Chilean Macroeconomic Highlights

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The Covid-19 crisis

The Chilean economy has steadily recovered from the major shock caused by the Covid-19 pandemic. After contracting a staggering 13% QoQ in 2020Q2, GDP expanded 12% cumulatively over the next two quarters (5.1% and 6.8% in Q3 and Q4, respectively). This occurred in the midst of a gradual reopening process, which combined with the adaptation of many firms and households to social distancing.

1. **Fiscal and monetary policies have provided unprecedented support to the economy and have contributed to mitigate major risks to firms.** Thanks to buffers accumulated over many years, the policy response to the COVID-19 crisis has been swift, strong, and wide-ranging. Early on, measures aimed at preventing widespread bankruptcies and protecting households' jobs and incomes. In contrast to historical downturns, interest rates stayed at historical lows, corporate credit expanded, and the banking system remained solid. In the recovery, new measures point at smoothing out debt repayment, stimulating job creation and limiting scarring effects.

2. **Partial withdrawal of pension savings by workers since August 2020 propped up private consumption**. Workers cumulatively withdrew some 12% of GDP from pension savings over six months but a significant fraction of about one third has re-entered the financial system through alternative saving vehicles and debt repayments. Another 36% still remains highly liquid, in bank accounts and cash. The remainder explains the strong recovery of consumption from September 2020.

3. **These combined forces have contained the largest risks for the corporate and financial sector.** The sudden stop of many activities due to lockdowns at the outset of the Covid-19 crisis raised fears of widespread bankruptcies. Supportive policies—including support for working capital lending—prevented the worst outcomes and two out of three firms that stopped sales in 2020 have resumed operations.

4. **Similarly, government transfers compensated most losses in labor earnings of the poorest 20% households, albeit with some delay due to the lack of more structured social protection system**. Middle-income households also suffered major earnings losses, but most of the compensation was provided by pension savings withdrawals.

5. **Recovery continued into the first two months of 2021, providing a strong starting point for the economy this year**. The strong fourth quarter in 2020 plus economic activity growing nearly 1% MoM in January and February pushed up the starting point of 2021 above expectations. This provides an effective cushion to potential surprises—including a new round of lockdown currently in progress—in the course of the year.

6. **The positive outlook for 2021 is further supported by fast rollout of the vaccination process, a more favorable external environment, and the continuation of accommodative policies.** After contracting 5.8% in 2021, real GDP is projected to grow between 6 to 7% in 2021, and 3 to 4% in 2022. The main factors supporting these projections include:
   - Vaccination already covering 40% of the adult population, half of it with two jabs and is expected to reach 80% by June 2021,
   - Exports are growing on the back of dynamism of major trade partners; terms of trade are improving 10% over 2020—especially due to the significant increase in the copper price since late 2020, and
   - The fiscal impulse will be marginally higher than in 2020, while monetary policy will remain accommodative at current levels at least until early 2022.

Macroeconomic outlook

7. **The outlook for the Chilean economy has improved in recent months but the exit from the crisis is still challenging, many risks loom ahead, and scarring effects are likely.** In the shorter run, GDP is likely to backtrack in 2021Q2 due to escalating contagion and mounting sanitary restrictions. At the moment, more than 85% of the population is under strict lockdowns, which will ease only gradually. Adaptation of firms and households will make the contraction less severe and easier to turn around once group immunity begins to take hold by mid-year. Lifting constraints will also foster the recovery of services sectors and pent-up consumption.

8. **Household spending is expected to lead the recovery of demand.** Consumption contracted -20% in 2020Q2 due to sanitary restrictions, lost jobs, and high uncertainty about the effects of the pandemic, turning around in the second half on the back of greater liquidity from pension fund withdrawals, government transfers and job recovery. This impulse will last well into 2021, adding to the gradual reopening of the contact-intensive sectors, with an expected real growth rate above 11%.

9. **Investment is expected to bounce back with support from infrastructure investment and large mining and energy projects under way.** Capital expenditure contracted nearly 12% in 2020 but started to recover by the end of the year with the resumption of several large projects, concentrated in the energy and mining sectors. This will be supplemented by government infrastructure investment which is budgeted to grow close to 15% in 2021. However, non-mining private new starts are proceeding at a slow pace due to high uncertainty and heavier financial burden of many companies.

10. **Still, the labor market is recovering with a substantial lag.** The Covid-19 shock to economic activity translated immediately to the labor market, where about 1.9 million jobs were lost in 2020Q2. Another 0.7 million workers were suspended on pay. So far, most of the latter have returned to work but only 1 million jobs have been recovered. Lasting effects on service sectors, pervasive uncertainty, changes in labor supply, and structural changes in production and delivery processes are raising doubts on the ability of employment to return to pre-pandemic levels.

11. **The recovery will be uneven across sectors and some will face longer-lasting constraints due to social distancing**. In particular, many activities in the tourism and hospitality industries may require new operation protocols, and adapted installations to operate under lasting social distancing requirements. Such heterogeneity is likely to surface across workers, with the more qualified better prepared to adopt teleworking, digital services and new logistics.

12. **There are still important risks related to the pandemic shock.** The evolution of the pandemic at the global and local level is still uncertain, which will determine when and how sanitary restrictions will be relaxed. At the global level, exit policies in advanced economies may trigger negative global spillovers into capital flows and emerging market economies.

Inflation and monetary policy

13. **Headline and core inflation are expected to converge to the 3% target by the end of 2022.** Inflation has remained close to 3% in recent months, although more volatile due to short-term supply constraints. In the coming months, headline inflation is expected to post a transitory increase to nearly 4% due to energy prices, to start converging to the 3% target later in the year. The combination of currency appreciation and a still large output gap will put sufficient downward pressure to contain any short-term spikes in prices. Core inflation (total inflation excluding volatile items) will fall to 2.6% by end-2021, and then return to 3%.

14. **The Central Bank has implemented a broad set of measures aimed at boosting the monetary impulse, stimulate credit, ease the adjustment of financial markets and gain policy space.** The monetary policy rate (MPR) completed a year at its technical lower bound (0.5%), while unconventional measures have mobilized resources of 13% of GDP. This has allowed the economy to navigate this crisis with interest rates at historical lows and a countercyclical behavior of corporate credit.

15. **Monetary policy will remain highly expansionary.** The MPR will remain at its 0.5% minimum until economic recovery takes hold and spreads to the more lagging components of expenditure, which will take several quarters. The unconventional measures will continue to operate under the stated conditions, complementing the monetary policy stance defined by the MPR.

Exit strategies and longer-term challenges

16. **Exit from non-conventional policies and market-stabilizing measures is built into the stated terms of such policies/measures**. In particular, FCIC3 will provide lending to banks at the MPR for another 4½ months up to a cumulative USD 10 bn, and repayment of the different FCIC1-3 facilities should proceed in 2024. The bond-buying scheme already reached its ceiling and the stock of bank bonds in the CBC portfolio will remain stable until June, when reinvestment of coupons is expected to end.

17. **The exit path from extraordinary conditions is further granted by a stronger reliance on market mechanisms for emergency lending and debt rollover.** Compared to other countries, Chile avoided compulsory across-the-board measures and relied on bank's KYC for the allocation of credit. Regulatory forbearance was more limited in scope, so the deterioration of bank portfolios is likely to be more limited as well and absorbed by government guarantees and heightened loan-loss provisions. A number of bank clients have also used pension savings withdrawals to repay debts, so risk indicators have improved at the margin.

18. **There is still sufficient policy space to respond to emerging new challenges.** While under unprecedented stress, public debt–at 33% of GDP in gross terms and 15% in net terms—remains low for international standards. Monetary and financial stability policies remain supported by subdued inflation, the cushioning effect of the exchange rate, and a deep financial sector. The CBC has gained further space to respond to future shocks from the expansion of its emergency powers to purchase Treasury bonds in the secondary market and a reserve accumulation program.

19. **Over the longer run, the main scars of the crisis will be reflected in the deterioration of balance sheets of firms, households and government.** In order to cope with the shock to regular earnings/revenues, economic agents have increased their debt, drawn down savings, or both. Rebuilding net worth will be far for immediate and its timing will depend a lot on medium-term growth potential, which might suffer negatively from the crisis as well.

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