*"Remarks on the Chilean Economy"**

Mario Marcel, Governor of the Central Bank of Chile

October 2020

I. Recent evolution of the pandemic in Chile and the ability to sustain a confinement strategy

- The evolution of the macroeconomic scenario in Chile and elsewhere remains closely determined by the evolution of Covid-19 and the containment measures applied by the authorities. After a sharp drop of activity at the beginning of Q2—alongside a pickup in contagion and stricter lockdowns—, in recent months the Chilean economy has given signs of stabilization, combining incipient improvements in some sectors and deterioration at the margin in others. Around the World, health systems, especially in countries first hit by the pandemic, have been making progress in tracking the spread of the disease and in treating the most critical cases. This has made authorities more reluctant to return to the tougher confinements with new outbreaks, opting for more targeted measures instead.

- The evolution of the pandemic differs across countries. Some show a more controlled environment as a result of preventive measures, test-trace-isolate (TTI) strategies, and the accumulated experience in treating the disease. Yet, several countries are seeing large outbreaks while others are still experiencing an upward trend. Some Latin American countries imposed strict confinement measures at an early stage, with a large economic impact, but mobility has recovered later, with or without de-confinement, drawing on the degree of informality in the economy and a lower capacity to counter the erosion in household earnings.

- In Chile, contagion seemed well under control until end-April, only to experience a large escalation in the next two months that brought it to the top-ten most affected countries in the World. This prompted authorities to broaden containment measures significantly in June and July. This, combined with an effective integration of public and private care facilities, investment in equipment, large-scale testing and a more effective involvement of the primary health system in TTI, eventually brought new cases down to 1,000-2,000 a day since end-July. Currently, active cases stand below 14,000[1], the case-fatality ratio remains comparatively low, and the basic reproduction rate (R_0) has remained at 1 or below for nearly four months. The availability of mechanical ventilators as well as emergency facilities has improved, while the ability to mobilize private sector facilities as well as to adapt equipment to respond to new outbreaks remains intact.

- Given the improvement in epidemiological data, Chilean authorities started a gradual deconfinement process (a five-step program titled "*Plan Paso a Paso*"). This process contemplates the possibility of going back to prior stages if indicators were to worsen, as has occurred in some territories. The total population in confinement has dropped from 60% at the peak of July, to 21% during the last week of September. In terms of economic activity, GDP spanning quarantined areas has dropped from 65 percent to 18 percent at the end of September.[2]

- It is interesting to note that despite the broad dominance of Covid-19 over the evolution of the economy, economic activity, contagion and containment measures have not gone completely hand-in-hand in Chile.

---

* Presented virtually at "2020 Investor Seminar" organized by Citi, October 6, 2020.

[1] As of mid-September, active cases were 35,000 in Bolivia, 125,000 in Argentina and more than 300,000 in Peru.

[2] The "*Plan Paso a Paso*" is a gradual strategy to face the pandemic according to the health situation of each particular area. These are five stages or gradual steps, ranging from "Quarantine" to "Advanced Opening", with specific restrictions and obligations. The advance or retreat from one particular step to another is subject to epidemiological indicators, health care network, and traceability. At the end of September, 255 municipalities out of a total of 345 are in Step 3, 4, or 5, and three municipalities (Punta Arenas, Chillán, and Coyhaique) have regressed from Step 3 to Step 1 due to an exponential increase in the number of cases.

The largest contraction of GDP took place in April, when the authorities were still following a targeted approach to social distancing; in turn, it started to stabilize and then recover at the peak of lockdowns. This may be due to three factors: (a) that lockdowns have never been as extreme as in other countries, leaving a number of critical activities exempt; (b) that actual mobility of people has differed from formal stringency of measures; and (c) that several activities were able to adapt to the new operational and logistical conditions, partly drawing on the experience of closures during the social unrest of end-2019.

II. Chilean economic performance and near-term prospects

- After contracting sharply between March and May, the Chilean economy has shown signs of stabilization, combining moderate improvements in some sectors with additional deterioration in others. A few—like Mining—were not significantly affected, given their geographical isolation. The positive figures since June were accompanied by a more positive evolution of the pandemic, a relatively fast adaptation of some sectors –especially Commerce—to new operating conditions, and the impact of expansionary policies. Still, the impact of the pandemic is very deep, reflecting in a massive contraction of earnings for workers and companies. Reversing the loss of jobs, addressing the fall in household income and the deterioration of consumption, and funding companies' needs for working capital and investment are now the biggest challenges in the path to economic recovery.

- The risk of infection has led to particularly sharp contractions in activities most intensive in social contact, directly affecting the income of related businesses and workers. This contraction has seen its impact amplified through a fall in self-employment—mostly in services requiring human interaction—that has been unable to perform its traditional cushioning role in the present circumstances. In fact, self-employment and other forms of non-contract jobs explain more than half the decrease in employment and, presumably, a large portion of the increase in inactivity.[3]

- As for corporate cash flows, an analysis of the tax database by the Central Bank of Chile (CBC) concluded that some 18% of firms reported no sales between March and July (more than doubling the previous year's), while another 25% saw their revenue drop more than 70%. The sectors with a larger share of inoperative firms include Construction, Personal Services and Tourism, while firms with a substantial contraction spread across all sectors.

- The Central Bank estimates that GDP will drop -4.5% to -5.5% in 2020. This assumes that the economy will recover during the second half of the year. Preliminary data for the third quarter is supportive of these projections, while Q4 will benefit additionally from a lower base for comparison in YoY changes. Still, the broad output gap that opened in Q2—estimated at -15.3%—will close only by 2022, with inflation converging to the policy target by the same date. Per capita income would return to its pre-crisis levels only by 2023. Overall, compared to projections in September 2019, a GDP gap of some 10% is likely to last, reflecting the economic loss caused by the social crisis and the Covid-19 pandemic.

- In particular, in Q2 the Chilean economy posted a contraction of 14.1% year-on-year, its worst record in several decades.[4] The sharpest month-on-month drop occurred in April, continuing into May. Starting in June,

---

[3] In the moving quarter June-August 2020, the unemployment rate decreased slightly compared to the previous moving quarter, reaching 12.9% (previous moving quarter: 13.1%). Employment fell 19.4% in 12-month variation (-1,736 thousand people) (previous moving quarter: -20.6%). The labor force participation rate was 52.5% (previous moving quarter: 51.8%). The workforce was reduced by 1,400 thousand people, presenting an annual fall of -14.5% (previous moving quarter: -15.6%).

[4] The contraction in quarterly GDP in 1982-83 was deeper and longer, reaching nearly 20% at some point and posting negative variations for nearly eight quarters.

activity has seen some upturn in sectors that were particularly hit, such as Retail, as well as some personal and corporate services. In contrast, Construction has suffered the most from the geographical and temporal extension of quarantines.

- In August, monthly economic activity measured by IMACEC fell 11.3% YoY, yet the seasonally adjusted series grew 2.8% compared to the previous month. The Mining IMACEC decreased 3.4%, while the Non-mining IMACEC did so by 12.2% YoY. The most affected activities were Services and Construction, and, to a lesser extent, Manufacturing. In Services, the falls in Education, Transportation, Business services, and Restaurants and hotels stood out. Trade growth partially offset this result. In seasonally adjusted terms, the Non-mining IMACEC grew 3.4%.

- Labor market conditions also became quite adverse in the first few months of the pandemic, with 1.8 million cumulative job losses for a labor force close to 10 million before the crisis. Almost half these losses hit self-employed workers, who were prevented from going out to work by quarantines. This explains most of the increase in "inactive" workers, that is, those that did not perform any work in the reference period but were not actively seeking a new job either. The lifting of quarantines would allow these workers to return to their usual occupations rather than adding to the unemployed, but many workers from the hardest hit sectors may take longer to recover.

- Still, combined with positive figures in Q1, GDP declined less than in other economies in the first half of the year. For the whole of the first half, GDP declined 10.2% between 2020Q2 and 2019Q4, at the lower (less negative) end of the range of output drops in a large sample of countries. This appears to be due to the Covid-19 shock hitting the economy only since mid-March, the continuing growth of the Mining sector, and the rebound of some sectors in June.

- Going forward, the relaxation of confinements and increased mobility will help activity to leave behind its lowest points. Some sectors will continue to adapt their operations to the new conditions through online operations, delivery services and teleworking. Consumption is also expected to improve thanks to rising earnings, government transfers and drawing down statutory and precautionary savings.

- Support to households in the form of subsidies, transfers and guarantees only started to operate in full in Q3.This is coming from three sources:

    - Government cash transfers, targeted at low-income families and middle-income households with falling earnings;
    - Deferral and rollover of a diversity of payments, including utility bills, taxes and loan repayments; and,
    - Drawdown of statutory savings and other financial operations, including enhanced use of unemployment insurance, furlough schemes, private unemployment insurance on consumer or mortgage loans, and partial withdrawal of pension savings.

- The immediate estimated fiscal cost of these measures is close to 5% of GDP and the bulk of them started in Q3. As a result of this, the balance between lost labor earnings and transfers went from an estimated -22% in Q2 to -3% in Q3. Several of these measures are expected to continue well to the end of the year. The withdrawal of pension savings was mostly conducted in August-September. Based on historical consumption behavior and the experience of other countries with such schemes—like Australia and Peru—, we estimate the total withdrawal at about 6% of GDP, equally divided between consumption (mostly goods) and savings (loan repayment, conventional savings and financial asset purchases), and distributed throughout the remainder of

2020 and early 2021. On this basis, prospects for private consumption in the second half of 2020 improved significantly, compensating for a more negative performance in the first half, as well as lower public consumption, due to the rebalancing of government expenditure, for an overall contraction of consumption of -4.2% in 2020.

- The baseline scenario assumes that the recovery in consumption will continue into next year, growing 6.8%, slowing down to 1.7% in 2022, considering that the transitory stimulus to household spending provided by the various income support measures will have dissipated while leaving a higher basis for comparison. The recovery of economic growth is projected to be coupled with an increase in employment levels. In the immediate future, as the tighter sanitary measures are lifted, employment in sectors such as construction and retail are expected to recover, as well as self-employment across sectors. Nonetheless, the recovery of employment may be slower in more labor-intensive sectors due to the effect of social distancing, particularly services.

- Gross fixed capital formation (GFCF), particularly construction and other works, will start recovering as quarantines are lifted, and suspended projects resume, according to the CBC *Business Perception Survey* of the second quarter. The highly expansionary monetary policy stance, the increase in public investment and the reactivation measures announced by the Government will also sustain its recovery. Non-mining investment may also increase next year, but it will be less dynamic than previously expected, given the growth in corporate debt needed to cover the cash deficits of recent quarters. Considering all of the above, our forecasts are that GFCF will contract 10.6% annually in 2020, to grow 8% in 2021 and 4.9% in 2022.

- Our forecasts also assume that this year and next the Government will provide a significant boost to the economy, consistent with the various measures adopted. For 2020, the structural balance is expected to broaden to -3.5% of GDP, while the overall balance will exceed 9% of GDP. While part of this is due to falling revenues, public spending will still grow above 10% in real terms. In the longer run, this boost will decline as the economy converges to its trend growth rates and the fiscal consolidation process announced by the Government unfolds. Still, the Budget for 2021 contemplates maintaining the effective spending level of 2020.

- In all, estimates for 2020-2022 compare favorably with a wide range of emerging and advanced countries. While historical in size, output decline in 2020 will be nearly half the expected figure for the rest of Latin America (Chile: -5.5%/-4.5%; Latin America: -9.2%), and similar to the global figure, even including China. As for 2021, GDP is projected to recover faster than in the rest of Latin America (2021: Chile: 4.0%/5.0%, Latin America: 2.0%).

III. Central Bank measures

- The CBC has adopted a variety of measures in response to the new economic challenges that emerged since the social crisis last October. These measures have pointed at providing liquidity to the markets and stimulating the flow of credit to the economy, in order to avoid a more severe disinflationary cycle and prevent risks to financial stability, which could escalate the economic and social cost of the current shock. CBC measures fall into four categories: (1) conventional monetary policy; (2) unconventional monetary policy; (3) market stabilization measures; and (4) enhancing policy space.

- On conventional monetary policy, the CBC cut the Monetary Policy Rate (MPR) by 125 bp to its estimated *effective zero lower bound* (EZLB) of 0.5% back in March. This is a highly expansionary rate measured either in real terms—where the Chilean real MPR ranks the lowest among Latin American and natural-resource-based economies—or compared to the estimated neutral rate between 3.75% and 4.25%. In addition to this, the Board of the CBC has provided specific forward guidance by stating that they expect the rate to remain at the EZLB for most of its policy horizon, covering the remainder of 2020, all 2021 and part of 2022.

- On unconventional policy, the CBC has implemented two major measures: (a) a credit policy program (FCIC), providing 4-year loans at the MPR to commercial banks conditional on their lending to companies, and (b) an asset purchase program, including repurchasing longer-term CBC bonds and purchasing bank bonds at market prices. These programs have a total envelope of USD 44 bn, equivalent to nearly 20% of GDP, of which ¾ have been already committed. These programs provide additional traction to monetary policy with the rate at the EZLB, pulling down longer-term market rates and helping credit to behave in a countercyclical way. In fact, the 10-year sovereign rate now stands at around 2.6% (200 bp over Treasuries), while lending to companies has been growing at more than 10% in real terms year-on-year over the last six months.

- On market stabilization, the CBC has implemented a number of measures to facilitate portfolio adjustment at a time of changing market perceptions. These measures have included repo and forward facilities, interventions in the FX market and purchase of assets in stressed markets, covering events starting with a severe sell-off in the light of social unrest in November 2019, market volatility at the outset of the Covid-19 crisis (March 2020), and the asset divestment of pension funds to respond to pension savings withdrawals (August 2020).

- Finally, while using policy space to implement several of the aforementioned measures, the CBC has been recouping it by strengthening its foreign position and broadening its policy toolbox. Thus, at the CBC's request, the IMF granted access to a *Flexible Credit Line* (FCL) equivalent to nearly USD 24.0 billion, a figure close to 60% of the International Reserves, for two years. At the end of June, the New York Federal Reserve accepted the registration of the CBC in the overnight transaction service *Temporary Foreign and International Monetary Authorities* (FIMA) REPO Facility. Also, the CBC agreed with the People's Bank of China (PBoC) to increase the *Bilateral Agreement on Swap of Renminbi/Peso Currencies* (RMB/CLP), to RMB 220 billion (more than USD 7 bn) for three years. Last, but not least, a Constitutional Reform was passed to allow CBC to purchase government bonds in the secondary market for financial stability purposes. This reform, approved by an overwhelming majority in Congress, more than doubles the potential for bond purchases in dealing with stress episodes in financial markets in the future.

- Special measures in categories 2 and 3 have been designed to avoid threshold and cliff effects. They have been adopted stating the problem that they are trying to address, their expected impact, the resources involved, a specific timeframe and the operational procedures for its implementation. This appears to be critical in preventing the distortionary impact of open-ended measures that interfere with market pricing and signaling. As figures suggests, most of these measures are far from exhausted, while the CBC has not hesitated to suspend or terminate those that are no longer justified. Still, the more conventional monetary policy measures, as well as the credit-enhancement programs, are planned to extend well beyond the immediate emergency so as to support economic recovery once the immediate emergency is over. The MPR is expected to remain at its technical minimum over most of the next 24 months, and FCIC funds are provided over a 4-year horizon. This should be able to offer banks sufficient liquidity for lending to continue to operate in a counter-cyclical manner, provided that risk can be managed with support from government programs.

- Several measures taken by the CBC have affected its assets, either by reducing them (sale of foreign currency) or increasing them (purchase of bonds and loans to commercial banks). They also have a counterpart on the liabilities side through active measures, such as the repurchase of long-term Central Bank bonds, monetary sterilization or, a larger monetary base to respond to a larger demand for cash. On aggregate, these operations have involved a balance sheet growth of 86 percent in one year, which is equivalent to almost 10 points of GDP. In net terms, these changes have contributed positively to the CBC's net worth, which had remained negative for many years due to the historical weight of *Subordinated Debt*, the effect of the exchange rate mismatch between assets and liabilities and a negative interest rate differential (between local debt and international reserves). Not only does the higher profitability of national assets contribute to closing this gap, but the reduction in the CBC's long-term debt stock (due to repurchases) will reduce the financial burden for the next few years. The combination of these factors has led to a positive net worth for the first time in many years, which in previous projections was only expected for 2028.

IV. Financial market response

- The liquidity provided by the CBC, coupled with government guarantees, regulatory forbearance and the solvency of the banking system, have contributed to commercial loans behaving in a countercyclical way. Thus, instead of contracting with economic activity, commercial lending has expanded over 10% in real terms YoY. As a result, nearly a quarter million loans have been granted to small and medium-sized enterprises under a special Government guarantee scheme (Covid-19 loans). There is robust evidence that a large number of these loans have reached the companies worst hit by the pandemic, sustaining their operational continuity, and cushioning the impact on investment. In turn, the asset purchase program announced in June has improved financing conditions in the corporate- and bank-bond market.

- In the course of six months–from October 2019 to March 2020—Chile went from facing a purely domestic shock to being a country with a response to the pandemic in line with the expected movements for a small and open economy. Before the onset of the global pandemic in March, financial asset movements all pointed to a marked increase in Chile's country risk premium, with sovereign and CDS spreads climbing significantly more than comparable economies. Both the sovereign bonds and the currency had depreciated by the largest amount, as policy uncertainty was still weighing heavily in the valuation of financial markets. However, with the transition from an idiosyncratic shock to a global shock, the performance of Chilean financial assets has been more in line with those of advanced economies. The swift policy response (both monetary and fiscal) and the sanitary measures taken, along with the country's stronger fundamentals and the stabilizing role of the exchange rate, have contributed to this switch.

- The gradual reopening of various economies has consolidated the more positive tone of global financial markets. Better-than-expected activity data has been especially relevant in China and several advanced economies, in a context in which the outbreaks have had much more limited effects on the functioning of the countries than at the beginning of the year. Thus, sovereign and corporate risk indicators—EMBI—have declined in most emerging economies, including Latin America. In general, stock markets have continued to evolve positively after Q2, with strong gains in China and the United States, whose levels are already higher than those of February. Meanwhile, the dollar has weakened multilaterally, except against Latin America.

- All these movements, however, have taken place in a context of high volatility of currencies, especially emerging ones. In addition, the markets have not been exempted from ups and downs associated with disputes between China and the United States on the political, commercial and technological factors, among others. Yet these events have not had the severity of the tensions observed at the beginning of the pandemic.

V. Inflation and monetary policy

- In recent months, inflation continued to post low monthly figures and medium-term inflationary pressures remained subdued. Still, on the margin, downside risks have diminished. The latest figures indicate a somewhat higher than expected increase in goods inflation, in a context in which activity has shown signs of stabilization in recent months, after the sharp fall at the beginning of Q2. To this, we should add the effects of the Government's support programs and the withdrawal of part of the pension savings, which, in the short term, will give a boost to consumption. On the other hand, the labor market has suffered a profound deterioration and although the projection scenario assumes a significant recovery of the economy in the second half of the year, completing the closing of the capacity gaps will take time.

- Regarding the fundamentals of inflation, the revision of potential GDP estimates results in an output gap somewhat smaller than that considered until June, although very wide compared to any recent episode, due to the sharp drop in activity in Q2. Going forward, a significant closing of the gap is expected in the second part of 2020, hand in hand with the relaxation of confinement and the transitory impulse in consumption as a result of the withdrawal of pension savings, as well as the greater fiscal transfers. All in all, the output gap is expected to remain open until early 2022.

- Inflation will converge to the CBC's 3% target by 2022. Although in the short term this trajectory runs somewhat above our June forecast, largely due to the projected growth in private consumption, into the medium term its main determinant continues to be the lower accumulated activity. The core measure will remain above 2.5% in the short term, to gradually converge to 3%, also in 2022. Two-year inflation expectations remain around 3%.

- Monetary policy will remain highly expansionary, combining the MPR kept at its 0.5% minimum with unconventional measures. These will be renewed or expanded if the economic recovery and the convergence of inflation so require. In turn, the MPR will remain at its lower bound well into the last part of the two-year monetary policy horizon.

- The macroeconomic scenario continues to show more uncertainty than normal. Projections recognize that social distancing will alter the way of operating in areas where social interaction is key for a long time. Nevertheless, more negative than estimated impacts would have particularly harmful effects on the recovery of the labor market, because of the many people employed in these activities. This would further weaken demand and negatively affect growth and the inflationary convergence, calling for a stronger monetary impulse. On the other hand, the picture of sanitary risks looks somewhat more balanced. The accumulated experience, the prevention measures applied, and reinforced sanitary systems reduce the probability that, in the event of a virus resurgence, the worst episodes of the pandemic are repeated, and strict quarantines have to be re-instated. Thus, deconfinement might proceed at a somewhat faster pace, allowing activity and employment to rebound more quickly. In such a case, the monetary impulse needed for inflation's convergence could be of slightly shorter duration.

- The possibility of more negative risk scenarios, associated especially with the economic wounds inflicted by the pandemic, is still present. The ability of the financial sector to sustain a positive flow of credit is crucial in this regard. Varied measures have allowed maintaining credit flowing in line with working capital and investment needs, breaking down the pro-cyclical relationship of credit. Going forward, the materialization of investments, the productive adjustments in the worst hit sectors, and the increase in activity, will continue to rely on these financing channels. For this reason, it is essential to ensure a steady flow of credit, in order to avoid a deterioration of the financial system's capitalization and liquidity levels, whether due to regulatory changes and/or a more pronounced deterioration in the repayment capacity of households and businesses. Otherwise, the financial sector might not be able to sustain credit growth, becoming an amplifier of the recession as has been known to happen in the past.

- The Board is committed to maintain the strong monetary impulse for an extended period of time, and to increase it if it deems it is necessary for the achievement of its objectives of controlling inflation, as well as taking the measures to safeguard financial stability.

VI. Longer term prospects and challenges

- The Chilean economy has been adapting to a new scenario prompted by social distancing. Firms are incorporating new forms of work that should have an impact on labor market dynamics. According to a recent survey[5], about 25% of those employed did at least one hour of teleworking in the last week of May (approximately 1.8 million people), compared to 75% who worked at the office. On average, people that teleworked in May worked 33 hours that month. Within the categories that make up online spending, the strong increase in e-Commerce stands out, with an increase of 41.5% in Q1, and then sharply accelerating in Q2, with an increase of 148.3%. In this way, the sector closes the first half of 2020 with a growth of 102.6%. On the other hand, the penetration of online sales through e-Commerce over the total reflected a strong increase, reaching 17.6% in Q2, where in June it already reached 20%, more than tripling its participation in 2019.

- Yet a number of challenges emerge in transitioning from recession to recovery. The first is the recovery of the labor market, severely affected by the abrupt halt of activities in all sectors and territories. This is a challenge of the utmost importance for the well-being of the population and needs to be approached with urgency, determination and realism. In no case will the recovery of employment be possible without the active participation of companies of all sizes and sectors.

- A second task is to smooth the transition of households and businesses from a phase of emergency support to a phase of recovery, incorporating the new challenges arising from social distancing. The success of this transition discourages both ending the support programs abruptly and prolonging them indefinitely. It will be key to an efficient use of resources to have the most comprehensive vision of the set of policies in application and their impact on different sectors.

- Third, it will be necessary to recover, restructure and/or reconvert the sectors most affected by the pandemic. Tourism, Transport, Restaurants, Hotels and part of Retail sectors will be affected more permanently by new patterns of interaction with users, customers and suppliers. This will require investments in infrastructure, modes of provision, adaptation of the logistics chain and incorporation of technology that will hardly occur based only on to the operation of market forces.

- Fourth, the materialization of investments, productive adjustments and increases in activity levels will require adequate financing, which will not come from the mere dynamism of income. Therefore, it will be essential to ensure a sustained flow of credit, under affordable conditions, by a financial system capable of performing its intermediation and risk distribution functions efficiently.

- Fifth, it will be necessary to significantly reduce uncertainty, which is about to complete a year well above its historical levels. These degrees of uncertainty have different causes, but we must be clear that the Chilean

[5] *Longitudinal Study of Employment*, Pontifical Catholic University of Chile.

economy and society will hardly be able to withstand its protraction or intensification without more permanent damage to entrepreneurship, investment and employment.

- A final challenge will be to raise—or at least maintain—long-term growth potential. The trend growth estimates for our economy have not been updated as yet, due to information limitations for a refined estimate, but it is evident that factors have appeared in recent months that could pressure it downward. Higher costs associated with security and social distancing in the provision of services, as well as higher transaction costs in the face of greater uncertainty and the deterioration of trust, act to reduce productivity, while higher hiring costs, low investment and business bankruptcy can affect the availability of work and capital. These are not irreversible phenomena, against which innovation and technological development cannot have a compensatory effect, but the challenge today is surely greater than it was a year ago.

***