Rate hikes moderate amid financial volatility

The recent tensions could significantly impact the economy and inflation, leading to a shift in the future monetary policy movements of the major Central Banks.

Highlights

- **Rate hikes cause financial instability.** Silicon Valley Bank's bankruptcy and Credit Suisse's collapse highlight one of the unintended consequences of the monetary normalisation process and lead to strong market volatility, with stock market drops, falling interest rates and falling commodity prices.

- **Authorities' quick intervention reduced the possibility of a deep financial crisis**. Nevertheless, the situation still calls for caution, as it is not yet possible to quantify the impact that volatility will have on global activity and the inflation outlook. Despite this, both the ECB and the Fed decided to implement further increases in their benchmark rates in March but moderated the forward bias.

- **In Chile, activity in 2022 ended with a 2.4% growth, lower than estimated due to one-off factors.** The latest figures suggest that the economy remains in an adjustment phase that will continue in the coming months before seeing an upturn in the year's second half. Consequently, we project GDP to fall by 0.25% in 2023. In 2024 we would return to the trend.

- **While February CPI surprised on the downside (-0.1%), measures of core inflation remain high.** The CPI excluding volatiles increased significantly for the second consecutive month, reflecting still elevated inflationary pressures. Nevertheless, after what we estimate to be a seasonally elevated March, inflation will start to decline and close 2023 at around 5%.

- **Financial volatility impacted local markets.** Although no liquidity problems were evident, the exchange rate depreciated, the stock market fell to one of its lowest levels of the year, and interest rates declined in line with international market movements.

- **The Central Bank would delay the rate cut to the third quarter.** Recent actual activity data have surprised on the upside, and core CPI has been somewhat above expectations. This would push the Central Bank to maintain the MPR at the current level for longer. We estimate that the first reduction will occur in July 2023, to end the year at around 7.75%.

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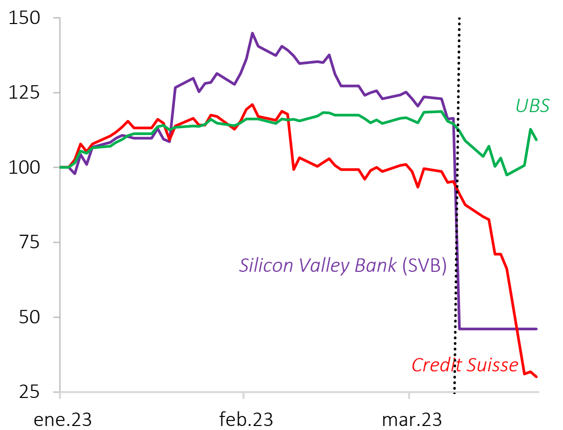
Financial turmoil calls rate hikes into question

The collapse of Silicon Valley Bank (SVB), following a run on its deposits, and the collapse in the stock market valuation of Credit Suisse (CS, subsequently bought by UBS for about US$ 3.2 billion) put markets on alert in recent weeks, generating strong volatility, and leading authorities to deploy contingency plans to ensure liquidity.

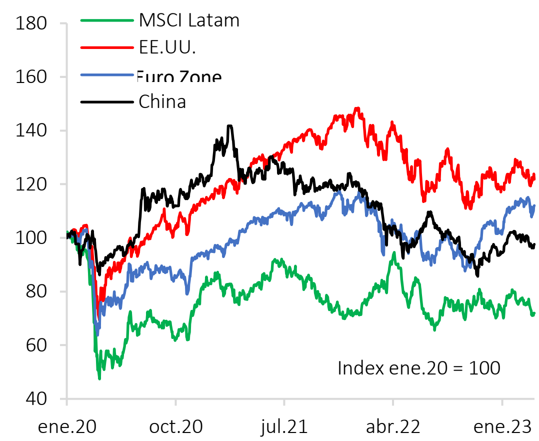
The fast government action helped shore up confidence and partially restored the value of riskier assets. Nevertheless, stock market indices declined across the board in the month (MSCI global: -1%; MSCI emerging: -3%; MSCI Latam: -6%; US and Eurozone: -1%). Moreover, the dollar, with swings, tended to depreciate (around 2%), long rates fell significantly (-40 bps on average so far this month, with US10Y below 3.5%), and commodity prices fell (aggregate index: -4%), in particular energy and agricultural commodities (-6%).

SVB collapse and Credit Suisse's fall triggered strong financial uncertainty



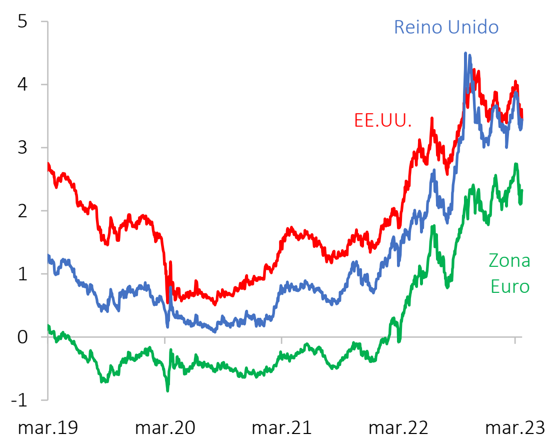
Source: Bloomberg and Santander

Stock markets tended to fall globally



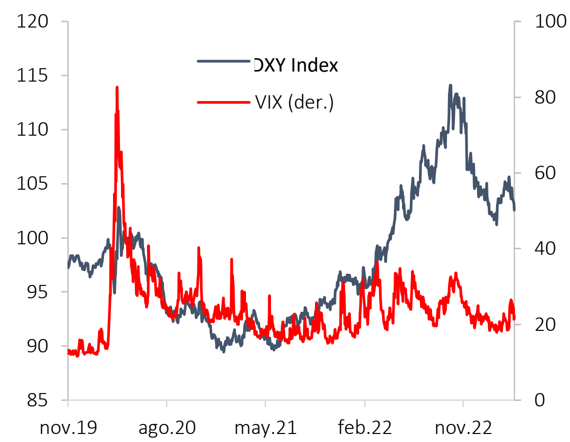
Source: Bloomberg and Santander

Long-term interest rates declined by around 40 bps on average in March



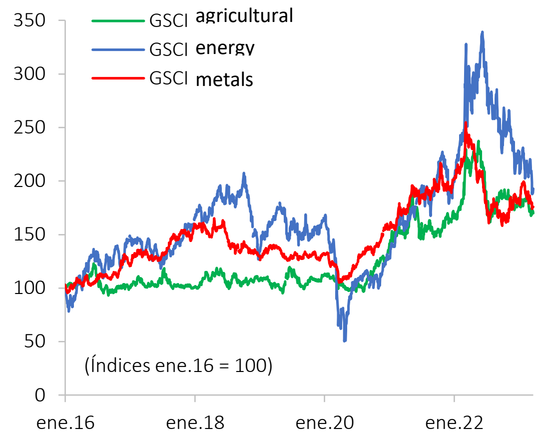
Source: Bloomberg and Santander

With volatility, the dollar ended the day with depreciation in multilateral terms



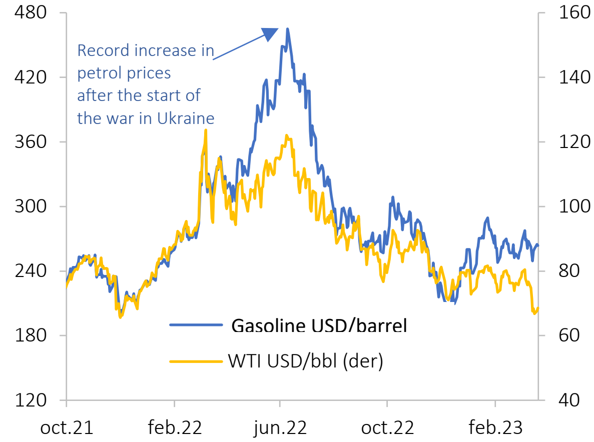
Source: Bloomberg and Santander

Commodity prices fall



Source: Bloomberg and Santander

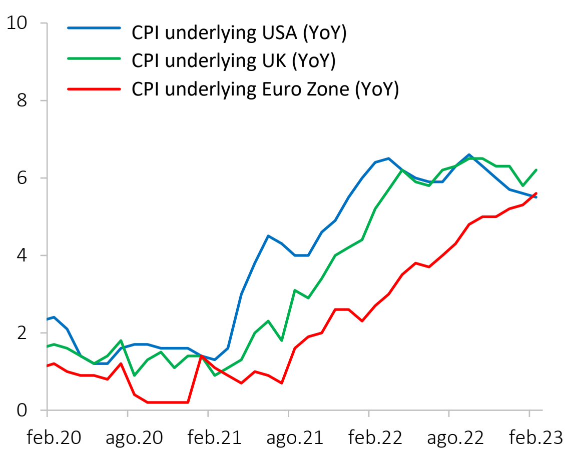
Fuel prices rise as refining spreads widen



Source: Bloomberg and Santander

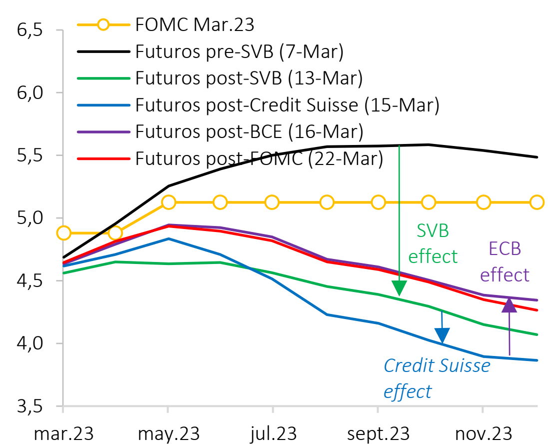
While the recent problems of the SVB and CS had specific causes, the common background is the sharp rise in interest rates over the past year due to the anti-inflationary policies of the major central banks. These episodes, therefore, pose a new dilemma for monetary authorities, who will have to worry not only about inflation - which remains high (6% in February in the US; 8.5% in Europe; 10.4% in the UK) - but also about avoiding a more acute problem of financial instability. In this context, the market made an abrupt shift in its bets regarding the Fed's actions, suggesting that the hiking cycle would end with the 25 bp hike of the last meeting and that during the second part of the year, we could start to see cuts. Nevertheless, the March FOMC dots remained at 5.1% for the end of this year, again generating a gap with market bets.

High inflationary pressures persist, especially in the underlying components



Source: Bloomberg and Santander

Banking tensions prompt turnaround in expectations for rate moves

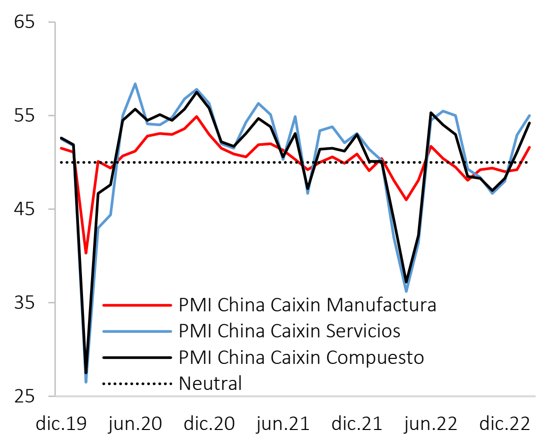


Source: Bloomberg and Santander

Meanwhile, at its March meeting - amid falling CS shares - the European Central Bank (ECB) decided to implement the expected 50 bps increase in its benchmark rate to 3.5%. In subsequent statements, President Christine Lagarde avoided mentioning future interest rate guidance and noted that the ECB stands ready to provide liquidity, if needed, to address problems in the financial sector. Nevertheless, as in the US, the market turned around and began to anticipate the end of the monetary tightening cycle before a prolonged pause in the year's second half.

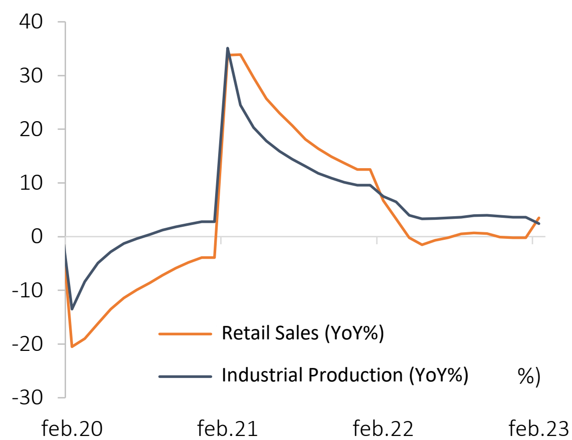
In China, after closing 2022 with an expansion of close to 3%, GDP growth expectations for 2023 have risen to around 5%. Moreover, the momentum after the announcement of the full reopening - overcoming the strict zero-tolerance Covid policy - pushed the economy into expansionary territory in February (manufacturing PMI: 51.6 vs 49.2 previously; services PMI: 55 vs 52.9 previously). Nonetheless, some sectoral figures gave mixed signals, with a significant rebound in retail sales (3.5% YoY vs -0.2% at the end of 2022) but a slowdown in industrial production (2.4% YoY vs 3.6% in December).

Reopening pushes China's economy back to expansion



Source: Bloomberg and Santander

Margin sectoral figures are mixed



Source: Bloomberg and Santander

The reopening of China, the resilience shown by the US labour market and less adverse weather conditions in Europe led the global economy to show signs of a rebound in recent records. In February, the global PMI was in expansionary territory (global composite PMI: 52.1 vs 49.7 previously), driven by the services component (52.6 vs 50 previously). Meanwhile, the OECD corrected its global growth expectations for this and next year to 2.6% (+40 bps) and 2.9% (+20 bps), respectively. The latter, added to China's reopening, is based on increased business and consumer confidence and falling food and energy prices.

Nevertheless, the impact of the recent financial tensions on global GDP remains to be seen. Even in the absence of a deep financial crisis, increased volatility and uncertainty may lead to a loss of confidence and a withdrawal of spending, which could impact real activity. Financial market developments in the coming weeks will be key to assessing the course of the global economy.

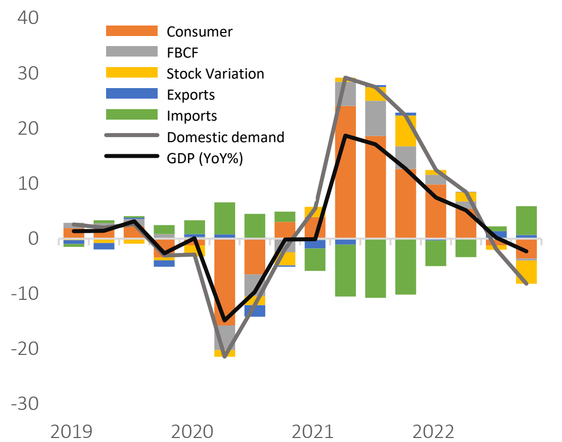
Chile's economy will continue to contract

The closing of National Accounts in Chile reflected an activity growth of 2.4% in 2022, somewhat below the 2.7% estimate based on the Imacec. The primary difference stemmed from the downward statistical adjustment in the last quarter due to financial fees paid abroad by Latam to exit its reorganisation process. This adjustment was fully reversed in the January Imacec, bringing activity to a level similar to October's. Domestic demand closed with a growth of 2.3%, in line with our estimates, from an expansion of 12.4% YoY in the first quarter to a contraction of 7.6% YoY in the last quarter of the year, with declines in all components, mainly consumption (-4.2% YoY in the last quarter) and inventory accumulation (0.6% of GDP in the last quarter).

By sector, the declines in the manufacturing branches since mid-2022 are noteworthy. The construction sector has also contracted, albeit at a slower pace than expected. After declining until mid-year, trade rebounded slightly in recent months due to the wholesale component associated with the sale of investment machinery. Despite the ups and downs due to statistical issues, the services sector has remained at high levels.

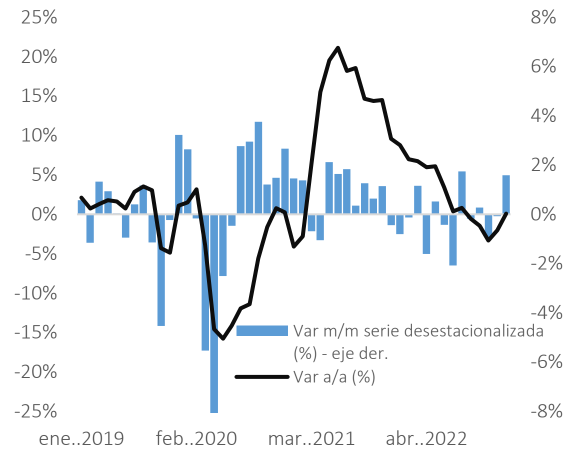
The external accounts showed a large deficit in 2022 (current account: -9% of GDP), impacted by the effects of the consumption boom until the first part of last year, the recovery of investment in machinery and equipment and high import prices in the first half of the year. Towards the end of the year, the deficit began to reverse as the terms of trade improved and domestic demand contracted. Nevertheless, the payment of Latam's financial fees caused the figures to close more negatively than estimated. The current account deficit would have been close to 8.6% of GDP without these fees.

GDP contracted further in the last quarter of 2022 due to lower consumption of goods



Source: Central Bank and Santander

The activity showed an acceleration in the latest data due to the reversal of specific factors

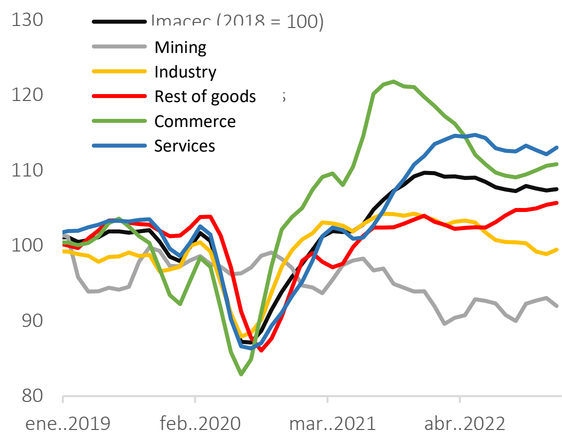


Source: Central Bank and Santander

Beyond statistical adjustments, the latest data confirm our earlier diagnoses. The economy remains in an adjustment phase, with a gradual contraction that, albeit less intense than estimated half through last year (due to, among other things, reduced political uncertainty and a high copper price) it still is expected to continue. Thus, we expect activity to shrink in the coming months with weakness in the domestic demand due to tight financial conditions, a lagging labour market and subdued global growth. However, a slight rebound could be seen in the second part of the year as financial conditions begin to ease.

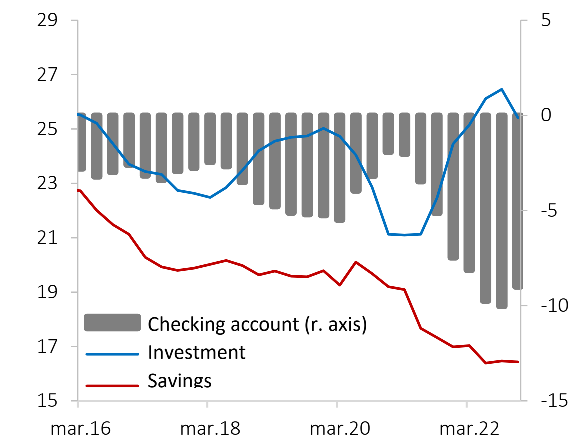
The recent financial stress due to the SVB bankruptcy and the collapse of CS could impact global growth and affect our economy. However, it is too early to assess such a contingency. Against this background, we revise marginally upwards our projections for growth for the year, from -0.5% to -0.25%, mainly due to the statistical effect of the lower base of comparison in the fourth quarter of last year.

The service sector has remained high, in contrast to the manufacturing sector



Source: Central Bank and Santander

Lower savings and rebound in investment lead to a large current account deficit



Source: Central Bank and Santander

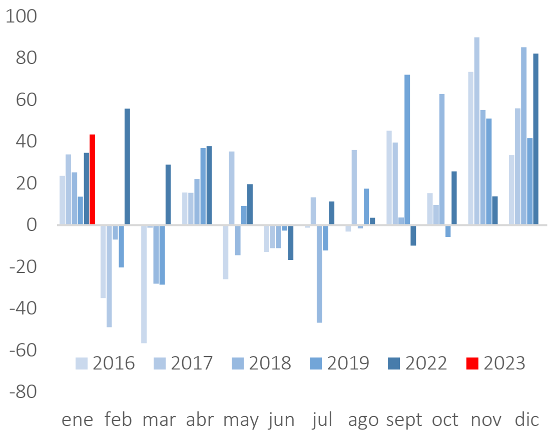
Seasonal factors accelerate job creation

The moving quarter ending in January saw an increase in the pace of job creation (43,000 new jobs), in line with the usual seasonal patterns associated mainly with agricultural activity. The labour force grew at a somewhat higher rate, resulting in a slight increase in unemployment to 8%.

The employment rate (employed to working age population) grew moderately but remains well below historical rates (55.8% vs 58.8% on average for the moving quarter ending in January in the pre-pandemic years). This means there is still a gap of almost 500,000 people out of work compared to a normal scenario. The sectors where the largest gaps remain are construction, manufacturing and trade. On the other hand, employment in services has returned to historical patterns.

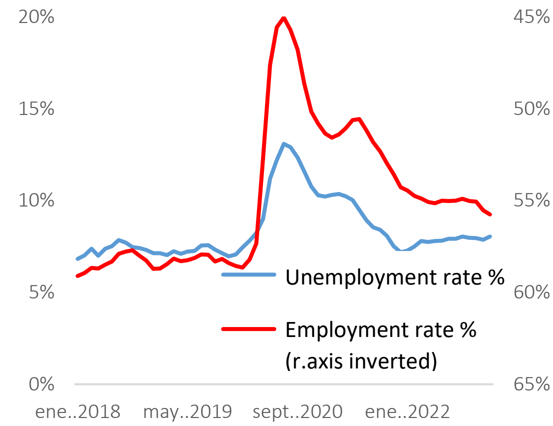
In the future, job creation is likely to moderate substantially. Seasonal factors aside, demand for labour, as reflected in the Central Bank's job vacancy index, has continued to contract and is at the lowest levels since the start of the pandemic. On the other hand, nominal wages have risen, albeit slower than inflation. In real terms, therefore, they continue to decline.

Job creation accelerates, partly due to seasonal factors



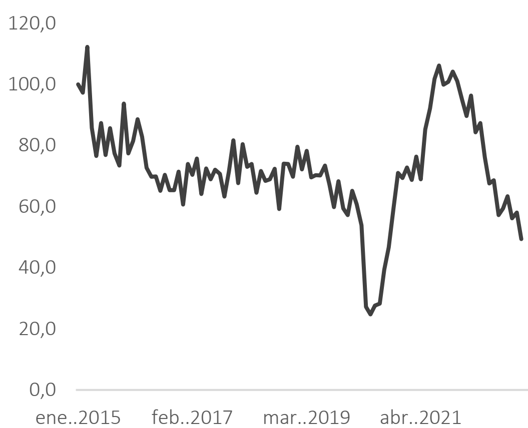
Source: INE, Superintendency of Pensions, Severance Fund Administrator (AFC) and Santander.

Employment rate remains below historical patterns



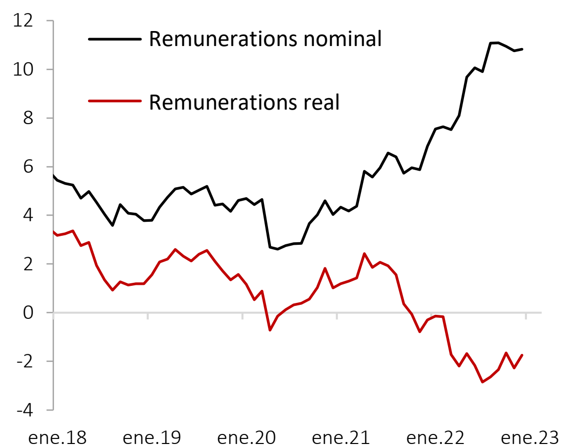
Source: National Institute of Statistics and Santander

Vacancies at the lowest levels since the pandemic



Source: National Institute of Statistics and Santander

Wages continue to suffer from high inflation and continue to fall in real terms

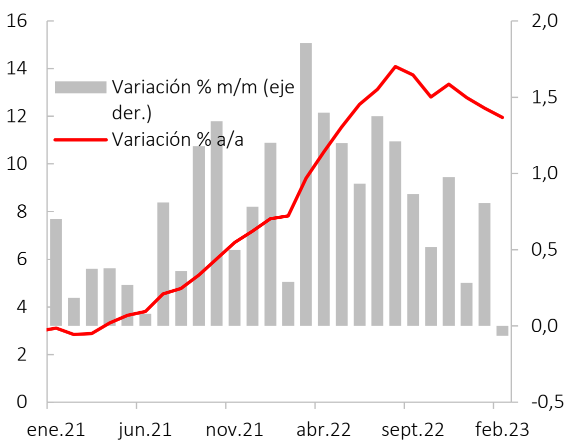


Source: National Institute of Statistics and Santander

Despite the negative record in February, inflationary pressures remain high

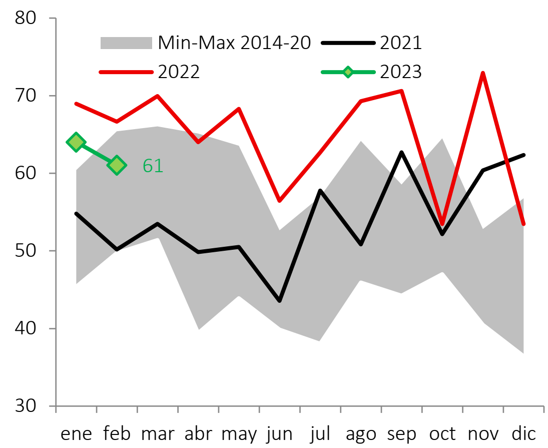
February CPI (-0.1% MoM) was below expectations (Bloomberg: 0.2%; Santander: 0.2%; inflation insurance: 0.3%) and the first negative reading since November 2020. This brought the annual price change down to 11.9% (12.3% in January). The month's decline was mainly due to sharp falls in airfares and package tour prices, two highly volatile items, alongside seasonally lower food and fuel prices due to decreasing international costs and the exchange rate appreciation. The CPI excluding volatiles had a high monthly change of 0.7%, similar to that recorded in February of the previous year. As a result, its annual change rose slightly to 10.7% (10.6% in January). Furthermore, the inflation diffusion index, which measures the percentage of basket prices rising in a given month, fell back to 61% within historical patterns for February, albeit at the high end.

CPI surprises with negative monthly change in February



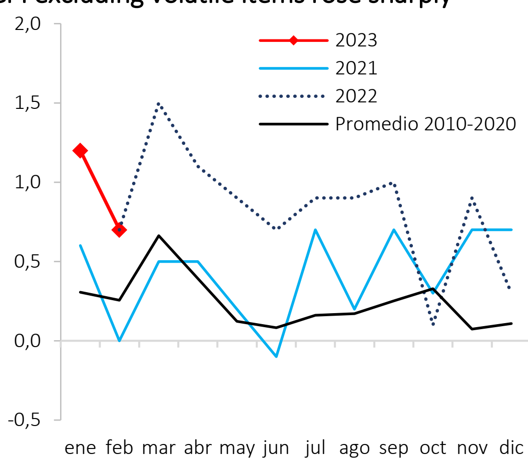
Source: National Institute of Statistics and Santander

Inflationary diffusion within historical patterns, but on the high side



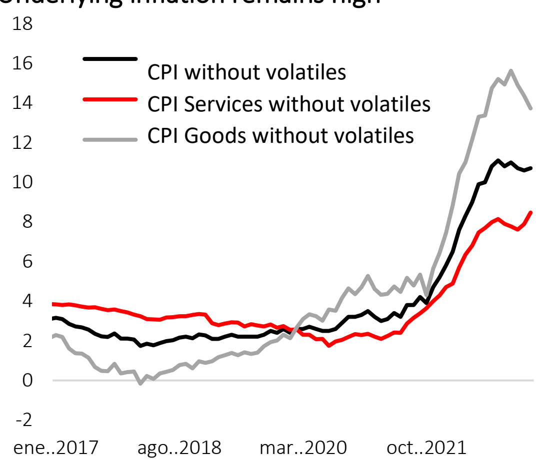
Source: National Institute of Statistics and Santander

CPI excluding volatile items rose sharply



Source: National Institute of Statistics and Santander

Underlying inflation remains high



Source: National Institute of Statistics and Santander

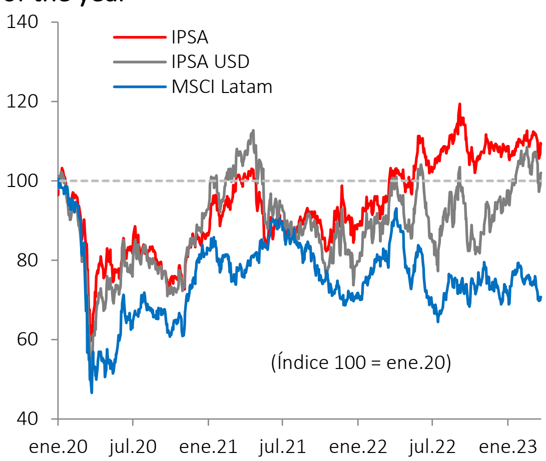
Thus, the decline in the February CPI should be taken with caution. While the data may impact future inflation due to its possible downward effect on expectations and indexation clauses, the fact that underlying inflation remains elevated suggests that inflationary pressures, while moderating, remain high. In March, due to seasonal factors, we will again see a high CPI change of over 1%, affected by the annual readjustment of education fees and the reversal of the fall in air fares in February. Then, from April and May, the decline in inflation will be more evident, driven by the appreciation of the Peso, the weak economy and lower global commodity prices. Thus, we maintain our forecast that the year will close with an annual CPI change of around 5%.

Domestic markets suffer from global financial tensions

Financial stress in international banking generated significant volatility in local markets, with losses in local risky assets, falls in interest rates and upward pressure on the exchange rate. Financial companies' share prices fell significantly - the financial local stock index IPSA declined 6% in the week of greatest stress (10-17 March) - dragging down the overall IPSA, which reached one of its lowest prices so far this year (5,112 points on March 17).

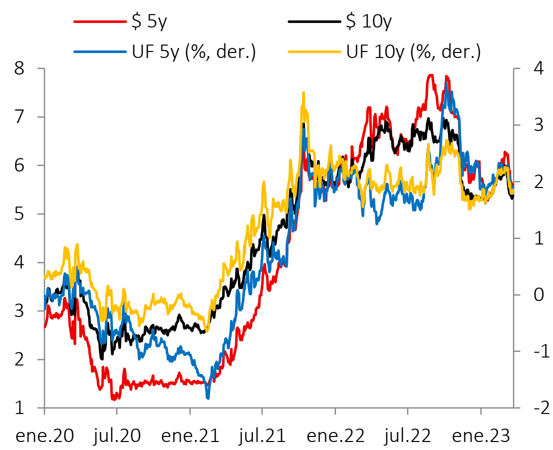
Interest rates on long-term bonds, which had been on an upward trend until a couple of weeks ago, quickly declined to levels similar to those at the end of January (BTP10: 5.4%; BTU10: 1.8%). Risk premia, meanwhile, rose significantly (CDS5y: 119 bps, +26 bps MoM), and lower liquidity pushed up corporate spreads, in particular for instruments with higher relative risk.

The local stock index IPSA falls to its lowest level of the year



Source: Bloomberg and Santander

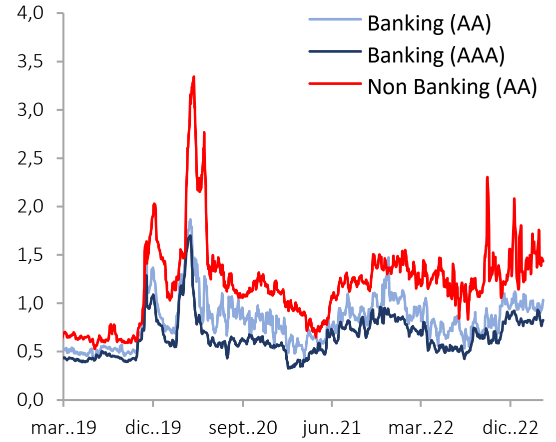
Long-term rates decline in line with international benchmarks



Source: Central Bank, Bloomberg and Santander

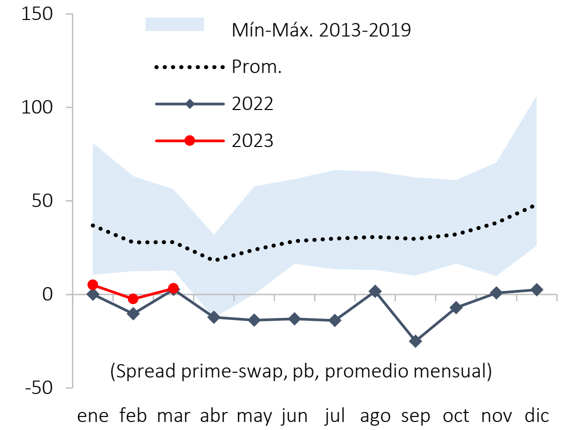
The local money market was largely unaffected by global financial volatility. The prime-swap spread remained stable and below historical levels, with deposit volumes growing at double-digit rates. Nevertheless, the flight-to-quality phenomenon, which characterises episodes of financial stress, implied a shift in the derivatives position of non-resident banks, increasing the flow of forward sales of local currency by almost US$ 2 billion during March. This added to the copper price decline and the global strengthening of the dollar, led to a significant depreciation of the exchange rate, which steepened to levels close to $830 (4% MoM). Meanwhile, dollar derivative rates rose at the peak (90-day on-shore rate: 2.75%), although this phenomenon had already been observed at the end of last year without major consequences.

Cost of corporate finance rises amid higher risk premiums



Source: RiskAmerica and Santander

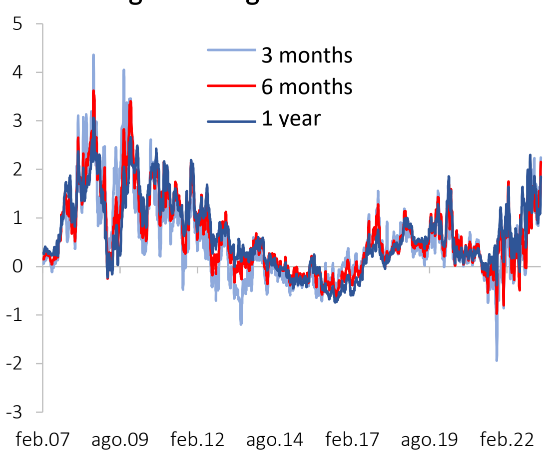
Liquidity in the local money market has remained stable



Source: Central Bank and Santander

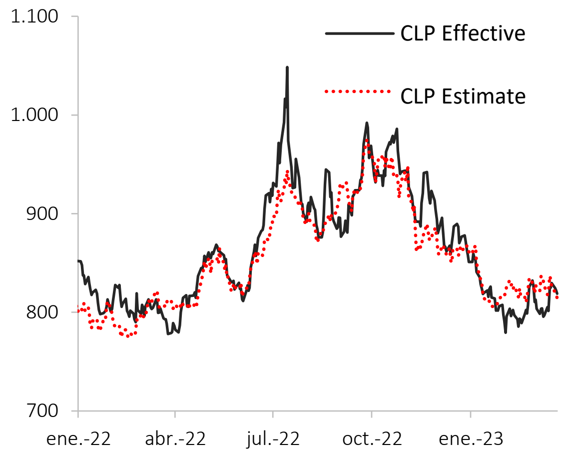
In the future, the possibility of increased political uncertainty in the run-up to the election of candidates for the Constitutional Council, as well as the legislative discussion around a new pension fund withdrawal, could again put pressure on the currency.

On-shore spreads widen, but no major tensions in the foreign exchange market are observed



Source: Bloomberg and Santander

Peso depreciates moderately and aligns with fundamentals



Source: Bloomberg, Central Bank and Santander

While the rejection of the self-borrowing bill by the Chamber of Deputies reduces the chances of a further withdrawal if such an initiative were to go ahead, financial asset prices would show further losses, and the exchange rate could return to levels above $900, driving interest rates up in response to the higher inflationary pressures this would generate.

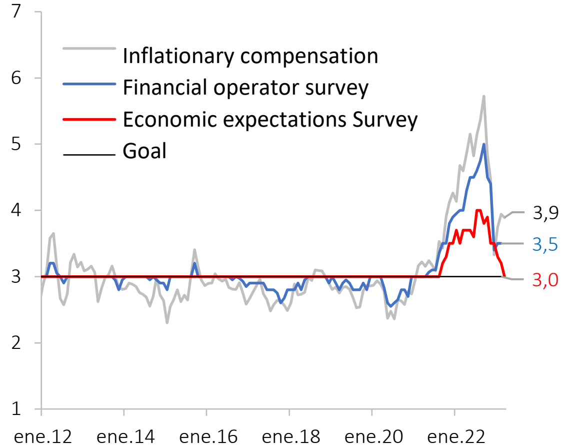
The start of rate cuts in Chile is delayed

At the last Monetary Policy Meeting (MPM) at the end of January, the Central Bank held the MPR at 11.25% and conditioned future movements on data collection, confirming the consolidation of inflation convergence to 3%. At the time, the local economy was perceived to be weak. Market projections, and ours, pointed to lower international prices and a significant exchange rate appreciation as helping inflation to decline rapidly. This gave the Central Bank room to start cutting rates in the April or May Monetary Policy Meeting.

Since then, real activity has surprised on the upside and core CPI has been somewhat above expectations in a context where, in addition, the global inflation outlook has risen. In the run-up to the next meeting, to be held on April 4, the Central Bank will only have one more activity data - February Imacec-which we estimate will continue to show a limited adjustment (-0.5% MoM). The March CPI, which will be relatively high due to seasonal factors, will not be known by that date. Given this, we believe that the Council will maintain the MPR at its current level. In the next Monetary Policy Report (IPoM), released the day after the meeting, this year's growth and inflation projections will be corrected upwards. Given this, the MPR corridor is also likely to be revised upwards.

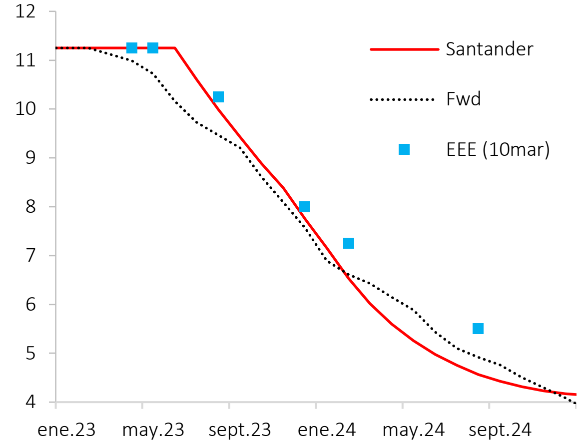
Nevertheless, the conditions could be in place to start the process of rate cuts as early as the third quarter. The data would confirm that the economy is weak, the labour market would deteriorate further, and inflation would have fallen below 10%. Inflation expectations have already been adjusted downwards, and some survey-based measures are back to the 3% target. The recent financial turmoil and the change in the outlook for global rates are still unfolding elements that add uncertainty to the policy decision.

Two-year inflation outlook moves closer to the 3% target



Source: Central Bank and Santander

Rate projections have been raised in the short term



Source: Central Bank, Bloomberg and Santander

Thus, in our baseline scenario, we expect the first cut to take place at the July meeting. Subsequently, successive downward movements of a significant magnitude -between 75 and 100 bps-would bring the MPR to levels of 7.75% by the end of the year. This projection is in the middle of the 8% estimated by the median of respondents to the Survey of Economic Expectations. The forward curve estimate based on market rates is 7.5% as of the day this report was closed.

This trajectory would significantly change if a further withdrawal of pension funds is approved and/or international financial tensions worsen. Uncertainty would raise risk premia and depreciate the currency, which, in a context of a stronger boost to aggregate demand from the new liquidity injection, would make inflation more persistent, further delaying the process of monetary normalisation.

National Accounts	2017	2018	2019	2020	2021	2022	2023 P	2024 P
GDP (% real var. YoY)	1.4	4.0	0.8	-6.1	11.7	2.4	-0.25	2.5
Domestic demand (% real var. YoY)	2.9	5.0	1.0	-9.4	21.7	2.3	-4.2	3.2
Total consumption (% real var. YoY)	3.8	3.6	0.7	-6.6	19.3	3.1	-2.9	1.8
Private consumption (% real var. YoY)	3.6	3.8	0.7	-7.4	20.8	2.9	-3.7	1.7
Public consumption (% real var. YoY)	4.7	3.1	0.5	-3.5	13.8	4.1	0.8	2.1
Gross fixed capital formation (% real var. YoY))	-3.3	6.5	4.7	-10.8	15.7	2.8	-4.2	1.1
Exports (% real var. YoY)	-1.0	4.9	-2.5	-0.9	-1.4	1.4	1.3	1.4
Imports (% real var. YoY)	4.5	8.6	-1.7	-12.3	31.8	0.9	-9.2	3.5
GDP (US$ billion)	276.5	296.0	278.9	254.9	316.5	304.5	333.1	348.4
GDP per capita (US$ thousand)	15.0	15.8	14.6	13.0	16.1	15.2	16.7	16.6
Unemployment (% as of December)	6.5	7.1	7.1	10.3	7.2	7.9	8.0	7.3
Population (million)	18.4	18.8	19.1	19.5	19.7	19.8	20.0	21.0

Payment Balance	2017	2018	2019	2020	2021	2022	2023 P	2023 P
Trade balance (US$ billion)	7.5	4.4	3.0	18.9	10.5	3.8	6.1	7.4
Exports (US$ billion)	68.9	74.8	68.8	74.0	94.8	98.5	95.4	97.3
Imports (US$ billion)	61.4	70.4	65.8	55.1	84.3	94.7	89.4	89.8
Current account (US$ billion)	-7.6	-13.3	-14.5	-5.0	-23.2	-27.1	-14.4	-10.2
Current account (% GDP)	-2.8	-4.6	-5.3	-1.9	-7.5	-9.0	-4.2	-2.9
Copper price (year average US$/lb)	2.8	3.0	2.7	2.8	4.2	3.9	4.0	4.1
WTI oil price (year average US$/bbl)	50.9	64.8	57.0	39.0	68.0	94.0	74	81

Money and Exchange Market	2017	2018	2019	2020	2021	2022	2023 P	2023 P
CPI Inflation (% var. YoY up to December)	2.3	2.6	3.0	3.0	7.2	12.6	4.9	3.1
CPI Inflation (% var. YoY average)	2.2	2.4	2.3	3.0	4.5	11.6	8.1	3.7
CPI Inflation excluding food and energy (IPC-SAE) (% var. YoY up to December)	1.9	2.3	2.5	2.6	6.4	8.6	5.2	2.6
CLP/US$ exchange rate (annual exercise)	615	696	745	711	852	875	825	835
CLP/US$ exchange rate (year average)	649	640	703	792	759	873	820	830
Monetary policy rate (% annual exercise)	2.50	2.75	1.75	0.50	4.00	11.25	7.75	4.50
Monetary policy rate (% year average)	2.7	2.5	2.5	0.8	1.2	8.6	10.4	5.8

Fiscal Policy	2017	2018	2019	2020	2021	2022	2023 P	2024 P
Public expenditure (% real var. YoY)	4.8	3.5	4.1	11.0	31.6	-24.0	4.0	3.0
Central Government balance (% GDP)	-2.8	-1.7	-2.9	-7.3	-7.7	1.3	-2.5	-2.7
Central Gov. gross Debt (US$ billion)	68.9	70.2	74.4	91.6	102.0	117.3	134.9	146.3

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