# A necessary macroeconomic adjustment

*After the overheating with which the economy closes in 2021, significant spending restraint will be needed to stabilise inflation.*

Highlights

**The local economy is showing clear signs of overheating.** As a result, activity will need to decelerate sharply to converge to the trend. Thus, after expanding by 11.9% this year, the GDP growth will moderate to 2% in 2022, with declines in both consumption and investment. The fiscal contraction and tighter financial conditions will underlie this moderation. Additionally, there is the impact of political uncertainty on investment.

**Employment continues to recover but still lies far from pre-pandemic levels.** The number of employees has increased, particularly in sectors that have benefited most from deconfinement, although in October there were still 600,000 fewer employed people than in February 2020. Future progress will depend on the factors contributing to low participation, especially among women.

**The CPI remains high, ratifying the intense inflationary pressures.** As a result, inflation will close in 2021 at 6.9% and will continue to rise until mid-2022. Subsequently, we assess a gradual decline as activity slows and external factors that have affected prices - bottlenecks in supply chains - begin to be resolved.

**Idiosyncratic elements are keeping local financial assets under pressure.** Domestic political uncertainty has continued to affect riskier assets. Despite retreating due to the rejection of the fourth pension funds withdrawal, long-term rates have remained high. The stock market continues to decline, having fallen 3% since our previous report, while the Peso is trading at the lowest levels of the year ($850 per dollar).

**The monetary policy begins a contractionary period.** The Central Bank raised the MPR to 4% at its last meeting of the year. Further increases are expected in the first quarter of 2022, which would bring the rate to range between 5.5% and 6%. After that, as activity slows and price pressures recede, the MPR could start to decline and return to neutral levels by the end of 2023.

**End of the cycle of abundant global liquidity.** The leading Central Banks are moving - albeit with differences- towards the withdrawal of monetary stimulus amid concerns about persistent inflationary pressures. Stock market indices registered falls compared to a month ago (MSCI global: -1%), in a context where the dollar is strengthening, and attention is focused on the evolution and impact of the Omicron variant on the economic outlook which for now remains favourable.

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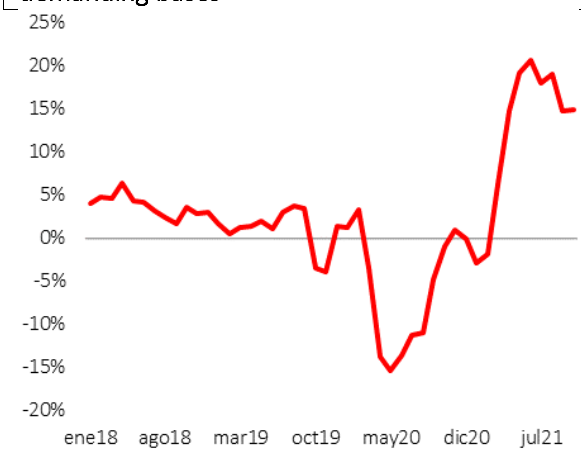
*Several data point to the economy being overheated.*

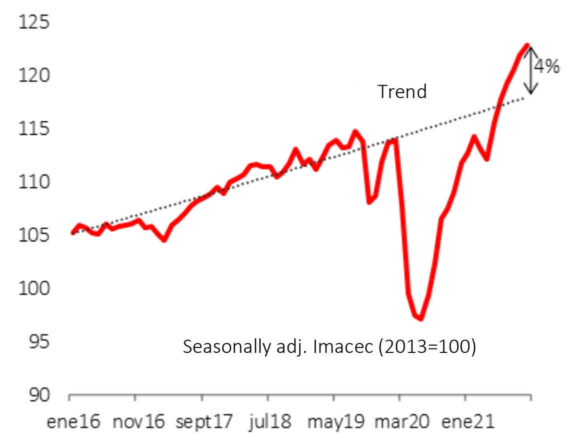
Domestic activity has continued to expand at a high pace. The Imacec in October grew at double-digit rates (15% YoY), despite more demanding comparison bases than in the second quarter, and continued to marginally advance (0.8 MoM, seasonally adjusted), albeit heterogeneously across sectors. Thus, various indicators suggest that the economy is operating above its potential. For example, the seasonally adjusted Imacec is between 4% and 5% above trend, and according to our estimates, the current account deficit will close the year at around 6% of the GDP - despite the high copper price - while consumption in the third quarter was over 20% above its pre-pandemic level.

Imacec grows at double-digit rates despite more demanding bases



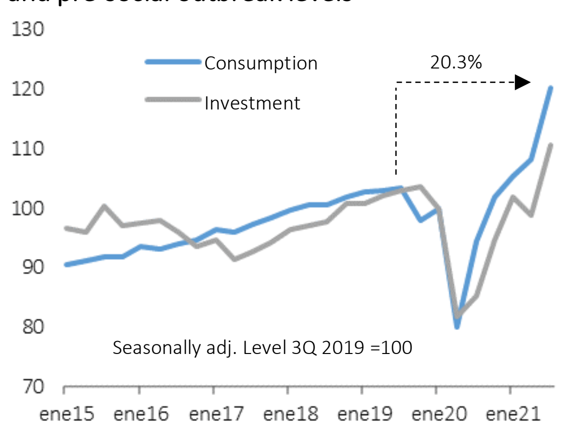

Source: Central Bank of Chile

Activity level is above its potential



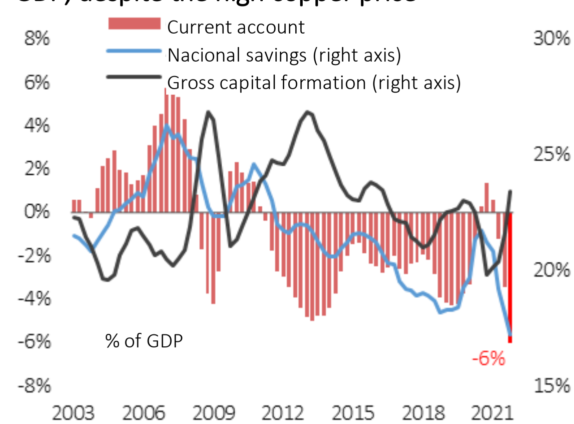

Source: Central Bank of Chile and Santander

Consumption is well above its pre-pandemic and pre-social outbreak levels




Source: Central Bank of Chile

The current account deficit will reach 6% of the GDP, despite the high copper price



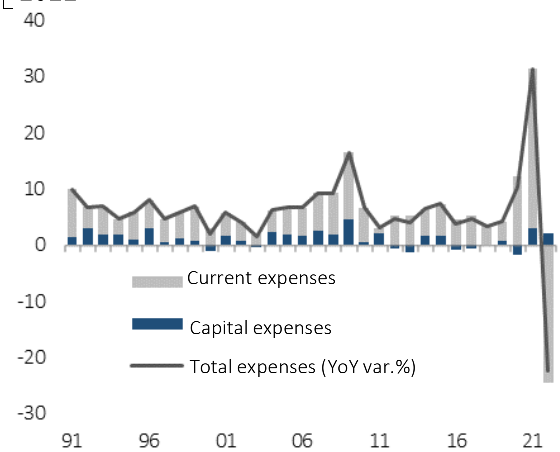

Source: Central Bank of Chile and Santander

Nevertheless, some indicators show a certain degree of marginal moderation. An analysis by components shows the trade Imacec, although at very high levels, has remained stable for three months while both the services Imacec and that corresponding to construction, agriculture, and fishing (the rest of goods) displayed drops in the latest data. The business perception index (IMCE) fell sharply below neutral values for November, while electricity generation stagnated. Therefore, the following activity records are likely to be weaker.

Employment has continued to recover, but it is still far from pre-pandemic levels. The number of employed people has increased, particularly in sectors that have benefited most from deconfinement, but in October, there were still 600,000 fewer employed than in February 2020. Future progress will depend on the factors contributing to low participation, especially among women.

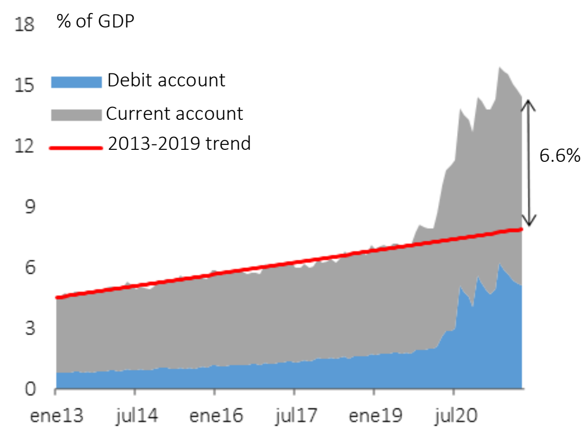
In the future, activity will be dominated by opposing forces. On the one hand, fiscal policy will have a clear contractionary bias, with a sharp fall in spending and a substantial reduction in the budgetary deficit from around 8% of the GDP in 2021 to levels of 3% of the GDP. As a result, this will slow down the demand. On the other hand, there is still a significant amount of liquidity available to individuals, which will sustain spending for a few more months. Given the above, consumption is likely to remain at high levels during the first part of next year, before falling back to levels consistent with its trend.

Public spending will contract significantly in 2022




Source: Ministry of Finance and Santander

There is still a large number of liquid assets available to households.




Source: CMF and Santander

The capital formation, while recovering, presents a more complex scenario in the future. Tightening financial conditions and the atmosphere of uncertainty make it unlikely that new large-scale projects will go ahead, opening the possibility for investment to decline significantly next year, as anticipated by the Monetary Policy Report (IPoM) presented this week.

Externally, several precedents point to a slower momentum. Beyond the pandemic risks - which remain latent due to the emergence of new strains, such as the Omicron variant – there is also the growth of the US economy, which should slow down as the withdrawal of monetary stimulus materialises. Added to this is the possibility of a sharp slowdown in China due to financial problems in its real estate sector.

Considering this background, we assess that after expanding by around 12% this year, the local economy will grow by about 2% in 2022. This will allow the gap between the GDP and trend to narrow, which is essential to containing the inflationary pressures that have built up in recent quarters.

| Amounts carried out in large-scale projects will recede in 2022 | Political uncertainty has had a significant impact on perception. |
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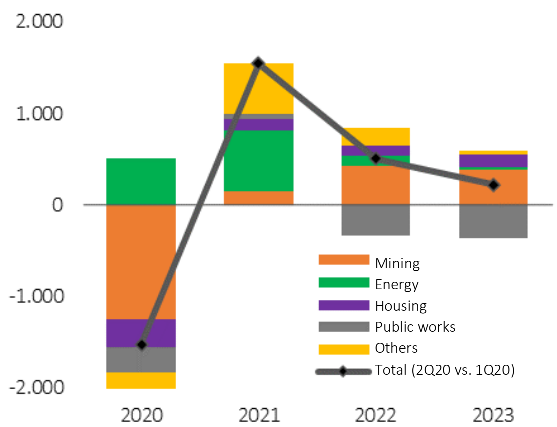
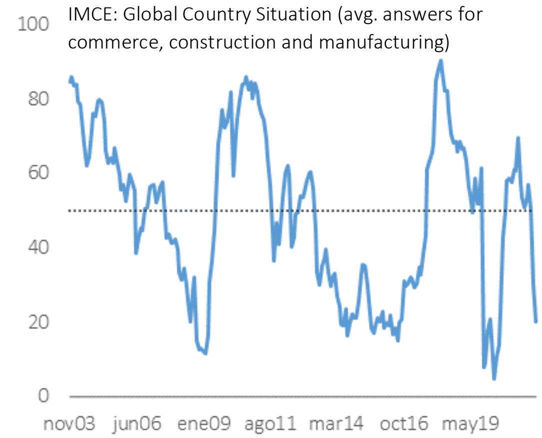



Source: Capital Asset Corporation (CBC)




Source: ICARE and Santander

## *High-risk premium continues to pressure local assets.*

After receding at the rejection of the fourth pension withdrawal, long-term interest rates have remained relatively stable at elevated levels. After surpassing 6% in the first half of November, long-term rates (BTP10) fell over 30 bps and have since fluctuated at around 5.7%. Explaining these values is the outlook of the contractionary monetary policy in the coming months and high-risk premia arising from the country's fiscal situation and political environment.

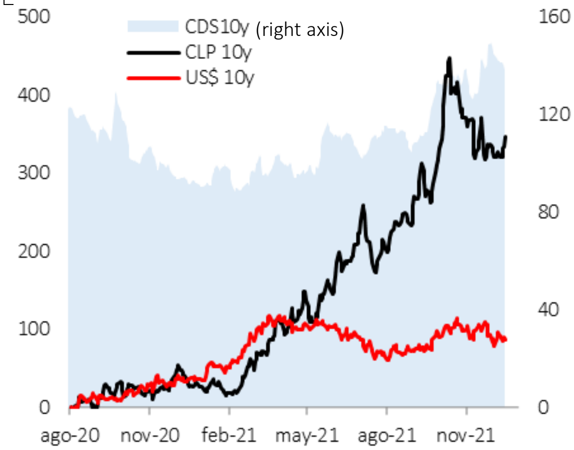
Short-term rates have risen sharply in anticipation of a rapid monetary stimulus withdrawal by the Central Bank. The BTU-2 rate reached 0.8% (+135 bps MoM) and the BTP-2 rate settled at 5.8% (+60 bps MoM). With this, the rate structure is already showing an inversion of the curve, indicating a future slowdown in the economy.

In line with the development of benchmark rates, bank lending rates have risen sharply. This higher funding cost could dampen credit demand in the future, even though lending has recently returned to positive grounds. In particular, commercial loans grew 0.9% YoY in November, the first positive record in the last twelve months, partly due to the basal effect and momentum of loans related to state guarantees (Fogape Reactiva), a programme that will end in December 2021. Consumer loans, meanwhile, continued to decline (-7.7%), contextualised by historically low levels of non-performing loans.

Conversely, the stock and foreign exchange markets fell sharply during the month. As a result, the Local Stock Index IPSA closed below 4,400 points (-2.8% MoM), reversing the post-election profits. Beyond the market expectations following the outcome of the second ballot on Sunday, the local stock market remains significantly lower to its pre-pandemic and regional peers' level. Moreover, it is likely to remain low in the face of the economy's weak outlook in the future.

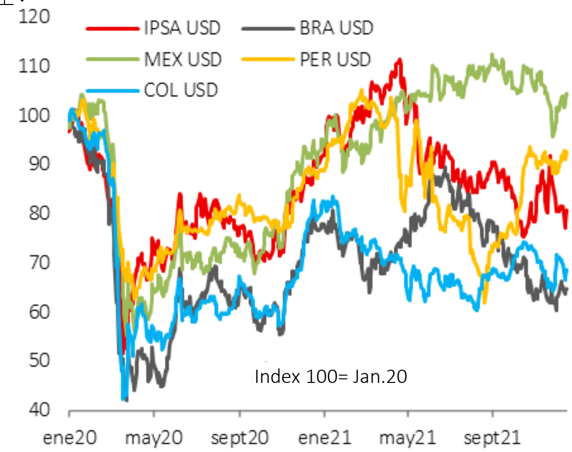
The exchange rate rose above $850, the highest level of the year, driven by idiosyncratic elements, the global appreciation of the dollar (+1%) and the decline in the copper price (-2.3% MoM).

Long-term rates are expected to continue its downward trend



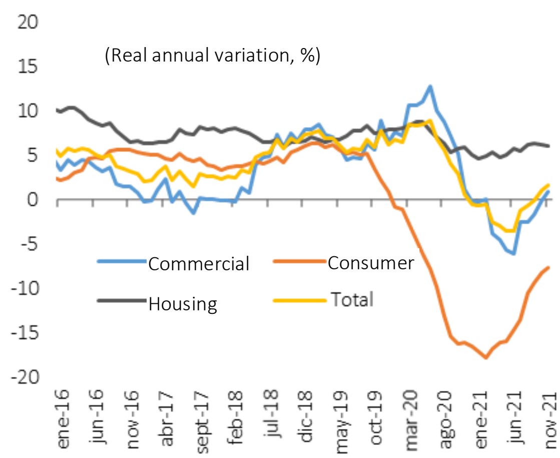

Source: Bloomberg, Central Bank and Santander

The stock market remains low relative to regional peers.



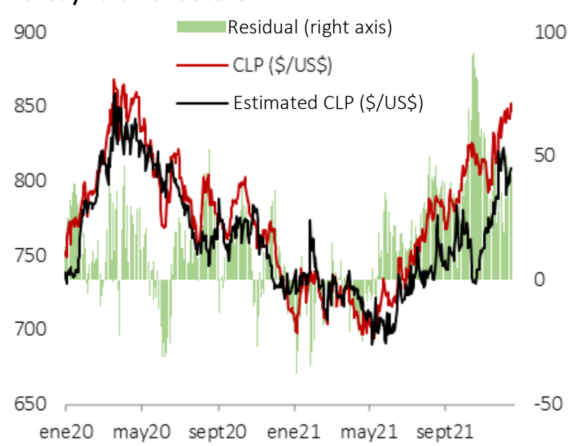

Source: Bloomberg and Santander

Bank loans return to positive grounds.




Note: Individual loans.
Source: Central Bank and Santander

The exchange rate is still explained by idiosyncratic factors.




Source: Bloomberg and Santander

## *Inflation to end above target range in 2021 and 2022*

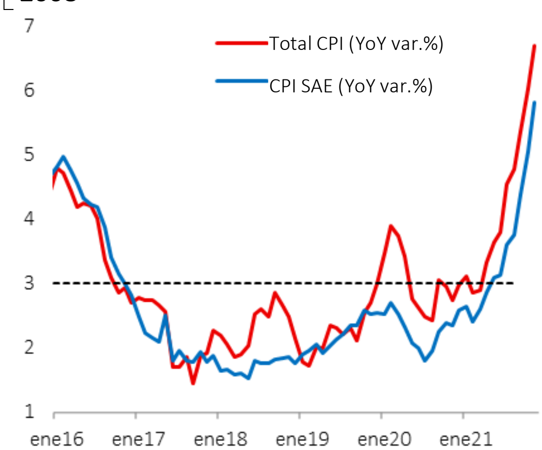
November's CPI (0.5% MoM) was somewhat above expectations (Santander: 0.4% Bloomberg: 0.4%), mainly explained by rises in goods (0.4 pp incidence) and, to a lesser extent, in services. As a result, the annual change in prices reached 6.7%. Core inflation, as measured by the non-volatile CPI, also rose significantly, steepening to 4.7%, in line with the Central Bank's year-end estimate in September's IPoM.

The high inflation continues to be underpinned by the factors that have driven prices in recent months: rising costs due to disruptions in value chains caused by the pandemic and the local depreciation of the exchange rate, against a background of solid growth in local consumption, which has allowed higher costs to be passed on to final prices. The impact of the reopening of services, which had a one-off effect on some prices, is now behind us.

In the future, inflation will continue to rise. This is because external pressures remain high, local demand remains buoyant, and the exchange rate has tended to depreciate further in recent weeks. Added to this are the second-round effects of the most recent shocks. Particularly, indexation clauses will start to affect the prices of several services - such as rents and education fees - and inflationary expectations have risen.

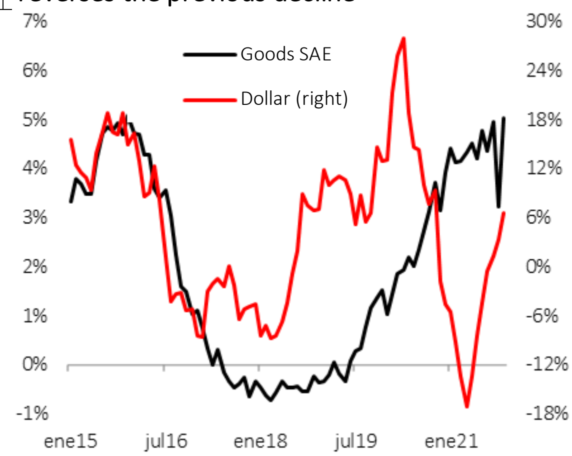
In this context, we expect inflation to reach 6.9% by the end of 2021, consistent with the latest IPoM projection, while remaining elevated until mid-2022, even somewhat above 7% YoY. Then, as the economy starts to decelerate, we expect inflation to gradually converge towards levels closer to the target. However, unlike the Central Bank's estimate, we expect the CPI to end 2022 still at around 4.5% (vs 3.7% YoY) and to be above 3% throughout 2023.

Annual CPI variation (6.7%) is highest since 2008




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

CPI sans food and fuel inflation (IPC-SAE) reverses the previous decline




Source: INE and Santander

## *Monetary policy enters a contractionary period.*

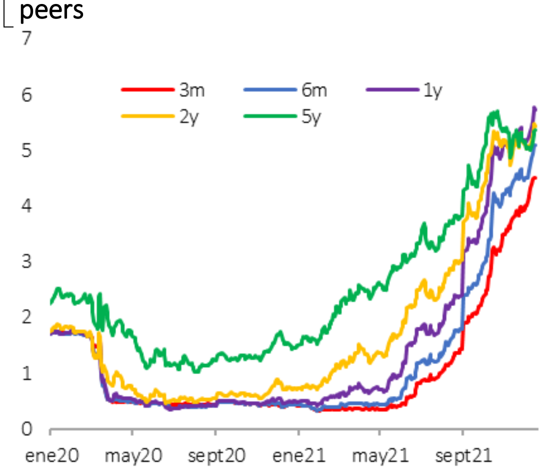
At its last Monetary Policy Meeting of the year, the Council decided to raise the Monetary Policy Rate (MPR) by 1.25%, in line with market expectations. As a result, the MPR moved directly into contractionary territory (4% vs neutral MPR 3.5%). According to December's IPoM data, this decision was based on the accelerating pace of the economy, where domestic demand surprised on the upside in the third quarter, driven by consumption and, to a lesser extent, investment. Although the two-year inflation prospects have moved above target (EEA: 3.5%; EOF: 3.9%), the Central Bank still does not anticipate this will affect the price formation process broadly, so expectations are still considered to be anchored. Furthermore, it is important to note that a significant part of the hike in prices has been due to volatile components and that core inflation has grown less, in line with what was expected in September's IPoM.

Hereafter, the MPR will undoubtedly continue to climb, as can be seen from the central range of the rate corridor in the latest IPoM. Swap rates suggest further, and somewhat more robust, increments at the upper end of the corridor, with the MPR remaining at more persistently elevated levels, even above the Central Bank's projection.

In our baseline scenario, we also anticipate the MPR will rise sharply in the first part of next year, with hikes of between 100 and 75 bps at each of the following policy meetings, reaching a level ranging between 5.5% and 6% by March 2022. From that level - firmly contractionary – the monetary policy would then remain stable and could begin to ease in late 2023, as activity slows down and the inflation gradually recedes towards the target. Hence, the MPR would end next year slightly above 5% and then approach levels close to its neutral value -which we estimate at 3.5%- by 2023.

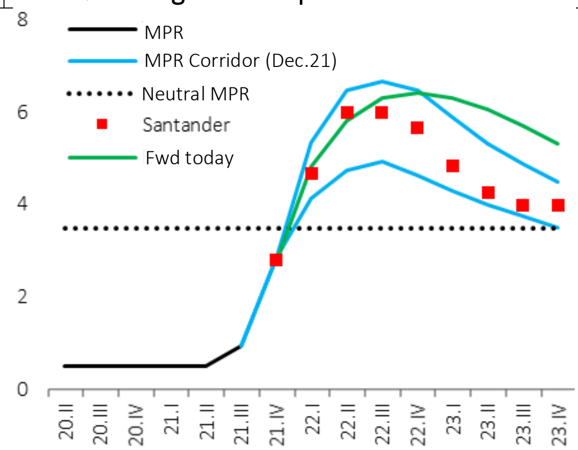
Nevertheless, in the event of a faster and stronger adjustment to the activity, the MPR could fall more sharply during the second half of 2022. This would take place if consumption shrinks rapidly given the low marginal propensity to consume remaining resources from accrued pension fund withdrawals, if the fiscal policy effectively remains on budget and finally, if investment falls abruptly amid the scenario of political uncertainty and tightness in financial conditions. On the other hand, in the event of further inflationary shocks stemming from the external scenario or from additional currency depreciation, it is possible that the MPR could rise further in the short term and remain elevated for longer.

One-year swap rates outperform their long-term peers




Source: Bloomberg and Santander

MPR would reach levels ranging between 5.5% and 6% during the first quarter of 2022.




Source: Bloomberg, Central Bank and Santander

## *Accelerated withdrawal of monetary stimulus in the world*

Since our last report in November, the main factors influencing global market performance have been: (i) the fast spread of the Omicron variant, whose degree of danger relative to other strains is still under discussion, but which has already proven to be more contagious than the Delta, sounding the alarm especially within sectors sensitive to possible new sanitary restrictions, such as services; (ii) rising inflationary pressures driven, among others, by persistent bottlenecks in global supply chains and high energy prices that have pushed the CPI data to their peak levels in decades, triggering a debate among leading central banks regarding their temporary nature; (iii) in this context, the Federal Reserve (Fed), the European Central Bank and the Bank of England took positions - not synchronised - to address the existing risks and avoid a further destabilisation of expectations; and, (iv) multiple reasons are fuelling concerns about the economic slowdown in China, prompting intervention by the authorities to boost activity and bolster local market liquidity.

In the US, the focus was on the Fed's last meeting of the year, which turned out to be more hawkish than expected. On the one hand, as anticipated, on Wednesday, an acceleration of the tapering was announced, doubling the pace, and concluding three months earlier (in March next year) than announced (initially mid-2022). On the other hand, they also made explicit their willingness to start raising the federal funds rate earlier than anticipated in the last meeting (now considering three hikes throughout the following year; +60bp more than in September). Furthermore, Jerome Powell emphasised at the press conference that normalisation could start before full employment is achieved. The Fed's signals suggest that, by now, there is sufficient evidence that inflation is more durable than temporary (CPI: 6.8% YoY in November vs 6.2% previously; PPI: 9.6% YoY vs 9.2% expected), so it would be counterproductive to maintain financial conditions and prolong stimulus for longer. This, amid the economic progress (annualised 3Q21 GDP: 2.1% YoY; Composite PMI: 57.2 vs 56.5 previously) and the signs of improvement in the labour market (initial unemployment benefits: 184,000 vs 220,000 expected; unemployment rate: 4.2% vs 4.5% expected), which supported the decision, despite the still latent risks, especially from the health front.

Meanwhile, the European Central Bank does not seem ready to withdraw the monetary arsenal they deployed in 2020 due to the pandemic, at least not at the speed of the US Central Bank. This lies in their conceptualisation of the inflation pressures' origin, the latter being of a "transitory" nature in the view of the European authorities, which is why they intend to keep monetary conditions quite stimulated for a prolonged time. This is despite November's CPI more than doubling the inflation target (4.9% YoY vs 2.0% target) and with the activity recovering close to 4% (3Q21 GDP: 3.9% YoY vs 3.7% expected). The Bank of England, in light of the concern fostered by the high inflation record reached in November (0.7% MoM vs 0.4% expected; 5.1% YoY vs 4.8% expected), decided to be the first developed country to increase the reference rate (from 0.1% to 0.25%), surprising 80% of market analysts who anticipated it to be maintained. Beyond the tightness of financial conditions and inflation concerns, the fears and implications of the rise of Covid-19 contagions have been key to European market sentiment in recent weeks, and their evolution will be crucial in determining the direction of the outlook for 2022 (composite PMI: 55.4 vs 55.8 expected).

| Inflation is the primary concern and has exceeded tolerance ranges. | Tapering acceleration entails finishing three months earlier than announced. |
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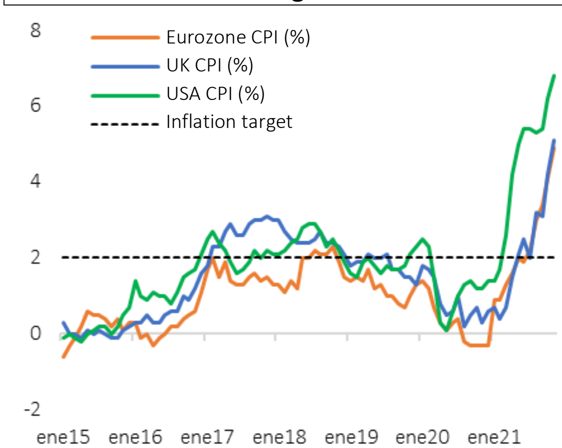
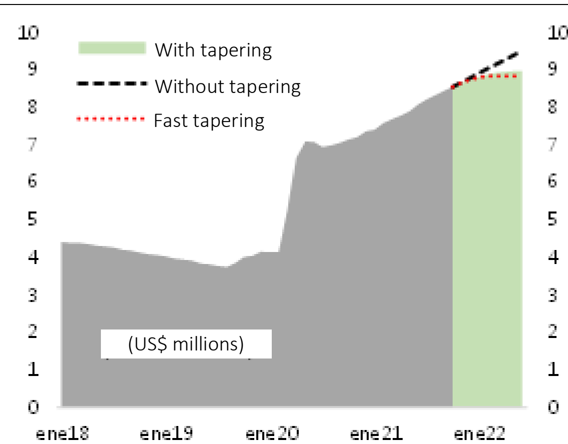



Source: Bloomberg and Santander




Source: US Federal Reserve and Santander

Unlike the rest of the world, Chinese inflationary pressures from the consumers' point of view are not a concern (CPI: 2.3% YoY vs 2.5% expected); nonetheless, the gap with producer prices is still very significant (PPI: 12.9% vs 12.1% expected), suggesting possible pressures in the medium term. The latter is an additional risk factor to the already delicate financial situation the country is going through, with a weakened real estate sector that has already ratified the default of several large companies -such as Evergrande and Kaisa, among others-, and economic frailty (Caixin Composite PMI: 51.2 vs 51.5 previously) which forced authorities to intervene again in order to stabilise the economic outlook (they reduced the bank reserve requirement rate from 12.0% to 11.5% on December 6). On the other hand, foreign trade still shows signs of optimism, having recorded in November significantly higher rates than anticipated by the market (imports: 31.7% vs 21.5% expected; exports: 22.0% vs 20.3% expected), while retail sales disappointed (3.9% YoY vs 4.7% expected).

Thus, amid this international situation, the stock market indices have reversed the last month's optimism and show -for the most part- declines (MSCI global: -1%; MSCI emerging, Eurozone and Latam: -4%). Conversely, China recovered its previous drops and, despite latent risks, the stock market shows increments of around 3%, thus reflecting that the authorities' stimulus announcements were well received by the market, while the S&P 500 in the US remains at record highs (+0.4%). All this unfolds in an environment of a strengthening global dollar (DXY: 96.0) and increased risk aversion (VIX: +3 points). Nevertheless, the global outlook remained favourable in November (global PMI: 54.8 vs 54.5 previously).

| Despite risks, the global outlook remains favourable in November | Stock indices display volatile and mixed performances, although overall, they drop in the month globally |
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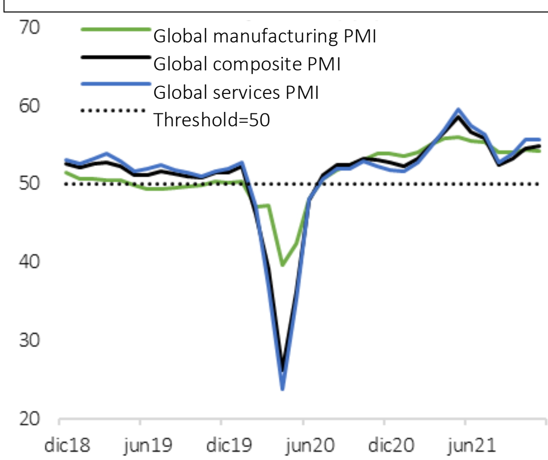
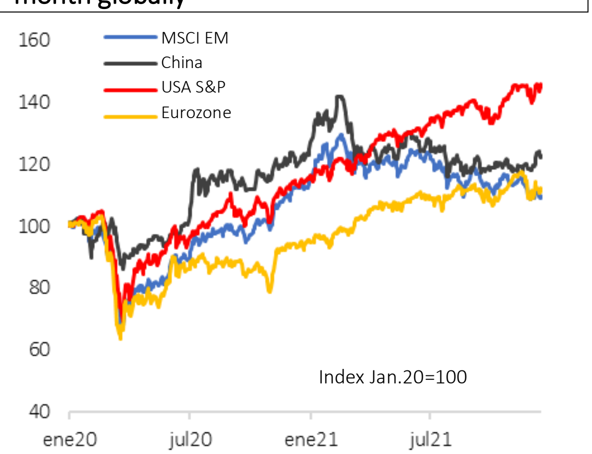



Source: Bloomberg and Santander




Source: Bloomberg and Santander

*Due to the new coronavirus strain, oil prices fall sharply among fears of a further slowdown in demand.*

The emergence of the new Omicron variant of coronavirus had a substantial impact on oil prices which, amid fears that it could significantly lower oil demand, shrank to levels not seen since August.

At the news of the new strain's appearance in South Africa, the price recorded one of its most significant daily falls, shrinking by 13%, exhibiting a much greater impact than any other commodities such as base metals, where copper only fell by 3%.

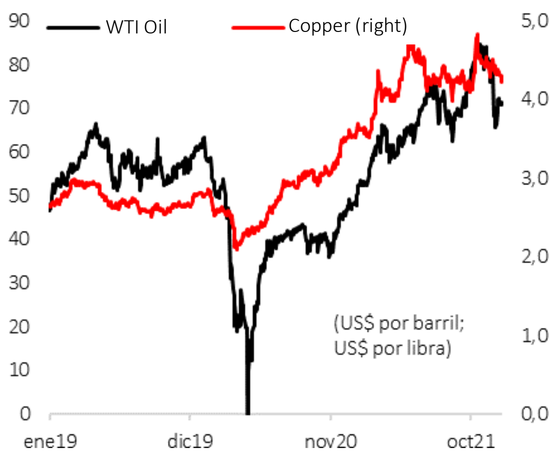
Despite the above, the OPEC plus announced at its year-end meeting that starting in January 2022, it will maintain its policy of gradual production hikes at a rate of 400,000 barrels a day per month. Their statement indicated that the pandemic's evolution and its impact on the market would continue to be closely monitored so that any necessary adjustments can be made. Its next monthly coordination meeting will take place on January 4, 2022.

WTI crude oil is trading at around US$ 72 a barrel, with a partial recovery after falling to US$ 65, and at a reasonable distance from the US$ 84 it reached in October. It would end the year at an average of US$ 68 (+71% compared to 2020).

The copper price has been scarcely affected by the emergence of the new variant. By the time this report was issued, it had displayed a downward correction, falling to levels of US$ 4.3 per pound in the face of the crisis in China's real estate sector. A significant focus on the supply side is the large and growing number of social conflicts related to extractive mining in Peru, the world's second-largest copper producer, which could paralyse more than 40% of its production if they continue to escalate.

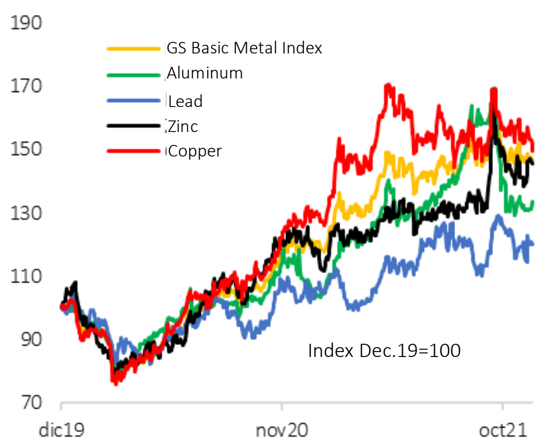
At current levels, the copper price would show the highest hike among base metals in 2021, closing the year at around US$ 4.23 per pound (+ 51% compared to 2020).

Oil prices fall back to August levels




Source: Bloomberg and Santander

Copper prices remain the highest in 2021




Source: Bloomberg and Santander

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