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Outlook for 2022:
The Challenges of Recovery

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Presentation

In 2021, the world began a winding path towards recovery. The progress in the vaccination rollout, though uneven among countries, allowed economies to reopen, with the activity of several regions regaining their pre-pandemic levels -though not their prior trend- by the end of the year.

The recovery process will continue this year, but new challenges lie ahead. Inflation, which had ceased to be a problem for several years, has resurfaced in the debates concerning macroeconomic policies. As a result, the leading central banks will proceed with the monetary normalisation, which may trigger financial volatility and present a risk factor for emerging markets. Meanwhile, the new wave of contagion unleashed by the Omicron variant reminds us that the pandemic is far from over. Nevertheless, this variant is expected to have more limited effects in the sanitary situation, so the reimposition of drastic social distancing measures is not likely. Furthermore, the political (and fiscal) capacity to afford these types of measures is scant.

In Chile, the economy presents evident signs of overheating, which is reflected by the large deficit in the current account, which will need to be adjusted. This means that we will observe negative GDP fluctuations in the second half of the year. Even though this might cause anxiety, the temptation to offset the deceleration with new fiscal stimulus policies or new liquidity injections -through fund withdrawals- would only delay the necessary adjustment making it more costly. On the contrary, if the economy moderates in an orderly fashion and the inflation relents, the Central Bank will have more space to relax its monetary policy and offer support through this path.

In tandem with the above, the country faces several challenges in the political spectrum. First, the execution of the new government's program will need to pursue a necessary balance to prevent harming investment and employment. In turn, even though an eventual new Constitution may provide more stability by setting agreed-upon civil coexistence regulations in a comprehensive manner, the conformation of a political system that could lack the adequate balance and countervailing, the loss of autonomy of critical institutions and the execution of spending policies that raise fiscal debt could be counterproductive.

In this document issued by Banco Santander's Economic Studies Department, we offer our outlook regarding Chile and the world's economic situation, as well as the prospects for this year. With it, we seek to contribute to the assessment and public debate concerning the challenges we must face to further the country's progress.

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Executive summary

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Despite a new wave of infections, the global economy began a gradual recovery in 2021, driven by the easing of lockdowns (due to the progress in the vaccination rollout), the strong liquidity injections given by the leading central banks, and the fiscal stimulus measures of advanced and emerging countries. Thus, the global GDP grew close to 6%, increasing above its pre-pandemic level, though still remaining below the levels it would have gained had there been no sanitary crisis.

The recovery of aggregate demand in the second half of 2021 added to a restricted offer of goods and services due to disruptions in the value chains, the readjustments of the labour market, and -in the case of crude oil- the OPEC's restrictive policies, which led to a vigorous hike in prices at an international level. This is why inflation, which had ceased being a concern for decades, has returned to the centre of macroeconomic discussions.

Given the above, several central banks reacted by hastening the monetary stimulus withdrawal. Last December, the Bank of England raised its reference rate after 21 months at minimum values. Added to this, the Federal Reserve began slowing down its asset purchasing program, giving signs that it would increase its rate by the end of this year's first quarter. This led to new hikes in long-term rates, though they still remain below the level reached some years ago.

The global economy should continue its rising trend during 2022, albeit at a slower pace, reaching around 4.2%, due to a more demanding comparison basis and the general shrinking of macroeconomic stimulus, in an environment that is not exempt from risks.

The pandemic will continue to be a relevant factor. In the last weeks, infections caused by the Omicron strain's spread have reached new peaks. Even though the available scientific information points towards less severe health effects than previous strains, its high transmissibility fosters fear of renewed pressure on the healthcare system. Even though this new wave is likely to have limited impacts on the economy due partly to the reticence to impose new social distancing measures, it is still too early to rule out more intense effects.

Another risk is China's situation. Despite strict confinement measures, China has had a relevant recovery so far. Notwithstanding, several retail businesses have faced grave financial problems, and as the country's primary drivers of growth, the magnitude of such impact on dynamism is not clear. Recently, this country's authorities announced additional liquidity measures to underpin the economy.

Moreover, as of the date this report was issued, the geopolitical tension between Russia and Ukraine presented an additional risk with a potential impact on the price of crude oil.

Finally, tight financial conditions are a source of concern for emerging economies. In the past, fluctuations in the monetary policies of leading countries led to periods of stress that entailed significant economic and financial impacts on more vulnerable countries. Therefore, organisms like the IMF have repeated their calls to caution and clarity in communicating the stimulus withdrawal strategies.

In Chile, the economy has had a strong recovery. The quick move into normalising mobility (thanks to the fast vaccination rollout) and the substantial liquidity injections given by public aid and pension fund withdrawals (US$ 80 billion approximately) led to a GDP growth of nearly 12% in 2021. With it, the economy not only recovered from the loss of the year prior but also reached quite above its trend. Nevertheless, this has created an overheating reflected in the climbing inflation, which ended the year at 7.2%, its highest level since the 2000's commodities boom. All of this with a hefty deficit in current accounts as the background. Even though part of the price hike reflects the foreign inflationary pressures, a relevant portion is linked to the solid internal demand and the Peso depreciation, affected by idiosyncratic factors.

The Central Bank has answered quickly, raising the Monetary Policy Rate by 350 base points, ending the year at 4%, above its neutral value. The Council will likely keep raising the ruling rate in months to come, which could range between 6% and 6.5% by the end of the first quarter. Meanwhile, public spending will have a substantial fall in 2022, with which the fiscal policy be contractionary. These factors, added to the natural adjustment of some durable goods in expenditure, will cause the economy to suffer a relevant slowdown this year.

The biggest unknown is the speed at which this adjustment will take place, as households still have a relevant volume of liquid assets that could be spent. In turn, the investment, having experienced a substantial hike during 2021 due to the reposition of obsolete inventories, will now be affected by tighter financial conditions and by domestic political uncertainty regarding the new government's instalment and the defining stage in which the institutional process will enter into. As long as there is a lack of clarity regarding future rules of the game, it is difficult for there to be fast progress in new large-scale projects.

We estimate that the economy will grow by around 2.5% this year in our baseline scenario. During the first half of the year, the GDP growth rates will remain high, while the second half will see negative rates, driving the activity to again converge into its trend. A delay in the consumption adjustment process could raise growth figures near 4%, but this would imply a more intense subsequent adjustment, with a contraction in activity during 2023. In turn, a significant moderation in investment caused by the domestic political situation currently and/or the worsening of the foreign scenario could substantially hamper the activity during this year, resulting in 1% growth only. The latter is also affected by pandemic-related risks.

Inflation in the meantime will remain high until the end of the year's semester, a period in which it could reach 8%. It would then decline gradually, ending 2022 at around 5.5%. Onwards, the convergence towards the 3% target will proceed slowly to only occur in 2024 due to the delays operating in the closure of gaps.

Despite the quick recovery of the Chilean economy, the local financial markets displayed a meagre performance in 2021. The exchange rate shrank by 20%, and the stock market only rose by 3% without offsetting the pandemic-related losses of 2020. Moreover, the long-term interest rates climbed strongly, reaching historical peaks akin to economies with lower credit ratings. This was influenced by the uncertainty linked to the approval of the third pension fund withdrawal- and its implications for the pension system-, the constitutional process, and the possible twist to the country's public policies resulting from a new government.

In times to come, the evolution of financial prices will depend on the global scenario, the political environment, and the macroeconomic adjustment. If the global economy continues its path towards recovery, if the constitutional process's uncertainty is favourably cleared, and if the macro adjustment develops gradually and orderly, just as in our baseline scenario, assets could stabilise and marginally climb. Conversely, a worsening of the foreign situation, the persistence of tensions at a local level and new liquidity injections seeking to artificially bolster the internal demand over its trend- and which results directly or indirectly in further fiscal damage- would pressure the risk premiums, causing new hikes in long-term rates, additional falls to the local stock index IPSA, and more substantial depreciation of the Peso.

As indicated in our previous annual report (Vision 2021: a winding path to recovery), the most relevant factor for the economy in the medium term is how institutional events will develop and, specifically, the drafting of the new Constitution. Setting comprehensively agreed-upon civil coexistence regulations can offer greater stability, which could favour investment and development. Nevertheless, the consolidation of a political system lacking the adequate balance and countervailing, the loss of autonomy of key institutions, and the setting of spending regulations that pressure public finances could overall undermine growth.

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Santander projections

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Global growth (%)

	2020	2021 (e)	2022 (p)	2023 (p)
Advanced economies	**-4.5**	**5.2**	**3.8**	**2.5**
Europe	-6.3	5.0	4.0	2.7
United States	-3.4	6.0	4.0	2.3
Japan	-4.6	2.4	3.0	1.0
Emerging and developing markets	**-2.1**	**6.4**	**4.5**	**4.2**
Latin America and Caribbean	-7.0	6.3	2.5	2.0
China	2.3	8.0	5.0	5.0
India	-7.3	9.5	8.0	6.0
World	**-3.1**	**5.9**	**4.2**	**3.5**

Fundamental variables

Commodities	2020	2021	2022 (p)	2023 (p)
Average copper price (US$/lb)	2.8	4.23	4.2	4.0
Average WTI oil price (US$/bbl)	39.3	68.0	78.0	80.0
Inflation	2020	2021	2022 (p)	2023 (p)
Average CPI (%)	3.0	4.5	7.0	4.5
End-of-year CPI (%)	3.0	7.2	5.5	4.0
Average CPI SAE* (%)	2.3	3.8	6.5	4.4
End-of-year CPI SAE* (%)	2.6	6.4	5.2	3.9
Financial conditions	2020	2021	2022 (p)	2023 (p)
Average exchange rate ($/US$)	792	761	851	855
End-of-year exchange rate ($/US$)	711	852	850	860
Average MPR (%)	0.8	1.2	6.0	4.5
End-of-year MPR (%)	0.5	4.0	5.5	4.0
Labor market	2020	2021 (e)	2022 (p)	2023 (p)
Average unemployment rate (%)	10.8	9.1	7.5	7.8

* CPI SAE = CPI sans food and energy

National accounts and balance of payments (%)

	2020	2021 (e)	2022 (p)	2023 (p)
GDP	-5.8	11.9	2.5	0.5
Internal demand	-9.1	21.2	0.3	1.0
Total consumption	-6.8	18.6	-0.8	2.2
Private	-7.5	20.6	-0.7	2.0
Government	-3.9	11.0	-1.5	3.5
Fixed capital investment	-11.5	17.2	-0.6	1.8
Construction	-11.3	11.3	2.4	1.0
Machinery & equipment	-11.8	26.8	-5.2	3.0
Exports	-1.0	-0.9	1.9	2.5
Imports	-12.7	30.3	-3.7	4.0
Current account (% GDP)	**1.4**	**-6.0**	**-3.0**	**-2.5**

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International scenario

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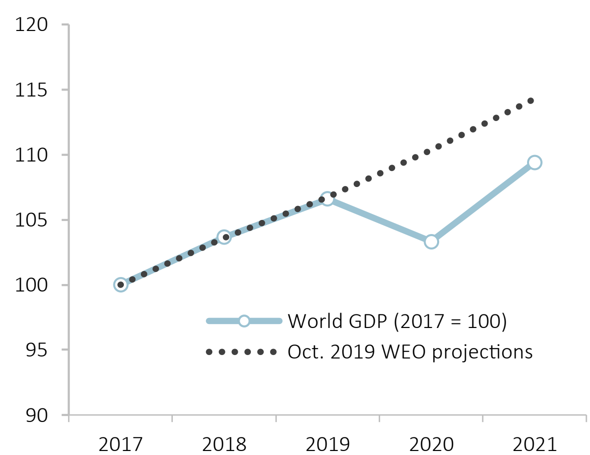
Despite the new wave of infections, the global economy is progressing

Despite several waves of infection during 2021, the global economy continued its recovery process after the dramatic global contraction of over 3% in 2020. The vaccination rollout was vital, allowing the gradual decrease in confinement measures. Furthermore, the leading central banks continued to provide liquidity, while the governments of advanced economies and some emerging ones implemented new stimulus plans. This led the global GDP to grow by 6%, quite beyond expectations and placing the global activity above its pre-pandemic levels. Nevertheless, a significant gap remains in relation to the situation that would have prevailed had there been no sanitary crisis.

Global activity recovered in 2021, but a relevant gap still remains

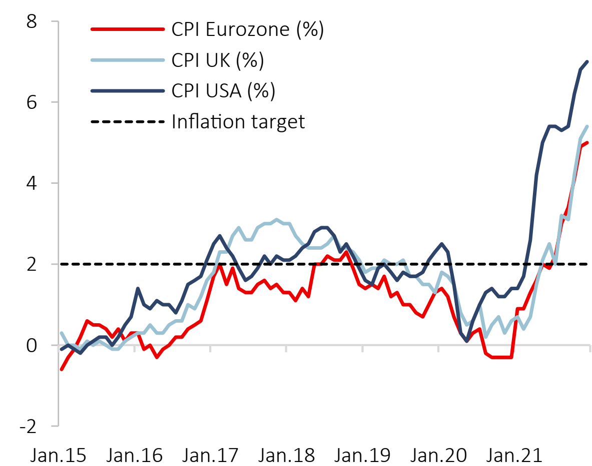


Source: FMI and Santander

The labour markets also showed progress; however, employment remained below its early 2020 levels, due to a still quite limited work offer in several countries.

The recovery of demand and the disruptions in global production chains drove inflation up in the second half of the year, ending at levels not observed for decades. The almost 70% rise in the annual average price of crude oil also influenced the above, after OPEC decided to uphold its limited production, along with bottlenecks in logistics, which raised substantially the cost of ocean freights *(Baltic Dry Index)*.

Inflation has become the new challenge at a worldwide level

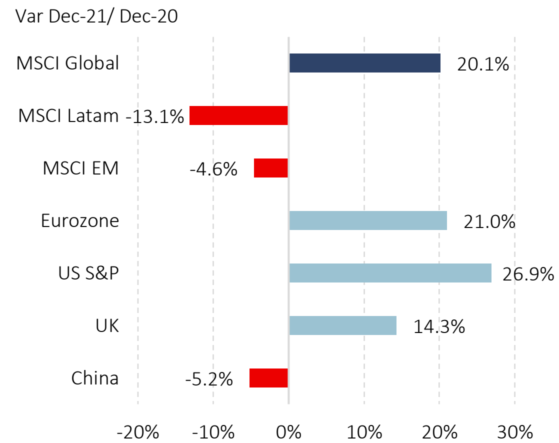


Source: Bloomberg and Santander

The hike in prices led to a change in the monetary strategies of several central banks. The Bank of England began raising its governing rate by the end of 2021, and the Federal Reserve started reducing its asset purchasing program. Furthermore, it gave signs that it will begin to raise its monetary policy this year. The European Central Bank (ECB), on the contrary, decided to maintain its quantitative stimulus measures, despite the inflation rise in the Eurozone. In Latin America, Brazil's Central Bank began its rates-rising process in March, with an increment of 500 bps throughout the year, and the Bank of Mexico followed suit starting June, though at a more gradual pace.

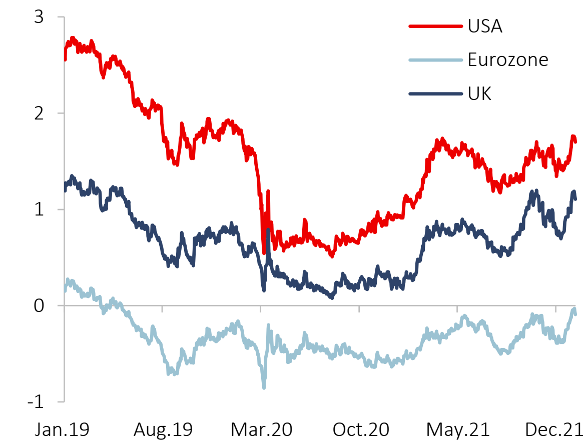
Stock markets exhibited certain volatility but ended 2021 with significant progress (Global MSCI: +20%), led by both the European (Eurozone: +21%; The UK: +14%) and the American stock markets (S&P 500: +27%; Dow Jones: +19%). Explaining this performance was the optimism at the progress in the deconfinement and the economic recovery in a context of high liquidity. Conversely, the Latin-American stocks moved in the opposite direction (MSCI Latam: -13%), affected by domestic political factors. The Chinese stock market also retreated (-5%) due to the heavy confinement measures imposed to prevent the pandemic's spread alongside the financial problems of the retail sector.

Stock markets of leading countries rise strongly



Source: Bloomberg and Santander

Long-term rates climb due to better prospects and hike in inflation



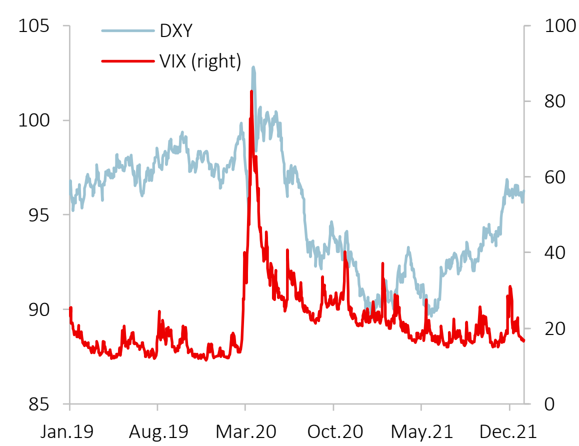
Source: Bloomberg and Santander

Long-term rates tended to rise early in 2021 at the prospect of a change in the monetary strategies. Nevertheless, during the first half of the year and before the inflationary rebound took place, the dovish signs given by the leading central banks caused these rates to settle and even recede moderately. However, by the year's end, the climbing inflation and the tonal change of the monetary authorities once again pressured these rates up. The dollar, in turn, tended to regain the losses of 2020.

The global economy will continue its path towards normalcy during 2022. Even though the outbreaks caused by the Omicron strain in the last weeks have increased the infection rate considerably and reached a new peak, the markets have reacted calmly. This is because the information available indicates that the new strain, while highly transmissible, has less severe health effects.

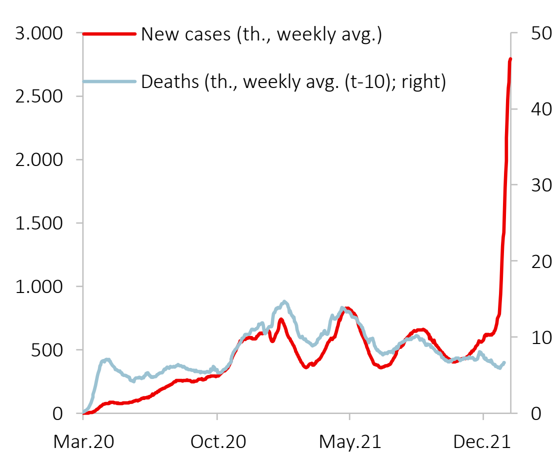
This, along with the ample coverage of vaccines in many countries, has prevented the reimposition of strict social distancing measures. Thus, mobility will remain high, which, added to the effect of last year's stimulus measures, will cause the economy to grow once again, though at a lower rate than in 2021, at around 4.2%.

Dollar recovers during the second half of the year



Source: Bloomberg and Santander

The new wave of infections seems to have a less severe impact on health



Source: OWID and Santander

Overall, risks related to the pandemic remain present, and a temporary slowdown in the activity cannot be ruled out in the first half of the year, to then return to an ascending trend. Another risk in the global landscape is related to China's economy, which could intensely lose buoyancy due to the problems in the retail sector.

Finally, there is inflation, which could generate further tightness to the global financial conditions if more persistent than anticipated.

Leading economies benefit from ample vaccine coverage

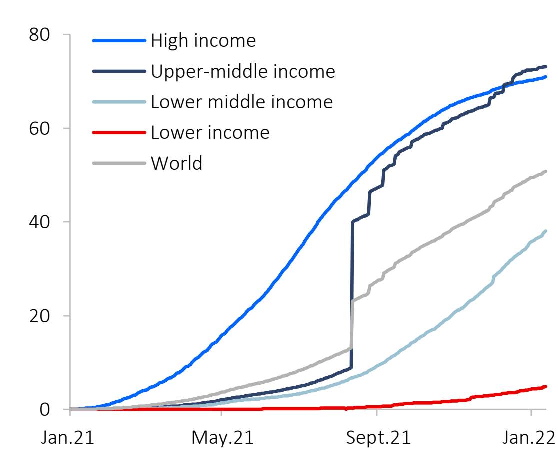
The recovery was driven by the leading economies throughout 2021, which opened their production sectors earlier thanks to speedy vaccination rollouts. In the US, the macroeconomic policy remained highly expansive, with the federal fund rate at its lowest, added to the quantitative monetary stimulus measures on behalf of the Fed –which increased their balance sheet by 19%- and high public spending with substantial aid directed at families. This encouraged the economy to grow by around 6%, driven by the dynamism in private consumption. The labour market continued its path of improvement and ended the year with a historically low unemployment rate (3.9%), though this was partly due to lower work participation. Employment climbed, but it did not reach its pre-pandemic levels. In the political domain, 2021 was a year of high polarisation between republicans and democrats, with opposing opinions regarding the budget proposed by President Biden and the increment to the debt cap. This last led the country to the edge of payment default-which was resolved just before its due date on the 15th of December.

In the year's second half, the rise in inflation-which ended at 7%, its highest record since the 80's- and the improving labour market led to a change in the Fed's statements tone. Its president Jerome Powell made explicit their disposition to begin the monetary normalisation this year by reducing their asset purchase pace (tapering) and then raising the federal fund rate (which would proceed as soon as by the ending of this year's first quarter). Like part of the market, we estimate that the Fed will apply at least four hikes to the monetary policy rate throughout 2022, raising it to 1.25%. This will tend to continue to strengthen the dollar at a global level and will moderate the growth pace of the American economy, which will settle at around 4%.

The Eurozone countries were the most hit by the waves of infection last year. For the same reasons, the recovery process showed both progress and setbacks. Despite this, the vaccination coverage allowed a quick deconfinement which, added to the support measures, enabled the year to end with a relevant growth of around 5%. Europe's labour market experienced a substantial improvement, but like in other countries, employment ended the year below its pre-pandemic levels. Notwithstanding the rise to the annual inflation (5%), the ECB decided to maintain its quantitative stimulus measures. According to its president, Christine Lagarde, the economy of the Eurozone is not sufficiently strong as to warrant prices will stabilise at the 2% target persistently.

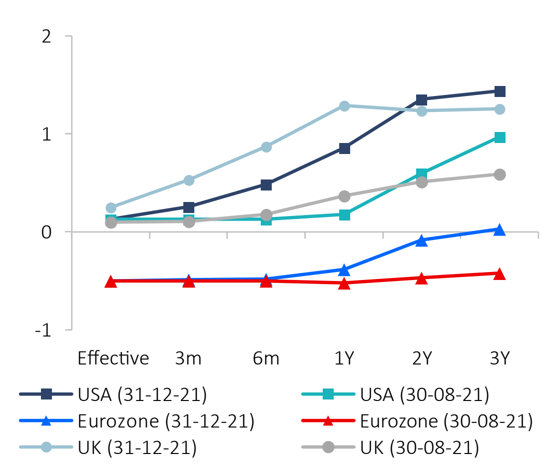
We expect the European economies to continue their recovery process this year and display relevant growth, albeit lower than that of 2021. The primary risks continue to concern the pandemic and the possible impact of the new outbreak caused by the Omicron strain. Overall, growth should fluctuate around 4%.

Ample coverage of vaccines in leading countries



Source: OWID and Santander

The FED is expected to raise its reference rate by at least 100 base points



Source: Bloomberg and Santander

Emerging economies face tightening financial conditions

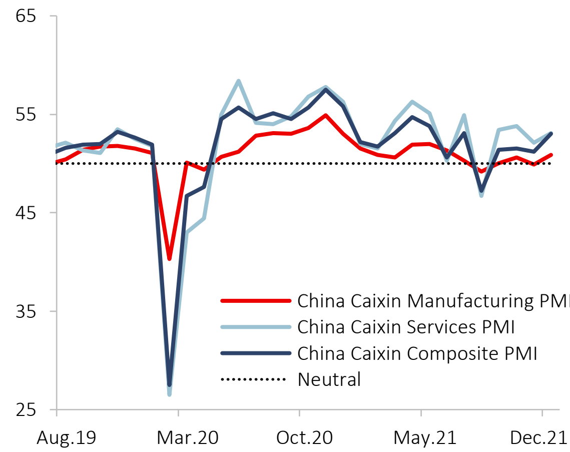
Even though the vaccination rollout was slower than in developed countries, emerging economies gradually relaxed their social distancing measures, allowing them to start recovering the pandemic-related losses. As a result, inflation has become a problem, and many central banks have begun to withdraw their stimulus.

The recovery process should keep on track this year, though relevant risks still remain. On the one hand, there is the sanitary situation, for a new wave of infections could have an impact, at least in the short term. On the other hand, there are global financial conditions. The eventual FED rate hikes could generate tension and affect the more vulnerable economies with currency depreciation, inflationary pressures, rate hikes and impacts to activity. The IMF has been particularly insistent and has warned that emerging economies should prepare for the developed countries to tighten their monetary policy.

In 2021, the Chinese economy was subjected to many sources of tension. On the one hand, the authorities' approach to weather the pandemic by pursuing the containment of any infection outbreak led to the strong imposition of lockdowns in large cities. Moreover, China's energy transition towards less contaminating technologies generated bottlenecks that impacted the activity in the second half of the year. Lastly, after the tightening of this sector's regulation, the defaults of several retail businesses caused a slowdown in the buoyancy of one of the most critical drivers of their economy. Nevertheless, despite the above, China grew by 8.1% in 2021. Notwithstanding, the growth prospects for this year have had a solid downward correction and are now located at 5%. The government, meanwhile, has answered by setting new measures to increase liquidity.

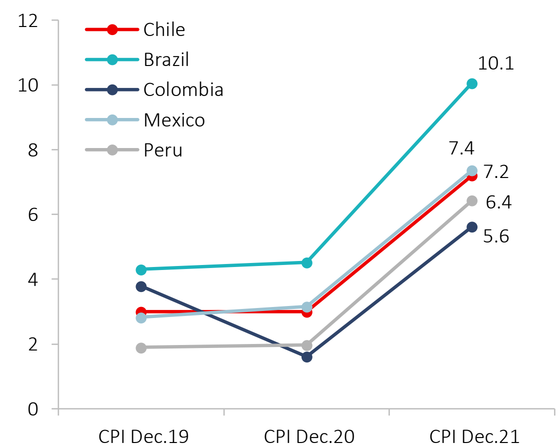
Latin America, in turn, confronted 2021 with resurgences of the pandemic and a series of crucial events of political nature in several countries. The region's economies grew somewhat above 6%, but a significant slowdown is expected for this year, locating growth at around 2.5%. The region has been particularly affected by inflation, and the central banks have increased the interest rates quite earlier than their counterparts in developed countries. The impact of new waves of contagion, the political uncertainty, the withdrawal of the monetary stimulus, and China's slowdown are the main elements keeping this region's risk balance in a downward bias.

Lockdowns and financial crises in the retail sector cause slowdown in China



Source: Bloomberg and Santander

Inflation has climbed strongly in Latin American countries



Source: Bloomberg and Santander

Prices of commodities climb strongly

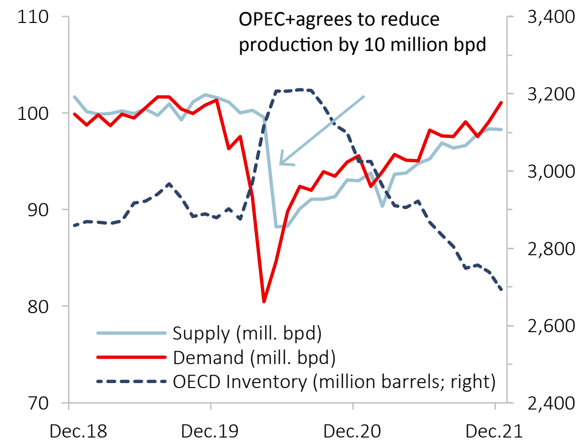
Last year, the WTI crude oil price rose substantially (72% on average), reaching US$ 68 per barrel average, its highest level since 2014. The hike was caused by the combination of a demand recovering faster than anticipated and the OPEC Plus maintaining restrictions to the offer. These were involuntarily reinforced by the US, the primary producer worldwide, as they faced substantial drops in production due to several climate events. Therefore, as the global demand grew by 5.5% in 2021, the offer only did so by 1.8%, which was reflected in the shrinking of crude oil inventories (OECD: -9%; US: -10%).

Towards late 2021, the rise in infections led to a temporary price drop, but it had significantly recovered as of the date this report was issued. Meanwhile, the OPEC Plus' recent decision to maintain a limited offer in the months to come, raising production only to 0.4 million of daily barrels, compounded with the demand's solid growth prospects, make us anticipate the crude oil price will remain high this year, at around a US$ 78 per barrel average.

The price of copper, in turn, experienced a significant hike early on 2021, surpassing the US$ 4 per pound threshold in February. It then fluctuated around US$ 4.3 throughout the year, reaching a yearly average of US $4.23 per pound and an annual increment above 50%. Just like the case of oil, this vigorous climb is explained primarily by the union of buoyant demand and a restricted offer, which was reflected in a 28% drop of inventories in the three leading stocks for this metal combined (London, Comex y Shanghai), its lowest closing level since 2005.

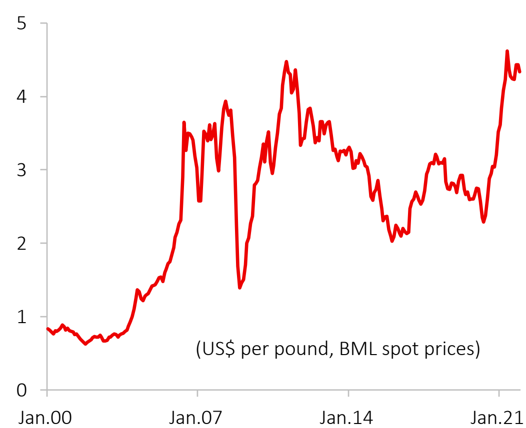
The low growth of copper production obeyed, fundamentally to the decrease of the mineral laws due to the ageing of the largest mining sites, which was not offset by new investments. This will maintain the offer limited for quite some time, as projects with relevant production about to go into execution are scant. Furthermore, the year is beginning already with tight inventories. Demand, in the meantime, will be affected by the slowdown of China's economy and its retail sector (which highly demands this metal). For these same reasons, we estimate that the price of copper will remain at high levels but that it will have a moderate downward correction, with which it will settle around US$ 4.2 per pound on average.

Recovery of the demand and a limited offer shrink crude oil inventories



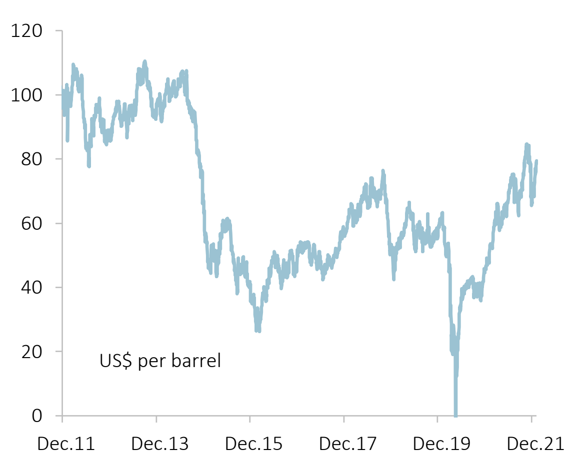
Source: EIA and Santander

The price of copper reaches its peak value in history



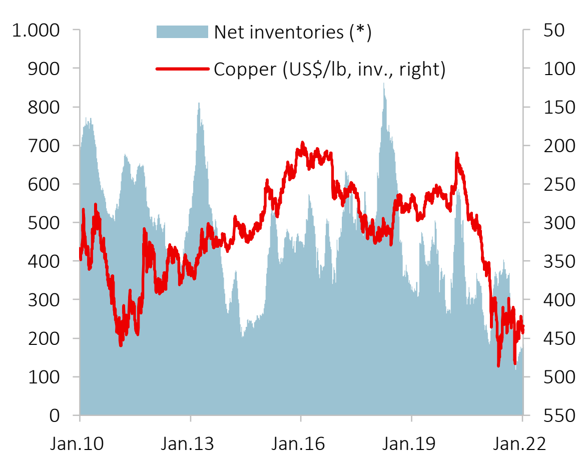
Source: Bloomberg and Santander

The price of crude oil climbs solidly



Source: Bloomberg and Santander

The year begins with limited copper inventories



(*) Net inventories discount the total of orders canceled.
Source: Bloomberg and Santander

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Local scenario

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The economy must face an adjustment process

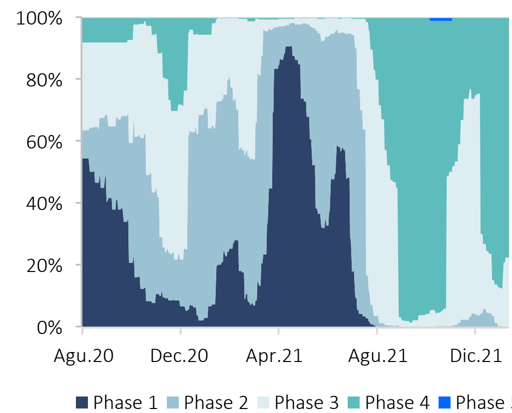
In 2021, the local economy was boosted by the recovery of mobility -thanks to the successful vaccination rollout, which made Chile the world leader in coverage- and by the significant liquidity injections related to the third pension fund withdrawal and state aid to families.

While the GDP started 2021 at pre-pandemic levels, a new wave of infections at the end of the first quarter led to the reintroduction of containment measures which impacted activity, albeit moderately. The decline in infections brought the economy back into a considerable upswing from May onwards. The Imacec for that month was 3.1% higher than in April, one of the most significant increases since the pandemic began. Explaining this figure are the better sanitary conditions and the substantial boost to consumption given by the third pension fund withdrawal, which was especially evident in the unprecedented 15% increase in trade. In addition, the payment of the universal Emergency Family Income (IFE) began in June, involving monthly disbursements of just over one percentage point of the GDP until November. This provided additional support to the demand in a context where employment and labour income continued to lag.

The manufacturing sector also benefited from the increase in spending, albeit to a lesser extent. Services, on the other hand, recovered their level during the third quarter when deconfinement allowed for the expansion of capacity and the return of several activities that had been restricted. As a result, we estimate that the economy will have an annual variation of 11.9% in 2021, one of the highest globally. With this, GDP would have been close to 4% above trend at the year-end, thus showing clear signs of overheating.

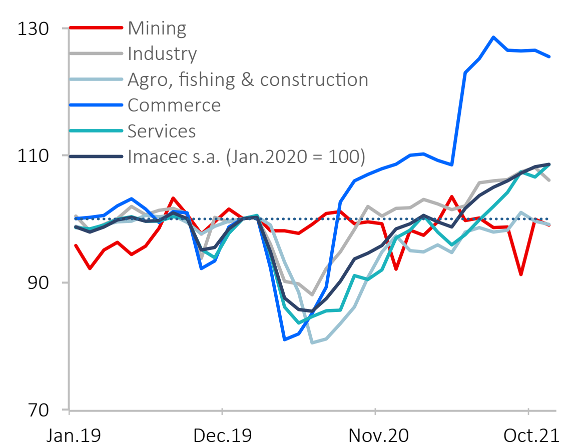
Private consumption led to a rebound in demand, expanding by 20.8% in 2021 and far exceeding its pre-pandemic level. By components, consumption of durables was particularly noteworthy, with a growth of close to 50%. In contrast, consumption of non-durable goods, which had already recovered at the beginning of the year, closed with a growth in the order of 17%. Consumption of services was slow in the first part of the year. Still, once the opening process was consolidated, it increased substantially and ended with a variation of 18% from the third quarter onwards.

Intensified lockdowns impacted the recovery in early 2021



Source: Ministry of Health and Santander

Imacec accelerated sharply after third pension fund withdrawal



Source: Central Bank and Santander

Investment also saw a significant recovery. The substantial increase in the machinery and equipment component stood out, with a growth of around 27%, driven by the restitution of equipment depreciated during the pandemic. Meanwhile, the construction component lagged for much of the year, affected by social distancing measures and the slow progress of large projects. Nonetheless, it expanded and closed the year with just above the 11% growth.

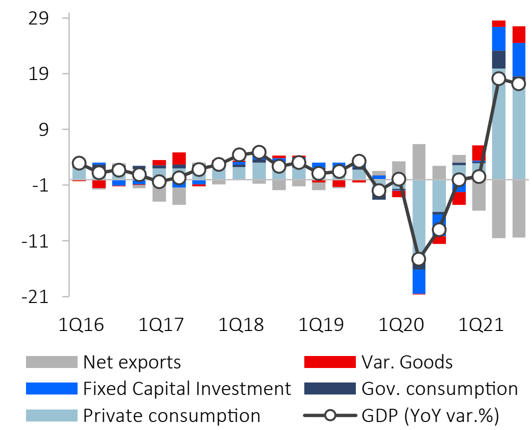
Exports fell again in 2021 due to a still weak external scenario and stagnant mining production. In contrast, imports rose sharply, by more than 30%, due to demand for durable consumer goods, investment in machinery and equipment and inventory replacement. Thus, despite the high copper price, the current account closed with a large deficit, close to 6% of the GDP.

In 2022, the economy should face an adjustment process, as activity is above sustainable levels and will necessarily converge towards its trend. Tighter financial conditions and a contractionary fiscal policy will be the main forces leading to this moderation. The Central Banks withdrawal of the monetary stimulus and the rise in risk premia have already resulted in a significant increase in the cost of credit and have raised the opportunity cost of liquid assets. Furthermore, public spending will severely shrink over 20% by 2022 due to the end of the universal Emergency Family Income. All this will cause private consumption to fall back from the high levels of 2021 and experience an annual decline close to -0.8%.

In terms of investment, after the restitution of depreciated material, its dynamics will depend on the progress of large projects, which will be influenced by tighter financial conditions and the political situation. Against this background, and considering the high bases of comparison, we project that gross capital formation will also fall by around -0.4% this year.

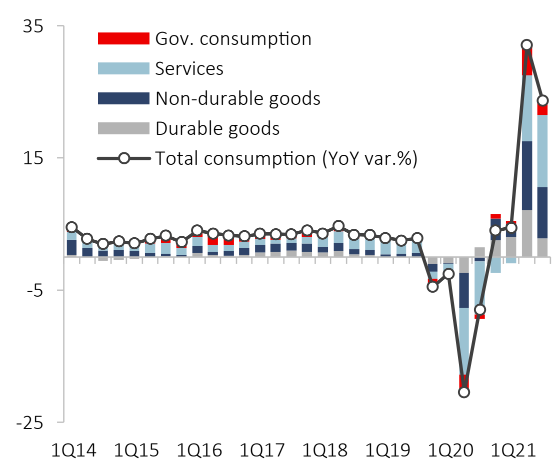
The external sector, in contrast, will show a moderate recovery. During the first quarter, the new wave of infections could impact foreign shipments, but by the second quarter -as the health situation improves- exports should pick up. On the other hand, as spending moderates, imports would show a significant reversal, thus reducing the current account deficit.

Private consumption made a rebound in activity during 2021



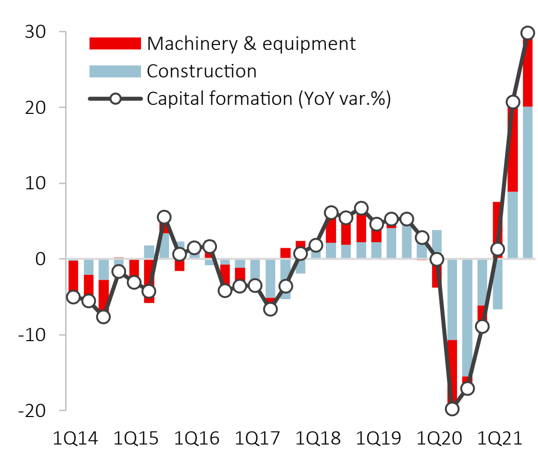
Source: Central Bank and Santander

Household spending should moderate in coming quarters



Source: Central Bank and Santander

Replacement of depreciated equipment recovered investment



Source: Central Bank and Santander

With these elements, our most likely scenario estimates that the GDP will expand by 2.5% in 2022, with still high figures in the first half of the year, while the second half of the year would have negative variations. In 2023, the convergence into the trend growth - which we estimate at 2% - and the high fundamentals of the first half of this year will lead to a minimal expansion of around 0.5%.

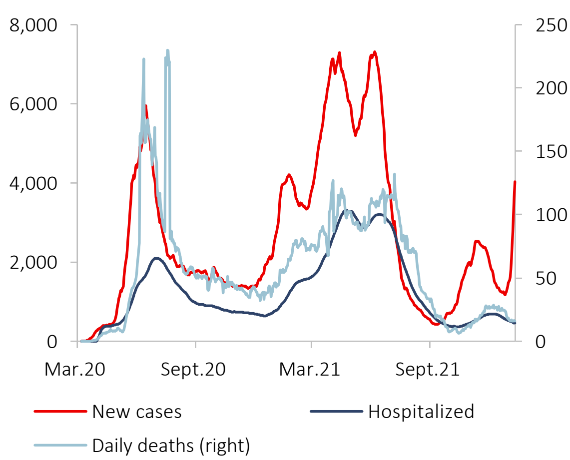
The risks in our scenario are balanced this year but skewed downwards for 2023. In the baseline scenario, we assume that the Omicron variant wave will have minimal effects on the economy as the ample vaccination coverage will prevent the reimposition of drastic social distancing measures in Chile, and its impact on the world will be moderate. Nevertheless, the information regarding the effects of this variant are still very preliminary. We do not rule out that this or other mutations of the virus may again require severe restrictions to be imposed.

aid and increases spending over budget. All this would delay convergence, pushing growth in 2022 higher than in our baseline scenario, but would make the subsequent adjustment more intense so that in 2023 we could have a deep recession.

Employment lags due to tight labour supply

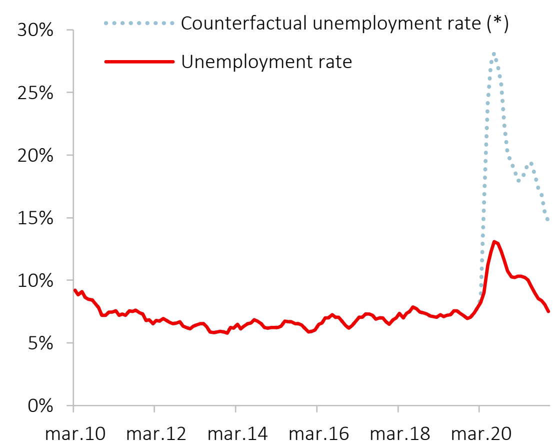
While the labour market showed a marked recovery throughout 2021, with more than 520,000 new jobs created and the unemployment rate falling to around 7.5%, there is still a significant gap compared to the pre-pandemic situation. There are 500,000 fewer jobs than in February 2020, and the employment rate stands at 53.6%, well below the 57.6% average of recent years.

Pandemic remains a risk factor for the economy



Source: Ministry of Health and Santander

Unemployment has fallen significantly



(*) Estimated with historical labor participation rate.
Source: INE and Santander

On the external front, the two major risks relate to the tightening of global financial conditions and the slowdown in China.

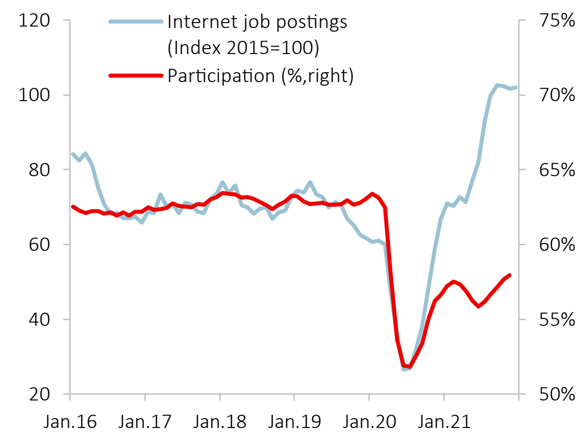
At the local level, aside from the pandemic, the most crucial downside risk to the economy is a further contraction in investment due to the political scenario. On the contrary, the upside threat in the short term is that consumption will remain high for longer, either because households spend the large volumes of liquid resources still available or because of further withdrawals from pension funds. This could also be the case if the government deploys new

By category, salaried employment - the hardest hit segment during the health crisis - rose sharply at the beginning of 2021 but then contracted again due to the new wave of infections in the middle of the year. It resumed its dynamism in the latter part of the year but closed with a gap of 180,000 jobs over its pre-pandemic situation. The self-employed, meanwhile, increased significantly over the year and returned to levels close to those of February 2020.

Employment has not yet recovered what was lost to the pandemic

Source: INE and Santander

Labour supply remains low, while demand has rebounded



Source: INE and Santander

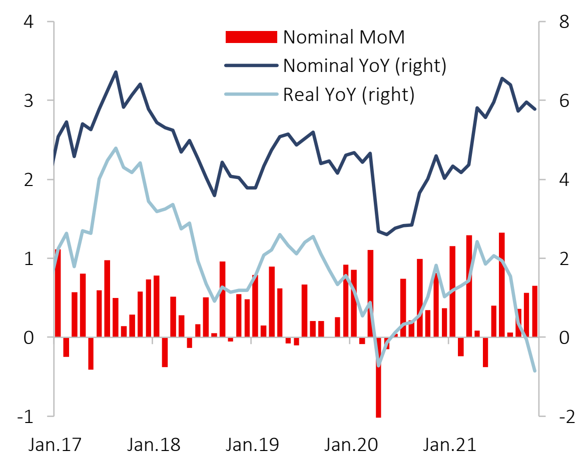
A subdued supply largely explains the lag in the labour market. Despite lockdowns ceasing and the widespread vaccine coverage, labour participation remains well below its historical average (58% vs 62%, respectively). Demand for labour, in contrast, has rebounded strongly, as indicated by the index of internet job advertisements, which is at record peak levels.

In this context, average wages have tended to rise, even though, in real terms, they have fallen in recent months due to inflationary surprises.

We expect the labour market to continue to improve in 2022 as the economy expands in the first half of the year, with both employment and participation increasing. As a result, the unemployment rate will settle at around 7.5% on average.

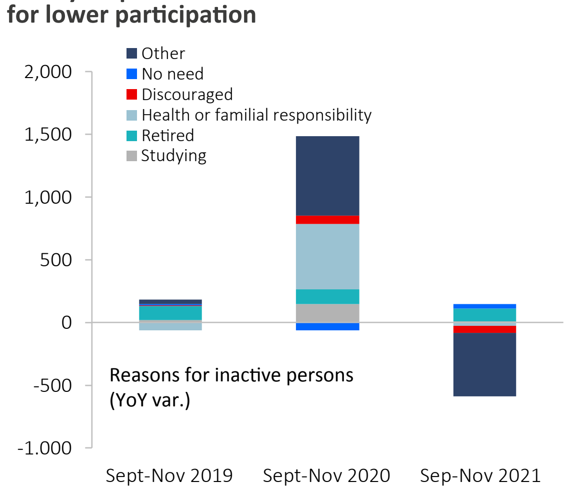
This recovery process faces major challenges. Firstly, while the end of state aid may encourage more people to look for jobs, the labour supply may remain subdued as long as there are Covid-19 related concerns. This is not only because of the fear of contagion but also because of the reduced availability to help with household caring tasks. Second, the slowdown in activity will reduce the demand for new jobs, especially in the second part of the year. Finally, state support will be less relevant. The employment protection programme -which benefited around 900,000 people- ended in October 2021, and the employment subsidy (IFE Laboral) will end in March 2022.

Nominal wages rise, but inflationary surprise pushes down real wages



Source: Central Bank and Santander

Family responsibilities remain a critical factor for lower participation



Source: INE and Santander

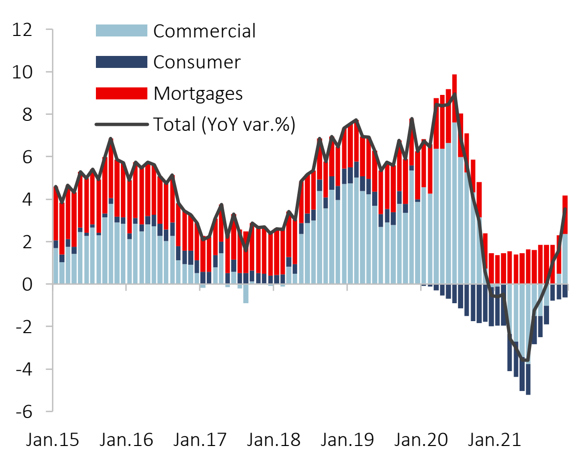
In addition, structural changes (automation and the development of digital services) are affecting labour in certain sectors. To prevent a sharper impact in the labour market, it is essential for the regulatory initiatives being discussed in Congress alongside some measures in the government's programme to ensure the conditions of those who are employed and try to foster conditions preventing the employment demand from being affected.

Loans grow again

After the unusual increase in bank lending during the first year of the pandemic - a result of the support measures - it lost momentum in 2021, with negative expansion rates. This is due to the high comparison basis, the reduction of incentive programmes and the high liquidity stock. Nevertheless, loans recovered mid-year onwards, and 2021 closed with a 3.5% expansion.

Commercial loans accounted for two-thirds of the credit expansion, having grown by 3.9% in the year. The state-guaranteed programmes - Fogape Reactiva and Postergación -continued to be relevant, with a total amount of US$ 14 billion, slightly less than the US$ 19.1 billion in 2020. In March 2021, the Central Bank implemented the third stage of the Conditional Credit Easing (FCIC) for US$ 10 billion- US$ 8.5 billion had been used as of the date this report was issued- which also bolstered corporate lending.

Loans have recovered modestly due to trade credits



Source: Central Bank and Santander

The financial conditions for these loans have become more demanding in recent months due to higher interest rates and a tighter supply, which could affect their dynamics in the future. The economic slowdown, particularly in investment, could also have an impact. Nonetheless, the low bases of comparison will keep growth in this segment on the rise until the middle of this year, after which a further deceleration should be observed.

After declining at double-digit rates until mid-2021, consumer loans closed with a 6.7% drop. Despite the high spending levels, the withdrawal of pension funds mid-year -and the universal IFE afterwards- reduced households' financing needs. In the future, the labour market's recovery will keep credit risk levels subdued, which, in the absence of further liquidity injections, should allow this segment to expand again during 2022.

On the other hand, mortgage lending showed stable rates of around 6% for much of the year though slowing down marginally. This was due to less favourable financial conditions and increased uncertainty. According to the latest Credit Survey, in 2021's fourth quarter, standards for these loans became restrictive for the first time in the year, resulting in a more extensive spread. Coupled with the increase in benchmark rates, this drove mortgage rates up by more than 150 basis points. As a result, this portfolio could show a significant slowdown this year.

Inflation rises to levels not seen in a decade

2021 ended with a significant climb in prices, resulting in a 7.2% rise in the CPI, the highest since the late 2000s. This was due to a combination of factors. On the one hand, disruptions in global value chains led to shortages of several goods - particularly cars - for which prices rose sharply, and on the other hand, logistical bottlenecks drove freight costs up. Oil prices rose quickly as the demand recovered and OPEC's management limited production.

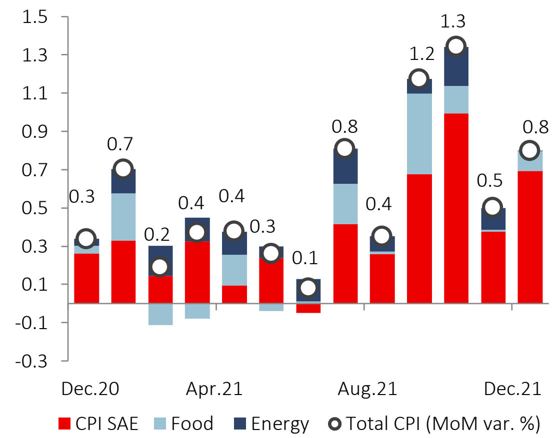
In Chile, all the above was combined with a buoyant demand and a depreciated exchange rate, which allowed a rapid pass-through of international cost hikes into final prices. This was accompanied by the climb of prices in some services due to the tight labour market.

Beyond the generalised pressures, some items contributed heavily to the rise in prices, such as fuel, airline tickets and package tours, which together accounted for 2.5% of annual inflation. Excluding volatile components (non-volatile CPI), inflation ended the year at 5.2%, which is high but somewhat lower than in mid-2015. Furthermore, it is essential to remember that two services with a high weighting in the CPI (electricity and public transport) have had their prices frozen for two years and that the MEPCO mechanism has prevented larger increases in petrol prices, which could have pushed the CPI variation to 8%.

In times to come, inflation will be determined by the evolution in international prices, the adjustment to the domestic demand, and the movements in the exchange rate. Second-round effects will be relevant in the coming months, primarily in several services with some degree of indexation to past inflation, such as education, health, and rents, all of which will keep inflationary figures high. In the short term, the main risks are on the upside and relate to possible rises to international costs linked to disruptions caused by new contagion waves and movements to the exchange rate, where a sharp depreciation could cause additional pressures.

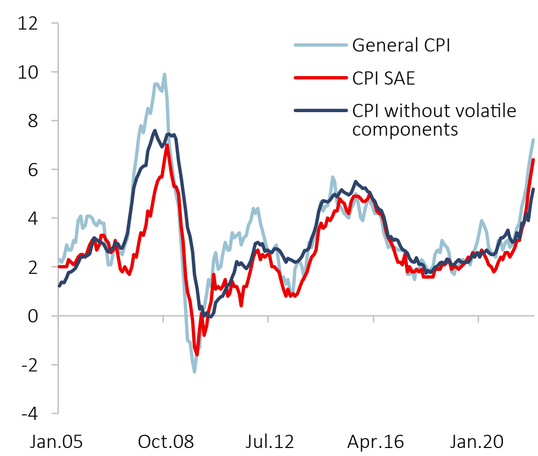
In the medium term, the normalisation of global supply chains - as the pandemic subsides - and the moderation of domestic demand will shrink the inflation. Overall, we expect this process to be slow and subject to several risks. In the short term, we estimate annualised inflation to reach near 8% by the end of the first semester, before slowing down towards December of this year -affected by high comparison bases- to end at around 5.5%. Prices will remain high in 2023 and converge to the target only in 2024.

CPI rose strongly in the second half of the year



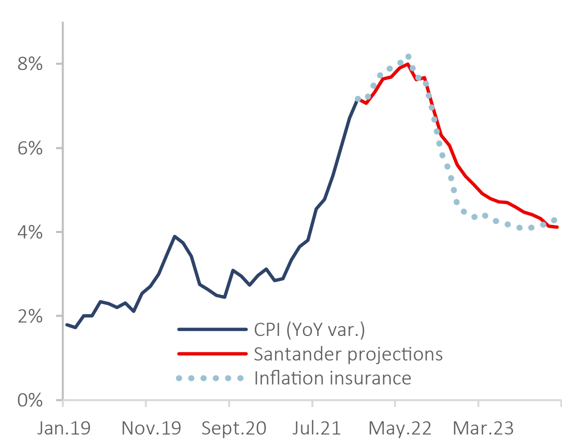
CPI SAE =CPI sans energy and food
Source: INE and Santander

Inflation surpasses figures in a decade



Source: INE and Santander

Inflation will gradually approach the target from the second half of this year onwards



Source: INE and Santander

Local financial assets suffer at domestic uncertainty

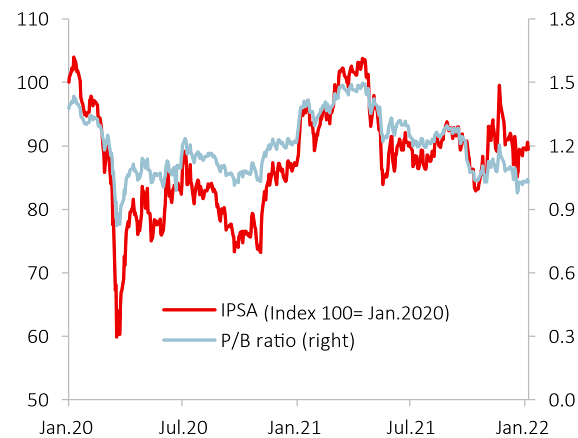
Local financial markets, which were severely affected during 2020, made a tentative recovery in the first months of 2021 in answer to the country's rapid progress in the vaccination rollout. Nevertheless, with the approval of the third pension-fund withdrawal mid-year (in a context where the technical consensus suggested that the initiative should not be approved) and the discussion of a possible fourth withdrawal, compounded with the temporary worsening of health conditions and the greater likelihood of a political turnaround in the country, caused financial prices to suffer great backlash. This in a context of significant capital outflows.

After reaching its peak in April, the IPSA fell sharply, decoupling from the international indices. Since then, it has fluctuated around 4,300 points, accruing a modest 3% recovery throughout the year, placing the index just above its book value. The local stock market, measured in dollars, was one of the worst performers in the region despite the country's rapid economic recovery. Beyond the deterioration of some fundamentals and higher risk premia, this poor performance was driven by selling flows from institutional investors due to the pension fund withdrawals.

After intensely appreciating during the first months of 2021, the Peso began a marked depreciation trend, partly explained by fundamental factors - a gradual reduction in the copper price and global strengthening of the dollar - and by idiosyncratic factors concerning the political climate. As a result, the exchange rate closed 2021 at $852 per dollar, accumulating an annual 20% depreciation, the sharpest in the last ten years and one of the largest internationally. This brought the real exchange rate to its highest levels in history, surpassing those reached during the financial crisis and the Asian crisis of the late 1990s.

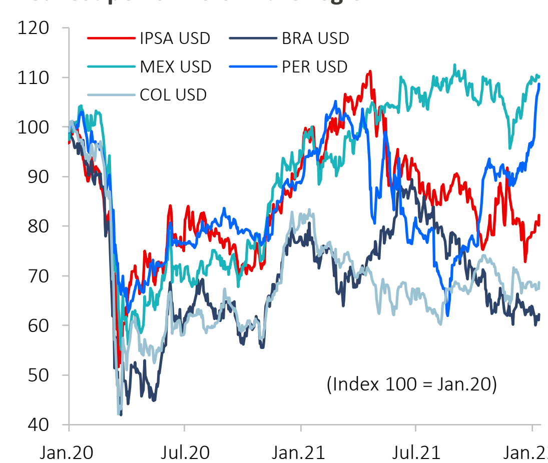
Against this background, the Ministry of Finance intensified its programme of dollar sales in the local market (US$ 33.9 billion in 2021 versus US$ 15.2 billion in 2020), while the Central Bank halted its reserve accumulation programme before achieving the US$ 12 billion target. Moreover, pension funds brought large inflows of foreign exchange into the local market to meet the cash needs caused by the third withdrawal (US$ 7.3 billion in May 2021). Added to the rise of the rate differential following the start of the monetary normalisation process, the above contributed to preventing an even more intense depreciation of the currency.

IPSA has not regained what was lost in the pandemic



Source: Bloomberg and Santander

The local stock market has been one of the weakest performers in the region



Source: Bloomberg and Santander

Bond prices also experienced a drastic fall throughout the year. The rise in the country's risk premium, the settlement of State instruments by pension funds following the approval of the third withdrawal, the start of the monetary normalisation, and the continued disinvestment by foreign investors led the long-term rates to rise by 250-300 basis points (BTU: 2.3%; BTP: 5.6%). The high volatility prompted the Central Bank to reactivate the spot purchase programs (CC) and forward sales (VP) of bank instruments amounting to US$ 9 billion. Furthermore, the Ministry of Finance adjusted its local debt issuance programme, favouring short-term and foreign currency issuance. At the end of the year, the Central Bank's anticipated hikes to short-term rates and the rejection of the fourth pension fund withdrawal dissipated the pressure over the long-term rates. Notwithstanding, they have remained hovering around historically high levels.

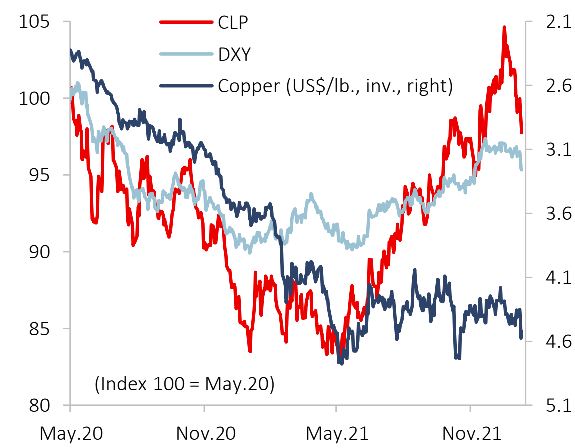
At the close of this report, the government announced its issuance plan for the year, which contemplates US$ 20 billion, with a large portion (68%) in local currency. This could exert some additional pressure over rates.

Throughout this year, the evolution of financial prices will depend on the external scenario, the domestic political environment, and the macroeconomic adjustment. If the global economy continues its recovery process, the uncertainty related to the constituent process is cleared, and a macro adjustment occurs in a gradual and orderly manner, as in our baseline scenario, assets could tend to stabilise and rise marginally. Conversely, a deterioration in international financial conditions, the persistence of domestic political tensions, and further liquidity injections aimed at sustaining domestic demand above trend might pressure risk premia, leading to further rises in long-term rates, further declines in the IPSA and a sharper Peso depreciation.

In terms of the stock market, these factors are compounded with the possibility of a legal reform introducing the taxing of capital profits, which could lead to lower liquidity and affect profitability in the medium term.

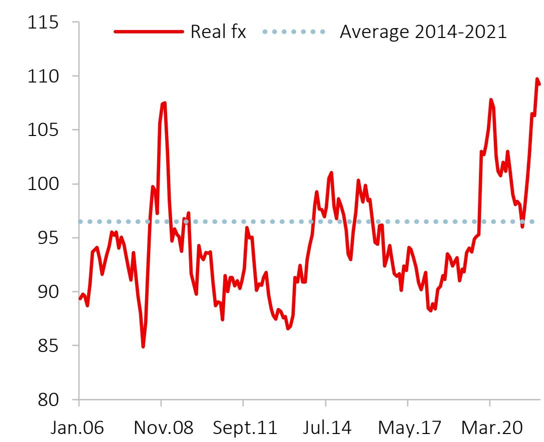
Our baseline scenario estimates that the exchange rate will end in 2022 with a slight depreciation over the levels recorded as of the date this report was issued and will settle at around $850. That is because we expect the copper price to gradually decline and converge into its trend at around US$4 per pound and because we anticipate the Fed's stimulus withdrawal will contribute to the strengthening of the international dollar.

The exchange rate has depreciated due to idiosyncratic factors



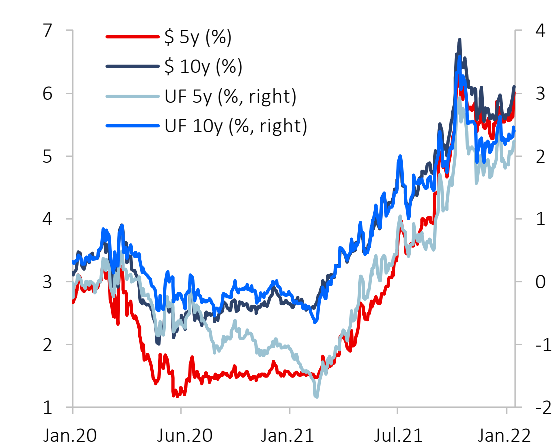
Source: Bloomberg, Central Bank and Santander

Real exchange rate hits record highs



Source: Central Bank and Santander

Long rates rose sharply but have stabilised

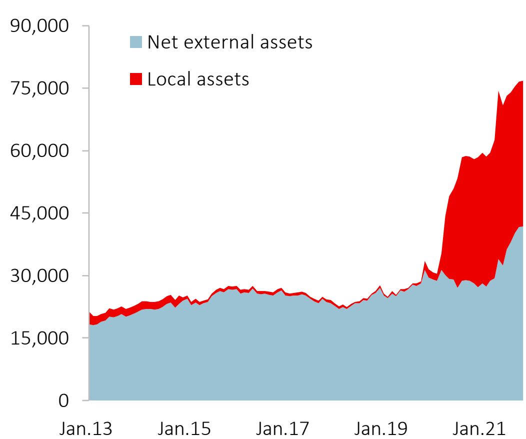


Source: Bloomberg and Santander

The Central Bank will continue to raise the MPR in the short term

The need for a highly expansionary monetary policy led the Central Bank to keep the Monetary Policy Rate (MPR) at its technical minimum (0.5%) during the first half of 2021. Nevertheless, the changes to the macroeconomic conditions following the improvement of the health situation, the third pension withdrawal and a robust fiscal expansion led to a shift in the monetary strategy. Thus, the Council began withdrawing the monetary stimulus, halting special measures and initiating policy rate hikes. At the Monetary Policy Meeting in July 2021, the MPR was raised by 25 basis points - after 16 months at the technical minimum level - which surprised the market not only because of the hike but also because of the hawkish tone of the message. Three further rises took place in the second half of the year, with the MPR ending in 2021 at 4%, above the neutral value of 3.5%.

Quantitative stimulus raised the Central Bank's balance sheet

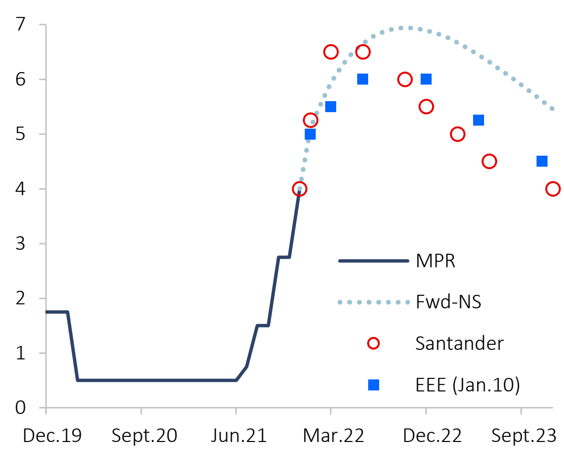


Source: Central Bank and Santander

In our baseline scenario, we assess that the Central Bank will continue to tighten the monetary policy in the first few months, with a total increase that would range between 200 and 250 basis points to the rate over the next two meetings (January and March). This would drive the MPR to range between 6% and 6.5% by the end of the first quarter. As the moderation to activity that we anticipated in our baseline scenario unfolds -similar to the last IPoM-the Central Bank is likely to maintain the rate at this level and then begin a gradual easing towards the end of the year. Thus, the policy rate would close the year at around 5.5% before tending towards its neutral value.

Nevertheless, if the economy receives further stimulus -through additional fund withdrawals or higher government spending- that delays the adjustment to the demand, the Council may seek a more contractionary monetary policy. As a result, the MPR could surpass 7% by mid-year and remain around that level until December, before starting to decrease only in early 2023. This path is similar to the one implied by the swap rates as of the date this report was issued.

Council will raise the MPR at forthcoming meetings but may cut it again by the end of the year



Source: Bloomberg, Central Bank and Santander

The challenge to fiscal consolidation

The fiscal policy in 2021 was characterised by its high degree of expansiveness, especially after implementing the universal Emergency Family Income half through the year. This programme entailed disbursements of almost US$ 20 billion (7.5% of the GDP), which, when added to the usual budget, led to an unprecedented expansion of public spending above 28%. Revenues, in turn, were boosted by high copper prices and strong buoyancy in the domestic demand. Compounded with the reversion of the tax relief measures implemented the previous year, the tax revenue grew above 30%. Nevertheless, the deficit widened marginally from 2020 and closed at around 7.4% of the GDP.

Meanwhile, the gross debt grew to just above 35% of the GDP. While this amount remains low compared to other countries in the region, the pace at which it has been increasing is concerning (it has doubled in six years). Therefore, the commitment towards a fiscal consolidation that reduces the hefty deficits of recent years in a sustained manner will be crucial in times to come.

The sharp reduction in spending contemplated by the budget (-22.2% according to our calculations), and the elected government's commitment to stay within the approved amounts, will allow the deficit to be reduced substantially to reach levels around 2% by the end of this year. In the future, it will be important that new permanent spending is underpinned by long-term funding to keep structural deficits in line and achieve the debt to converge to levels that do not significantly impact the cost of funding for the country.

In this regard, the debate on financing the new universal Guaranteed Pension (PGU) is essential. If approved, this will increase spending by about one percentage point over the next few years, and possibly by more significant amounts in the medium term, as a growing number of people gain access to the benefit due to demographic dynamics. After an initial proposal that did not include permanent resources, the government has introduced an amendment to the tax code to fund the expenditure that this reform will entail with new revenues.

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