Outlook 2023: A necessary adjustment to resume growth

Presentation

The global economy has faced challenging years. First, the pandemic, beyond the direct human costs, caused poverty and led to the sharp inflationary spike we have been experiencing since late 2021. Subsequently, the war in Ukraine further fuelled price escalations and generated long-standing geopolitical tensions.

Central banks tightened monetary conditions in response to rising inflation, significantly raising interest rates. The drastic slowdown of the global economy has been one of the consequences. This year, monetary policymakers will have to strike a delicate balance between continuing to push inflation down - and preventing it from becoming a permanent problem - and simultaneously trying to avoid a severe contraction in activity. The normalisation of commodity prices and logistics chains since the middle of last year will assist in this task.

Our country has also experienced the inflationary outbreak and had to make a significant adjustment. In contrast to other economies, the rise has been stronger due to the substantial liquidity injections in 2021. For the same reason, the financial contraction has been deeper, and the economy's slowdown will be stronger, resulting in a moderate recession in 2023. This year, however, we should see a turnaround in monetary policy that will allow the economy to return to growth in 2024.

One of the factors conditioning economic performance has been the high level of political uncertainty. However, the overwhelming rejection of the constitutional text proposed by the Constitutional Convention and the beginning of a new process with a more limited outline makes reaching a consensus on a new institutional framework more feasible, which will provide stability. This new process is not without risks, but if successful, it could open a new stage of development for the country.

In this document from Banco Santander's Research Department, we provide our view on the economic situation in Chile, the world and the outlook for this year. In doing so, we seek to contribute to the diagnosis and public debate on the challenges we must face to continue advancing towards the country's progress.

Executive Summary

In the past year, the global economy was shaped by the scars of the pandemic and the Russian invasion of Ukraine. One of the biggest problems was the strong inflationary outbreak, triggered by the rapid recovery of global demand after the opening processes in mid-2021, and a lagging supply of goods and services, both due to logistical problems and structural changes in labour markets. To this was added the impact on grain and fuel prices due to the war in Europe.

The spread and persistence of inflation prompted the major central banks to tighten their monetary policy. As a result, the Federal Reserve (Fed) in the United States and the European Central Bank reversed their asset purchases and raised their benchmark rates. In the case of the Fed, this happened earlier and was done more aggressively. This led to a tightening of global financial conditions, a strengthening of the dollar and widespread stock market declines.

In this context, economic activity suffered more than expected before the war. Moreover, China's zero-tolerance policy on Covid also played a role, leading to a significant decline in its growth. Thus, the global economy expanded by around 3%, well below the 6% with which it closed in 2021.

In the second part of the year, some moderation in inflationary pressures began to emerge. Oil and food prices declined substantially, and problems in logistics chains started to be solved. Even so, inflation closed 2022 at highs not seen in several decades.

In recent weeks, weather in the northern hemisphere has been less cold than usual, helping to keep energy prices down and avoid gas rationing in Europe, easing some of the fears that had persisted for some time.

Global growth will continue to slow this year, driven by advanced countries and a large part of the emerging world. As a result, a recession in the major economies, which we expect to be mild, is not out of the question. In contrast, China will accelerate as sanitary measures are relaxed. Still, we project that the world will grow by only 2.2%, further away from its pre-pandemic trend.

Lower global activity, coupled with the decline in commodity prices in the last months of 2022 and the resetting of logistics chains, will cause global inflation to recede. However, it is unclear whether this will be fast enough for the major Central Banks to turn their monetary policy around and start the easing process this year. The Fed's Federal Open Market Committee has signalled that significant hikes in its MPR are still needed and will remain high throughout the year due to a tight labour market. Nevertheless, the market is betting we could see cuts already in the last quarter.

The war in Ukraine has entered a relative stalemate limited to the country's eastern regions. While reports of military build-up are currently causing concern, in our baseline scenario we assume that the conflict remains contained and will not escalate again. As such, we project that oil prices could rise modestly but would not return to the levels seen in the first part of 2022. We also assume that, despite the advance of new variants, there will not be any massive outbreaks of Covid that would require severe containment. Finally, we believe that the Fed will signal a looser monetary policy in the second part of the year, allowing global financial conditions to ease. If these assumptions are not met, the global economy could slow down more significantly than in our central scenario. In addition,

the inflationary outbreak could become more persistent, driven by supply-side factors, resulting in tightening monetary conditions.

In Chile, the economy started the adjustment process after overheating at the end of 2021. The swift and aggressive reaction of the Central Bank, which raised the Monetary Policy Rate (MPR) by 10.75 percentage points in a short period, a contractionary fiscal policy, a complex international scenario and domestic political uncertainty, led to a significant fall in domestic demand. As a result, consumption slowed from the second quarter of 2022 due to stagnant job creation and higher interest rates, and investment fell sharply in the first quarter, although it rebounded after that. Nevertheless, this closed the year with a growth of 2.6%, in line with what we projected at the beginning of 2022.

Despite the fall in domestic demand, the current account deficit remained high, impacted by the deterioration in terms of trade. However, public accounts improved thanks to sharp cuts in public spending and higher revenues. The latter was influenced by the large dividend payments by companies in the second part of 2021, which meant a high-income tax collection, and the rise in the price of lithium, which contributed almost US$4 billion to the fiscal coffers. All the above led to a reduction in public debt to around 35% of GDP at the end of the year.

Similarly to the rest of the world, inflation was a major concern. The CPI rose strongly in the first part of the year, boosted by the lagged effects of demand expansion in 2021, the rise in external prices and the significant currency depreciation until July last year. In August, the annual change in the CPI reached 14.1%, reaching its highest level in more than 30 years. From the third quarter onwards, signs of moderation in prices started to become evident. Even so, inflation closed in 2022 at historical levels (12.8%).

This year, we project that the economy will continue to adjust and contract by between 1% and 1.5%. This will be influenced by monetary conditions that will remain tight for much of the year, weaker global growth and the impacts of the high political uncertainty Chile has faced. As a result, the latter will be reflected in a significant decline in investment, which could fall by 5%. The labour market is expected to weaken further during the year, and the unemployment rate will tend to rise, averaging 8.5% for the year. However, the activity could begin a slow recovery process in the second part of the year as monetary conditions ease and the political landscape becomes more predictable. This would allow growth to pick up in 2024, with the economy expanding by 2.5%.

The decline in activity, the exchange rate appreciation of the last few weeks and lower external pressures will help inflation to continue to decline over the year and close at around 4.75%. In this scenario, the necessary conditions will be in place for the Central Bank to start lowering the MPR at the beginning of the second quarter. For better or worse, inflationary expectations over the policy horizon, a major concern of the Council, have already fallen back to near-target levels. Thus, in our central scenario, we expect that, as in the hiking cycle, the cuts will be relatively aggressive and will bring the MPR down to 6% by the end of this year. This will help to moderate real interest rates, which, despite lower growth prospects, have remained very high in recent months. This would help to underpin growth in the run-up to 2024.

Local assets were subject to high volatility. However, after historic losses in the first part of 2022, local assets recovered and closed with favourable movements. This year, we expect the stock market

to continue to rise, albeit more modestly, and long-term rates could move downwards. Nonetheless, these already incorporate significant declines in the MPR. As a result, the exchange rate would depreciate slightly from the values at the close of this report to around $850 by the end of 2023.

The domestic political scenario has been dissipating some of the sources of risk to the economy. The rejection of the text proposed by the Constituent Convention, and the approval in Congress of a reform that enables a new process within predefined frameworks, limits the possibilities of radical institutional changes. Furthermore, the parliamentary negotiations could mean that the structural reforms proposed by the government will not have a significant impact on growth. Nevertheless, the domestic political process remains subject to high volatility and a major source of uncertainty.

In the short term, beyond the uncertainties of the global scenario, the main risk is an eventual new pension fund withdrawal. Should this happen, there would be a new liquidity shock that, while it could somewhat temper the contraction of the economy this year, would again raise inflation and tighten monetary conditions, making a deep recession likely in 2024. Moreover, even the mere discussion of this project would generate concern in financial markets and could inhibit the Central Bank from acting promptly, despite signs of a reduction in inflation.

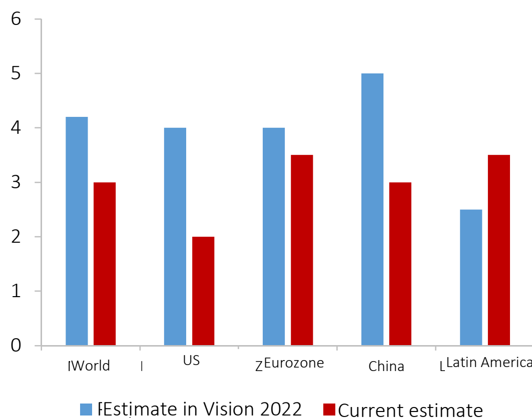
In the medium term, the Chilean economy continues to face the challenge of raising trend growth. Economic growth has been revised downwards systematically, most recently to between 2% and 2.5%. This implies a very low expansion in per capita terms and limits the possibility of extending social benefits. Raising medium and long-term growth requires increasing productivity and creating the conditions for investment to materialise.

International Scenario

The delicate balance between controlling inflation and restraining the economy

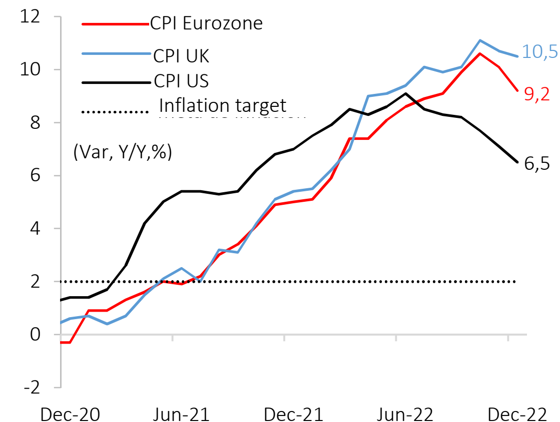
During 2022, global activity moderated significantly - according to the World Bank, the largest slowdown since 1970 - triggered by tighter financial conditions, lower fiscal impulses and the geopolitical shock from the war in Ukraine. Although the pandemic continued to affect a significant fraction of the world's population, it was no longer a priority issue because vaccination and the reduced severity of the new variants prevented drastic containment measures. The exception was China, whose zero-tolerance Covid policy involved strict quarantines affecting its economic performance. As a result, according to available data, world growth would have been around 3%, well below the 4.2% we estimated in January last year in our pre-Russian invasion Outlook 2022 report and a far cry from the 6% growth of 2021.

Global GDP growth in 2022 was substantially lower than expected



Source: Santander

The major concern was the sustained escalation of inflation



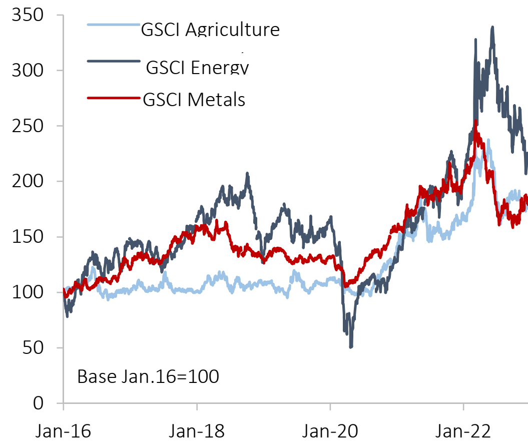
Source: Bloomberg and Santander

The biggest concern during 2022 was the significant and persistent rise in inflation, which led to a global price escalation not seen in almost forty years. Behind this was the rapid recovery in demand following the deconfinement in mid-2021 and large injections of liquidity by several governments; a tight supply of goods due to disruptions in logistics chains - especially due to health policies in China; and a subdued supply of services due to lower labour participation in most countries. This was exacerbated by the sharp rise in oil and grain prices due to the conflict in Ukraine in February last year and, in many countries, the weakening of their currencies following monetary tightening by the US Federal Reserve (Fed).

In the second part of the year, inflation began to moderate. However, the value of oil, after rising nearly 60% to over US$ 120 a barrel in the second quarter, fell back to levels like those of late 2021 - around US$ 80 a barrel - because of the stalemate in the war conflict and weakening global demand. On the other hand, grain prices rose sharply after the Russian invasion and fell near pre-war levels

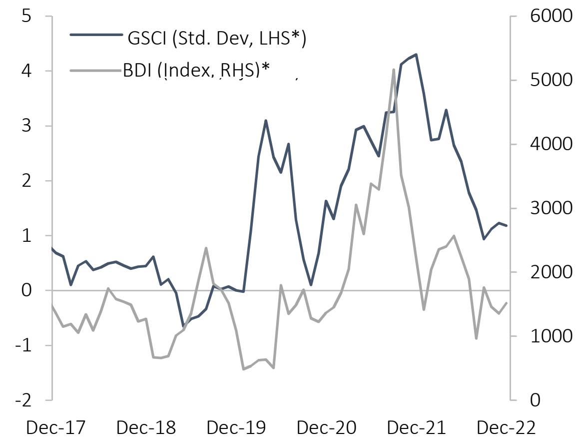
(GSCI agriculture index: -25% below the year's peak). Furthermore, logistics chains displayed signs of normalisation, with significant reductions in transport costs and product clearance times.

Commodity prices temporarily affected by the war in Ukraine



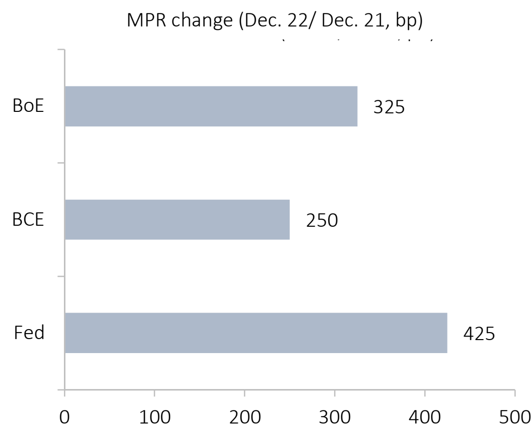
Source: Bloomberg and Santander

Logistics chains get back on their feet



(*) GSCPI: *Global Supply Chain Pressure Index*. BDI: *Baltic Dry Index*. Source: Bloomberg, New York Fed and Santander

Major central banks tighten their monetary policies



Source: Bloomberg and Santander

Multilateral dollar appreciated strongly until mid-2022 but subsequently lost momentum

Source: Bloomberg and Santander

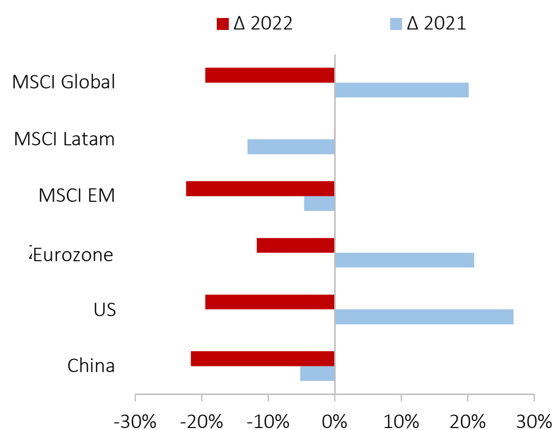
The generalised rise in prices prompted the monetary authorities to tighten their policy. The Fed, which had begun tapering its asset purchase programme at the end of 2021, raised its rate sharply from 0%-0.25% to 4.25%-4.5% at the end of last year and at its last meeting hinted that there was still some way to go before pausing. This led to a strong overall appreciation of the dollar in the first part of the year, but after that, the dollar tended to depreciate.

The European Central Bank (ECB) also raised its benchmark rate for the first time since the 2009 financial crisis and began to reverse its quantitative easing policy. Even the Bank of Japan, which maintained an ultra-loose monetary policy for decades, raised the ceiling for its long-term rates in a

sign of monetary tightening. Latin America's major central banks followed suit, albeit more quickly, setting their policy rates at their highest levels in several years.

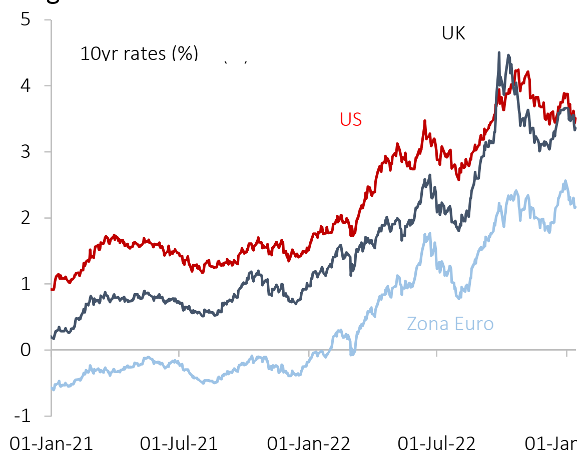
Stock markets suffered the consequences of tighter financial conditions and closed 2022 with declines (MSCI global: -20%), in the US (S&P 500: -19%; Dow Jones: -9%), Europe (Eurozone: -12%; UK: 0%) and China (-22%). After rebounding until mid-year, Latin American markets ended the year flat (MSCI Latam: 0%). In line with monetary tightening, long-term interest rates tended to rise (+260 bps on average over the year), albeit with some easing in recent months.

Except for Latin America, global stock exchanges declined significantly in 2022



Source: Bloomberg and Santander

The tightening of monetary conditions caused long rates to rise



Source: Bloomberg and Santander

In the future, advanced countries are likely to face a recession. The sharp monetary contraction, coupled with the lagged impact of the energy impact of the war in Ukraine, will cause the GDP in the United States and Europe to contract in the first part of the year. Nevertheless, an eventual recession would be moderate. These countries would expand again in the second part of the year, driven by receding inflation and tighter financial conditions. In China, the economy is expected to be more dynamic due to the relaxation of sanitary restrictions. However, the recent wave of infections raises doubts about the pace of recovery. With these elements, we anticipate that the global economy will slow its pace of expansion and grow by around 2% in 2023. This estimate is similar to recent projections by other international organisations, such as the World Bank, which, in its economic outlook report published in early January, estimated an expansion of 1.7%.

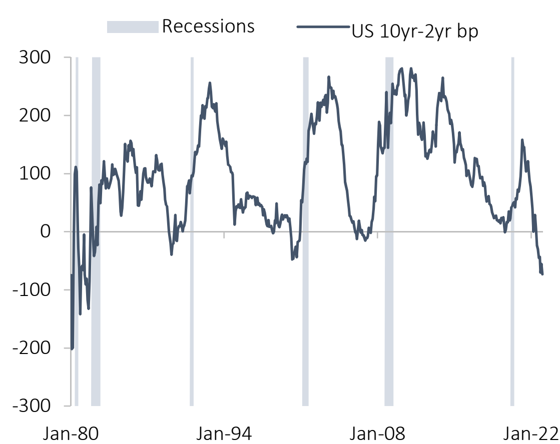
The main risks are on the upside for inflation and on the downside for global activity. First, there is the possibility of an escalation of the war in Ukraine, which would again increase energy and agricultural prices, impacting growth and pushing inflation up. There is also a possibility that the inflationary persistence will lead to tighter financial conditions, which could strengthen the dollar globally and weaken the activity. Lastly, outbreaks of Covid-19 - such as the XBB variant of Omicron - in China or other countries could force the reimposition of containment measures, which would stress supply chains and impact growth.

Advanced economies tighten their monetary policy

The United States closed the year with a resilient economy and a tight labour market. The rate hikes that began last March, coupled with the conflict in Ukraine and the contraction in activity in the first quarter, led many analysts to anticipate a recession during the year, which ultimately did not become a reality. While gross capital formation showed a significant fall, consumption remained dynamic, bolstered by the leftovers of the 2021 liquidity injections and robust job creation. Nevertheless, the economy expanded by only 2%, half of what we projected at the beginning of 2022, and ended the year with activity indicators in negative territory (December 2022 manufacturing ISM: 48.4; services ISM: 49.6).

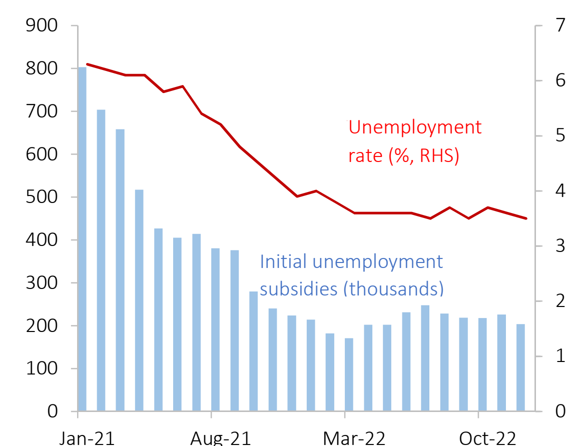
Beyond the war, the main concern was the high inflation and the Federal Reserve's monetary policy response. The Fed's initial diagnosis in mid-2021, when significant price increases were already visible, assumed that inflation would be a transitory phenomenon and that no significant monetary tightening would be necessary, contrary to market expectations at the time.

Rate differential points to the US recession



Source: Bloomberg and Santander

The labour market remains robust



Source: Bloomberg and Santander

Nevertheless, the systematic surprises in the first part of 2022, which pushed inflation to a 40-year high (CPI: 9.1% YoY in June), and the tight labour market, led to a change in tone. In subsequent meetings, the Federal Open Market Committee (FOMC) raised its policy rate sharply, taking it to 4.25%-4.5% by the end of the year. These hikes were significantly stronger than what the FOMC had communicated at the beginning of the year when the dots pointed to a target rate of only 2.75% and went well beyond what the market had expected. Long rates, therefore, increased sharply, with the 10-year rate rising from 1.6% in January to more than 3.5% at the end of last year.

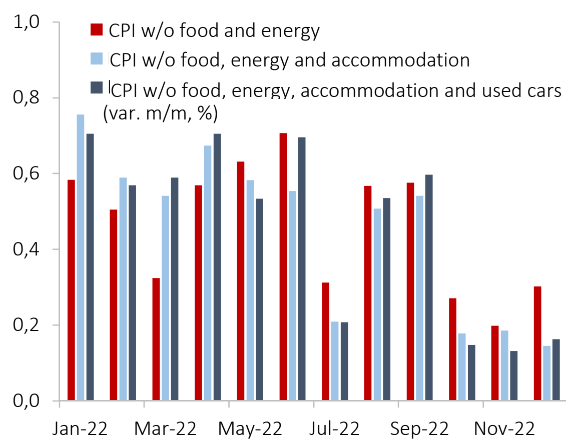
In the coming quarters, US growth will continue to moderate, and a recession cannot be ruled out based on the differential between short- and long-term rates. Nonetheless, this would be mild due to the resilience shown by the labour market, which should support consumption. Thus, for the year, we estimate growth to be around 0.5%.

Inflation, which already started to show signs of easing in the second half of last year and closed at 6.5% YoY, will continue to decline due to the falls already seen in commodity prices and the slack that the slowdown in activity will create. This will allow the Fed to conclude its hiking process in the first

part of the year, with the benchmark rate at around 4.75%-5% (50 bps above its current level). The biggest question is whether it will decrease this year, as implied by market prices. We estimate that even if the latest employment data have surprised on the upside, this situation will not be sustained, and unemployment should rise. Prices, for their part, are likely to moderate more sharply than anticipated by the Fed, which would give the FOMC room to initiate cuts as early as the end of 2023.

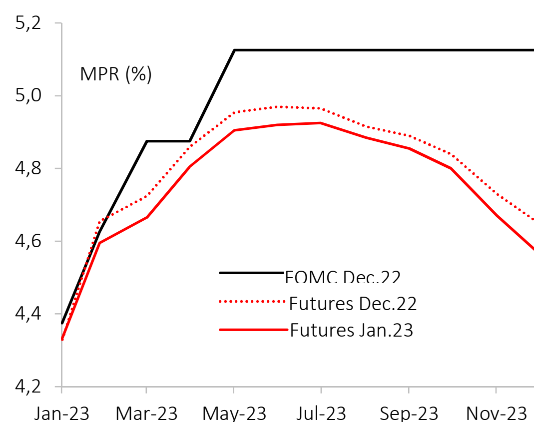
On the fiscal front, recent statements by Treasury Secretary Janet Yellen point to the need for extraordinary measures to avoid a default on the government's financial obligations. Therefore, discussing a new public debt ceiling will once again be a heated political debate.

US core inflation has moderated in recent months



Source: Bloomberg and Santander

The market expects a Fed rate cut later this year



Source: Bloomberg and Santander

European countries were the most affected by the invasion of Ukraine, especially those whose industrial bases depended on Russian gas. In addition, the impact of a massive wave of Ukrainian refugees aggravated restrictions on energy supplies and higher costs. Despite this, most European economies could sustain a positive pace of growth throughout the year, expanding by about 3.3%. Nevertheless, similar to the US, the year closed with several indicators in negative territory, although improving at the peak (December manufacturing PMI: 47.8; services PMI: 49.8; ZEW survey: -23.6; consumer confidence: -22.2).

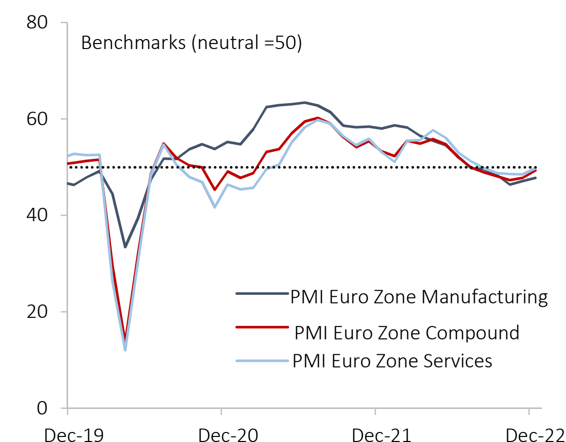
Inflation rose steadily until the beginning of the fourth quarter, reaching 10.6% YoY in October, and then started to decline to end the year at 9.2%. As a result, the European Central Bank (ECB) delayed its monetary tightening, betting that price rises would be transitory and that an eventual economic contraction due to the war would dampen underlying pressures. Nonetheless, persistent inflationary pressures and a less intense slowdown in activity led to the start of monetary easing in mid-year. First, the ECB reduced its asset purchases and then, in July, began raising its benchmark rate for the first time in more than ten years. By the end of 2022, it had accumulated increases of 250 basis points, with the deposit rate reaching 2% and the lending rate 2.75%.

The European winter has been less cold than usual. This has allowed energy prices to remain low and prevented gas rationing, which was a risk factor for the activity.

Nevertheless, the tightening of monetary conditions will cause European economies to moderate their expansion further and, as in the US, may face a recession. As a result, annual average growth

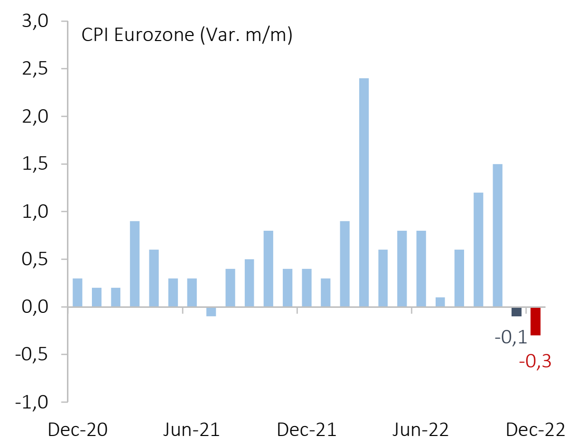
would be zero. Against this background, inflation will continue to decline. Still, the Central Bank will likely continue to raise its benchmark rate in the short term, considering that it is not yet in full contractionary territory.

Despite a marginal rebound, the economic outlook for Europe remains pessimistic



Source: Bloomberg and Santander

Latest inflation figures in the Eurozone surprised on the downside



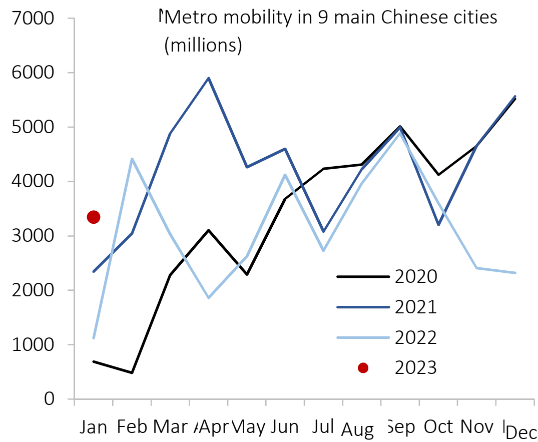
Source: Bloomberg and Santander

Emerging economies at different paces

In 2022, the Chinese economy suffered the consequences of its zero-tolerance Covid-19 policy, with severe mobility restrictions in the second part of the year. That, coupled with problems in the real estate sector, caused China to grow by only 3%, well below the 5% target set by the government. The weakness of domestic demand meant that, unlike in other countries, inflation remained subdued (December CPI: 1.8% YoY vs 1.5% at the end of 2021). By the end of the year, internal political pressure led to the lifting of the confinement measures. Reduced mobility constraints, coupled with the cut in the benchmark rate in mid-2022, higher public spending and targeted incentives, will lead to a rebound in the economy this year, which should expand by around 4.5%. Nevertheless, the high number of infections in recent weeks and the overcrowding of the health system provide a note of caution for this economy.

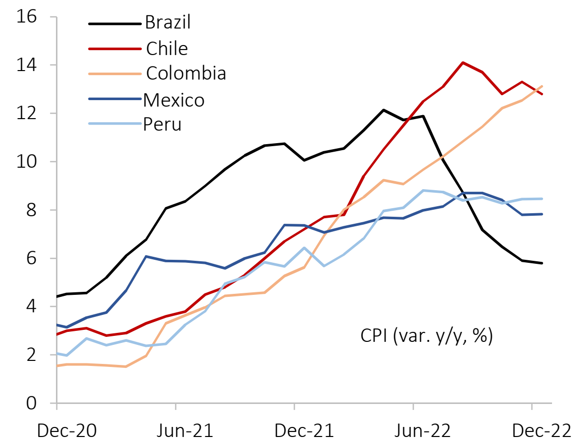
Latin America faced a volatile year marked by high inflation, economic slowdown and strong political tensions. Higher commodity prices due to the war in Ukraine benefited some of the region's economies, allowing them to expand strongly in the first part of the year. Subsequently, they suffered the consequences of monetary tightening and lost momentum, closing with a growth of around 3.5%, somewhat more than we had expected at the beginning of the year. Inflation peaked in the third quarter and started to ease in the last months of the year. For 2023 we expect a significant moderation in activity due to tight financial conditions and a drop in terms of trade in the second part of last year. With this, the region should grow by around 1.5%. In addition, political tensions in several countries are a major risk factor, which could further undermine growth in the region this year.

China's reopening generates optimism in some markets for 2023



Source: Bloomberg and Santander

Inflation decline in Latin American countries could allow them to turn around monetary policies



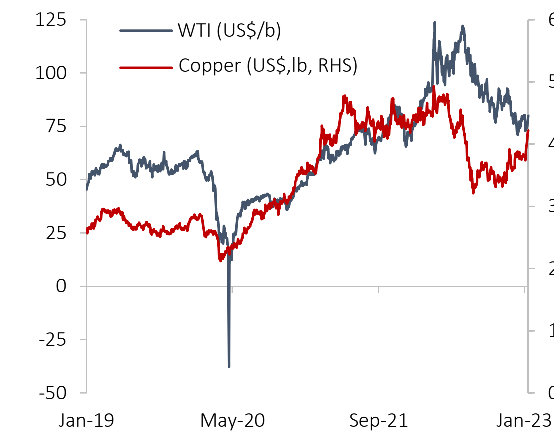
Source: Bloomberg and Santander

Commodity prices will rise only marginally

In early 2022, the war in Ukraine and sanctions against Russia triggered record-high commodity prices, particularly for grains, oils, gas and oil. The latter was also influenced by OPEC's expanded production cut policy, which had a high degree of compliance throughout the year. However, as the months passed, the stalemate in the war and concerns about global growth led to a significant decline in grain and oil prices, which were at pre-war levels as early as the third quarter.

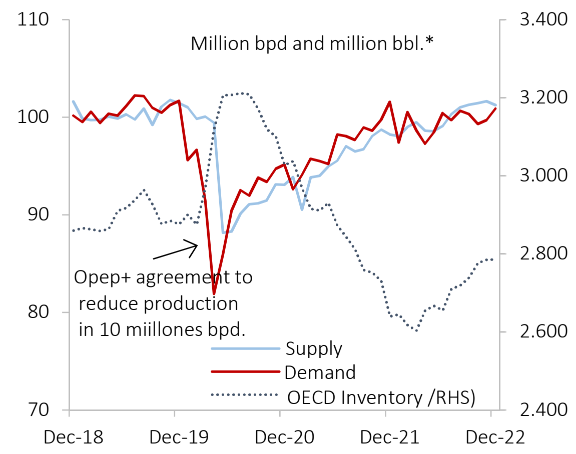
The copper price, while not rising aggressively with the war, remained high until the first part of the year. However, from the third quarter onwards, with the slowdown in China and the tightening of monetary conditions, it fell sharply to around US$ 3.5 per pound. The decline was mitigated by lower ore supply, mainly due to lower production in Chile. Towards the end of 2022, the metal price showed a significant recovery due to better growth prospects in China and the market bets on a less restrictive monetary policy in the US.

Oil price went up and then down in 2022, contrary to the copper price



Source: Bloomberg and Santander

Oil demand stagnates, supply shows incipient recovery



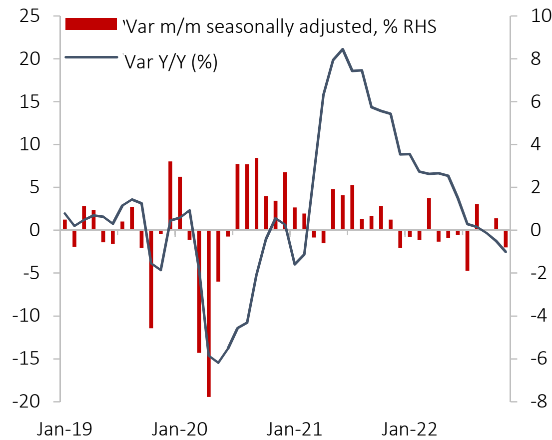
(*) bpd: barrels per day, bbl: barrels
Source: Bloomberg and Santander

This year, different forces will pull in opposite directions on commodity prices. In the case of oil, while slower growth in the US and Europe could affect demand, the prolongation of the war and OPEC restrictions will keep supply tight, pushing oil prices up. Thus, by the end of 2023, crude oil could reach values close to US$ 85 a barrel. In the case of copper, its price has been under upward pressure in the first weeks of this year not only because of the greater dynamism of China but also because of concerns about possible disruptions in supply due to political tensions in Peru. As the latter is gradually resolved, the value of the metal could fall back moderately to levels close to US$ 3.9 per pound, which is what we expect to happen by the end of the year.

The local economy will face a recession

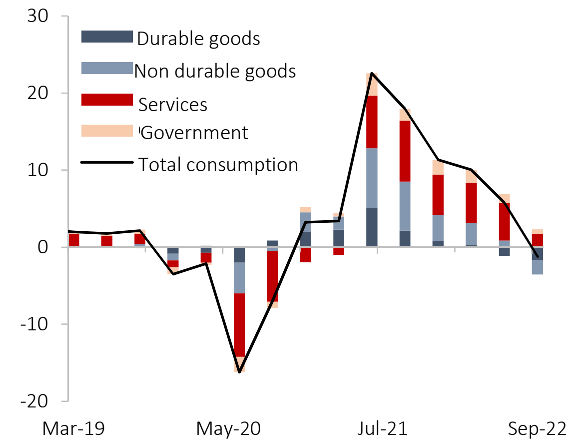
The Chilean economy underwent a major adjustment in 2022, with a significant decline in growth. The year began with superior levels of activity, supported by strong consumption due to the high level of liquidity still available at the time. However, during the second and third quarters, consumption of goods began to fall sharply, reflecting the tightening of monetary conditions and the negative impact of the inflationary shock on real wages. Consumption of services, on the other hand, continued to normalise and settled around its trend values from the second quarter of the year onwards.

Local activity contracts, in line with expectations



Source: Central Bank and Santander

Moderation in consumption leads to the adjustment in domestic demand

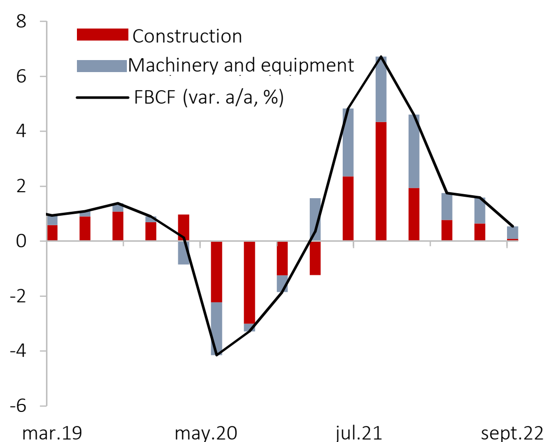


Source: Central Bank and Santander

Investment, which had closed 2021 with high dynamism, fell sharply at the beginning of last year due to the stagnation of projects amid uncertainty over the political scenario. Nonetheless, there was a strong rebound in the third quarter, with increases in both construction and the machinery and equipment component. However, exports remained low for much of the year due to subdued demand from major trading partners and the problems faced by mining in Chile, which sharply reduced copper production.

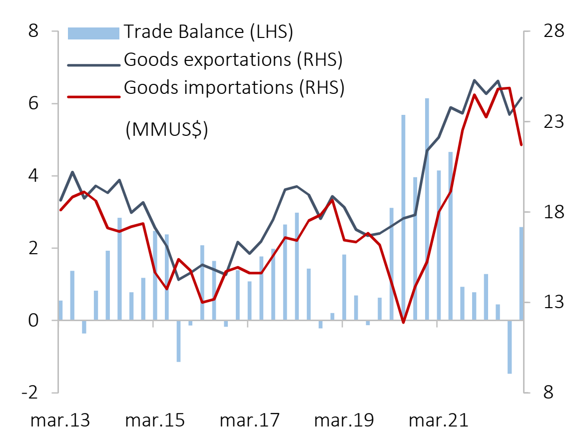
According to trade data, consumption is said to have moderated its declines during the last quarter, but the investment is said to have resumed its downward path. Therefore, we estimate that 2022 would have closed with GDP growth of around 2.6%, in line with the 2.5% projected in our Outlook 2022 report.

Investment moderates less than anticipated



Source: Central Bank and Santander

The year closes with a significant reversal in the trade balance



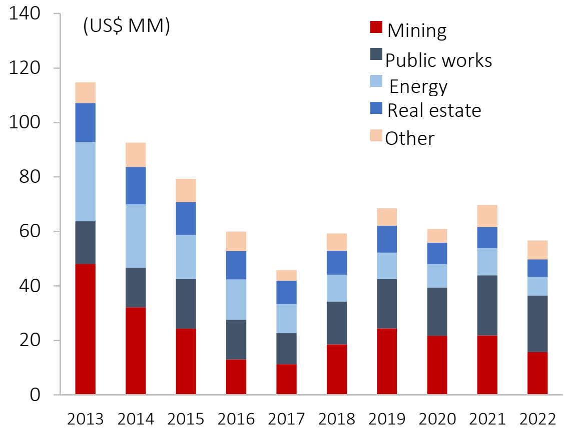
Source: Central Bank and Santander

The current account deteriorated significantly during the year due to the fall in domestic savings and investment recovery. In the case of savings, it was not only the high level of consumption that played a role but also the fall in terms of trade and the large inflow of payments abroad for income from production. However, by the end of 2022, the rebound in exports and the decline in imports would have mitigated the deterioration in the external accounts, ending the year with a current account deficit of almost 9% of GDP.

By 2023, our baseline scenario assumes that the economy will continue its adjustment and face a recession, pushing GDP below trend levels. This is explained by the tight financial conditions facing households and businesses, a deteriorating labour market with slow job creation and falling real wages, and a weak international environment with the possibility of a recession in advanced countries. Added to this are levels of political uncertainty, although lower than a few months ago, still high due to the constitutional process. Thus, we estimate that after a partial rebound in last year's last quarter, GDP will fall back in the next two quarters before resuming an expansionary path in the second part of 2023. Hence, the economy will end the year with a change of around -1.25%.

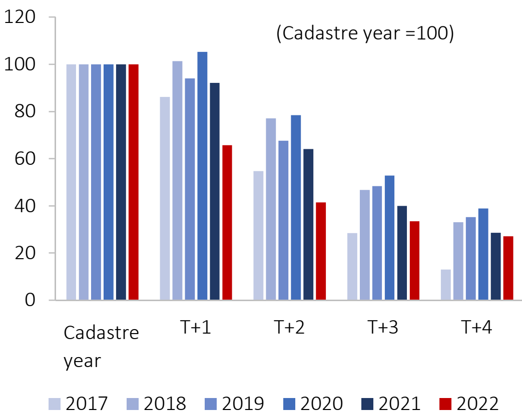
Private consumption will continue to fall for much of 2023, especially in the goods sector, with a change of -4.7%. Government consumption, meanwhile, will grow by 3.2%, in line with what was approved in the last budget. On the other hand, after the recovery shown during 2022, the investment will decline by around 5%. Background information from the latest *"Corporación de Bienes de Capital"* (Capital Goods Corporation, CGC) cadastre suggests this development, with projects for this year and the following years considerably smaller than those for 2022.

Investment for the next five years falls to a 5-year low



Source: CGC and Santander

Projects for the following years for substantially less than in 2022



Source: CGC and Santander

Despite a fragile international scenario, exports will show a moderate increase, close to 1%. This will be influenced by the low base of comparison in 2022, the increased dynamism of China and the lagged effects of a depreciated real exchange rate.

Lower consumption will lead to a recovery in national savings despite a fall in national income. Combined with weak investment and the normalisation of import costs, this will allow the current account deficit to fall back to around 5% of GDP by 2023.

In 2024, the economy will recover its growth and approach its trend level with an expansion of 2.5%.

Risks to activity are skewed to the downside. First, external risks could lead to a deep global recession, affecting our economy through different mechanisms. Second, there is the possibility of monetary over-tightening, delaying the recovery of GDP in the second part of the year. Finally, political risks could impact the business climate and further affect investment and activity.

The bill's dismissal to allow self-borrowing from pension funds has removed one of the most important stress factors in the short term. Nevertheless, a constitutional reform allowing further pension fund withdrawals, as proposed by some parliamentarians, would lead to a sharp increase in risk premium, a depreciation of the currency and new inflationary pressures that would force the Central Bank to tighten monetary policy further. While this potential liquidity injection would mitigate the economy's contraction in the short term, the tightening of financial conditions would cause the country to face a severe recession in 2024.

A weakening labour market

In early 2022, the labour market continued to recover from the pandemic. Both employment and labour force grew at a strong pace in the first few months, helped by a low comparison base. Nonetheless, job creation slowed in the second half of the year, against a background where demand for labour fell systematically after the record levels at the end of 2021. Furthermore, the labour force stopped expanding, leaving the unemployment rate unchanged at around 8% since March.

Therefore, the gaps created by the pandemic remained open. Indeed, at the end of 2022, the labour participation rate was still 4 points below trend, corresponding to more than 650,000 fewer people, and jobs were about 160,000 fewer than at the end of 2019.

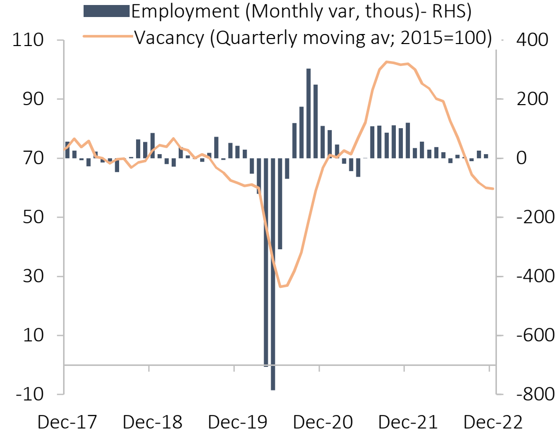
Meanwhile, formal employment has lost momentum. While INE figures revealed relative stability in formal employment during the year, AFP and unemployment insurance contributors have declined since the beginning of 2022.

Nominal wages have risen significantly since the end of 2021, mainly due to indexation clauses. Nevertheless, the magnitude of the inflationary shock in real terms drove them to close with a fall of almost 2.5%. This, coupled with stagnating job creation, has caused the wage bill to fall since the middle of last year, moving away from its trend.

The unemployment rate tends to rise marginally

Source: National Institute of Statistics and Santander

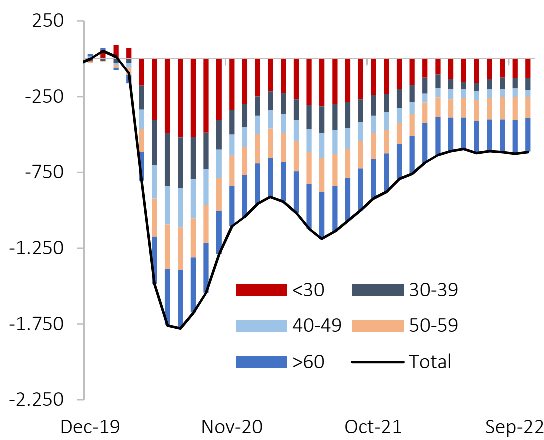
Job creation loses momentum, along with a significant drop in demand for labour



Source: Central Bank, National Institute of Statistics and Santander

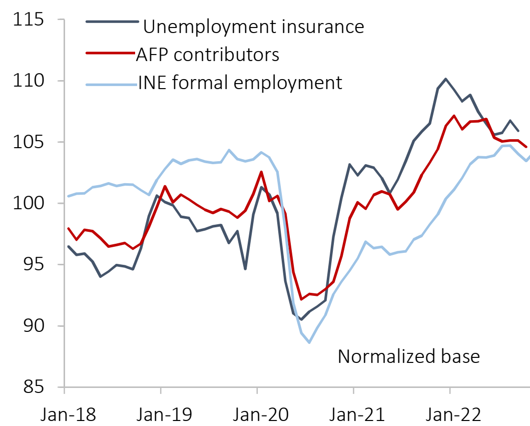
During 2023 the labour market will continue to weaken. Vacancies for new jobs have receded and are below pre-pandemic levels. Over the year, as economic activity continues to contract, demand for labour is likely to remain subdued, causing employment to remain low. On the other hand, the low labour force participation could be partially reversed.

Labour participation remains below pre-pandemic levels



Source: National Institute of Statistics and Santander

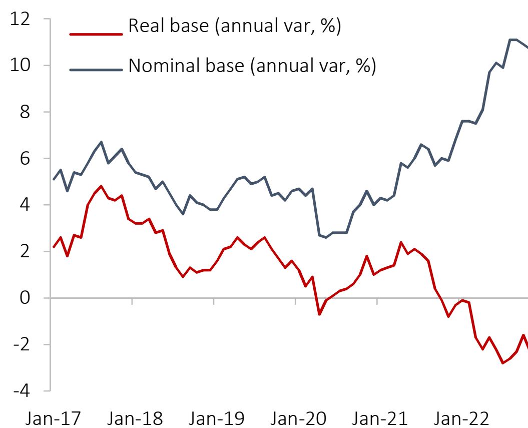
Formal employment declines



Source: National Institute of Statistics, Superintendency of Pensions and Santander.

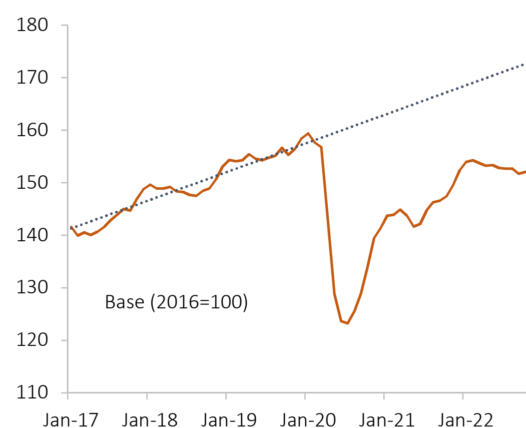
This phenomenon has been related to several factors, including the income effect caused by liquidity injections, the early retirement of older people and the low participation of young people. However, in the future, as the income effect fades and younger generations return to work, we will see a greater re-entry into the labour force. As a result, the unemployment rate will likely rise and average 8.5% for the year.

Real wages shrink due to inflationary shock



Source: National Institute of Statistics and Santander

Wage bill deviates from the trend



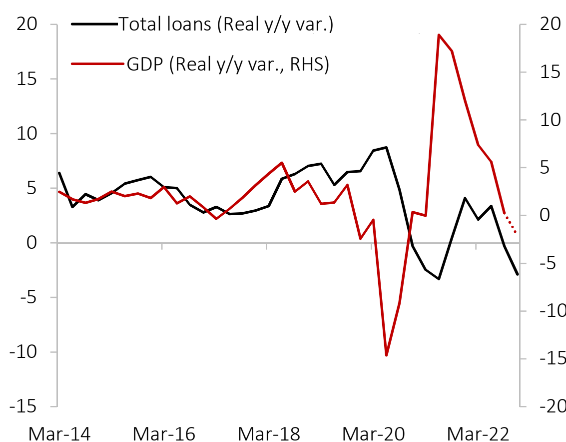
Source: National Institute of Statistics and Santander

Bank lending declines, and liquidity returns to trend levels

Bank lending fell sharply in 2022 following the heavy leveraging during the pandemic. In the first part of the year, credit grew by an average of 3% in real terms but then gradually declined to close the year with negative annual changes (-3% in real terms). The commercial segment - which accounts for 60% of loans - contracted by almost 6% in a context of tighter credit standards, high-interest rates - as high as 15% per year - and lower demand for loans in the absence of major investment plans. Non-performing loans in this portfolio tended to increase, surpassing pre-pandemic levels (1.9% of loans in November).

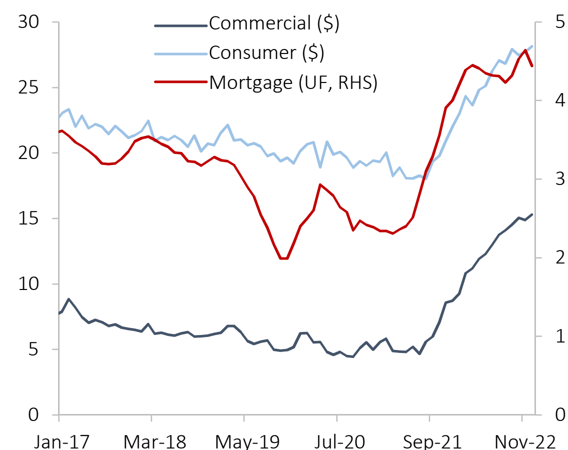
Consumer credit also declined in 2022 (-2.5% real), in line with the reduction of household consumption and tighter financial conditions. While expanding, the stock of housing loans did so in a limited way (only 1% at the end of 2022).

Credit slows in line with GDP moderation...



Source: Central Bank and Santander

... and tighter financial conditions due to higher interest rates



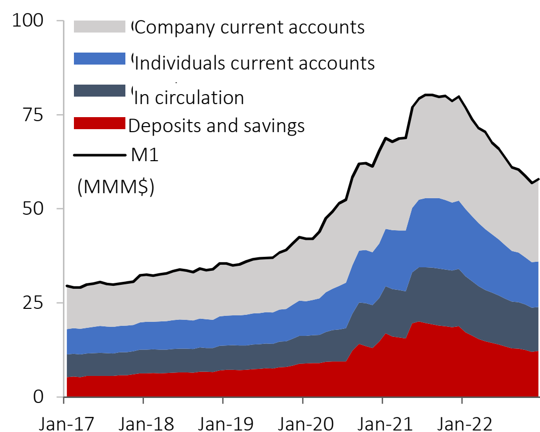
Source: Central Bank and Santander

Monetary aggregates continued to decline as people used their liquidity to finance spending, and high rates encouraged deposits. As of December 2022, the most liquid balances showed a fall of 28% and represented just over 8% of GDP, consistent with the historical trend.

In the coming months, the credit will remain weak. However, it should recover moderately in the year's second half as the economy returns to an expansionary path and monetary conditions loosen. To date, lending conditions are generally perceived to be tight, according to the Central Bank's Credit Survey.

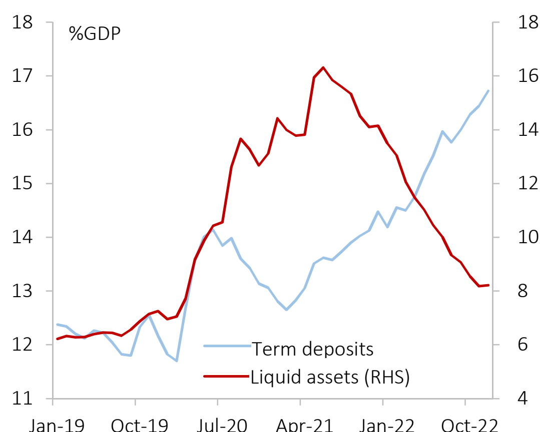
Nevertheless, in the case of SMEs, loans would be favoured by the Fogape Chile Apoya programme, whose objective is to encourage financing for working capital, investment and debt refinancing under favourable financial conditions (maximum interest rate of MPR+5% per year). Meanwhile, mortgage loans will be supported by the government's new programme that will provide a state guarantee to finance up to 10% of the house's value. A moderation in property values may also contribute, allowing for a rebound in real estate sales (see Box). Thus, for the year, we project total loans to have zero real change and to recover in 2024.

Monetary aggregates retreat



Source: Central Bank and Santander

Some of the excess liquidity goes into term deposits

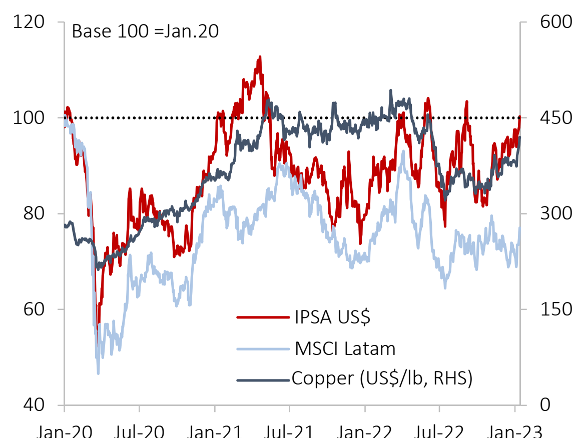


Source: Central Bank, Financial Market Commission and Santander

Despite high volatility, local markets end 2022 with positive results

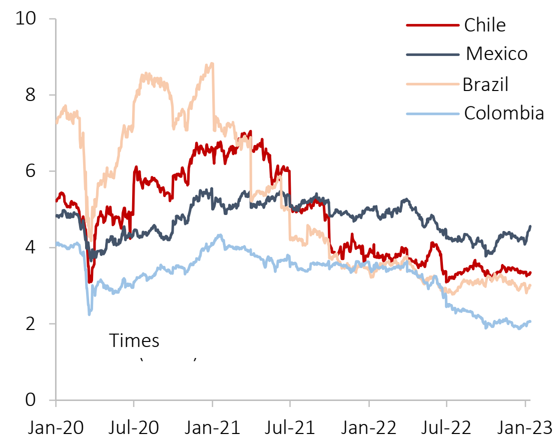
At the beginning of the year, global financial tightening and domestic political uncertainty over the constitutional process kept local assets punished. Long-term interest rates continued their upward trend since mid-2021, and the exchange rate rose sharply. In July, the sharp downward correction in the copper price from US$4.4 per pound, on average between January and June, to US$3.5 per pound, combined with speculative positions against the Peso, pushed the parity above $1,000 per dollar, deviating from its fundamentals. As a result, the Central Bank announced a massive foreign exchange intervention programme, with spot and forward sales of up to US$25 billion.

In a year of high volatility, the local equity index closed higher



Source: Bloomberg and Santander

Local shares remain cheap, according to the utility price ratio



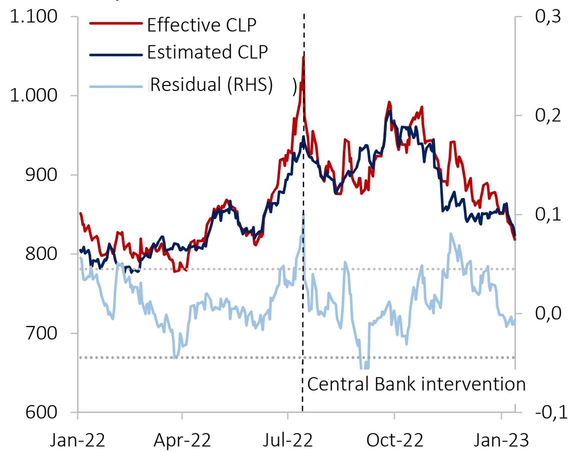
Source: Bloomberg and Santander

The intervention was successful, and by the middle of the third quarter, the exchange rate had fallen back to levels consistent with its fundamentals. As a result, the stock market remained on an upward trend in the first months of 2022, albeit with swings, driven in one direction by a favourable appetite for emerging markets and rising commodity prices - particularly for lithium - and in the other by tighter financial conditions.

Despite being rejected by Congress, the discussion of a "fifth" pension fund withdrawal gave a negative signal for the capital market and the future of the pension system. This pushed the country's risk premia up to levels not seen since the start of the pandemic (CDS5y: 108 bps). In this context, Chile suffered a downgrade of its sovereign rating.

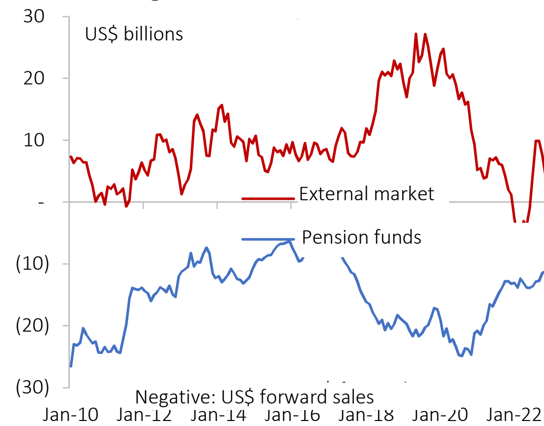
In the second part of the year, as financial conditions became less tight and domestic political uncertainty abated following the constitutional referendum, local assets tended to rise. As a result, the stock market closed the year with a gain of more than 20% (IPSA: 5,260 points), and the exchange rate appreciated to levels similar to those at the end of 2021 ($850, consistent with the projection of our Outlook 2022 report). Global dollar depreciation and the partial recovery of copper also played a role in the exchange rate stabilisation. The bond market, meanwhile, benefited from a decline in nominal long-term rates, which fell by about 30 bps to 5.3%, and in real rates, which declined by 60 bps to 1.7%.

After depreciating sharply, the exchange rate ends the year on a downward trend



Source: Bloomberg and Santander

Position in foreign currency derivatives reflects lower bets against the Peso



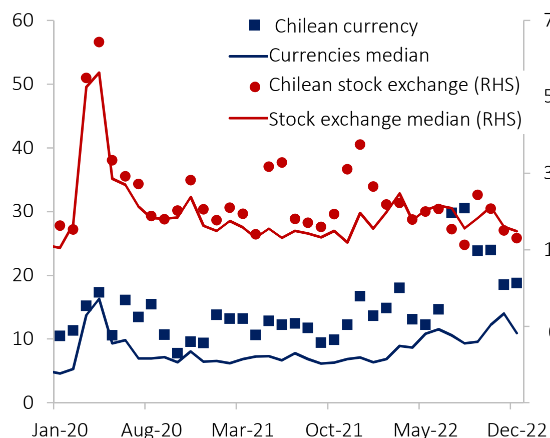
Source: Central Bank and Santander

Beyond these trends, the unusual volatility of Chilean asset prices has been notorious. The standard deviation of the Peso reached 20% per year, twice the median of a sample of 19 developed and emerging countries, and something similar occurred in the case of the stock market. One of the reasons was the decline in market liquidity due to pension fund withdrawals. As a result, equity and fixed-income exchange-traded amounts declined by 18% and 22% between 2021 and 2022, respectively, while foreign currency spot transactions declined by 5%.

In the future, the exchange rate could exhibit some depreciation from its levels at the close of this report (around $820 per dollar), mainly due to a possible decline in the price of copper, after the high levels at the beginning of the year. However, the global dollar price should remain relatively stable and domestic political uncertainty limited. Thus, in our baseline scenario, we consider that by the end of 2023, the parity should be around $850 before rising to $860 in 2024.

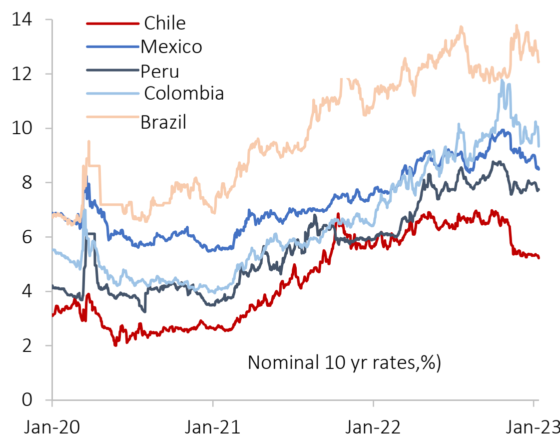
On the other hand, even though the fall in GDP could affect corporate earnings, we believe that the stock market could continue to rise, albeit modestly, boosted by high commodity prices and looser monetary conditions. As a result, long-term rates would continue to hover around current levels, with some downward bias in case the monetary easing process is faster than expected.

The volatility of financial assets exceeds that of other countries



Source: Bloomberg and Santander
Note: Median exchange rate volatility considers 19 advanced and emerging countries and 21 countries for the stock market.

Interest rates fall amid slower activity and inflationary pressures



Source: Bloomberg and Santander

After closing at historic levels, inflation starts the convergence process

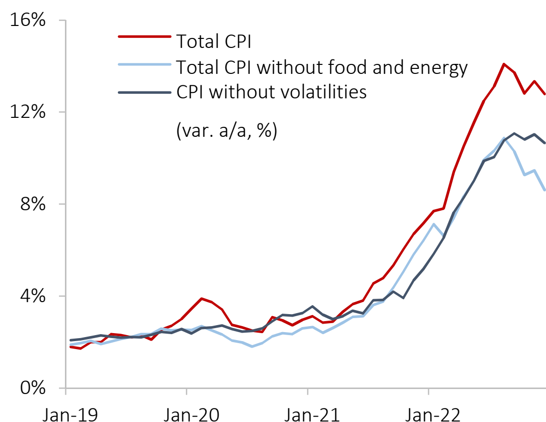
As in other countries, inflation climbed to levels not seen in decades and closed in 2022 at 12.8%, well above pre-war projections. Several elements were responsible for this phenomenon. On the one hand, there has been a fast expansion of domestic demand since mid-2021 due to the opening of the economy and strong liquidity injections in the context of rising costs globally. In addition, the significant depreciation of the Peso in the same period also contributed. On the other hand, as in the rest of the world, the rise in commodity prices due to the conflict in Ukraine also impacted prices.

Thus, the inflationary phenomenon, which had originated largely from local elements, was reinforced by global factors that put pressure on food and energy prices in particular. As a result, core inflation, which excludes these two components, had a smaller increase, closing 2022 at 8.6%.

By product type, goods prices (excluding volatile goods) rose sharply by 14.9%. Services (excluding volatility) rose by a lower 7.6%, reflecting the slowdown in domestic demand during the year and a weak labour market. It also favoured the freezing of electricity tariffs and the metropolitan region's transport system. Nevertheless, inflationary diffusion was broad-based, with a large percentage of the products in the reference basket showing price increases, reflecting the widespread nature of the phenomenon.

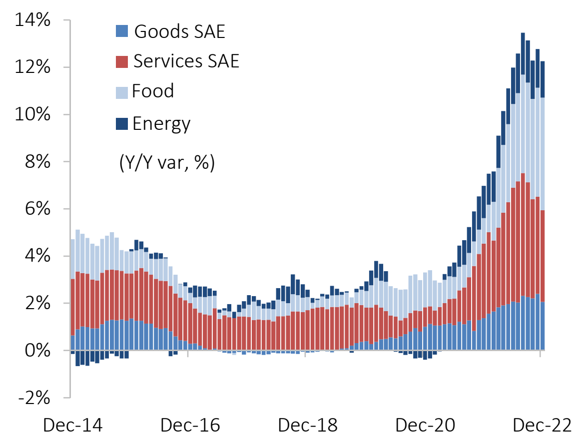
In the latter part of 2022, moderation in price increases became evident. Fuel prices declined, reflecting the appreciation of the exchange rate in the last weeks of the year and the fall in international oil prices. Food prices continued to rise sharply, but goods prices - excluding volatile goods - and services prices moderated.

Inflation rose sharply through mid-year



Source: National Institute of Statistics and Santander

Food and energy are responsible for a large part of price rises

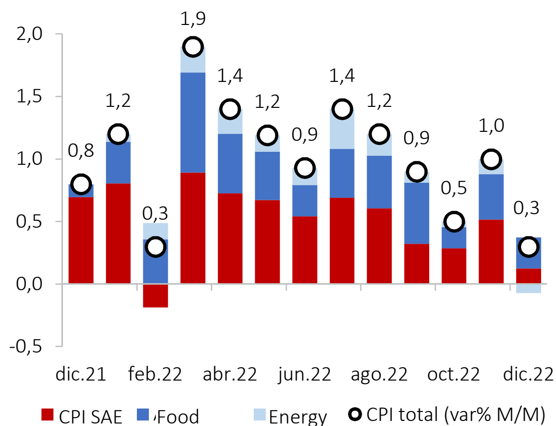


Source: National Institute of Statistics and Santander

Inflation is expected to remain on a downward trend in the coming period. On the one hand, international oil and food prices are expected to stabilise. On the other hand, the liquidity drain at the local level and the slowdown in domestic demand will continue to squeeze margins. The weak labour market and the strengthening of the Peso intensify this. Nevertheless, some elements will make the decline in inflation gradual at first. Specifically, the indexation of some high-incidence services, such as education, will be felt in the coming months. In addition, the unfreezing of electricity and Transantiago fares could put some pressure on the CPI over the year. The VAT application to several services that were exempted could have some impact on January values, but this would be limited. Then, from the second quarter onwards, we will see a marked decline in inflation, which we project to be around 4.75% by the end of this year. Convergence to the 3% target would occur by the end of 2024.

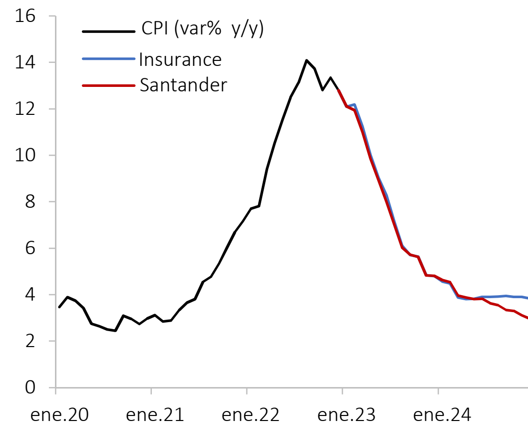
There are both downside and upside risks to the price trajectory. If the exchange rate and fuel prices remain at similar levels to those at the close of this report throughout the year - lower than in our baseline scenario - inflation could close in 2023 at around 3.5%. Furthermore, a reform allowing further pension fund withdrawals would cause inflation to remain high throughout the year, closing the year in double digits again. This risk is exacerbated by all those related to the international scenario.

Prices showed signs of moderation in the latter part of the year



Source: National Institute of Statistics and Santander

In the future, we project inflation to fall systematically



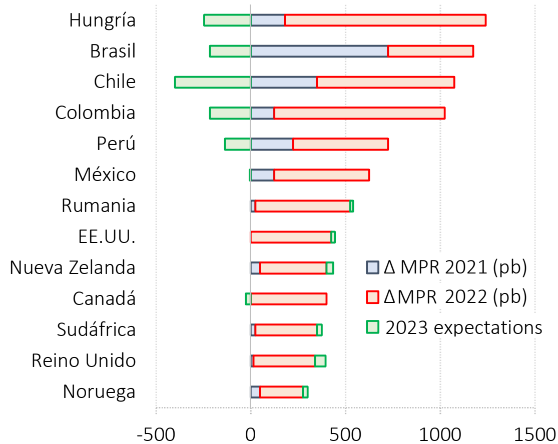
Source: Bloomberg, INE and Santander

Monetary easing in Chile could begin in the second quarter

To contain inflationary pressures generated by the economy's overheating in 2021, the Central Bank started 2022 with a significant increase of 150 basis points in the Monetary Policy Rate (MPR) at its January meeting. It was anticipated that the MPR could peak at 8% by mid-year and then begin to decline as activity and prices slowed.

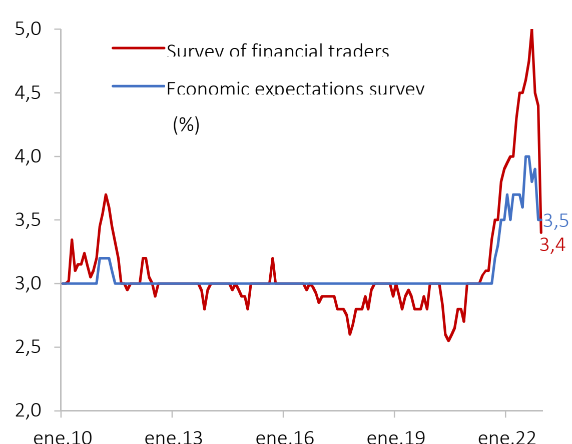
Subsequently, recurrent surprises in the CPI, which pushed medium-term inflation expectations well above the 3% target, prompted the Central Bank to accelerate rate hikes and raise the target level for the rate. In the October MPR, following signs that inflation might start to ease, the Council raised the MPR to 11.25% and announced that it would enter a pause period, ratified in the December IPoM. This brought the reference rate to its highest level since a nominal monetary policy instrument was used in the early 2000s, accumulating increases of 1,075 basis points, of which 725 basis points materialised in 2022. This was one of the most aggressive rises in the world.

Chile is one of the most aggressive countries in terms of rate hikes



Source: Bloomberg and Santander

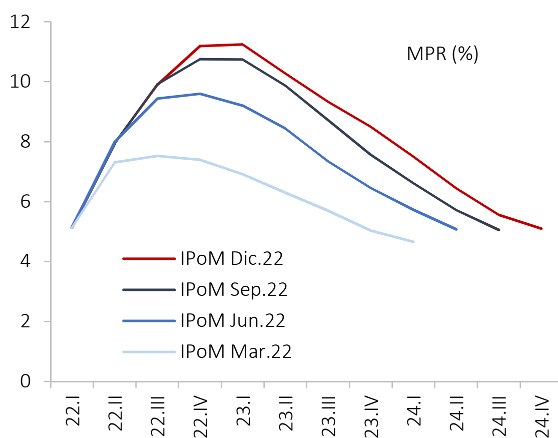
Medium-term inflationary expectations begin to recede



Source: Central Bank and Santander

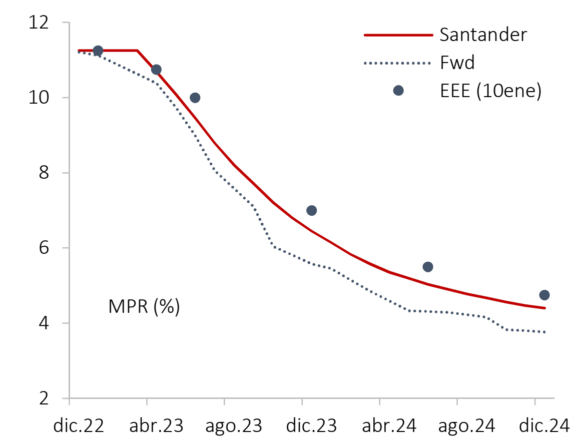
One of the elements that forced the maintenance of a tight monetary stance was the misalignment of inflationary expectations over the policy horizon. Nevertheless, more recently, they have fallen back to levels close to 3%. We, therefore, expect the Council to enter a period of cutbacks in the coming period, consistent with the economic slowdown and lower inflation.

Central Bank systematically adjusted the MPR trajectory upwards during 2022



Source: Central Bank and Santander

Monetary easing could start in the second quarter of the year



Source: Bloomberg, Central Bank and Santander

In the most likely scenario, we expect the first decline in the MPR to occur at the April meeting, which will be between 50 and 75 basis points. By that time, the Council will have the CPI data for January and February - the March register is published two days after the Monetary Policy Meeting - which we expect to show a moderating trend in prices. After that, the rate will continue to fall at each subsequent meeting, ending 2023 at around 6%. Then, in 2024, additional cuts will bring the MPR closer to its neutral value - which we estimate to be around 4.25%.

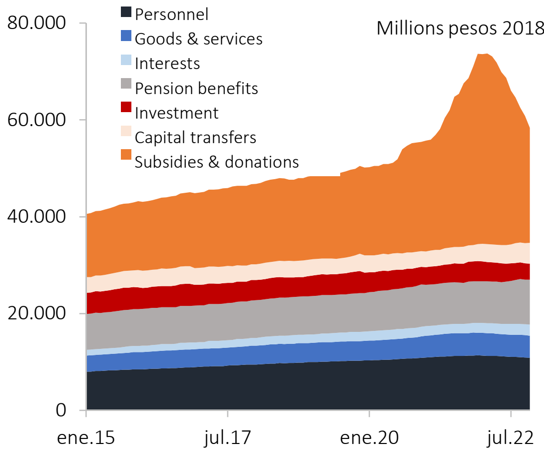
If the downside risk scenario for inflation is fulfilled, the cuts could be faster. This seems to be implicit in the swap rates, which envisage an MPR between 5.5% and 5.75% by the end of 2023. Alternatively, discussing a new withdrawal of pension funds in Congress could inhibit the Council from lowering the rate later. In this case, however, subsequent cuts should be aggressive as inflation falls.

That said, the risk of not acting in time and delaying MPR cuts in the context of falling inflation is that real interest rates will continue to rise and lead to a sharper slowdown in activity, causing a recession this year and jeopardising the recovery next year.

Fiscal figures improve temporarily

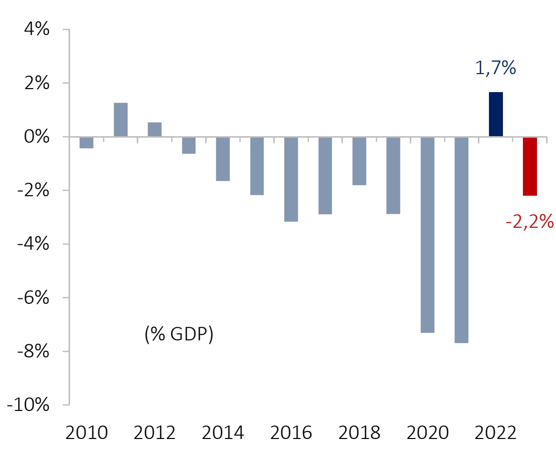
After a highly expansionary 2021, the year 2022 was marked by significant fiscal restraint after the withdrawal of state aid led to an unprecedented 25% drop in public spending at the end of the year. Revenues, meanwhile, surprised on the upside, with favourable tax collection and the contribution of the new lithium royalty, which involved extraordinary revenues of almost MM US$4,000. As a result, tax revenues grew by 7%, and the fiscal balance closed with a surplus of close to 1.7% of GDP. Meanwhile, public debt fell for the first time in ten years and closed, according to our estimates, at 35% of GDP.

Sharp adjustment in public spending due to lower transfers



Source: Dipres and Santander

Fiscal accounts close in surplus in 2022 but deteriorate this year

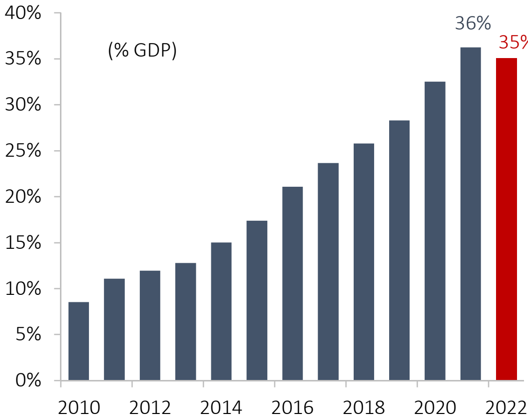


Source: Dipres and Santander

In 2023 the fiscal figures will again show a deterioration. Spending will grow by around 5.5% in real terms, considering the provisions of the budget law and some of the new spending contained in the announcements of support for families made earlier this year. Meanwhile, revenues will fall by close to 9% in real terms due to lower activity and the non-recurrence of some phenomena that made the 2022 income operation particularly high. As a result, the fiscal balance will return to a deficit of 2.2% of GDP, bringing gross debt to 37%.

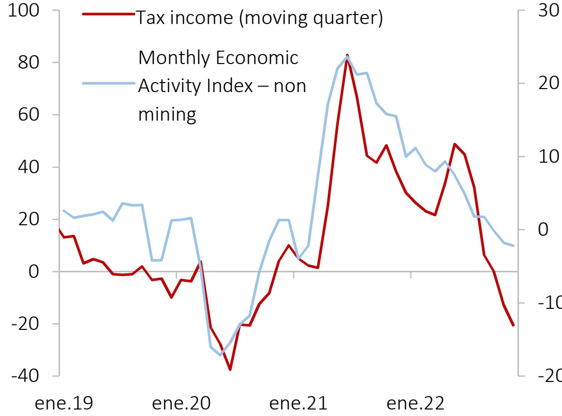
This year's macroeconomic and social context will be particularly challenging for fiscal management. The government will be under strong political pressure to expand spending to compensate for the loss of purchasing power of wages. Unfortunately, a stronger fiscal impulse would contradict the demand containment effort in which the Central Bank has been engaged. If so, interest rates would come under upward pressure, and new inflationary outbreaks are possible. It will therefore be important to ensure macroeconomic policy coherence that any additional assistance package is within budgetary parameters.

Gross debt falls for the first time in ten years



Source: Dipres and Santander

Tax revenues will decline as the economy shrinks



Source: DIPRES, Central Bank and Santander

Sectoral projections

Agriculture, forestry and fisheries: While climate issues are a persistent problem in the agricultural sector, the rains in 2022 reduced water stress. This suggests a better season early this year after the 8.2% drop in 2022. Furthermore, after rising sharply with the war in Ukraine, lower fertiliser prices will improve the sector's profitability, boosting agricultural production, which we estimate will grow by 5.8%. In 2022, the salmon industry benefited from a sharp price increase, which boosted production. As a result, good levels of production recovery are expected this year, although more demanding sanitary regulations could pose short-term challenges. Hence, we estimate a growth of 0.5%.

Mining: After a poor 2022 affected by structural factors - water access limitations at some sites - and one-off problems, the sector is expected to recover partially by 2023. This is partly explained by the operational start of a new mine and a possible improvement in ore grade, allowing the sector to approach its historical production levels. However, Codelco's postponement of the Rajo Inca project will limit further expansion. Nevertheless, we expect growth of 1.2% this year.

Electricity, Gas and Water: Although electricity generation did not increase significantly in 2022, the shift in composition from thermoelectricity to NCRE technologies involved the addition of a strong hike to the sector's value. This year's added value is expected to remain relatively constant, with sectoral GDP growth expected to be limited.

Manufacturing: After its rapid recovery in 2021, manufacturing performed poorly in 2022, contracting by around 1.9%. This year, the sector will be affected by a shrinking domestic demand and weakness in the external sector, which will fall again by 2.2%. Again, the branches linked to consumption and investment will be the most affected, while those oriented to exports could have a better performance this year.

Construction: Activity will be marked by falling investment and real estate activity. The progress of some large mining projects and further stimulus from public investment would provide some support. On balance, the sector will fall by 3.3%.

Trade, restaurants and hotels: Trade was one of the fastest expanding sectors in 2021 thanks to the boost in consumption. As household spending slowed in the second part of last year, business activity adjusted significantly and closed with a double-digit decline. This year, consumption will continue to contract, and trade will remain negative. On the other hand, restaurants and hotels had a later recovery when health restrictions were lifted. As a result, these services will have a limited performance this year. On the one hand, domestic demand for them will be weak. Nevertheless, it is possible that demand from foreign tourists may partially compensate, especially in the summer.

Business services: During 2022, business services were driven by advertising, consulting, in particular engineering, and, during the first quarter, by staffing services amid high labour demand and returning to face-to-face work, growing 6.0% in the year. During 2023, the expected sharp fall in investment with a weakened construction sector, and the deterioration of the labour market, will imply lower demand for these services. The sector will thus show a contraction of 1.1%.

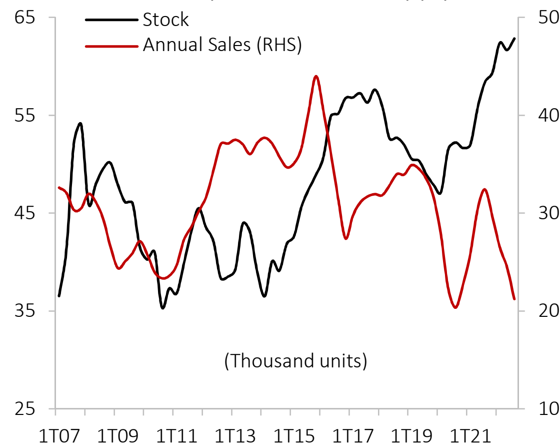
	2020	2021	2022 (e)	2023(p)	2024(p)
Agriculture and forestry	-1,8	2,3	-6,9	5,1	2,4
Mining	2,3	-0,6	-4,3	1,2	0,8
Manufacturing	-3,3	8,3	-1,9	-2,2	2,2
Trade, restaurant and hotels	-10,5	24,1	0,3	-4,8	2,1
Transportation and telecommunication	-8,0	11,5	13,2	-1,5	3,0
Business and Financial Services	-1,6	9,1	3,5	-1,7	2,1
Construction	-12,1	13,6	0,1	-3,3	0,8
Balance	-7,9	12,2	6,2	-1,1	3,4
Factor cost	-5,9	10,6	2,3	-1,36	2,29
GDP	-6,0	11,7	2,6	-1,25	2,5

Prospects for house prices

The monetary tightening cycle and the economic slowdown have particularly affected the real estate and construction market. High mortgage rates and a weakening labour market caused new home sales to decline sharply in 2022 (-40% YoY in annual flow to September). In addition, lower demand and higher supply, due to the completion of projects that were under construction, put downward pressure on real estate prices although, unlike in developed markets, without falling into negative territory. Thus, if these prices were increasing at double-digit annual rates (12%) by September 2021, they increased by only 4% in the first nine months of 2022.

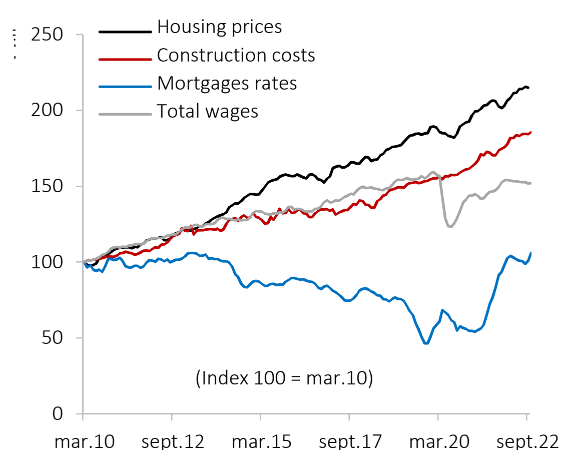
In the future, these values will be exposed to opposing forces. The economic slowdown and the weak labour market suggest a moderation in the wage bill, which would reduce the demand for housing. On the other hand, construction costs, which increased significantly until the middle of last year, are expected to ease as overall inflation moderates. These two elements will put downward pressure on prices. Additionally, the possibility of lower long-term interest rates once the Central Bank starts monetary easing could support higher values for house prices. Based on these elements, we estimate that house prices will continue to decelerate through 2023, ending the year with an annual change of close to 2% in real terms.

New house sales plummet, and supply rises



Source: CChC and Santander.

House prices reflect the movements of their economic determinants



Source: CChC, Central Bank and Santander.