this country reduced the price of raw materials and impacted the pace of activity of other emerging countries, Latin America in particular, which was also affected by internal tensions.

Labour markets in the major economies remained robust, but inflation remained restricted. This, in tandem with the slowdown in growth and the risks to activity, led the major central banks to change their course and apply a higher boost. In that context, long-term interest rates fell sharply during the first half of the year. Despite the slowdown, global exchanges performed well, and recovered the losses observed towards the end of 2018. Influencing this were the fall in long-term interest rates and the change of tone in the dispute between the United States and China, which dispelled the fears of a possible recession at a global level.

In the future, we assess that the tensions caused by the commercial conflict will be less intense, at least during the election process in the United States. Moreover, political uncertainty in Europe will decrease, as many doubts about Brexit have been dispelled. However, given the maturity of the cycle in the major countries, we estimate that the global economy will expand only 3.1% by 2020, rising to 3.2% by 2021.

The Chilean economy began 2019 with a slow performance, affected by the external scenario and a relatively weak labour market. The growth prospects were reviewed downwards as the year progressed and the world decelerated, and the local activity disappointed. Consumption remained contained, but investment rebounded with large investment projects in mining, energy and infrastructure, and real estate dynamism. At the end of the year, the social upheaval of October 18th (18-O) triggered a sharp contraction in the economy. The temporary disruption of several activities –primarily trade and some services– led to an unprecedented monthly drop of more than 5% in the Imacec —or Monthly Indicator of Economic Activity— that month. Local assets had a heavy loss of value and risk premiums increased. The Central Bank injected liquidity and intervened the exchange market to restrict the volatility and to facilitate portfolio adjustments.

Activity began to return to normalcy over the weeks which, together with the intervention of the Central Bank, led to a reversal in asset prices. November's Imacec reflected a partial recovery, which continued throughout December. Therefore we estimate that the year has closed with a growth of 1.1%, below the 3.5% we projected at the beginning of 2019 and the 2.4% we predicted before the crisis.

Inflation remained low but went gradually rising along with the increase in the exchange rate and closed at the 3% target after several years below it. The lower inflationary records, the uncertainty of the external scenario and the gradual weakening of activity led to a shift in the local monetary policy. Thus, the Central Bank

went from announcing a trajectory of increases in its rate in early 2019, to successively cutting the Monetary Policy Rate (MPR), from 3% in June to 1.75% in October.

By 2020 the activity will be strongly influenced by the evolution of the internal political process. While the frequency and intensity of violent episodes have been decreasing, the impact on confidence and business climate after the events of 18-O will be persistent, and new disruptive events are not ruled out. Added to this is the uncertainty generated by the discussion regarding the constitutional process, which could affect spending decisions. The magnitude of this impact will depend on how the political process develops.

On another note, the large projects that affected 2019 should provide a minimum basis for investment this year. Added to this is the fiscal stimulus package announced by the government in November, with a robust infrastructure expenditure component. Despite this, we foresee a contraction in capital formation. Consumption, meanwhile, will grow at low rates. The external sector will be favoured by a slight improvement in the international scenario and a higher real exchange rate. With these elements, we anticipate that the growth of 2020 will be around 1%.

Inflation will rise temporarily in the first part of the year due to the depreciation of the exchange rate. However, the greater gaps that the slowdown in growth will generate, coupled with the freezing of a series of public tariffs, will cause it to fall back and close again below the target in 2020.

Despite the above, we assess that the Central Bank will maintain its policy rate unchanged. The risks of any abrupt adjustments to financial prices in the current context will make the Central Bank more cautious when acting through its monetary policy.

Fiscal policy will play an essential role in sustaining domestic demand this year. The strong expansion of public expenditure, which we are projecting, will exceed 8%, and limited revenue growth will bolster the fiscal deficit to a range of 4.5% - 5% of the GDP. With this, public debt will exceed 30% of the product by the end of the year, so a gradual and credible fiscal consolidation process will be needed to stabilise this variable. To reach this, the government should take special care in the ongoing spending commitments as it acquires them. The social agenda announced in November includes some expenses that are to be paid only once, but it contains many measures that are of a permanent nature. Furthermore, the pension reform is to be considered, which will also involve substantial fiscal amounts.

There are several risks to our scenario. Externally, new tensions may arise between the United States and China, and the trade war may escalate again, affecting global growth and the price of raw materials. In addition, President Trump's impeachment process and the elections in the United States could be a source of uncertainty. In Europe, the negotiations between the United Kingdom and the European Union after Brexit could lead to further episodes of volatility. Added to this are the geopolitical tensions that have surfaced in the Middle East over the past few weeks. At a local level, the main risks are associated with the political scene and with how the constituent process develops.

At a legislative level, there are several initiatives already underway in Congress which will have a material economic impact. The tax modernization project stands out, which has significantly evolved from the original project that began its processing a couple of years ago. The reform of the pension system is to be highlighted as well, which substantially increases contributions and introduces a repartition mechanism. Other initiatives, such as the project involving a weekly labour time of 40 hours, if it thrives, must be calibrated in a way to ease the adjustment costs of the labour market.

Finally, the first election of regional governors during October and the process for eventual constitutional change will mark a year in which politics will have a leading role.

SANTANDER PROJECTIONS

Table 1. Fundamental variables

Commodities	2018	2019	2020	2021
LME copper price (US$/lb)	2.94	2.74	2.85	2.90
WTI oil price (US$/bbl)	65	57	61	65
Inflation	**2018**	**2019**	**2020**	**2021**
CPI (%. aop)	2.4	2.3	3.2	2.6
CPI (%. eop)	2.6	3.0	2.7	2.7
Core CPI (%. aop)	1.9	2.2	2.5	2.3
Core CPI (%. eop)	2.3	2.5	2.4	2.4
Financial conditions	**2018**	**2019**	**2020**	**2021**
Exchange rate (Ch$/US$. aop)	641	703	772	775
Exchange rate (Ch$/US$. eop)	696	745	770	780
MPR (%)	2.75	1.75	1.75	1.75
Labor market	**2018**	**2019**	**2020**	**2021**
Unemployment rate (%. aop)	7.0	7.0	8.2	8.0

Note: aop=average of period
eop= end of period

Source: Bloomberg and Santander

Table 2. World growth (%)

	2018	2019	2020	2021
Advanced economies	1.9	1.7	1.6	1.6
Eurozone	1.9	1.2	1.4	1.5
USA	2.9	2.3	1.7	1.5
Japan	0.8	0.9	0.7	0.5
Emerging and developing economies	4.5	4.0	4.1	4.3
Latin America and the Caribbean	1.0	0.2	1.0	1.8
China	6.6	6.1	5.9	5.8
India	6.8	5.0	5.5	6.0
World *	3.6	2.9	3.1	3.2

* Calculated with purchasing power parity

Source: IMF and Santander

Table 3. National Accounts and Balance of Payments (%)

	2018	2019	2020	2021
GDP	4.0	1.1	1.0	2.5
Domestic demand	4.7	0.8	-0.7	1.6
Consumo Total	3.7	1.8	1.5	2.1
Private	4.0	1.7	0.9	1.9
Public	2.2	2.2	4.4	3.2
Gross capital formation	4.7	3.1	-4.0	2.1
Construction	2.7	5.1	0.0	1.9
Machinery and equipment	8.2	-0.5	-10.9	2.3
Change in inventory (effect)	0.8	-1.3	-1.1	-0.5
Exports	5.0	-1.6	3.0	3.3
Imports	7.6	-2.6	-3.0	0.5
Current account (% GDP)	-3.1	-2.9	-1.6	-1.0

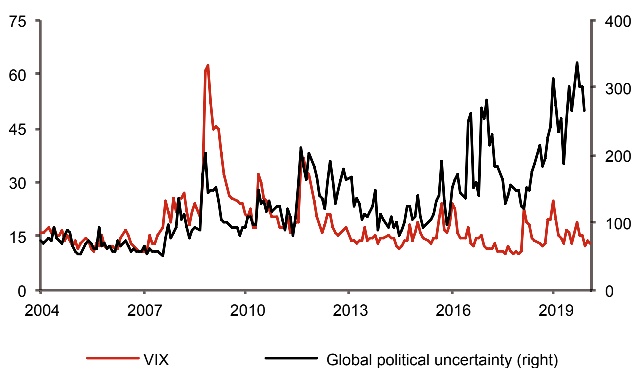
Source: BCCh and Santander

GLOBAL SCENARIO

During 2019, the global economy decelerated sharply within a complex political environment. The year was marked by advances and setbacks in the trade dispute between the United States and China –which affected not only these two countries, but also other countries, due to its effect on the global value chains and trade-, the political tensions in Europe in the Brexit context, and a wave of social protests in different countries that undermined the confidence and generated uncertainty. The world grew only 2.9%, below the 3.6% of the previous year and less than the 3.5% we projected in our 2019 Outlook, where we had already warned of the downside risks to the global activity.

Among the different world regions, the lower dynamism within Europe and emerging countries, particularly within Latin American countries stands out. The United States, though slowing down its pace of expansion, grew at a significant rate. Furthermore, it completed 40 quarters of uninterrupted advance, which is the longest phase since ever recorded.

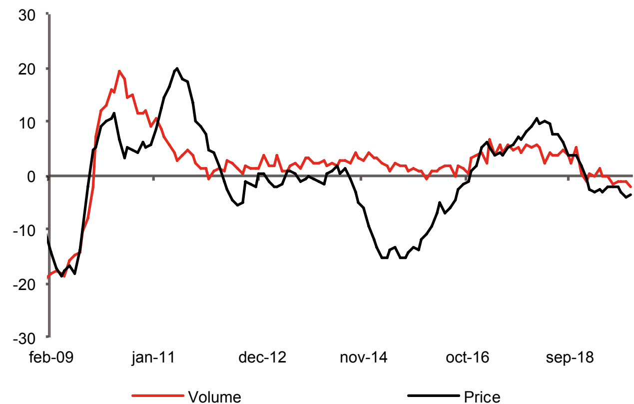
Graph 1. VIX and Index of global political uncertainty (%, Index)



Source: Bloomberg and Santander

Labour markets around the world remained dynamic, undergoing further reductions in unemployment rates, mainly in the United States and Europe. Despite this, inflation remained low. Together with the slowdown in activity and the risks to growth, the latter led to a shift in the monetary policies of the major central banks, which expanded their momentum by reducing their reference rates. This created a drop in the long-term rates and encouraged the major stock markets.

Graph 2. Global economy (annual var,%)

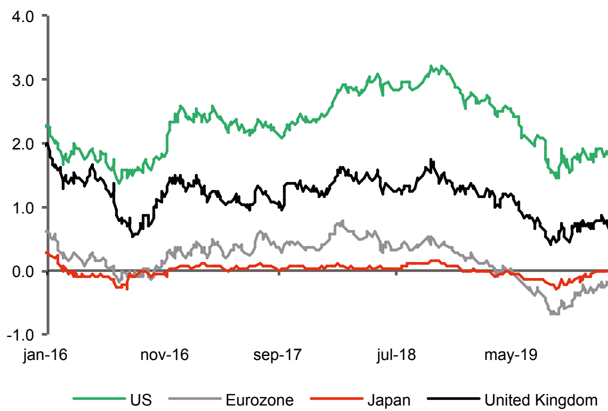


Source: Bloomberg and Santander

By 2020 we expect the global economy to recover moderately and to expand by 3.1%. Europe and the major Latin American economies should see a slight upturn, while China and the United States should continue to decrease their growth due to the maturity of their economic cycles and factors specific to each country. By 2021, we project a global growth of 3.2%, driven primarily by emerging economies. We estimate that global inflation will remain contained. Despite this, we see that the probability of new monetary stimuli by the leading central banks is low. The European Central Bank (ECB) has very limited room for manoeuvre, while the Federal Reserve (Fed) has shown signs of being comfortable with its current rate level.

The risk balance continues its downward trend. Although there have been advances in the trade dispute between the United States and China, the struggle for medium-and long-term hegemony will be a source for new conflicts that could rekindle protectionist measures. In the United States, while impeachment is not expected to culminate in the removal of the president, the process could be a source of volatility.

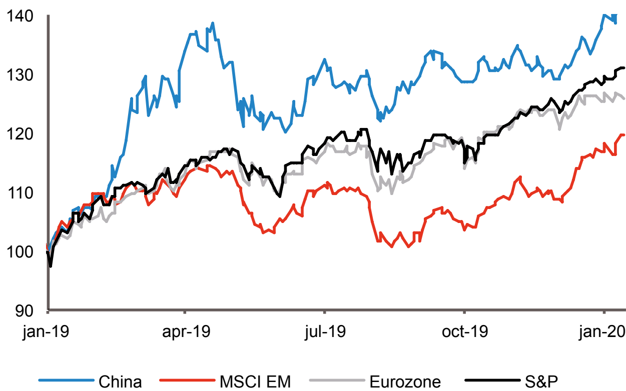
Graph 3. 10-year nominal rates (%)



Source: Bloomberg and Santander

The European Union and the United Kingdom will face a difficult negotiation over the terms of their future relationship once Brexit starts. So far, the situation in Northern Ireland remains largely unclear. At this report's conclusion, there was a new focus of tension following the assassination of a critically important Iranian military leader on behalf of the United States. It is still too early to assess the impact this situation may have on the global scenario. For the time being, the effect on assets and the price of oil has been limited.

Graph 4. International stock exchanges (Index 100 = Jan. 19)

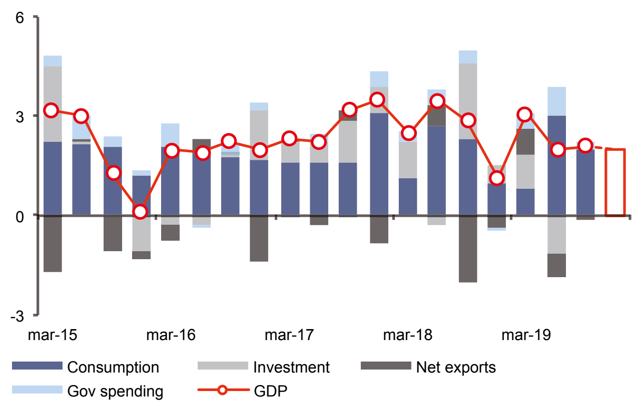


Source: Bloomberg and Santander

Major economies lose dynamism, but the U.S. displays resilience

The U.S. economy kept a robust pace during 2019, driven mainly by private consumption and a vigorous labour market. The year began with a sharp increase of 3.1% (annualised QoQ) and then moderated, with expansion rates around 2% in the second and third quarter. While indicators within the fourth quarter point towards an additional decrease, the year would have closed with a growth of around 2.3%, in line with what we projected in our 2019 Outlook.

Graph 5. United States GDP (%, annualized QoQ)



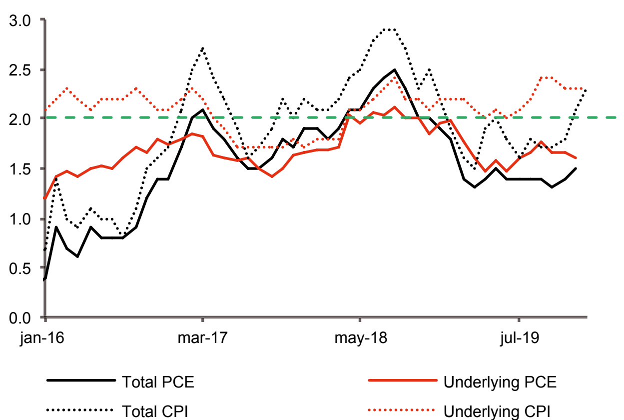
Source: Bloomberg and Santander

The dynamism of consumption has been bolstered by high levels of confidence, favourable financial conditions and a significant employment creation. Investment, conversely, underwent a substantial moderation. During the year, the drive of service sectors stood out, which compensated for the low performance of manufacturing sectors affected by the decline in investment, a robust dollar and the deterioration of the global trade.

Employment creation began at a high rate and tended to slow down during the second half of the year. Meanwhile, the unemployment rate fell again to around 3.5%, its lowest since the late 1960s. Wages accelerated in the first part of the year, but then they moderated and

closed the year with a nominal growth below 3%. Despite the above, inflation remained below the target. The annual change in the consumption deflator (which is the inflation measure preferred by the Fed) suffered a significant decline at the beginning of the year when fuel prices reversed the hike undergone throughout 2018. Coupled with the global strengthening of the dollar and the slower pace of wages in the second half of the year, this caused inflation to close at about 1.5%, far from the Federal Reserve's 2% target.

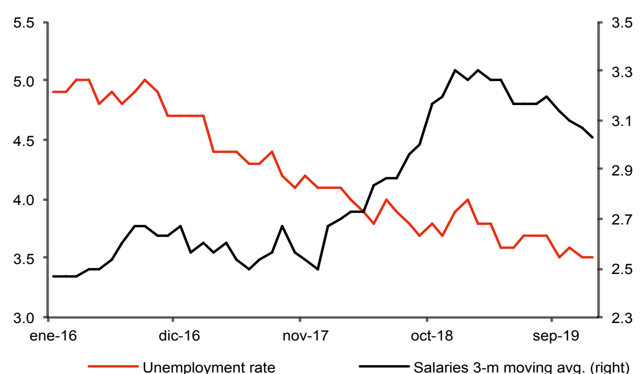
Graph 6. United States Inflation (%)



Source: Bloomberg and Santander

During the year, the Fed changed its stance on monetary policy. After having raised its benchmark rate four times in 2018 –and signalling that it would continue to do so- the year 2019 started with a change in tone, giving indications it would keep it unchanged. However, halfway through the year, when inflation retreated, the economy showed signs of slowing down, and the risks related to the trade conflict increased, the Federal Open Market Committee (FOMC) decided to initiate an interest cut process, which was materialised throughout three consecutive meetings starting in July. Thus, the rate of federal funds decreased from 2.5% - 2.75% to 1.5% - 1.75% in October 2019, well below what was expected a year ago, and reversed almost all the 2018 rises. At the last meeting of the year, the rate was upheld, and the dots suggested that it would remain in the current range throughout 2020, only to start rising gradually the following year. The political front has been marked by advances and setbacks in the trade war with China, the impeachment process against President Trump and the presidential race. At the end of September, the president of the House of Representatives, Nancy Pelosi, announced the start of investigations concerning the efforts that Trump may have made to force Ukraine to investigate the former vice president and Democratic presidential candidate, Joe Biden. The Chamber of Deputies approved the accusation of abuse of power and obstruction of Congress against the President, making him the third president in the country's history to face an impeachment trial. The process will continue with the vote to be removed from the Senate, which probably won't succeed due to the high quorum required and the Republican majority.

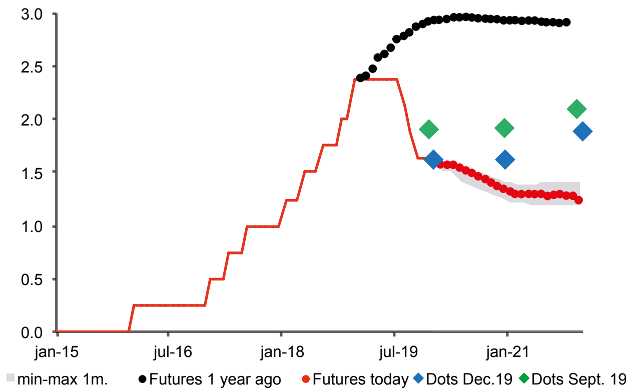
Graph 7. United States: Labor market (%)



Fuente: Bloomberg y Santander

For this year, we expect the United States to moderate its growth and expand by about 1.7%. Behind this slower pace is the maturity of the cycle and a less expansive fiscal policy, to which the internal political tensions will be added. The recession risk –which was of concern during the first part of 2019– is perceived as more limited, due to the resilience shown by the economy, the strength of the labour market and the trade agreement with China. To further this there is also a more expansive monetary policy, considering the tax cuts applied by the Fed during 2019.

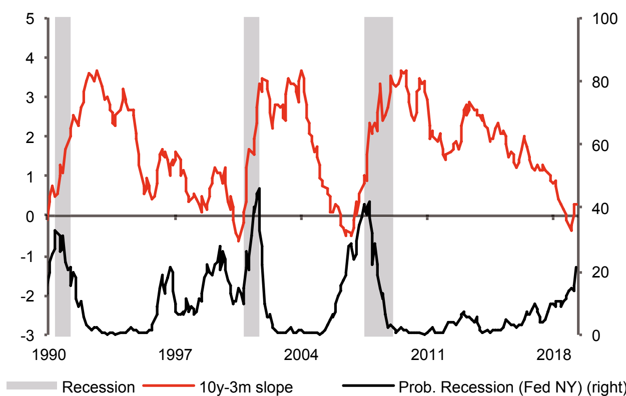
Graph 8. United States
Fed Fund Rate Expectations (%)



Source: Bloomberg and Santander

Notwithstanding, significant risks still remain. This year's presidential elections could be a source of volatility, and new hotbeds of conflict resurfacing in the field of foreign trade should not be ruled out. In addition, open tensions with Iran could impact the price of oil and keep influencing the prices of financial assets. Moreover, while in our base scenario, we estimate that the Fed will keep the federal fund rate stable throughout 2020, it is possible that, if inflation does not rise, the monetary stimulus will increase.

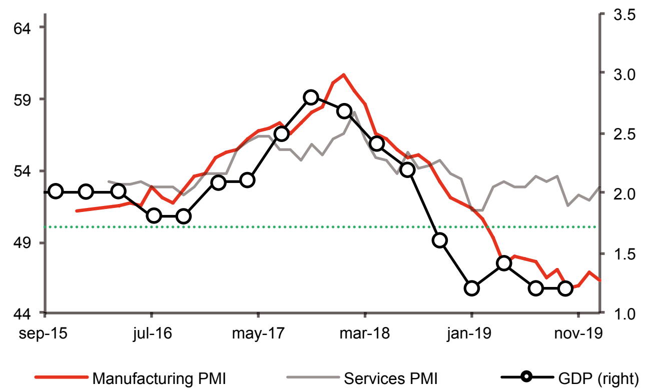
Graph 9. United States:
Differential rates and probability of recession (%)



Source: Bloomberg and Santander

After moderating substantially in 2018, the Eurozone growth continued to deteriorate during 2019. It grew by 1.4% in the first quarter and then expanded only 1.2% in the next two quarters. Fourth-quarter data point towards even more restricted growth, so we expect the year to conclude at 1.2%, below the 1.5% we projected in the 2019 Outlook. This poor performance has been marked by the weakness of the industrial sector, affected by the trade conflict and by a series of internal political disputes that have undermined confidence and investment.

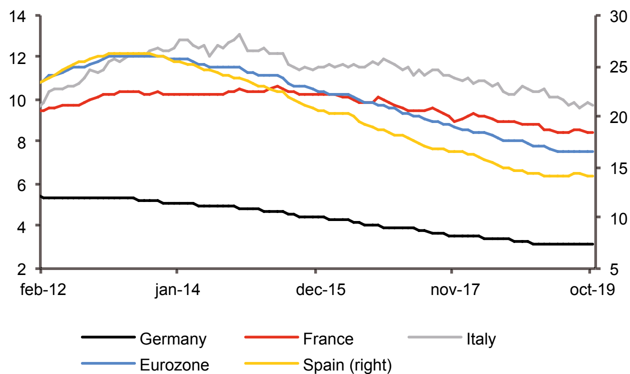
Graph 10. Eurozone: GDP and activity indicators
(annualized quarterly var.%, neutral = 50)



Source: Bloomberg and Santander

Despite the above, the labour market was robust, and the unemployment rate fell once more in almost all the countries in the Eurozone. Nevertheless, inflation was reduced due to the fall in oil prices during the first half of the year and a contained underlying inflation. In this context, the ECB sought to expand its momentum by cutting its benchmark rate –which has been on negative ground since 2015- and by implementing a new asset purchase program. Along with that, it introduced measures to mitigate the effect that negative interest rates were having on the banking system. In its public announcement, Christine Lagarde, the new president, has reaffirmed the commitment to maintain current rates until inflation converges to the target in a sustained manner. The possibilities for further rate cuts are low, given that being on negative ground, the additional momentum that cuts could generate is minimal.

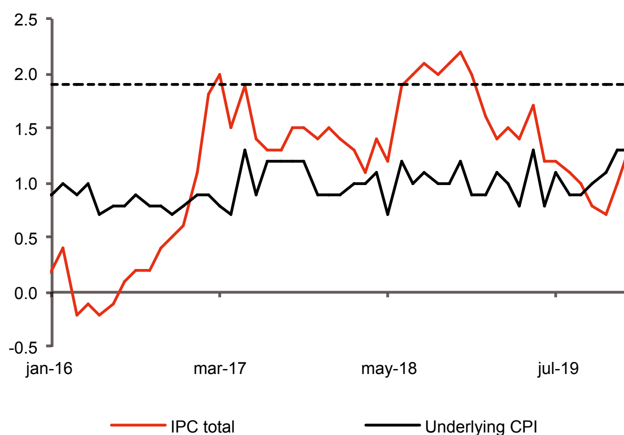
Graph 11. Eurozone: Unemployment rate (%)



Source: Bloomberg and Santander

In the future, we anticipate a slight acceleration in the Eurozone due to the greater monetary stimulus, the reduced tensions in the business area and the increase of certainty regarding some of the sources of political conflict. In particular, Brexit has already been decided, and only the conditions for the future relationship between the countries of the European Union and the United Kingdom remain to be laid down. With this background, we anticipate that Eurozone activity over 2020 will grow by 1.4%, with a significant recovery from countries like Germany and Italy, which performed very poorly last year.

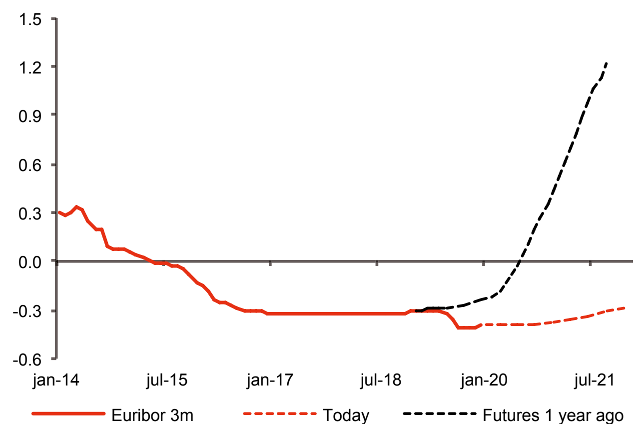
Graph 12. Euro Zone: Inflation (%)



Source: Bloomberg and Santander

The uncertainty surrounding Brexit caused the U.K. growth to fall to 1.2% in 2019, somewhat better than we expected. Investment and the external sector were the most affected, but consumption remained resilient. The year began with the failed attempt by Theresa May, Prime Minister back then, to gain the Parliament's support for the agreement she had reached with the European Union (EU) and thus materialise the Brexit process. In June, after three rejections, May resigned and was succeeded by Boris Johnson. Once he became Prime Minister, he reached a new agreement with the EU and gained broad support in the early general elections held in December. With this, the Brexit will take shape at the end of this month, and the terms of the future trade relationship with the EU will be negotiated during the year. In the case of not reaching an agreement, Brexit arrangements will be governed by the rules of the World Trade Organization (WTO). The situation in Northern Ireland is still pending. Regarding other areas, the Scottish independence movement has gained ground.

Graph 13. Eurozone: Euribor Futures 3m (%)



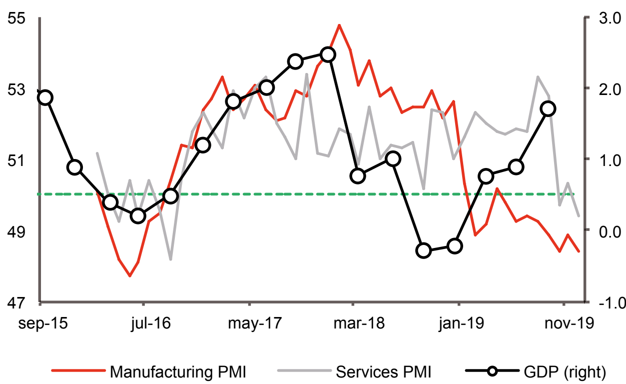
Source: Bloomberg and Santanderr

The Japanese economy, having grown 0.9% during the first part of last year, expanded 1.7% in the third quarter, driven mainly by consumption and private investment. However, the fourth quarter would have slowed due to the impact of the increase in sales tax

–similar to Value Added Tax (VAT)– from 8% to 10%. With this, we estimate that the activity closed with an annual expansion of 0.9%, somewhat higher than the projection in our 2019 Outlook. During the year, the government implemented a major fiscal stimulus to offset the rise in sales tax.

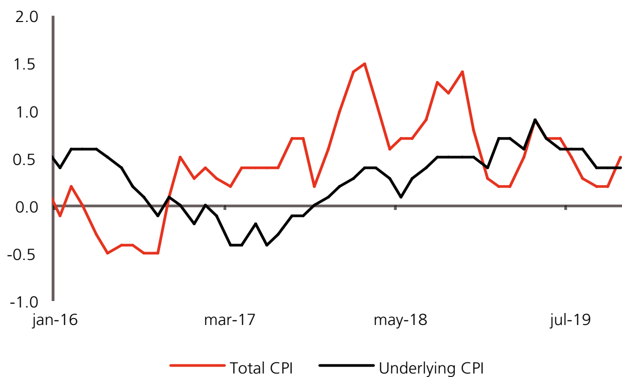
The Bank of Japan (BoJ) kept its rate marginally negative (-0.1%) but, despite an almost null inflation, it avoided lowering it further due to the possible consequences of a too highly negative rate on the financial sector. For this year, we hope that this economy will grow by around 0.7%, due to a slowdown in consumption and a still weakened external sector. Fiscal policy and the Olympic Games in July of this year should encourage growth.

Graph 14. Japan: GDP and activity indicators (annualized quarterly var.%, neutral = 50)



Source: Bloomberg and Santander

Graph 15. Japan: Inflation (%)



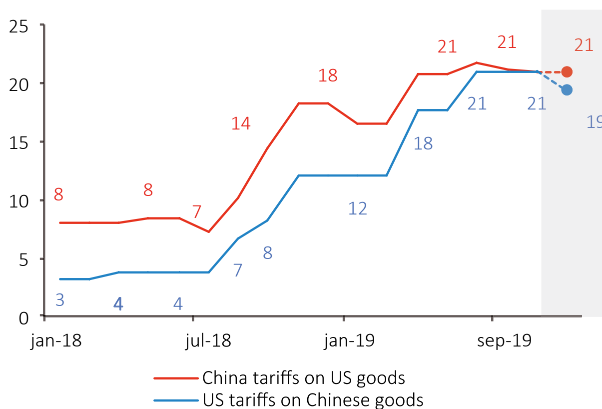
Source: Bloomberg and Santander

Box 1. Commercial war

During 2019 the trade conflict between the United States and China continued to escalate and even spread to other countries, with the imposition of tariffs by the United States on some imports from Europe, Canada, Japan, Turkey, India and Mexico. In May, a moment of critical tension ensued when the United States increased its tariffs from 10% to 25% upon US$ 200 billion of Chinese imports. China announced reprisals and executed the same upon imports from the U.S. equivalent to US$ 36 billion, thus exacerbating the gravity of the conflict. In September, President Trump's administration announced that it would apply a 10% staggered tariff upon the remaining imports from China equal to US$300 billion, and China announced the same measure upon imports from the U.S. equivalent to US$ 75 billion. Then, in October, President Trump announced that he would not raise tariffs to 30% on products for US$250 billion –with 25% tariffs– to create room for negotiations with China.

Throughout the year, there were attempts to reach an agreement, which was only achieved in December with the so-called "Phase 1", which was signed on January 15th. This agreement implies a commitment from China to increase the purchase of American goods and services, mainly manufacturing, agricultural, energy and services. Likewise, China is forced to increase efforts to improve the protection of intellectual property. Additionally, the United States compromises to suspend a new round of tariffs (15% on goods for US$160 billion) and to reduce tariffs from 15% to 7.5% to an equivalent of US$120 billion of Chinese imports, which had been imposed last September.

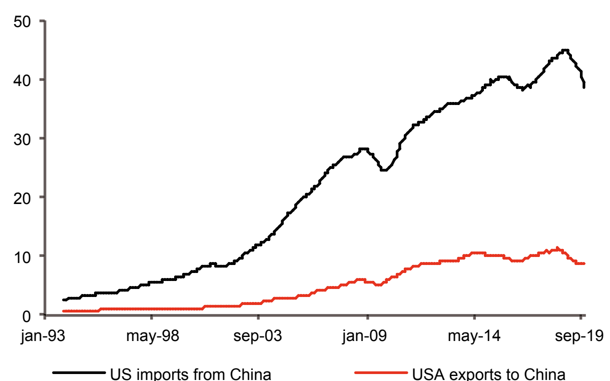
Graph 16. Average tariffs between China and the United States (%)



Note: Grey area corresponds to what is expected in March 2020 according to the Phase 1 agreement signed Jan. 15, 2020

Source: Peterson Institute for International Economics (PIIE) and Santander

Graph 17. United States trade balance with China (billions of US $)



Source: Bloomberg and Santander

Even after the agreement was implemented, the average U.S. tariffs to imports from China will remain high, somewhat above 19%. These tariffs are more than six times higher than before the commercial war began. China's tariffs will also remain higher than previously, at around 21%. In this way, protectionist measures will remain high pending what a possible 'Phase 2' might mean.

The trade dispute has not only resulted in a significant decrease in trade volumes between China and the United States but has also affected other countries that have not been directly involved in the conflict due to its impact on global value chains. In turn, this has had an impact on the low dynamism the global manufacturing sector has shown. Moreover, the conflict has generated uncertainty and undermined confidence, which has also affected economic growth and trade.

By 2020, we do not expect the conflict to escalate again. However, given the long-term hegemonic dispute between the two countries and the mercantilist vision prevailing in the current U.S. administration, it is not possible to rule out the possibility of protectionist measures rekindling in the future.

Significant milestones in the trade conflict between China and the United States

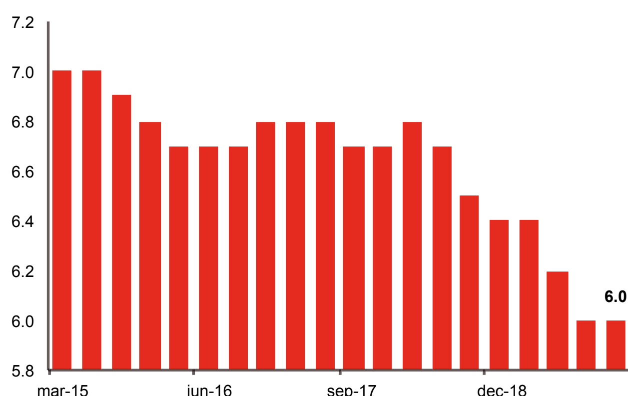
Date	United States	China
dec - 18	90-day truce for negotiations, ending on March 1st. In addition, the increase is frozen to 25% for the last US$ 200 bn during the truce.	
jan - 19		Commitment to increase purchases of American soy. Progress has been made in the area of Agriculture, where there was an absolute consensus from the outset to reach agreements.
feb - 19	The meeting with Xi Jinping in February is cancelled, and it is announced that the truce will extend beyond March 1st.	
may - 19	Tariffs are increased up to 25% from 10% equivalent to US$200 bn.	Rates of 25%, 20% and 10% to US$60 bn on imported American goods are announced.
jun - 19	Trump and Xi agree to resume negotiations and meet at the G-20 summit in Japan. At the meeting, Trump agrees to not apply new tariffs, while Xi agrees to new purchases of US agricultural products.	
aug - 19	Tariffs on 10% of imported Chinese goods equivalent US $ 300 bn which would enter into force in two rounds (Sept 1st and Dec 15th), and the increment on tariffs to 30% (from 25%) equivalent to $250 bn on October 1st are announced. Delay on the entry into force of the Dec 15th round.	New purchases of American agricultural products are suspended. The yuan depreciates above the level of seven yuan per dollar. An additional tariff of 10% on US$75 bn, which would enter into force in two rounds (Sept 1st and Dec 15th), is announced.
sep-19	15% tariff on a subset of US $ 300 bn is implemented. The tariff increase to US$250 bn is postponed from October 1st to October 15th.	The exemption from the September additional tariff on several agricultural products is announced.
oct - 19	Phase 1 of the agreement is reached, and the indefinite delay of the increase on October 15th to 30% equivalent to US $ 250 bn is announced.	
dec - 19	Both sides announced that they have reached the Phase 1 agreement to be signed on January 15th.	
jan -20	Phase 1 of the agreement is signed.	

Source: Santander

Emerging economies are markedly slowing down

As we anticipated, China's economy slowed significantly during 2019. Growth began the year at 6.4% and then declined to 6% in the fourth quarter, closing at 6.1%, its lowest record since 1992 and just at the bottom of the government's target range. The lower performance is primarily explained by the weakness of the external sector, affected by the commercial war, and to a lesser extent by the deleveraging process initiated a few years ago; the latter, despite the different stimulus packages that the government has applied. Overall the year concluded in an upward trend. The manufacturing PMI in December stood at 50.2 points, above the neutral level after six months in the contractionary field, and the external sector rebounded, surprising the market.

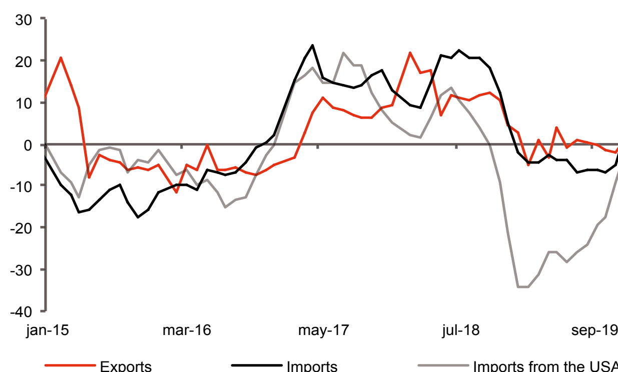
Graph 18. China's GDP (var. QoQ annualized%)



Source: Bloomberg and Santander

By 2020, we project that, due to the maturity of its economic cycle, the lagging effects of the trade conflict and a moderate global economy, the Chinese economy will grow by 5.9%. In 2021 China will maintain a somewhat slower pace, with an expansion rate of 5.8%.

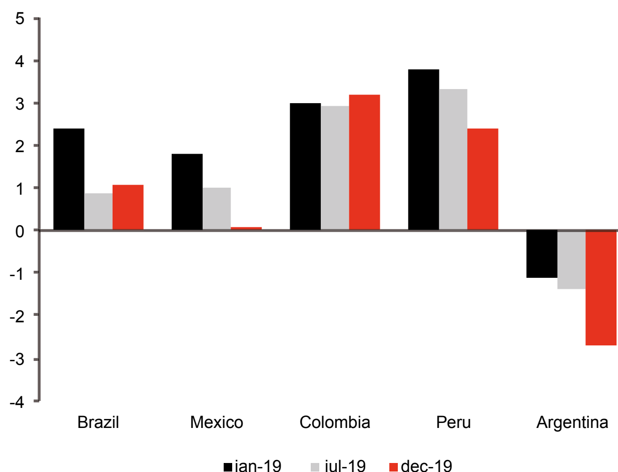
Graph 19. China: External sector (annual var.,%)



Source: Bloomberg and Santander

Latin America's economic activity was unsatisfactory in 2019, in a context of intense political uncertainty and social upheavals in several countries. Brazil continued its recovery, albeit at a slower rate than expected. During the first part of the year, the economy started weakly and expanded only 0.9%. Nevertheless, it accelerated to 1.2% in the third quarter, after the change to the pension system and progress in other structural reforms improved the business climate. In Mexico, the economy has slowed down and suffered two quarters of negative annual growth, with a weak external sector due to trade disputes with the United States and a moderated fiscal policy.

Garph 20. Latin America: Growth Expectations 2019 (%)

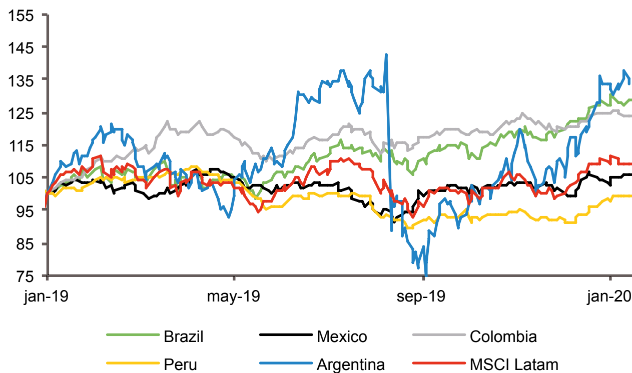


Source: Consensus Forecasts and Santander

Argentina's economy continued to moderate, and inflation rose by over 50%. The change of government –where Kirchnerism returned to power through the Fernández duo– was accompanied by significant disruptions in the financial markets. The peso depreciated by more than 30% and the country risk increased substantially. The new administration has implemented social and tax measures, including a 30% tax on foreign exchange purchases. The new Minister of Economy, Martín Guzmán, began talks with creditors - including the International Monetary Fund (IMF) - to renegotiate and extend the deadlines for paying the foreign debt.

For this year, we expect Latin America to accelerate its growth to 1%, driven by Brazil's progress and Mexico's recovery. The risks, however, are skewed downwards due to the social and political tensions that the region still maintains.

Graph 21. Latin America:
Stock markets (Index 100 = Jan. 19)

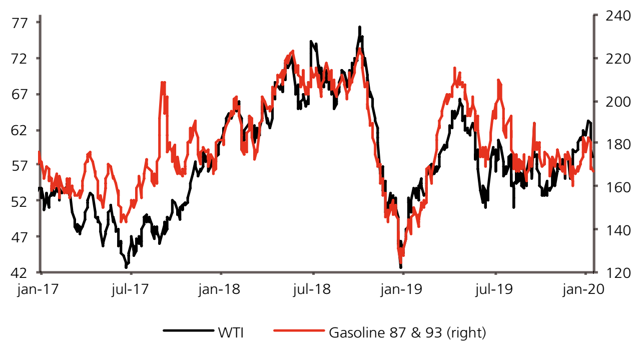


Source: Bloomberg and Santander

Restricted supply will drive a moderate increase in raw material prices

During 2019, the Organization of the Petroleum Exporting Countries (OPEC) and a group of other producers of crude oil including Russia, maintained a significant reduction in the production of oil (1.2 million BPD), restricting the growth of the supply. However, fears of a substantial fall in demand due to the global slowdown kept the price of crude oil contained for much of the year. Only toward the end of 2019, once the trade tensions eased and after an extension of the agreement to cut production by OPEC, the price had a slight recovery and closed somewhat over US$ 60 a barrel. However, the average annual price reached US$ 57 a barrel, 12% lower than in 2018.

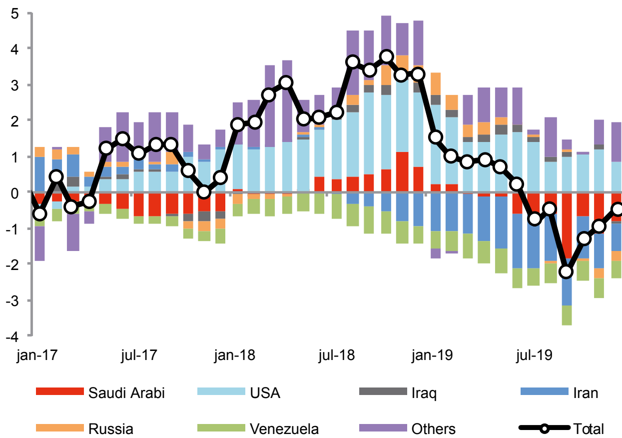
Graph 22. Price WTI oil and gasoline
Gulf Coast of Mexico (cUS $ / gallon and US $ / bbl)



Source: Bloomberg and Santander

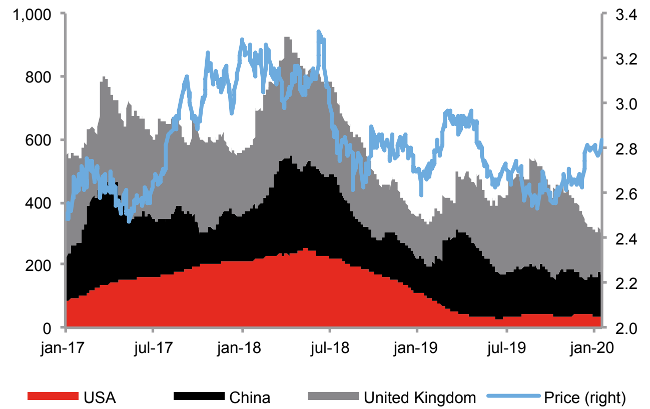
During 2020, production in the United States will slow down due to a sharp decline in the number of operating oil wells. Other major producers will also be restricted in their productive capacity. Added to this are the geopolitical tensions in the Middle East that, which, despite not having had any material impact on the price so far, could generate volatility and upward pressures in the future. This leads us to project an increase in the price of oil, which in average could be around US$ 61 a barrel by 2020 and could close the year at US$ 65 a barrel.

Graph 23. Oil production (annual var.,%)



Source: Bloomberg and Santander

Graph 24. Copper inventories and price (thousands ton. and US $ / lb)

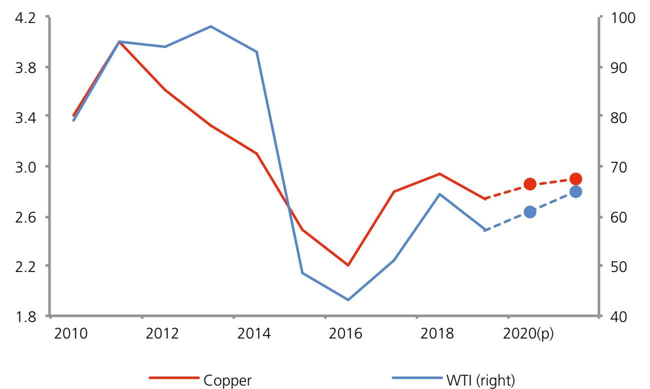


Source: Bloomberg and Santander

The price of copper experienced an average low of 8% during the year due to the slowdown in China –economy that demands about 45% of the copper consumed globally- but closed with a significant rise. Behind the latter was a sharp increase in imports of refined copper into China during October and November as well as better prospects after the trade agreement between this country and the United States.

The higher growth in demand towards the end of the year was also reflected in a significant drop in inventories in the major stock exchanges. Coupled with an offer that would grow moderately by the shortage of large projects that come into operation, this suggests that the price of copper will increase modestly, to levels up to US$ 2.90 a pound by the end of 2020. The year would settle around US$ 2.85 a pound on average.

Graph 25. Commodity price (US $ / lb and US $ / bbl)



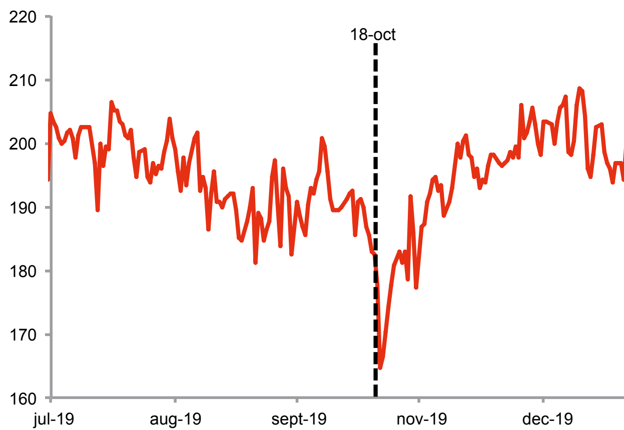
Source: Bloomberg and Santander

LOCAL SCENARIO

Social upheaval impacts the economy

The Chilean economy began 2019 with a slow growth, affected by the external scenario and a relatively weak labour market. Over the months, the growth prospects were reviewed downwards as the world decelerated, local activity disappointed, and expectations fell. Consumption remained contained -reflecting a slow job creation and wages moving at a restricted pace– but investment rebounded thanks to construction projects.

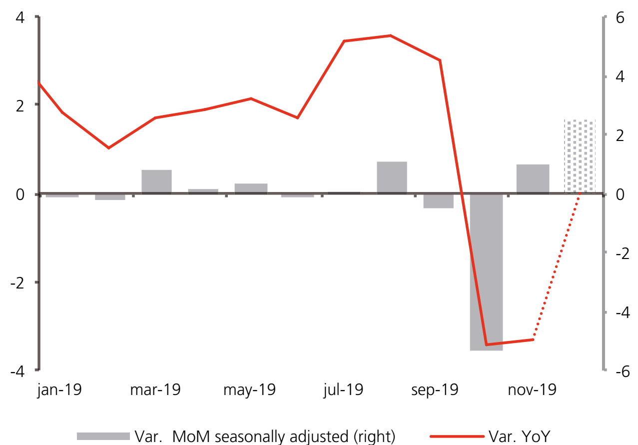
Graph 26. Daily electricity generation (GWh, adjusted for weekend effect and holidays)



Source: CEN and Santander

Towards the end of the year, the social upheaval marked a break that created a sharp contraction in the economy. The temporary disruption of a range of activities -mainly commerce and some services– led to an unprecedented monthly fall of more than 5% in October's Imacec. Local assets had a relevant loss of value, risk premiums increased substantially, and confidence indicators collapsed. Over the weeks, the activity gradually returned to normal as the episodes of violence were reduced. November's Imacec showed a certain recovery, with a seasonally adjusted monthly variation of 1%. In December the improvement continued, as can be seen from figures such as electricity generation and certain foreign trade lines. In this context, we estimate that the last quarter had an annual fall of 2.2%, with which the year would have closed with a growth of 1.1%, well below the 3.5% we projected at the beginning of the year and the 2.4% we anticipated before the crisis.

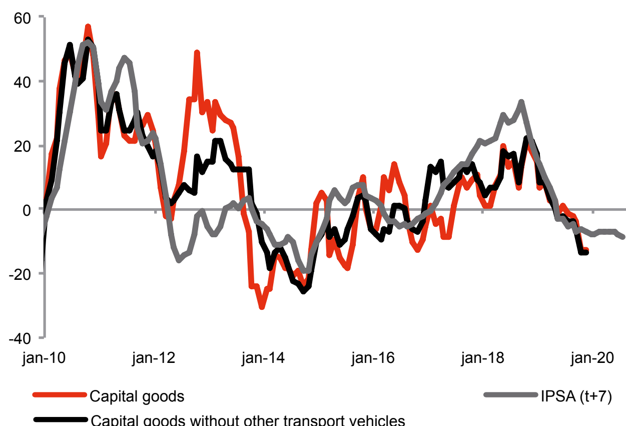
Graph 27. Imacec (%)



Source: BCCh and Santander

During the year, investment in machinery and equipment lost dynamism after its steady growth during 2018. This was offset by the acceleration of the construction component, due to the advance of large mining, energy and infrastructure projects, and the drive of the real estate sector. In the latter part of the year, after the social upheaval, expenditure on machinery fell sharply, reflected in the annual contraction of more than 15% of imports of capital goods. Nevertheless, the construction sector remained dynamic due to the inertia of this type of investment. With this, we estimate that the gross total capital formation has closed 2019 with an expansion of around 3%, below the 5.6% we had predicted a year ago.

Graph 28. Imports of capital goods and lagging IPSA (annual var.,% - mobile quarter)

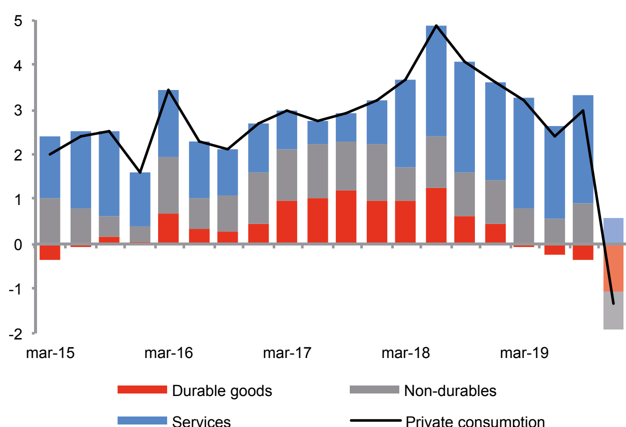


Nota: En este gráfico el IPSA se rezaga 7 meses, por lo que el último dato efectivo (dic-19) se muestra en julio de 2020.

Source: Bloomberg, BCCh and Santander

Before the social upheaval, private consumption had shown modest progress, with an average growth of 2.7% in the first three quarters. Consumption of durable goods exhibited a systematic contraction, offset by a more dynamic consumption of services, which expanded at an average rate of 4.7%. The limited growth of consumption up to that moment was mainly explained by the labour market weakness.

Graph 29. Private consumption (annual var.,%)

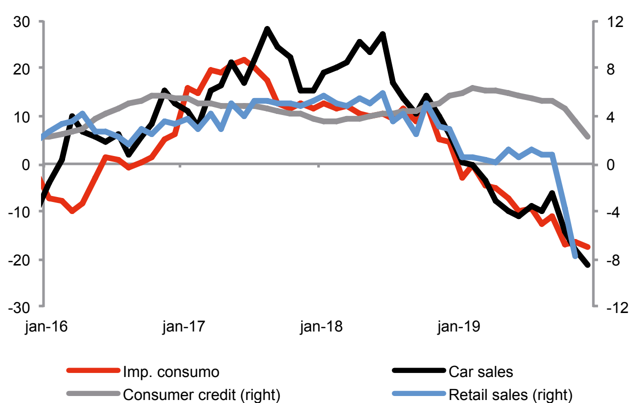


Source: BCCh and Santander

From 18-O onwards there was an acute slowdown on consumption. Retail and car sales dropped dramatically, and consumer banking loans slowed sharply. The services sectors was moderate as well.

Beyond the disruption of the normal functioning of commerce due to the disturbances, it incited the loss of confidence in households which, according to IPEC, reached historical lows (November, 28.3 points; December 29.4 points). So, we assess that consumption would have grown by around 1.8% in the year, well below the 3.6% we projected in our 2019 Outlook.

Graph 30. Consumption indicators (annual var.,% - mobile quarter)

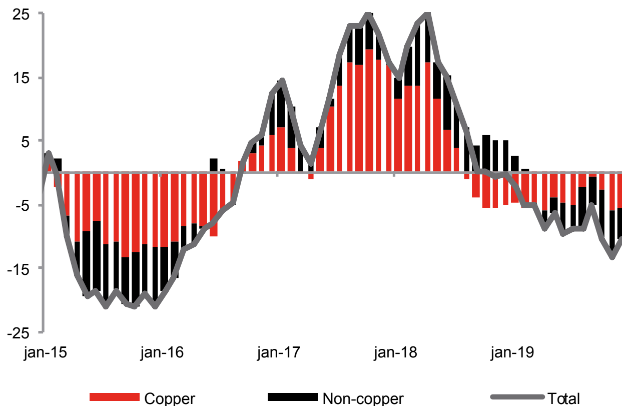


Source: ANAC, INE, BCCh and Santander

The external sector of the economy resented the effects of the global slowdown and trade conflict. Exports of goods contracted in the first three quarters, with a particularly severe fall in industrial shipments. Imports also showed negative records, due to lower internment of durable consumer goods and a slow growth in machinery investment. In the last quarter, industrial exports contracted again, but agricultural and mining exports rebounded, favoured by price increases and a depreciated exchange rate. Imports, meanwhile, increased their falling rate across the board.

Overall, exports had an annual real contraction of 1.6% and imports a 2.6% annual contraction. The current account, for its part, closed with a deficit of 2.9% of GDP, below the 3.1% of the previous year.

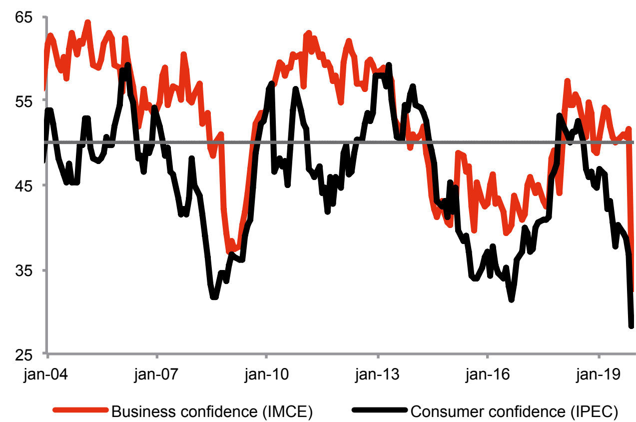
Graph 31. Nominal exports by type of good (annual var.,% - mobile quarter)



Source: BCCh and Santander

By 2020 the activity will be heavily conditioned by the internal political process. After the events of 18-O, investment will be affected through several fronts. On the one hand, there is an apparent loss of confidence and risk premiums have risen, making the cost of financing projects more expensive. On the other hand, the discussion about constitutional change fosters a series of uncertainties, which could delay decisions on capital spending, especially when the costs of reversing these decisions are high. This would primarily affect the development of new projects but would not affect those already in the advanced stages of implementation. Real estate activity, which performed well during 2019, could slow down. Preliminary marginal information indicates that housing sales have declined. Nonetheless, financial conditions remain favourable.

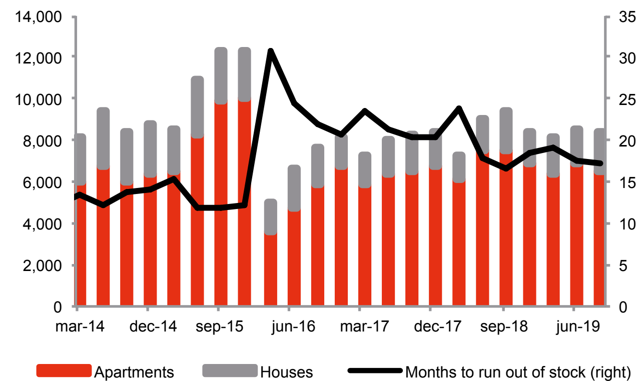
Graph 32. Confidence indicators (neutral = 50)



Source: Icare, GfK and Santander

So far, the background data shows that after the social upheaval, there has been a significant flow of new projects that have been submitted for environmental processing. However, those that were approved in 2019, which could begin to materialise in 2020, are considerably smaller in comparison to previous years. Furthermore, the fiscal stimulus package announced in December contemplates initiatives in public infrastructure for more than US$ 2.5 billion that should contribute significantly to investment. With this data, we project that fixed capital formation will have a contraction of 4%.

Graph 33. Home sales and supply stock, Santiago (units, number of months)

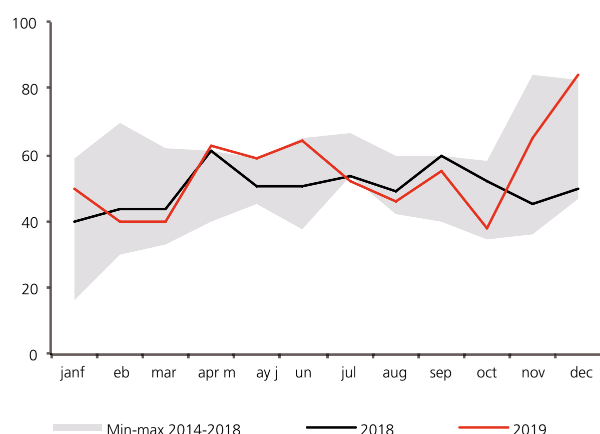


Fuente: Icare, GfK and Santander

Box 2: Projects under environmental processing

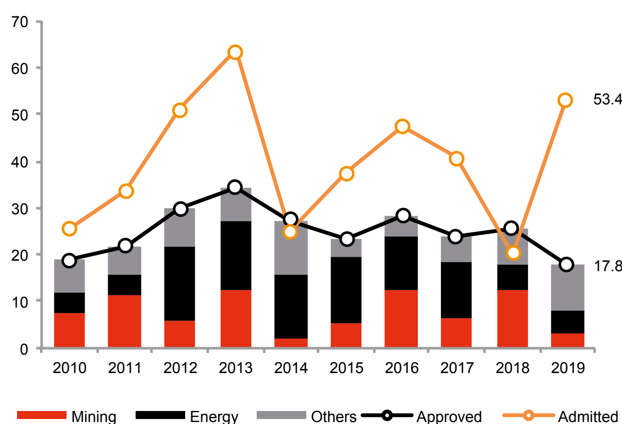
Notwithstanding the most uncertain scenario, so far the Environmental Assessment System (Sistema de Evaluación Ambiental, SEA) figures do not reflect a change in the flow of projects submitted for evaluation. On the contrary, between November and December, there was a significant increase in new projects, both in their number and in the amounts involved. Energy projects worth US$ 30.1 billion for the total of the year stand out, reflecting the importance that this sector will continue to have from now on.

Graph 34. Projects entered into the Environmental Assessment System(Number of projects)



Source: Environmental Evaluation System and Santander

Graph 35. Investment approved and entered into Environmental Assessment System (US$ billion)



Source: Environmental Evaluation System and Santander

Before the social upheaval, environmentally approved projects had significantly decreased, reflecting the lower amount submitted for evaluation in 2018, as well as the relatively long processing periods. In 2019, the investment approved by the SEA was US$17.8 billion, the lowest since 2010. The most significant corrections were in mining and energy. In regards to the average resolution timeframe, only the projects over US$ 200 million show a decline in the number of days for approval. For projects concerning small amounts of money, processing days remain high.

In June last year, the Government presented a new bill that modifies the environmental institutionalism, with the goal to improve citizen participation in the evaluation processes (extending it to all environmental assessment processes) and giving greater relevance to the technical component in decision-making (eliminating political bodies such as the Committee of Ministers). Although the proposal points towards the right direction, in the current political scenario, it is unlikely that the project will move forward in Congress, at least during this year.

Private consumption will be affected by a slow pace of expansion in labour income due to the low employment creation we anticipate in the near future. Wages will remain contained, but a portion of these would perceive a benefit on behalf of the Guaranteed Minimum Income that is part of the government's social agenda, which at this report's conclusion has yet to be legislated. Also, the renegotiations of mortgage loans in the second half of 2019 increased the resources available to people, which could be used to finance other expenses. Moreover, the sharp fall in consumer confidence and the possibly less favourable financial conditions in comparison to 2019 will also have an impact on household consumption decisions.

Government consumption, in turn, will grow by 4% driven by a robust fiscal expansion and the fiscal impulse package. Like this, we anticipate that the total consumption will have a restricted growth of about 1.5%.

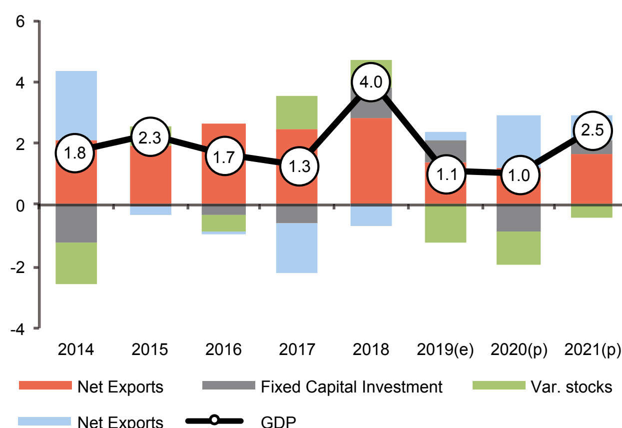
The external sector will be favoured by a slight improvement in the external scenario and a more depreciated real exchange rate. Exports will grow by around 3%, also encouraged by low comparison bases. Imports, meanwhile, will remain low due to a slow growth in domestic demand and will decline by 3%.

Considering these elements, we anticipate the rate of expansion of 2020 to be around 1%. Growth will also benefit from it being a leap year. Towards 2021, as the global economy achieves slightly more traction and the local uncertainty dispels, the economy could achieve higher growth, at around 2.5%.

The risks to this scenario are mainly skewed downwards. Risks associated with the external scenario are added to those associated with the internal political scene. On the one hand, new events that could affect the normal functioning of some activities are not ruled out.

On the other hand, the magnitude of the potential effect that the uncertainty of the constitutional process may have on investment and activity will depend on how the next milestones are resolved. Moreover, the legislative agenda includes a series of projects that could increase labour costs and hinder the process of recovering growth.

Graph 36. GDP by expenditure component (annual var.,%)



Source: BCCh and Santander

Box 3: Sectoral Activity

The tradable activities of the economy – agroforestry, fisheries, mining and some manufacturing industries– will be favoured by a more depreciated real exchange rate and a gradual improvement of the global scenario. On the other hand, those most linked to domestic demand –services, mainly– will have a decline in their performance. Below is a picture of the main sectors of the economy.

Agricultural, forestry and fishing. Primary crops have reduced planted areas and are in a phase of adapting to climate change. Meat production –particularly poultry and pork– will be favoured due to unfavourable phytosanitary conditions in China. The forestry sector will benefit from a higher global dynamism and a depreciated real exchange rate. Considering this, we assess that the forestry sector, along with fisheries will grow by 1.9%.

Mining. The productive capacity has been falling due to a lower ore grade. Although there are extensions of work and new projects, their contribution will not be perceived until a few years from now. The higher price will stimulate the activity of small and medium-sized mining, which, together with a favourable comparison basis due to the climatic effects of last year, will cause the sector to expand by around 1.7%.

Manufacturing industry. Industrial sectors linked to investment and consumption will see a decline in their demand. Meanwhile, those related to exports will see a more considerable boost encouraged by better international prospects. Like this, we projected a slight growth of about 0.4%.

Construction. This was one of the best performing sectors in 2019, favoured by the progress of large investment projects and real estate dynamism. For this year, the slowdown of investment in construction will be reflected in a moderate contraction of this sector, which will be around -0.1%.

Commerce, restaurants and hotels. Commerce had a low performance during the year and was one of the most affected after the social upheaval. We project a slow recovery, a slowdown in purchasing power and low levels of confidence, and an annual growth of about 1%.

Business services. Business Services -strongly linked to investment– will be affected by falls in engineering studies, particularly in housing, commerce and manufacturing. The more substantial budgeted public investment will only mitigate what we project to be a drop of more than 1% for this year.

Table 4. GDP by sector of activity (annual var., %)

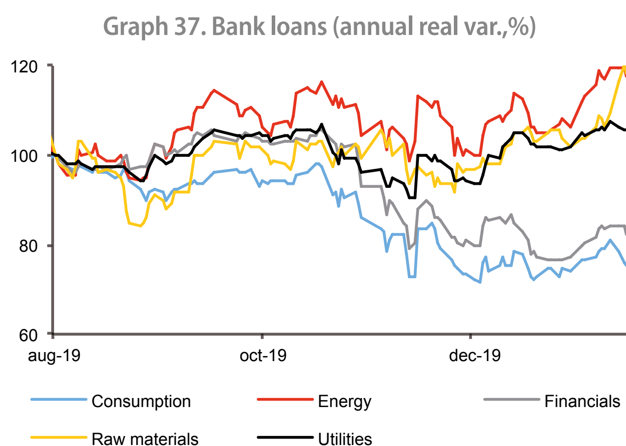
	2018	2019(e)	2020(p)	2021(p)
Agricultural, forestry and fishing	5.7	-3.0	1.9	2.8
Mining	5.2	-1.2	1.7	0.7
Manufacturing industry	3.9	-0.2	0.4	2.0
Construction	3.2	3.6	-0.1	1.4
Commerce, restaurants and hotels	4.7	0.8	0.8	3.4
Business services	3.2	1.4	-1.3	2.6
Other sectors	3.6	2.3	1.9	3.0
Gross Domestic Product	4.0	1.1	1.0	2.5

Source: BCCh and Santander

A challenging scenario for banking loans

Banking loans had a significant acceleration in 2019 and expanded by 6.6% on average. This dynamism was bolstered by the growth of mortgage loans, which increased by 7.3%, favoured by historical declines in long-term interest rates. Commercial loans began the year with a relatively high increase but slowed down as the economy slowed. In the latter half, they showed a rebound, but this was caused mainly by an exchange-rate effect. Consumption loans also started the year at a good pace but decreased in the second half and closed 2019 with a significant slowdown after the social upheaval.

Graph 37. Bank loans (annual real var.,%)

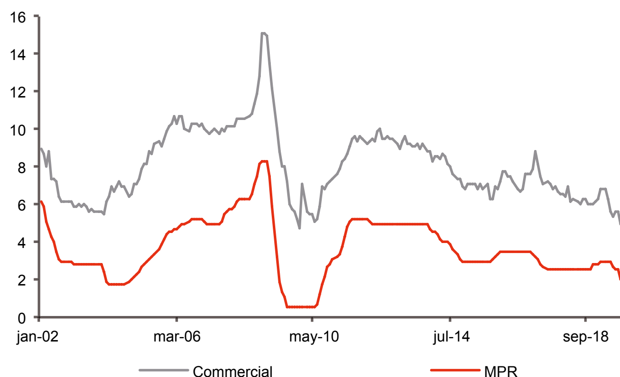


Source: BCCh and Santander

Interest rates were favoured by the greater monetary stimulus on behalf of the Central Bank and the global drops in long-term rates. Commercial loan rates declined steadily, following Monetary Policy Rate (MPR) movements, averaging 5.7% during 2019. In contrast, mortgage rates closed the year by 2.2% after reaching the historical minimum of 1.99% in October and November.

Consumption rates decreased at a slower pace. During the first half of the year they placed at 21.2%, while they closed the year around 19%.

Graph 38. Commercial credit rates (%)



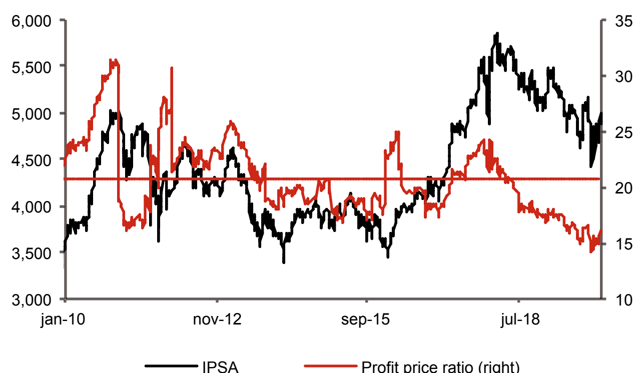
Source: BCCh and Santander

In the future, we estimate that the cost of funding will remain low, even though risk premiums could boost rates in some segments. Meanwhile, loans will slow down and show a restricted growth due to a weaker domestic demand growth and a possible increase in unemployment.

Prices in the financial markets retreat due to increased risk perception

Local financial assets depreciated throughout 2019, a trend which, with ups and downs, became more pronounced after 18-O. In the first quarters of the year, the fall in these prices was mainly associated with external factors –the uncertainty of the trade war, the constant downward review of global economic prospects and geopolitical risks– and was in line with the performance of other emerging markets. Thus, between January and the first half of October, the stock market lost just over 2% of its value, while the Peso depreciated by around 5%.

Graph 39. IPSA and profit price ratio (%, index)

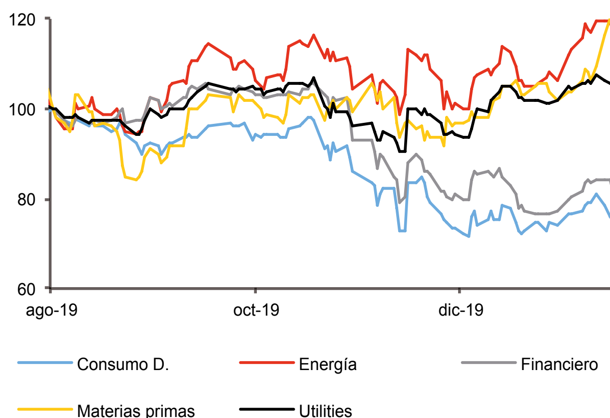


Note: Dotted line corresponds to the average since 2010

Source: Bloomberg and Santander

During the last quarter, following the social upheaval, the increased perception of local risk caused assets to fall even more sharply. The exchange rate reached levels close to $830 at the end of November, and the IPSA placed around 4,400 points, 15% less than prior to the social upheaval. The most affected assets were those linked to consumption and investment. From then on, along with the progressive normalisation of several activities, a clearer political path, and the intervention of the Central Bank, these assets have tended to partially recover.

Graph 40. IPSA Sectors (Aug-19 = 100)

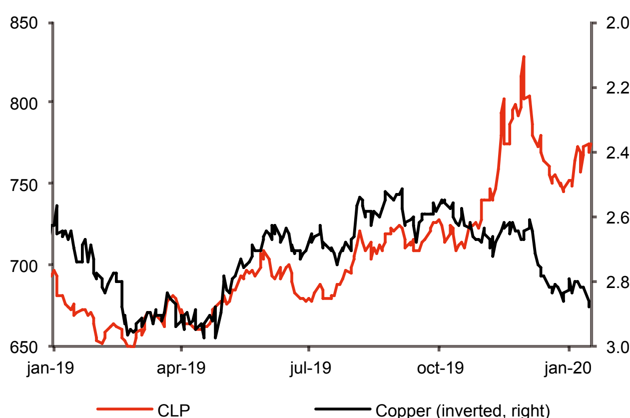


Note: Estimate based on approximation of weights.

Source: Bloomberg and Santander

However, the local stock index IPSA closed the year at around 4,700 points, 8.5% below its previous year's value. The exchange rate, in contrast, was around $750, more than 8% above the end value of 2018. In real terms, this implies a level of approximately 10% above its historical average over the last 20 years, which is consistent with a slowdown in domestic demand similar to the one we are projecting.

Graph 41. Exchange rate and copper ($ / US $, US $ / lb)



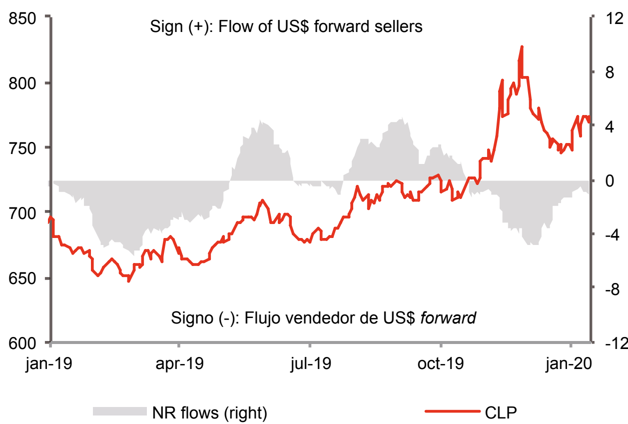
Source: Bloomberg and Santander

By 2020, we assume that the dollar at the global scale will remain at levels similar to the current ones, in line with a stable monetary policy and under the assumption that the risks facing the United States will not escalate. Meanwhile, we expect the price of copper to recover to values around US$ 2.9 a pound, mainly due to a contained offer. Under this scenario, we project that the Peso should settle between $760 - $780 by the end of 2020. Nevertheless, due to the different sources of uncertainty, both internal and external, we estimate that the currency will be subject to higher volatility this year and we do not rule out that it may end up more weakened if any of the risk factors are triggered.

Fixed income market rates were adjusted significantly downwards throughout the year, following changes in the outlook for local monetary policy and the international trend following the Fed's change of

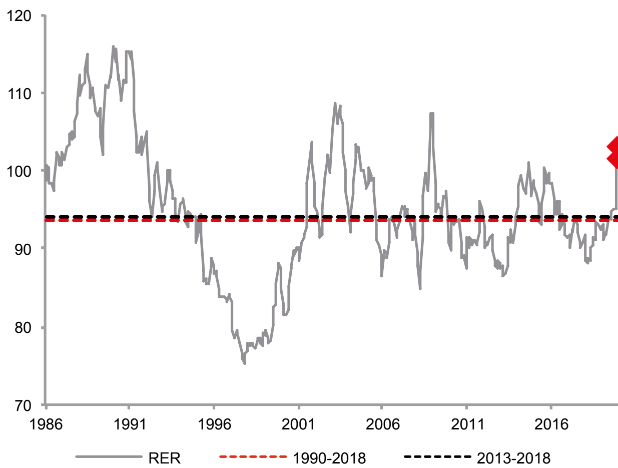
direction. After the social upheaval, rates rose significantly, reflecting an increase in risk premiums and more moderate liquidity conditions. They also revealed the portfolio adjustments triggered by pension fund movements. Over the following days, and similar to the prices of the riskiest assets, the rates partially reversed these hikes. Meanwhile, after rising significantly, corporate debt spreads retreated.

Graph 42. Exchange rate and non-resident flows forward ($ / US $, millions of US $ miles)



Source: BCCh, Bloomberg and Santander

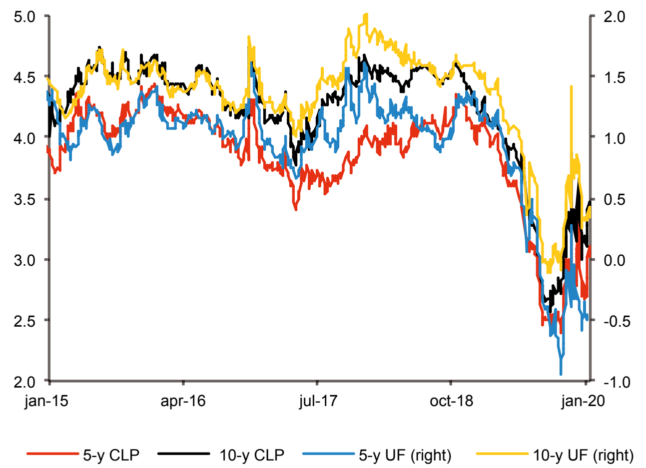
Graph 43. Real exchange rate (Index = 1986 average)



Note: Dots correspond to Santander estimate for Dec. and Jan.

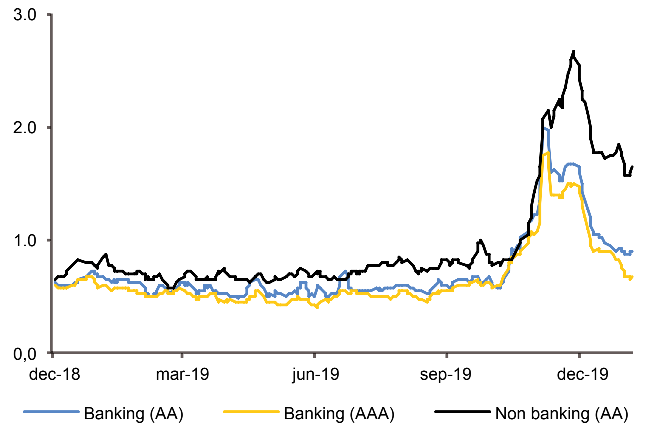
Source: BCCh and Santander

Graph 44. Fixed income market rates (%)



Source: BCCh, Riskamerica and Santander

Graph 45. Corporate spreads by sector and risk classification (%)



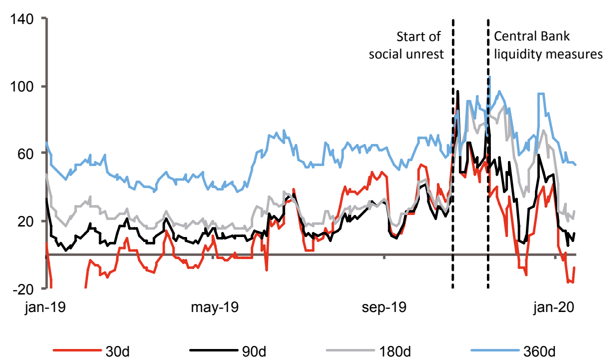
Source: Riskamerica and Santander

Box 4: Central Bank Interventions

Following the social upheaval, the portfolios were adjusted, which tightened liquidity and led to large fluctuations in the prices of financial assets, in particular to the exchange rate. In this context, the Central Bank implemented measures to support liquidity management in Pesos and dollars and began a direct intervention upon the exchange market.

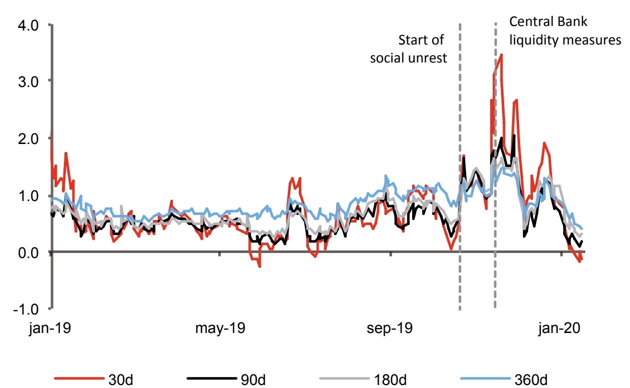
The program to support liquidity consisted of swap currency purchases of up to US$ 4,000 million along with repurchase agreements (REPO) to counteract the effects on liquidity in Pesos. This was followed by the expansion of eligible collateral for the REPO programme, the Permanent Liquidity Facility (Facilidad Permanente de Liquidez, FPL) and the Intraday Liquidity Facility (Facilidad de Liquidez Intradía, FLI), and then by a bond-repurchase program on behalf of the Central Bank itself. As a result of these measures, it was possible to contain the increase in money market spreads and dollar hedging operations, which went back to levels even below those prevailing before 18-O.

Graph 46. Deposit spreads and swap rates (bp)



Source: BCCh, Bloomberg and Santander

Graph 47. Spread on shore (%)



Source: BCCh, Bloomberg and Santander

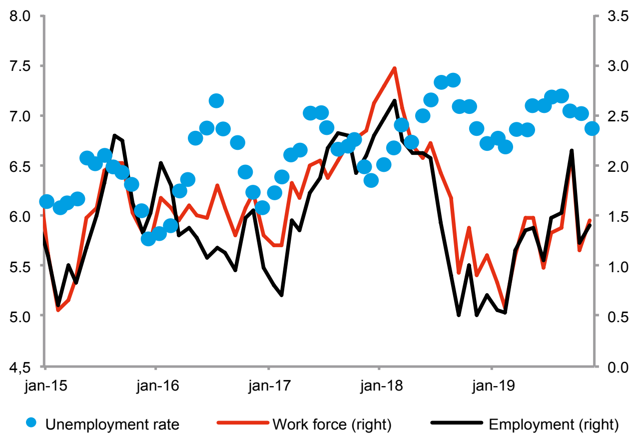
Towards the end of November, after the sharp depreciation of the Peso that led its trade to be over $830, the Central Bank announced the start of an exchange-rate intervention for a period of six months. This consists of the sale of spot and forward dollars for a total amount of up to US$ 20 billion, divided into equal parts. Of these, only the spot sale compromises the use of international reserves, which until before the intervention amounted up to about US$ 40 billion. So far there has been relevant market demand and some currency depreciation has been reversed and volatility reduced. At this report's conclusion, spot sales reached US$ 2.55 billion, while the total forward operations amounted to US$ 7.1 billion, with a current stock of US$ 5.0 billion.

Labour market will remain weak

Employment started 2019 with a slow growth, due to the poor conclusion of the previous year. Throughout the year there was a slow recovery, with the expansion rate rising up to 2% in September. Wage employment showed a very similar dynamic, but with slightly higher annual growth rates, the same as administrative data.

Moderate employment growth, together with a limited expanding labour force, caused the unemployment rate to reach up to around 7%.

Graph 48. Unemployment, employed and workforce (% and annual var.,%)

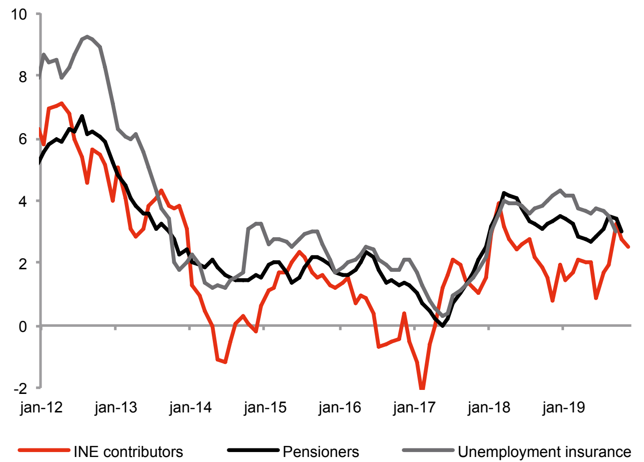


Source: INE and Santander

Following the social upheaval, a slowdown in employment and a very significant increase in unemployment was expected. However, according to data from September-November, job creation was only moderately affected, and the unemployment rate fell to 6.9%.

In contrast, the data of dismissals attributed to company needs informed to the Labour Office showed a significant increase in the last two months of the year, accumulating 80,000 additional dismissals than usual. This figure represents about 1% of the labour force, so unemployment may have increased significantly by the end of the year.

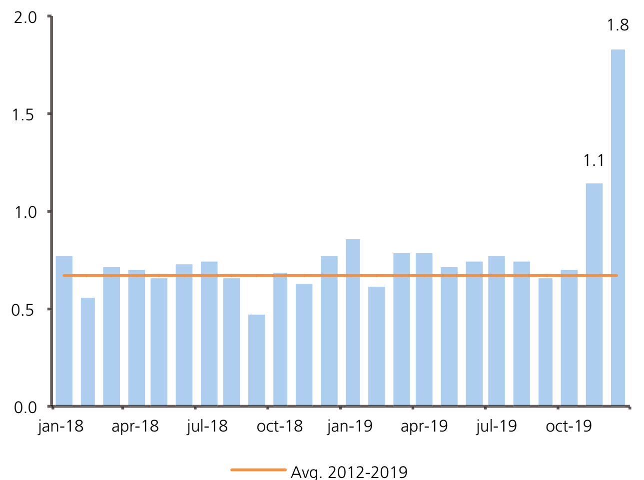
Graph 49. INE contributors and administrative records (annual var.,%)



Source: INE, Superintendency of Pensions and Santander

Wages gained momentum in the first part of 2019, reaching expansion rates of around 5% from May to August. Nevertheless, a significant portion of this result is explained by the increases applied to the minimum wage in September 2018 and March 2019, months in which the rate of remuneration expanded by 1% per month. Towards the end of the year, this indicator decelerated, and the latest INE figure –for November– reached 4.1%. Considering that inflation gained traction in recent months, real wages increased by only 1.2%.

Graph 47. Layoffs due to company needs (% of pension contributors)

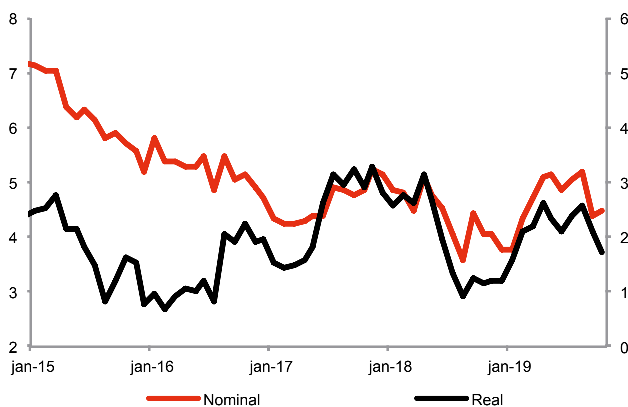


Source: Labor Ministry and Santander

By 2020, employment trends will be conditioned by activity dynamics and, to a lesser extent, possible regulatory changes affecting labour costs. In our base scenario, the low growth will affect the creation of new jobs, fostering a highly reduced expansion of the total employment number. The labour force will also lose some dynamism due to a slower rate of population growth and a stable participation rate. However, unemployment will rise moderately and reach levels around 8% or slightly higher. In this context, wages will decelerate.

Given the higher inflation we expect for the first part of the year, real wages could face a contraction in January and February. However, according to the Readjustment Act passed in September 2018, the minimum wage should have a 2.5% real readjustment next March –which according to our projections for the CPI will place it at a level of $ 319,000 - bolstering the wage payroll index.

Graph 50. Remuneration rate (annual var.,%)

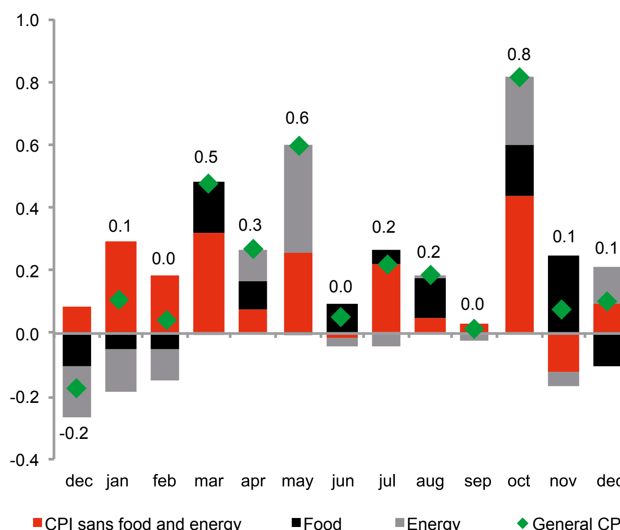


Source: INE and Santander

Inflation accelerates temporarily

After starting 2019 with very limited records in the lower part of the Central Bank's tolerance range, inflation accelerated and closed the year just at the 3% target. This, after remaining below that figure for three years almost without interruption. The rise in the rate of price increases was caused primarily by the depreciation of the currency and, to a lesser extent, the recovery of the international price of fuels, which had fallen at the beginning of the financial year. The drought, which could have affected food prices, did not have a greater impact.

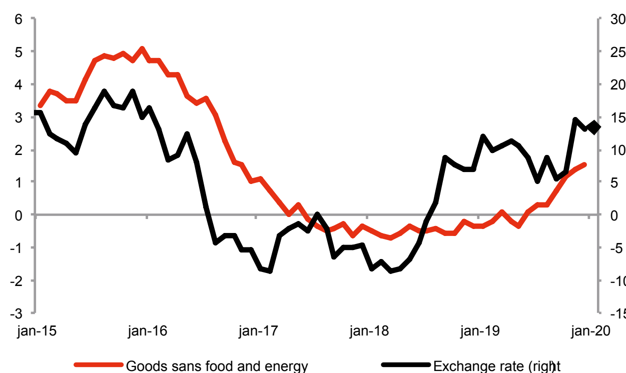
Graph 51. CPI 2019 (monthly var.,%)



Source: INE and Santander

Despite the above, medium-term pressures were contained. Underlying inflation measured by the CPI sans food and fuel (CPI SAE), closed the year by 2.5%, while the rate of inflationary diffusion, although rising, remained within historical patterns.

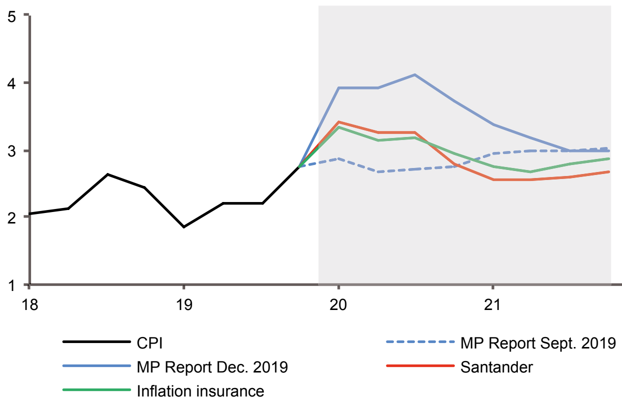
Graph 52. CPI underlying assets (annual var.,%)



Source: BCCh, INE and Santander

At the start of 2020, inflation will increase due to the lagged effects of currency depreciation and could be somewhat above 3.5% during the first quarter. However, going forward it should lose its momentum due to the prospects of slow growth, which will maintain a restricted labour cost, and also due to the impact of the freezing of tariffs for high-incidence public services, such as electricity, drinking water and public transport. Like this, if the relatively stable exchange rate remains at the levels it had at this report's conclusion –our base scenario– we project that inflation will close the year at around 2.7%, again below the Central Bank target.

Graph 53. Inflation projection (annual var.,%)



Source: INE, Bloomberg, BCCh and Santander

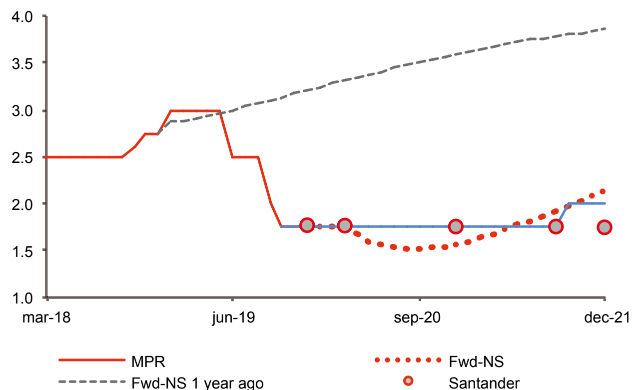
Monetary policy will remain stable

Until the beginning of 2019, the diagnosis of the Central Bank pointed towards the closing of the economic gaps and that, therefore, it was necessary to continue the monetary normalisation process started in mid-2018. Thus, in January last year, the Monetary Policy Rate (MPR) increased by 3%, indicating it would continue to do so, slowly, during the following months. However, after activity showed evident signs of deceleration and inflation remained low, the Council adjusted its speech and surprisingly reduced MPR by 50 bps during June. In that time, the argument for the shift in policy was that updating the structural parameters –potential and trend growth and neutral MPR– led to the conclusion that there were greater economic gaps than thought, and that effective monetary stimulus was lower. Subsequently, the risks of inflation not converging to the target led the Central Bank to re-cut the reference rate at the September and October meetings by 50 bps and 25 bps respectively. Thus, the MPR closed the year by 1.75%, well below what was expected at its beginning.

The social upheaval created significant disruptions in the money markets. As noted above, the Central Bank intervened in the exchange market to reduce currency volatility and announced that it would keep the MPR at its current level at least until such intervention lasted.

In our base scenario, the MPR will remain unchanged during this year. On the one hand, the current level of the rate is already expansive and gives a boost to the economy. On the other hand, the risks of abrupt adjustments in financial prices in the current context will make the Central Bank more cautious about changing its monetary policy. If inflation slows down more dramatically due to the gaps in the economy and given that financial risks dispel in a clear manner, there would be the possibility of further cuts, which could bring the MPR close to 1%.

Graph 54. MPR Expectations (%)



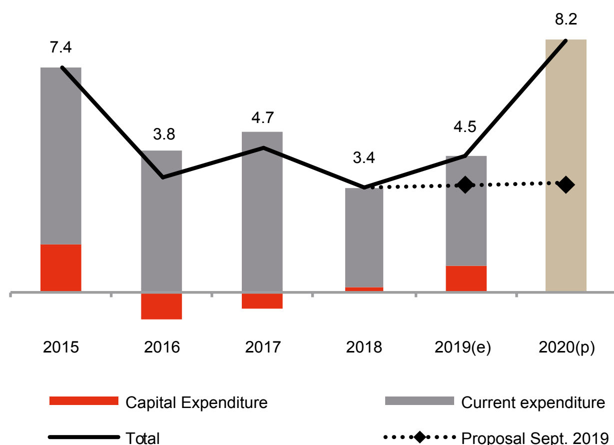
Note: MPR= Monetary Policy Rate
NS = Nelson Siegel

Source: Bloomberg and Santander

Strong fiscal expansion will accelerate debt growth

Over the past year, the slowdown in activity and domestic demand –coupled with a demanding basis for comparison– caused inter annual fiscal revenues to contract close to 1%. Meanwhile, the spending dynamism –which accelerated with the social crisis due to a greater execution of the capital component– caused it to expand by about 4.5%, well above the latest projections of the Ministry of Finance. If these numbers are confirmed, the actual deficit in 2019 would have reached 2.9% of GDP, its highest value since 2009.

Graph 55. Government expenditure (annual var.,%)

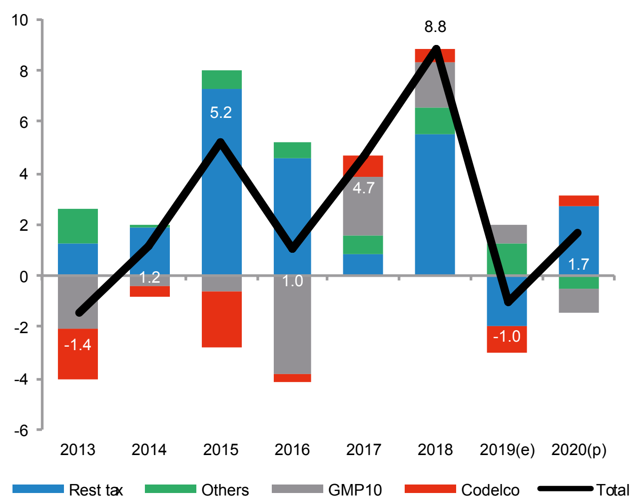


Note: 2019 data corresponds to Santander estimate. In 2020 the level of expenditure announced by the Government is used.

Source: Dipres and Santander

In response to the social crisis, the government announced a series of measures to respond to demands and boost the economy. During the budgetary discussion, the Executive committed US$ 1,272 million in resources for reconstruction, basic pensions, health care and the guaranteed minimum income project; part of this amount would be financed by reallocations.

Graph 56. Government income (annual var.,%)

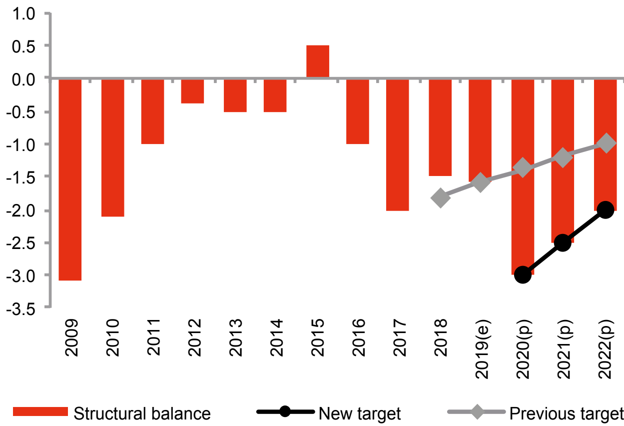


Source: Dipres and Santander

Subsequently, a tax package of economic stimulus equivalent to US$ 5,500 million was announced – additional to what is included in the budget– with measures to support SMEs and employment, and a robust infrastructure spending. This package, with what was approved in the budget, will mean a real expansion of expenditure of the order of 8.2% by 2020, thus placing the deficit in the range 4.5% – 5%, depending on whether the Tax Modernization that is being processed in Congress is approved.

This fiscal boost will be necessary for sustaining activity and investment this year, but it will also have a substantive impact on debt, which we estimate will close by over 30% of GDP. From now on, it will be essential to establish a credible consolidation process so that debt stabilises after a few years.

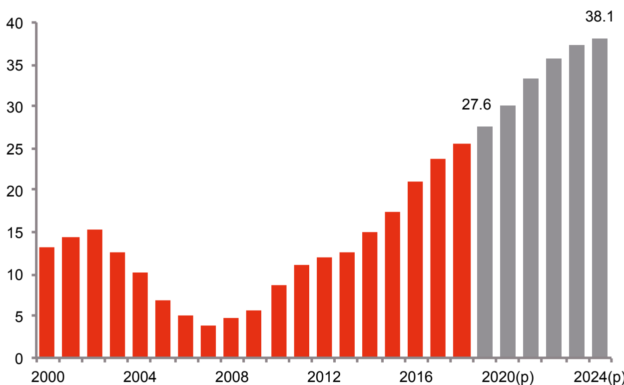
Graph 57. Structural balance and fiscal goal (% GDP)



Source: Dipres and Santander

LThis implies a change of route for the long-term fiscal policy. In June 2018, the Government self-imposed the target of reducing the structural deficit by 0.2% of GDP each year, which meant bringing it to 1.6% by 2019 and 1.4% by 2020. Under the new scenario –as reported by the Ministry of Finance– the structural deficit would reach 3% of GDP by 2020. The Executive set a new goal to reduce it by 0.5% each year, bringing it to 1% by 2024. We estimate that this is impractical and that the deficits will remain high. For the same reason, public debt will grow significantly in the coming years and could exceed 40% of GDP by 2024.

Graph 58. Gross debt of the Central Government (% GDP)



Source: Dipres and Santander

Box 5: Legislative and electoral Agenda

The year will be marked by an intense political agenda, with several large-scale bills in Congress and important electoral milestones. Below are some of the bills that will advance this year and the most relevant events.

Tax modernization

After taking control of the Finance portfolio, Minister Briones announced modifications to the tax modernization project, eliminating the total reintegration of income tax, one of the critical measures of the reform presented by the Executive in 2018. Together with the opposition, it was also agreed to establish a surcharge on real estate whose tax assessment exceeds $400 million, to create a new tranche of the Complementary Global Tax with a marginal rate of 40% and to phase out the tax refund to companies with a loss. On the other hand, the pro-SME scheme of the original project was extended to companies with sales up to UF 75,000, a 100% integrated system based on withdrawals, 25% rate, instant depreciation and cash-based taxation. Besides, a new "transparency regime" was created for companies whose owners are natural persons (with annual sales up to UF 75,000), which provides for simplified accounting and taxation according to the owner's final tax, exempting themselves from first-class tax. With these modifications, the government plans a collection of an additional US$ 2.2 billion in the new tax regime. In 2020 the additional revenue would be US $ 400 million, where the most significant impact is derived from the substitute tax to the FUT (Tax-exempt Earnings Funds) and, to a lesser extent, from the surcharge to the contributions.

The bill has already been approved by the Senate, but it will have to be re-examined by the Chamber of Deputies. In the most likely scenario, the discrepancies raised by members will have to be resolved in the Joint Committee, so final approval could be given in a few more months.

Pension System Reform

To speed it up, in November 2019 the government divided the pension reform project and achieved a fast release of the law that gradually increases the Basic Solidarity Pension (Pensión Básica Solidaria, PBS) and the Solidarity Insurance Contribution (Aporte Previsional Solidario, APS) for all pensioners who currently receive such benefits. In mid-January, the new proposal to reform the pension system in a structural manner was announced, with an additional contribution of 6% from the employer, of which 3% will go to an individual account, 2.8% will finance the new Collective Solidarity Savings (Ahorro Colectivo Solidario, ACS) and the remaining 0.2% will go to a dependency insurance. All these funds will be managed by a new independent public body. The ACS will establish a sharing component in the system that adds to the solidarity pillar to improve the lowest pensions quickly. Thus, the pensions of women who have contributed for at least eight years will rise by 2.5 UF and those of men, who have paid for 12 years, by 2 UF. It also seeks to ensure that any person who has contributed for at least 30 years has a pension higher than or equal to the current minimum wage (indexed to inflation).

Working hours

Congress is dealing with two projects aimed at changing the working hours. The first, a parliamentary initiative, proposes to reduce the weekly working time from 45 to 40 hours. The second, offered by the government, gives the parties space to agree on the day so that finally there is the possibility to work four days a week and have three days off. Furthermore, the Executive announced that it will advance the reduction from 45 to 41 hours, maintaining the flexibility to agree, with a transition of at least six years.

Although the Executive's project is extremely urgent, it has made little progress and is still in its first stage in the Senate. Meanwhile, the parliament's plan has already passed the Chamber of Deputies and is being reviewed by the Senate, although it has no urgency. Both initiatives are expected to merge and move forward in Congress. Adequate calibration of transitions and flexibility mechanisms are essential to minimise the impact this regulation will have on labour costs.

New regional governors

The first election of regional governors will take place in October, in conjunction with mayors and councillors. From then on, the regions will be headed by elected authorities with at least 40% of the vote. However, their powers will initially be limited. At present, the regional mayor has two functions: he is the representative of the president of the Republic in regions and heads the regional government. With the election of governors, both functions are now separated, the first function oversees the presidential delegate -which remains by presidential appointment- while the second function oversees the new authority. The future presidential delegate will oversee law and order and the security forces, as well as the coordination and monitoring of the regional ministerial secretariats. The regional governor must, among his main functions, decide on the investment of the resources that belong to the region in the distribution of the Regional Development National Fund, which represents about 25% of the effective public investment. From this moment, the devolution mechanism from the central level could be a source of conflict, as case by case is defined by regulation.

Constituent Process

In the context of the social crisis, Congress reached an agreement to open a process that, if supported by the citizenship, would culminate in a new political constitution of the Republic. Following the approval, the constitutional reforms that institutionalise the process were approved at the end of December, beginning with a plebiscite on April 26. It will vote on two questions: (i) accepts or rejects the proposal to draft a new basic charter; and (ii) what type of body should draft it. On the second point, the alternatives are a Mixed Convention (50% of sitting parliamentarians and 50% of citizens elected for this purpose only) or a Constitutional Convention (100% of elected citizens).

If the drafting of a new Constitution is approved, the election to choose the members of the constituent body will take place in conjunction with the municipal elections on October 25th. The convention -whether Mixed or Constitutional– will define the voting rules which will require a quorum of two thirds for each rule and shall have a maximum period of nine months –renewable by three additional months– to approve a proposal for a new constitution. Then the President of the Republic must call a plebiscite -with compulsory suffrage– for citizens to approve or reject the proposal. According to the deadlines set in the process, such a plebiscite would be tentatively held in September 2021 or March 2022. If the proposal is rejected, the current Constitution will remain in force.

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