Overview

2016 will be another lackluster year for the Chilean economy. GDP registered an expansion of 1.6% YoY in Q3 2016 and a similar expansion is expected for Q4 (1.6%). This means that GDP growth for 2016 will be lower than in 2015.

The forecast for Chilean economic growth in 2017 is between 1.5 and 2.5 percent. This is due to higher expected prices of copper and an increase in investment.

Both consumer and business confidence indicators have remained pessimistic for the last 30 months. The levels these indicators are reporting are very similar to what was registered during the financial crisis and it appears that any recovery will proceed at a slower pace than it did 7 years ago.

Gross Fixed Capital Formation (GFCF) declined 1.3% YOY in Q3 2016. GFCF is being affected by weaker domestic demand mainly related with the construction sector that is being affected by an absence of investment projects.

In September 2016, Bachelet’s administration approved one of the most austere budget proposals over the last 13 years. Tax revenues are expected to increase as a result of the tax reform package recently enacted and government expenditures are expected to only increase modestly. These austerity measures may slow any recovery that is taking place in Chile and prolong this period of very modest economic growth.

Chile’s YoY inflation rate in December was 2.7%, the lowest rate since March 2014, and just below the inflation target at 3.0%. The Central Bank expects the inflation rate for 2017 to be under the inflation target of 3.0%. The monetary authority commented that external events could force the Central Bank to raise interest rates, but they are taking precautions and are ready to act to combat any negative external shock. Given the current situation, with inflation expectations low and weak economic activity the Central Bank decided to decrease interest rates by 25 points to 3.25% in an attempt to spur economic growth.
1. GDP, Economic activity

The Chilean economy is experiencing another disappointing year in 2016. GDP grew by 1.6% YoY in the third quarter (Figure 1) and it is expected that 2016 year-over-year GDP growth will also be 1.6%. This represents a slowdown from the previous year (2.1%).

Economic activity – excluding the natural resources sector – expanded by 1.9% YoY in the third quarter of 2016 (Figure 2). This expansion was driven mainly by personal services that stood out with an expansion of 6.6% YoY the Q3 in 2016, transport (5.0%) and commerce (3.1%), and while positive, represented the smallest expansion of the year and was substantially lower than for the same period in 2015 (3.2%). The sectors linked with investment are still on weak footing, with both construction and manufacturing contracting by 1.4%, the latter was driven by a decrease in the production of beverages and tobacco.

The annual change in GDP derived from natural resources registered a contraction for the fifth consecutive quarter (0.8% YoY). This was mainly driven by a reduction in water generation and a decline in copper production.

Similarly, consumption increased by 2.9% in Q3 of 2016, driven mainly by an increase in both government consumption (6.9% YoY, Q3 2016) and household consumption (2.0% YoY, Q3 2016) (Figure 3). A principal factor for the growth in household consumption was an increase in the consumption of durable goods, principally vehicles and technological products. While this result demonstrates a modest recovery, household consumption is still below from just before
the financial crisis in 2007 (7.5% YoY Q4).

Despite some signs of improvement in the Chilean economy, the confidence indicators (Figure 4) have remained pessimistic (value under 50 points) for 30 consecutive months. These values remain at close to their lowest levels since the financial crisis of 2008. The slight improvement that can be seen in consumer confidence is mainly due to consumers’ expectations of lower inflation and increased stability in the medium term. Business confidence registered a decrease in November 2016 in comparison with the previous month (from 42.7 to 40.9 points) and even on a YoY basis (from 42.5 in November 2015 to 40.9 in November 2016). The monthly variation was driven by the industry and mining confidence indicators, which both registered a substantial decrease of almost 5 points with respect to the previous month. On a YoY basis, the construction sector (which decreased by 14.6 points) drove the decrease in business confidence.

Gross Fixed Capital Formation (GFCF) declined 1.3% YoY in Q3 2016 (Figure 5). GFCF has been affected by weak domestic demand, mainly in the construction sector, that has led to an absence of investment projects.

Exports increased modestly by 0.1% YoY in Q3 2016, due to an increase in food exports and metals. Imports, on the other hand, experienced a drop of 1.5% YoY in Q3 2016, due to a reduction of imports of vehicles and mining and construction machinery.
The Economic Uncertainty Indicator\(^1\) increased by more than 100 points from October to November (Figure 6). This reversed a downward trend that was observed in September and October, attributed principally to Donald Trump’s victory in the US elections. His victory increased uncertainty regarding trade relations with the United States\(^2\). Other factors that could cause the Economic Uncertainty Indicator to increase are the price of copper and the economic situation in China\(^3\).

The Chilean Central Bank forecasts that Chile will grow between 1.5 and 2.5% in 2017. The IMF forecasts Chile to grow by 2% while Consensus Forecasts, forecasts a growth of 2.1%. The projected increase in Chilean economic activity for 2017 results from the expectation that copper prices will increase in 2017 (after the bottoming out in 2016) and from an increase in investment, although these changes are expected to occur mainly in the second half of 2017.

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\(^1\) The Economy Uncertainty Indicator is constructed by counting the number of articles that mention the word uncertainty and the word economy or economics from the main three Chilean newspapers, La Tercera, Diario Financiero and El Mercurio. Then, each of these series is divided by its respective standard deviation for the period January 2007 to October 2016. The resulting series are averaged simply for each month, thus obtaining a single series of monthly periodicity. Finally, this unique series is divided by its respective average until October 2016, and is multiplied by 100, in such a way that its average is 100. The indicator is made by The Latin American Center for Economic and Social Policies (CLAPES).

\(^2\) The US is the second most important partner for Chile with 13% of the Chilean exports going to the US. Information based on World Integrated Trade Solution.

\(^3\) 26% of Chilean exports went to China in 2015. Information based on World Integrated Trade Solution.
2. Fiscal Policy

Chile expects to end 2016 with a fiscal deficit of around 3.1% of GDP, an increase in the deficit of almost 50% when compared to 2015 (2.1% of GDP). The government's budget for 2017 expects the fiscal deficit to increase to 3.3% of GDP; this could be one of the biggest deficits Chile could register since the financial crisis of 2008 (even taking into account the fiscal consolidation program, explained below).

In September 2016, President Bachelet announced that government expenditures for 2017 will only rise by 2.7%, one of the smallest increases in government expenditure since 2003. Additionally, certain parts of the tax reform package, which will be fully implemented by 2018, will be incorporated during 2017.

The decision to implement fiscal consolidation was not an easy one for Bachelet's administration. Her administration had promised free college education for all and to increase investments in health care. However, with presidential elections looming in the second half of 2017 and with her approval ratings at their lowest point ever (around 20% approval rating), her administration decided that the best course of action was fiscal restraint rather than increasing government expenditure for the aforementioned programs.

The decision to move towards increased fiscal austerity was expected to help Chile maintain its credit rating and corresponding access to relatively inexpensive financing. However, in December 2016, Fitch downgraded Chile's credit rating from AA to A+, due to the combination of prolonged economic weakness and a substantial rise in public debt.

Chile has had a fiscal rule in place that mandates the government to have a structural balance of 0% of GDP. The structural balance adjusts central government revenue based on the cyclical movements in the price of copper and authorizes a public expenditure consistent with those revenues. This goal has not been met in any of the nine previous years (Figure 7). However, the government expects the structural deficit to improve to 1.5% of GDP in 2017 from 1.7% in 2016.

These pro-cyclical fiscal policies with such austerity measures - tax increases and cuts in spending- may potentially prolong Chile’s lackluster GDP growth rates and lead to further deterioration of the economy.

4 For more information, please see box 1.
3. Monetary Policy and Financial Markets

The YoY inflation rate in December 2016 was 2.7%, the lowest rate since March 2014, and just below the inflation target of 3.0%. This decrease was driven by a moderate growth in the prices of food, equipment and home maintenance, on the goods side, and communication, recreation and culture and transport, on the service side (Figures 8 and 9).

The Central Bank expects the inflation rate for 2017 to be under the inflation target of 3.0%. The Monetary Authority has commented that external events, such as an increase in US inflation that correspondingly drives up US interest rates, growing protectionism in the US that may affect terms of trade, BREXIT plus elections in several European countries, and the economic situation in China could have a significant impact on the Chilean economy. Chilean authorities are preparing to react in the event any of these possible scenarios negatively affects the Chilean economy. Finally, if inflation remains as low as the Central Bank is expecting and economic activity remains weak, the Central Bank could decide to cut interest rates in an attempt to stimulate the economy. In fact, the past week (19 January 2017) the Central Bank lowered the interest rate by 25 points, to 3.25%.

As a final point, the Chilean Peso has appreciated since January 2016 (Figure 10). When compared with other Latin American currencies, the Chilean Peso was one of the only currencies that appreciated during the last 3 months of 2016, this appreciation has been attributed to the increase of copper’s price as well as the positive data results coming from the manufacturing and commerce sectors.
Box 1. Chile’s Fiscal Reform

With tax revenues representing around 18% of GDP, Chile has one of the lowest levels of tax collection and one of the highest levels of inequality among OECD members. The tax collection system was designed in the 1980s and one of its principal objectives was to promote corporate savings. Since the tax system needs to adapt to the new economic situation in Chile, tax reform is needed.

Tax reform (Law Nro. 20.780) was introduced in September 2014 and amendments to the tax reform under Law Nro. 20899 were approved in February 2016. This reform began implementation in a gradual manner in 2014 and will be fully implemented by 2018. Among the principal changes of this tax reform are changes to business income tax and Value Added Tax (VAT) for real estate business. It is expected that these structural changes will lead to an increase of around 50% in tax revenues. For instance, although tax revenues from 2011 to 2015 increased at an average annual rate of 9.5%, the increase in tax revenues since the reform was implemented (2014 to 2015) was 12.2%\(^5\).

The main goals of the tax reform are: 1) to increase tax revenues to be able to finance expenses such as education and health care; 2) to reduce the fiscal deficit; 3) to improve tax equity; 4) to improve the incentives for savings and investment; and 4) to decrease tax evasion and avoidance.

The main changes include the following points:

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<th>Before the tax reform</th>
<th>After the tax reform</th>
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<tr>
<td><strong>Income Tax-Corporations</strong></td>
<td>Tax rate 20%. Tax paid by a company could be used in its entirety as a credit against the tax that taxed the dividends of shareholders or partners.</td>
<td>Creation of 2 systems that are now fully in place: 1- Fully integrated regime, tax rate of 25% 2- Partially integrated regime, tax rate 25.5% in 2017 and 27% starting in 2018. Under this regime, the shareholders or partners could use 65% of the taxes paid as credit</td>
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<tr>
<td><strong>VAT-Real Estate</strong></td>
<td>Non-existent</td>
<td>Companies or people that work in real estate for both selling and leasing will pay VAT (with an exception for the ones that receive a state subsidy).</td>
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<td><strong>Tax to Repatriation of Capital from Abroad</strong></td>
<td>Non-existent</td>
<td>Taxpayers could declare income from abroad, paying a preferential rate of 8% (as an amnesty period, 2015). After the amnesty period the tax rate increased to 35%</td>
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<td><strong>Personal Income Tax Rate</strong></td>
<td>40%</td>
<td>35%</td>
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\(^5\) Tesorería General de la Republica, Chile.
For reference to our previous reports, see our website at: http://researchreports.mufg-americas.com/reports/economic-research

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