Inflation or growth?

The Central Bank completes the monetary tightening cycle in Chile with a 50 basis points hike to the MPR. It will remain at 11.25% until the first quarter of next year before descending.

Highlights

- **Inflationary pressures and geopolitical risks continue to dominate global markets.** Financial conditions continue to tighten, raising global long-term interest rates and strengthening the dollar.
- **Global growth prospects are again lowering but in a contained manner**. According to the latest IMF projections, the global GDP this year would be around 3.2%, similar to July's forecast. Still, it would fall to 2.7% in 2023, with more than a third of economies contracting due to tight financial conditions and the escalating geopolitical conflict in Ukraine.
- **The local economy surprises on the upside in August (0.6% MoM, 0% YoY),** showing a somewhat stronger resilience than expected. Nevertheless, we assess that in September, the economy will show its first annual contraction (-0.8% YoY), while the year will close with a growth of 2.25%. In 2023, activity will fall by 1.2%.
- **The current account would continue to deteriorate.** The September trade balance data show a higher deficit, influenced by the fall in terms of trade. As a result, we estimate that the current account deficit will reach 8.9% of GDP in the third quarter and then partially reverse to end the year at 7%.
- **CPI in September rose 0.9%, in line with expectations.** With this, the annual change reached 13.7%, slightly below prior records. While the rise was widespread, the first signs of moderation were evident. In the future, we estimate a further slowdown to end the year at around 12.7%.
- **The Central Bank raised the MPR by 50 basis points to 11.25%, its highest level of this cycle.** In its statement, the Council delivered a clear neutral bias by noting that this would be its last hike of the monetary tightening cycle that began in mid-2021.
- **Fiscal figures improve temporarily.** Record revenues, benefiting from the Payment of Substitutive Tax for Final Taxes (ISFUT for its acronym in Spanish), a high lithium price and a sharp contraction in spending will bring the fiscal balance into surplus by 1.6% of GDP this year, reducing gross debt to 36% of GDP. By 2023, spending will expand by 4.2%, bringing the balance sheet back into deficit at around 2.7% of GDP, and debt will rise to around 39% of GDP.

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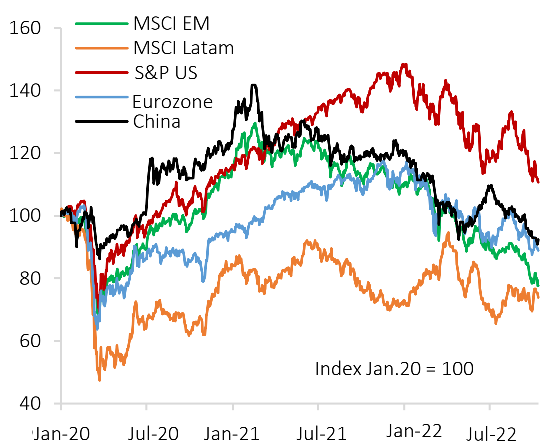
Recession fears hit global markets again

In recent weeks, inflation concerns in major markets have remained elevated, prompting renewed bets for a more contractionary monetary policy, especially from the Fed. Moreover, tightening monetary conditions, coupled with geopolitical tensions over the war in Ukraine and the expanded OPEC (OPEC+) decision to cut its oil production, have significantly increased the likelihood of a global recession. Consequently, stock markets have seen almost generalised falls since mid-September (MSCI global and emerging markets: -10%; US: -9%; Eurozone and China: -7%). The exception was Latin America (+1%), thanks to the Brazilian market's almost 4% rebound amid the tight presidential election process, which faces a run-off at the end of the month.

Despite fears, the latest US activity figures have been rather mixed (durable goods orders: -0.2% MoM vs -0.1% previously; industrial orders: 0% vs -1% previously; manufacturing PMI: 50.9 vs 52 expected; composite PMI: 49.5 vs 49.3 previously), with a further confirmed decline in annualised GDP in 2Q22 (-0.6% QoQ), but with a rebound in consumption (2% vs 1.5% expected). The labour market, meanwhile, remains robust (September unemployment rate: 3.5% vs 3.7% expected; increase in non-farm payrolls in September: 263k vs 255k expected).

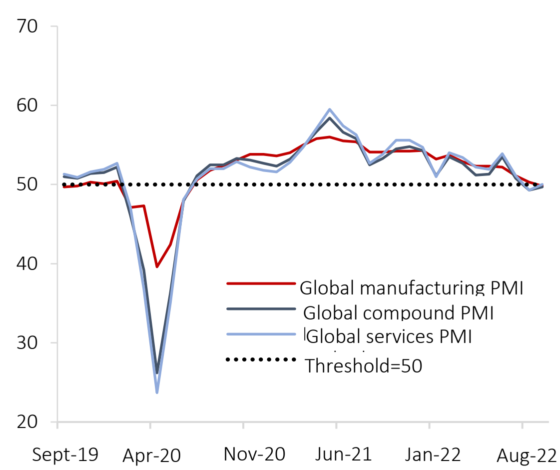
As of the date this report was issued, attention is focused on the release of the September CPI in the US, for which a moderation in the total annual measure is expected (from 8.3% to 8.1%), but alongside an acceleration in the core component (from 6.3% to 6.5%), which would reaffirm the Fed's expected aggressive stance. Against this background, the dollar strengthened again, reaching record levels in multilateral terms (the DXY index reached over 114 points).

Stock markets fall across the board, except in Latin America



Source: Bloomberg and Santander

The global economy continues to lose its strength



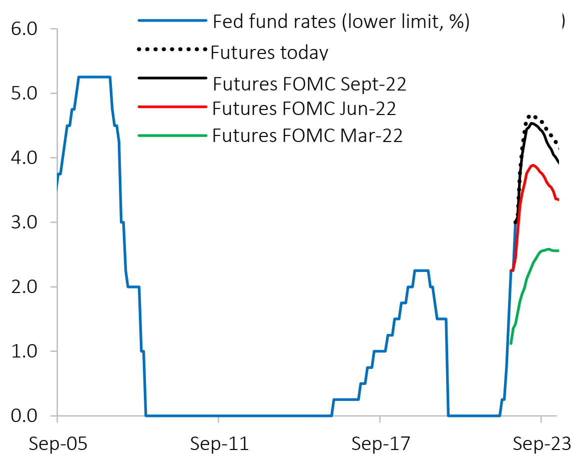
Source: Bloomberg and Santander

Long-term interest rates have resumed their upward trend, rising nearly 80 bps on average, with the UK 10-year rate rising 130 bps in the last month, driving it over 4.4%. This followed the proposal of a fiscal plan with deep tax cuts and additional subsidies by Liz Truss's government, which the market interpreted as potentially inflationary and fiscally unsustainable and led the Pound Sterling to fall close to parity with the dollar, forcing the Bank of England to intervene.

Inflationary pressures have intensified in Europe driven by the energy crisis (Eurozone CPI: 10% YoY vs 9.1% previously), while expectations for economic performance have deteriorated markedly, falling into pessimistic territory (manufacturing PMI: 48.4 vs 49.6 previously; services PMI: 48.8 vs 49.8). This comes amid the escalating armed conflict in Ukraine, with several recent explosions detonated in the capital of Kyiv and the Russian annexation of four territories. In this regard, investor confidence continued to weaken in October (Sentix index: -38.3 vs -34.7 expected), the lowest level since May 2020.

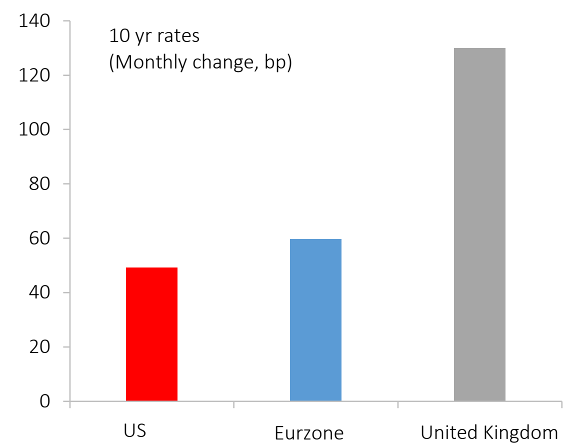
In China, economic recovery remains a cause for concern. While some upturns were seen in August (industrial production: 4.2% YoY vs 3.8% expected; retail sales: 5.4% vs 3.3% expected), growth has been held back by the prolonged pandemic-related containment measures and the housing crisis (composite PMI: 48.5 in September vs 53 previously), leading to further corrections in market expectations (GDP 2022: 3.3% vs 3.5% previously). While the authorities have tried to bolster the economy with monetary stimulus, the ongoing measures still seem insufficient to prevent a slowdown. As this report was issued, US restrictions on semiconductor imports added uncertainty to an already complex scenario.

The Fed will continue its normalisation cycle until inflation is under control.



Source: Bloomberg and Santander

Long-term interest rates continue to rise, especially in the UK



Source: Bloomberg and Santander

In its October World Economic Outlook (WEO), the IMF highlighted the tightening of financial conditions in most regions. As a result, while it kept its global growth projections for this year unchanged at 3.2%, it revised the outlook for 2023 downwards again to 2.7% (-0.2% since July). Beyond this, the IMF stressed the importance of restoring price stability by maintaining the monetary policy stance and a sufficiently tight and aligned fiscal policy to alleviate the cost-of-living pressures.

In recent weeks, the oil price has risen significantly due to the announcement of an OPEC+ production cut of 2 million barrels per day from November, which is twice the expected amount. The lower production would fall mainly on the largest producers - Saudi Arabia and Russia - with 50% of the cut in equal shares. The announcement of this measure, coupled with the intensified war in Ukraine, pushed the price of WTI oil temporarily above US$92 a barrel after falling back to US$79 at the end of September. Nevertheless, as of the date this report was issued, crude oil was trading at around US$87 a barrel.

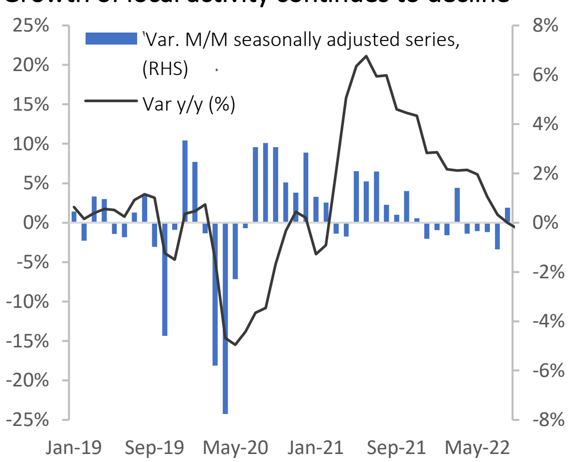
Local activity rebounds in August due to temporary factors

The August Imacec surprised on the upside with a positive monthly change (0.6% MoM seasonally adjusted). Therefore, the annual change was zero in a situation where a contraction was expected. Surprising data was seen in the services sector, which recovered from the previous month's decline (1.9% MoM seasonally adjusted), and in 'other goods' which, although suffering a slight monthly decline (-0.2% MoM seasonally adjusted), remained at a high level after July's significant increase. Furthermore, trade continued its downward trend with a significant contraction (-2.1% MoM seasonally adjusted). Thus, non-mining activity showed a seasonally adjusted monthly increase of 0.7% and achieved annual growth of 1.3%. Mining activity, meanwhile, remained stagnant, with low production levels and a negative annual change (-7.5% YoY).

In September, the economy will continue to lose dynamism, albeit moderately. While car sales dropped substantially on year on year basis, they recovered slightly compared to August. Likewise, daily retail sales reported by the Central Bank showed a slight increase in the first half of the month. Furthermore, the Monthly Business Confidence Indicator (IMCE) showed an increase due to an improved outlook of the country's global situation and a more robust perception of demand in some sectors. Nevertheless, the level of confidence remains severely punished.

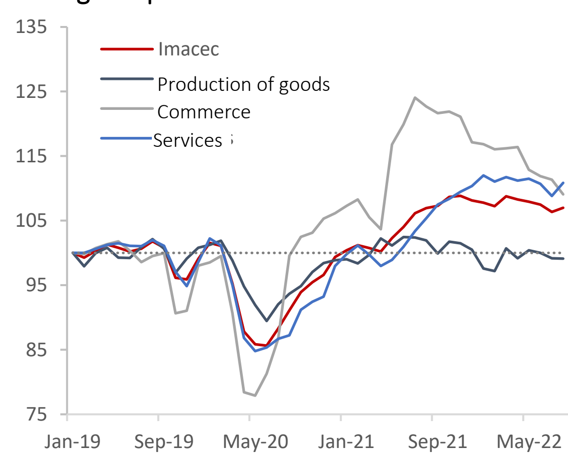
Against this background, we estimate that the September Imacec would have been close to 0%, while its annual change would have fallen to -0.8%. The economy will contract further in the following months of the year. Nonetheless, given the August surprise and our estimate for September, we revised our projection upwards for annual GDP to 2.25%, which is at the upper end of the range given by the Central Bank in its latest Monetary Policy Report (IPoM). For 2023 we maintain our estimate of a contraction in activity of around 1%. Financial conditions have continued to tighten, and domestic political uncertainty remains high, although it had tended to ease during early October. Additionally, the labour market has weakened, and job creation has stagnated, with real wages falling. Moreover, the external environment has become more complex, impacting our economy. Against this background, consumption will continue to contract until the first half of next year, and investment will remain weak. On the other hand, the external sector will suffer from a weaker world.

Growth of local activity continues to decline



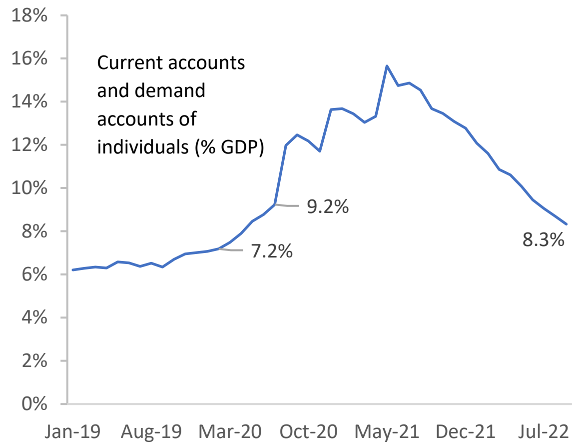
Source: Central Bank and Santander

August Imacec temporarily surprised due to non-mining components



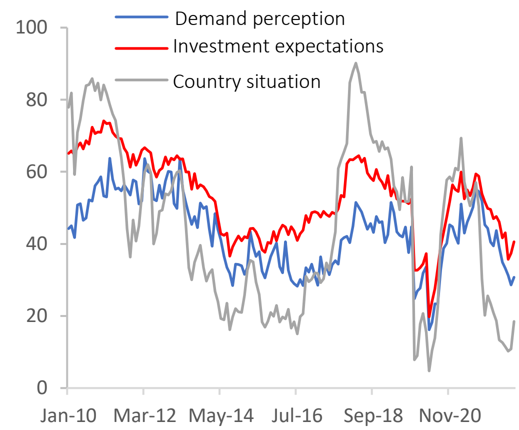
Source: Central Bank and Santander

Excess liquidity has been draining out



Source: Central Bank and Santander

Business and consumer confidence remain in negative territory

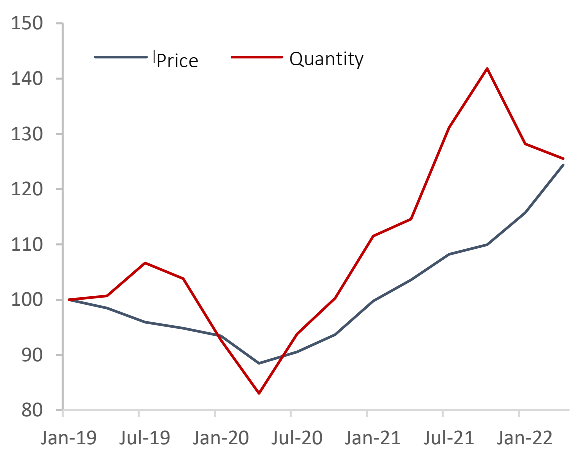


Source: ICARE and Santander

The current account deficit reached 8.5% of GDP in the mobile year ending in the year's second quarter. Furthermore, foreign trade figures for the third quarter show that the trade balance has continued to deteriorate, reaching a deficit of US$1.4 billion. This is explained by a decline in nominal exports coupled with continued high imports.

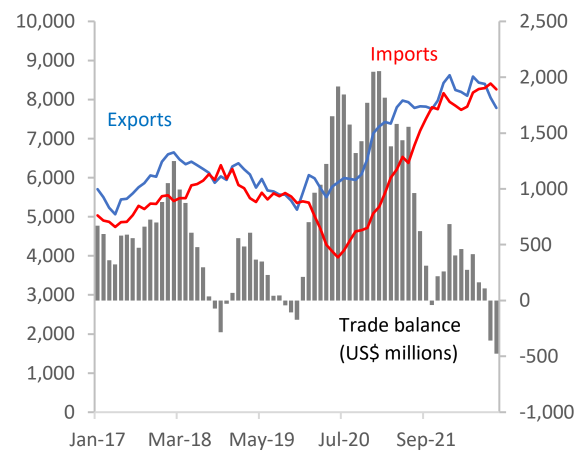
Thus, we estimate that the current account deficit would have widened further by the third quarter to around 8.9% of the GDP. This deterioration is largely explained by the fall in terms of trade, the rise in import prices and the fall in the price of copper. Therefore, for the year, we revised our projection to a deficit of 7%.

Imports remain strong due to high prices



Source: Central Bank and Santander

External accounts have deteriorated due to a fall in terms of trade.

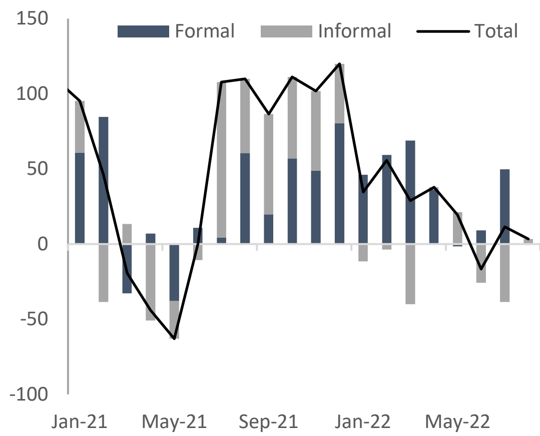


Source: Central Bank and Santander

Further signs of deterioration in the labour market

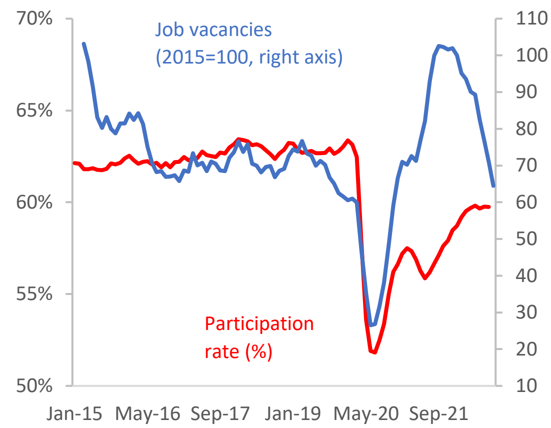
Employment figures for the June-August quarter showed virtually no job creation (only 3.5 thousand) compared to the moving quarter ending in July. Of these, the vast majority were informal (2.9 thousand). Thus, the employment rate remains well below pre-pandemic levels (55% vs 58% in August 2019), with little prospect of recovery. On the other hand, labour participation remains low (59.7% vs 63.4% pre-pandemic), so the unemployment rate has remained somewhat below 8% (7.9% in the moving quarter ending in August).

Small net job creation, almost entirely accounted for by the informal sector



Source: Central Bank and Santander

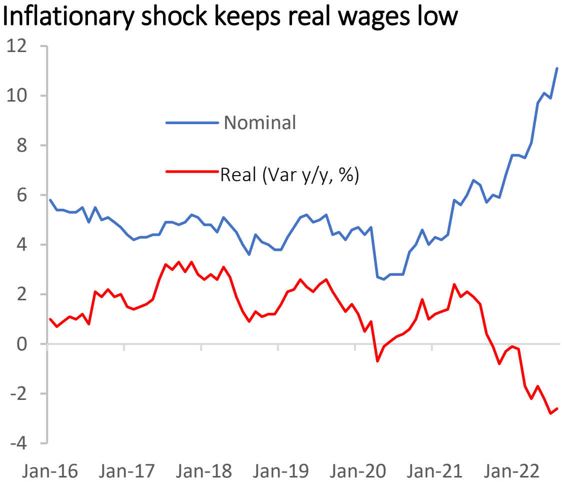
Stagnant labour supply and significant decline in demand for labour



Source: National Institute of Statistics (INE) and Santander

Furthermore, the Central Bank's vacancy rate has declined and is below historical averages. However, a subdued labour supply and a shrinking demand for labour suggest that job creation from now on will be very limited. At the same time, the inflationary shock has dampened real wages, which continue to fall. As a result, the real wage bill remains on a downward trajectory, which will impact the resilience of consumption.

Inflationary shock keeps real wages low



Source: Central Bank and Santander

Real wage bill stagnates

Source: National Institute of Statistics and Santander

Monetary and financial conditions continue to tighten

Lending activity has continued to weaken, with a real annual decline of 0.3% as of September. This negative performance follows twelve months of positive growth in the loan portfolio. It is mainly explained by the weakness in the commercial segment (-0.8% YoY), given the environment of low economic growth and investment - and a perception of higher credit risk for companies - which has led to more restrictive credit standards by banks, according to the Credit Survey as of the third quarter.

On the other hand, mortgage loans grew by a tentative 1.7% YoY due to slower real estate sales, while consumer loans again intensified their fall (-3.1% YoY) due to the weak labour market. In this context, both the supply of and demand for credit to individuals are perceived to be weaker and associated with higher credit risk.

Furthermore, monetary aggregates - measured by M1 - fell 24% in twelve months, reflecting the moderation in the balances of current and demand accounts of individuals as they return to their trend levels. This scenario follows the extraordinary increase in 2021, resulting from pandemic-related liquidity injections. The reduction in this index is also related to the shift of balances to term deposits in an environment of higher interest rates.

Inflationary pressures remain high, although there are incipient signs of moderation

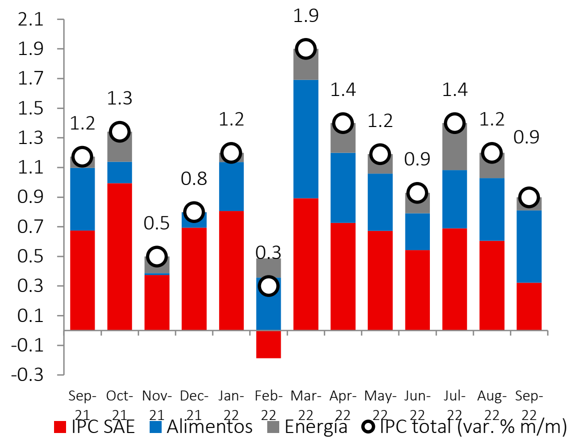
The CPI for September was in line with estimates (0.9% vs Bloomberg and Santander: 0.9%). With this figure, the annual change fell back to 13.7%, the first decline since the beginning of 2021. The figure was strongly influenced by falls in the items of airfare and package holidays (joint incidence: -0.26%). On the other hand, food prices continued to rise strongly, although the value of bread declined. Excluding volatile items, the CPI increased by 1%, reaching an annual change of 11.1%. Furthermore, the CPI excluding food and energy (CPI SAE) increased by only 0.4% in the month, bringing its annual change down to 10.3%.

While the diffusion index remained high and above historical averages - with more than 70% of basket prices rising - some evidence suggests incipient signs of moderation. Beyond the fall in the price of bread, the value of restaurant and hotel services increased only marginally (0.7% MoM), reflecting less intense second-round effects. Similarly, car price increases were low, and there were falls in several imported products.

New shocks have emerged in recent weeks that will cause inflation to fall more gradually than expected. International fuel prices have climbed again following the OPEC+ production cuts announcement and the again depreciating exchange rate at the possibility of further rate hikes by the Fed.

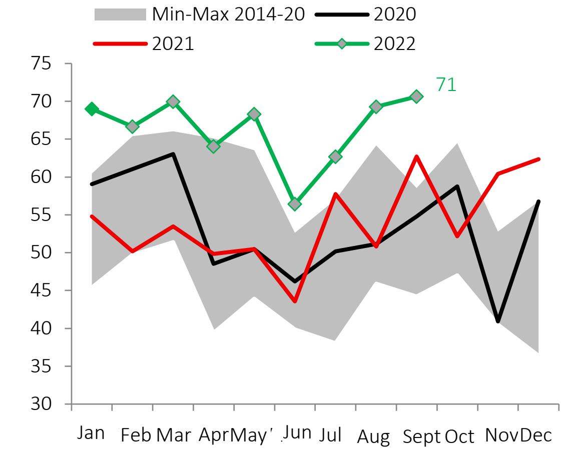
We have thus corrected our inflation estimates upwards, projecting the CPI for October to increase by 0.8% to 0.9% and the year to close between 12.5% and 13%.

Food represents a large part of the price increases (% incidence)



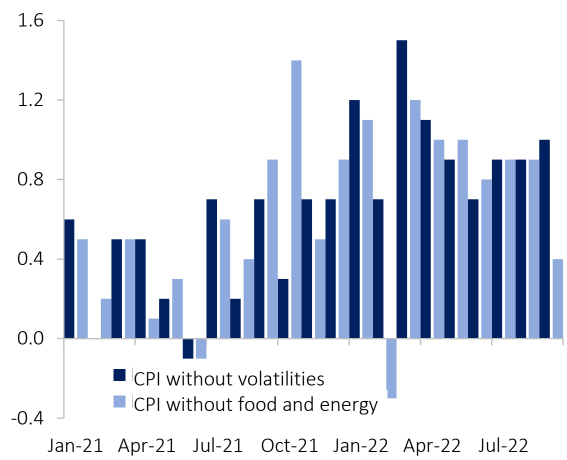
Source: National Institute of Statistics and Santander

Inflation diffusion shows pressures remain high (% basket with increases)



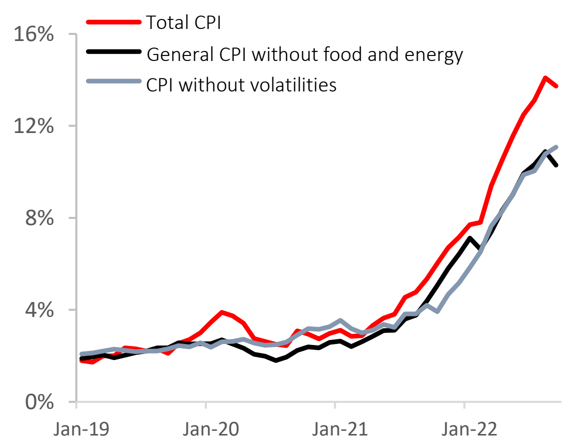
Source: National Institute of Statistics and Santander

Underlying inflation still high (var.% MoM)



Source: National Institute of Statistics, Central Bank and Santander

Annual inflation starts to decline (var.% YoY)



Source: National Institute of Statistics and Santander

Local assets lose value again

The tightening of global monetary conditions, the risk of a global recession and the intensification of the conflict in Ukraine triggered a further outflow of international investors from emerging market positions to safe-haven assets. Moreover, in the case of our country, sources of specific uncertainty were added to the external noise due to ambiguities surrounding the new constituent process, disputes over the country's foreign policy strategy and new but limited episodes of violence.

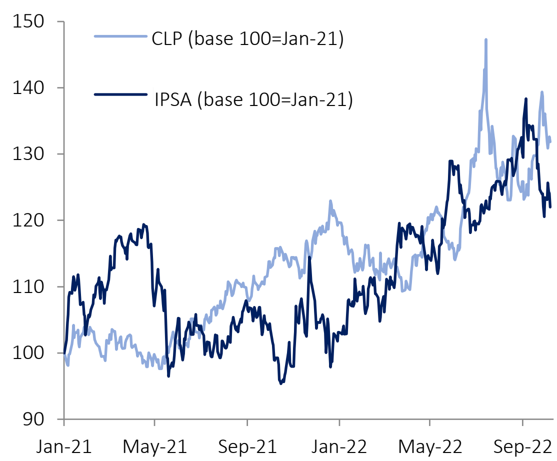
All of the above impacted local financial stocks, with renewed pressure on the exchange rate, stock market declines and losses in fixed-income values. Thus, at the end of September, the dollar returned to close to $1,000, the local stock index IPSA fell back to 5,100 points, and long-term interest rates jumped by almost 50 bps to just below 7%.

As announced in July 2022, the Central Bank ended its foreign exchange intervention programme at the end of September, ceasing to operate in the spot market. Nevertheless, the Council announced it would continue to roll over the stock of forward dollar sales, for the equivalent of US$9.11 billion, until January 2023. At the same time, flows of NDF dollar purchases by non-resident investors have tended to stabilise, accumulating a stock of US$10.4 billion.

In this context, the exchange rate recently reversed some of the late September losses and stood at close to $925. However, in the future, we anticipate that the local currency could face further depreciation. On the one hand, the strengthening of the global dollar and the economic slowdown in China impose a ceiling on the evolution of the copper price. On the other hand, the withdrawal of monetary stimulus in the US remains aggressive, and even as domestic rates have continued to rise, the rate differential has tended to moderate. Lastly, economic and political uncertainty remains high. Therefore, we expect the parity to close the year at around $950.

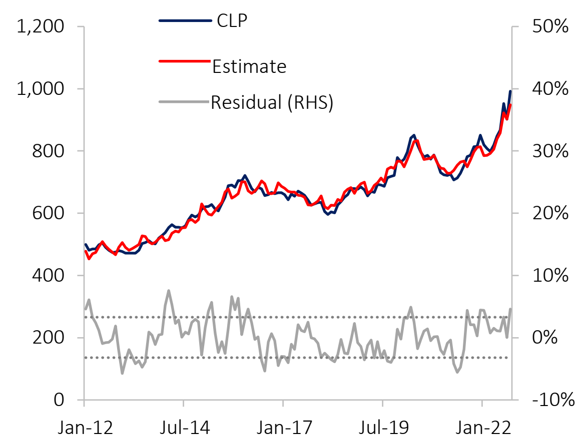
Regarding the fixed income market, the signals given by the Central Bank in its latest Monetary Policy Meeting regarding the end of the rate hike cycle and a more comfortable fiscal year-end in 2022, with lower cash needs, should lead to some moderation in long-term rates. Furthermore, the government announced a US$4 billion debt buyback programme on behalf of the Treasury, bringing public debt down to US$13 billion this year, which should also lead to an adjustment in long rates.

Risky assets lose value in the face of the flight-to-quality effect



Source: Bloomberg and Santander

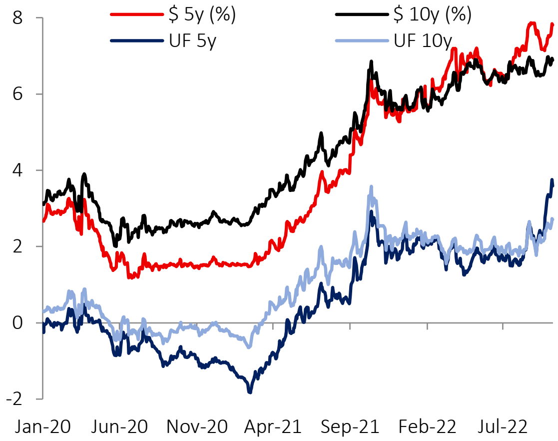
The exchange rate remains at the upper end of the range, consistent with fundamentals



Source: Bloomberg and Santander

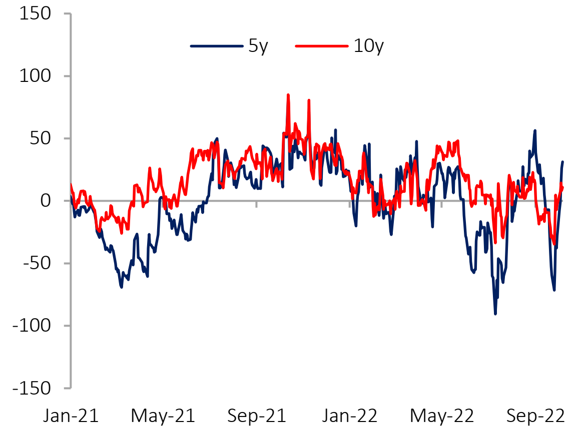
Nonetheless, risk scenarios persist. On the one hand, the delay in the constitutional discussion and the likelihood of conflicts deviating from the institutional path would affect the country's risk premium and lead to potential additional downgrades in the sovereign risk rating. On the other hand, as long as there is no certainty about the impact of structural reforms on investment dynamics and capital market functioning, risk premia in asset prices will remain high.

Long-term rates rise sharply...



Source: Bloomberg and Santander

...showing a positive risk premium



Source: Bloomberg and Santander

The Central Bank concludes the hiking cycle with a 50 basis points hike

At its October Monetary Policy Meeting, the Council unanimously decided to raise the MPR by 50 basis points, in line with market estimates, to 11.25%. In its statement, a clear signal of bias neutrality was given, mentioning that this would be its last hike in the monetary tightening cycle that began in the middle of last year.

The Council noted that international financial conditions have deteriorated, global inflation has increased, and benchmark rates continue to rise. It also emphasises the recent increase in oil prices and the exchange rate depreciation (5% since the September MPR). On the other hand, it notes that although the August Imacec was somewhat above expectations, sectors linked to domestic demand, such as trade, manufacturing and construction, continue to fall. Furthermore, they point out that inflation in the last two months has been higher than expected in the last IPoM. This, together with higher exchange rate and oil price pressures, would have influenced the decision to raise the MPR by 50 bps at this meeting instead of ending the cycle with the MPR at 10.75%, as implied in the statement of the previous Monetary Policy Meeting.

In the future, the Council specifies that 'the MPR has reached the maximum level of the cycle that started in July 2021 and will remain at this value for as long as necessary to ensure the convergence of inflation to the target over the two-year policy horizon'. This implies a strong bias towards neutrality for the forthcoming meetings.

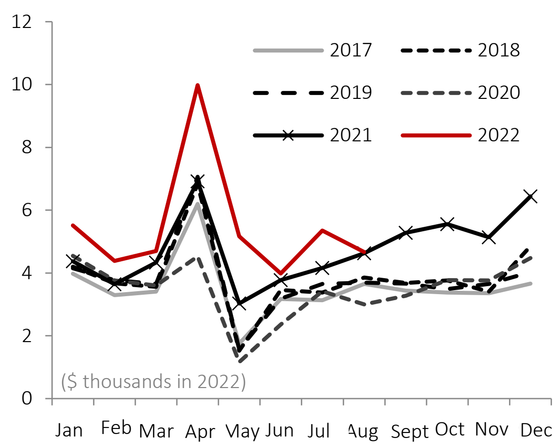
We estimate that in the coming months, we will start to see a gradual but steady decline in inflation along with a still contracting economy. This will allow the Council to assess a shift in its monetary strategy at the next IPoM in December. The downward cycle could materialise at the last Monetary Policy Meeting occurring in January or, more likely, at the one in early April, which is held in conjunction with the March IPoM. At that point, the Council will have sufficient information to assess a rate-cutting cycle and will have the opportunity to explain it to the market.

Public debt contracts for the first time in more than 10 years

Fiscal revenues for the year have been at record levels, favoured by the strong dynamism of demand at the beginning of the year, the effect of some tax measures - in particular the ISFUT - and revenues from lithium exploitation due to high prices and Corfo's new contracts with SQM and Albemarle. Nonetheless, despite the additions legislated during the year, spending will close with a historic drop of more than 24%. The fiscal balance in 2022 will thus end with a surplus of 1.6% of GDP. Gross debt, meanwhile, will decline slightly and close at 36% of GDP.

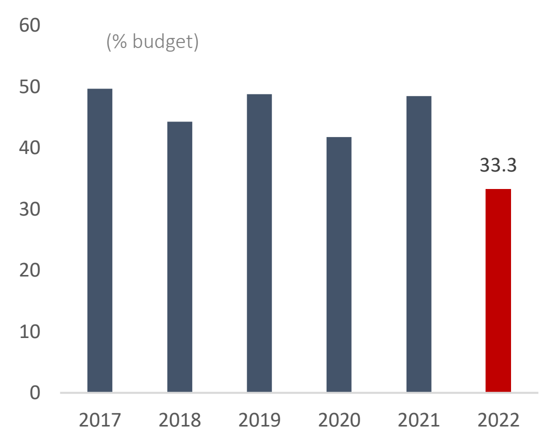
The budget for 2023 considers a 4.2% expansion in spending. Of this, 60% would go to finance the expansion of the coverage and amounts of the Pensión Universal Garantizada (PGU), while the rest would be focused on three pillars: public investment, public security and some transfer and subsidy programmes (IFE Laboral, Bono canasta protegida). Revenues will decline by just over 10%, raising the deficit again to 2.7% of GDP. Henceforth, the fiscal commitment to reduce the structural deficit by 0.75% of GDP per year will impose severe constraints on the expansion of spending, which, in the absence of new structural revenues, would have to remain constant from 2025 onwards to meet the target.

Tax collection remains at record levels



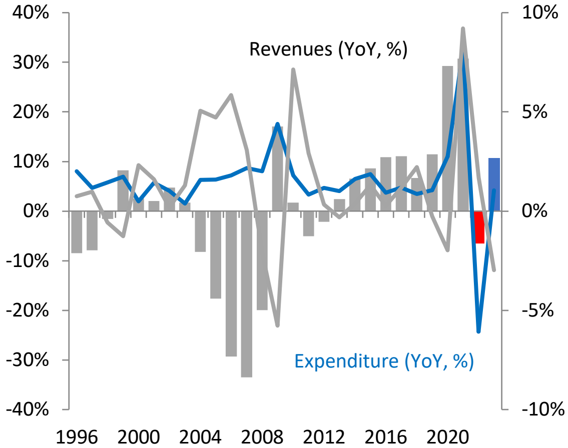
Source: Dipres and Santander

Executed investment as of August remains behind in comparison to previous years



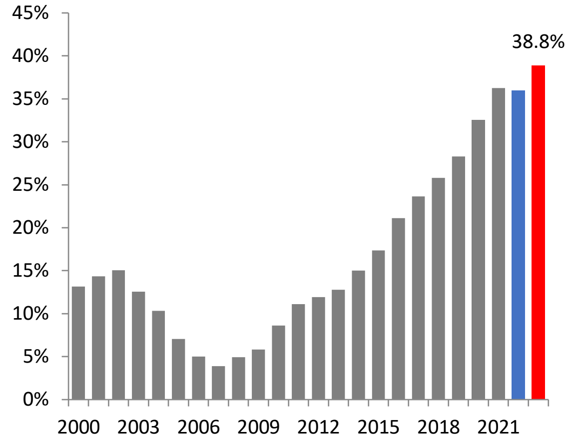
Source: Dipres and Santander

Fiscal balance to be in surplus in 2022, then fall in 2023



Source: Dipres and Santander

Public debt temporarily halts its upward trend



Source: Dipres and Santander

ECONOMIC PROJECTIONS

National Accounts	2016	2017	2018	2019	2020	2021	2022 P	2023 P
GDP (% real var. YoY)	1.8	1.4	4.0	0.8	-6.0	11.7	2.25	-1.2
Domestic demand (% real var. YoY)	1.9	2.9	5.0	1.0	-9.3	21.6	2.5	-3.4
Total consumption (% real var. YoY)	4.1	3.8	3.6	0.7	-7.2	18.2	2.8	-3.1
Private consumption (% real var. YoY)	3.3	3.6	3.8	0.7	-8.0	20.3	2.3	-4.4
Public consumption (% real var. YoY)	7.6	4.7	3.1	0.5	-4.0	10.3	4.9	2.0
Gross fixed capital formation (% real var. YoY))	-2.4	-3.3	6.5	4.7	-9.3	17.6	-1.9	-4.4
Exports (% real var. YoY)	0.6	-1.0	4.9	-2.5	-1.1	-1.5	0.9	1.3
Imports (% real var. YoY)	1.2	4.5	8.6	-1.7	-12.7	31.3	1.9	-6.2
GDP (US$ billion)	249.5	276.5	296.0	279.0	253.5	316.8	302.0	297.0
GDP per capita (US$ thousand)	13.7	15.0	15.8	14.6	13.0	16.1	15.3	14.9
Population (million)	18.2	18.4	18.8	19.1	19.5	19.7	19.8	20.0

Payment Balance	2016	2017	2018	2019	2020	2021	2022 P	2023 P
Trade balance (US$ billion)	5.0	7.5	4.4	3.0	19.0	10.5	4.7	6.1
Exports (US$ billion)	60.8	68.9	74.8	68.8	74.1	94.7	96.2	86.1
Imports (US$ billion)	55.8	61.4	70.4	65.8	55.1	84.1	91.5	80.0
Current account (US$ billion)	-6.5	-7.6	-13.3	-14.5	-4.3	-20.3	-21.1	-12.1
Current account (% GDP)	-2.6	-2.8	-4.6	-5.2	-1.7	-6.6	-7.0	-4.0
Copper price (year average US$/lb)	2.2	2.8	3.0	2.7	2.8	4.2	3.9	3.6
WTI oil price (year average US$/bbl)	43.2	50.9	64.8	57.0	39.0	68.0	96.0	78.0

Money and Exchange Market	2016	2017	2018	2019	2020	2021	2022 P	2023 P
CPI Inflation (% var. YoY up to December)	2.7	2.3	2.6	3.0	3.0	7.2	12.7	6.3
CPI Inflation (% var. YoY average)	3.8	2.2	2.4	2.3	3.0	4.5	11.6	8.8
CPI Inflation excluding food and energy (IPC-SAE) (% var. YoY up to December)	2.8	1.9	2.3	2.5	2.6	6.4	9.0	6.9
CLP/US$ exchange rate (annual exercise)	667	615	696	745	711	852	950	960
CLP/US$ exchange rate (year average)	677	649	640	703	792	759	885	955
Monetary policy rate (% year end)	3.5	2.5	2.8	1.8	0.5	4.0	11.25	7.00
Monetary policy rate (% year average)	3.5	2.7	2.5	2.5	0.8	1.2	8.6	9.4

Fiscal Policy	2016	2017	2018	2019	2020	2021	2022 P	2023 P
Public expenditure (% real var. YoY)	3.8	4.8	3.5	4.1	11.0	31.6	-24.0	4.2
Central Government balance (% GDP)	-2.7	-2.8	-1.7	-2.9	-7.3	-7.7	1.6	-2.7
Central Gov. gross Debt (US$ billion)	53.4	68.9	70.2	74.4	91.6	102.0	108.7	114.0

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