Chilean Economic Outlook | August 2018

Chile boasted sound economic growth in the first half of the year. This could moderate in the next few quarters, due to more demanding comparative bases, structural factors limiting its potential and a more complex international scenario.

EXECUTIVE SUMMARY

The Chilean economy had sound growth of 4.8% YoY in the first half of the year, reverting the marked weakness in prior years. The highlight was the 5.1% increase in investment in fixed capital in that same period, reverting several years of decreases. In the next few months, however, this economic dynamism could moderate due to various factors. Firstly, the comparative base will be more demanding because of recovery related to higher expectations that started to be evident as of the last few quarters of 2017. Secondly, the economy is gradually shifting to its potential growth rate of 2.7%, on account of structural factors that have slowed the economy. These include the drop in investment up to late last year, along with lower labor flexibility instilled by the reform implemented in this area some years ago. Maintaining higher growth rates requires a simpler tax system that provides incentives for investment, particularly for small- and medium-sized enterprises (SMEs), and a boost in productivity. The proposal made by President Piñera for this is on these lines, highlighting that this would not have a negative impact on the total tax burden. Thirdly, the international scenario has become more complex, which has led to a large drop in the copper price. Threats of a trade war have escalated, which could generate lower global growth rates. When a trade war is declared more openly, which at this stage still seems a risk scenario, the slowdown of the global economy could be greater, which might hit Chile's growth despite its good economic fundamentals on account of the evident opening up of its economy. Growth in the year could then be around 3.8%. In 2019, we expect a slight decrease to 3.4% and 3.5% by 2020, assimilating convergence to potential growth and considering lower global economic growth.

Despite the growing trade tension, the US economy continues to be very dynamic, reflected by growth of 4.1% QoQ annualized in the second quarter of the year and the ongoing strength of its labor market. This economy could close the year with growth of 2.8%, beating the forecasts a few months ago, and virtually 1% above its potential. In line with this, the Fed will keep up its monetary normalization process, with interest rate hikes of 25 basis points expected in September and December, and three further increases of the same size in 2019. This will contain inflationary pressure, which is still limited.

Chilean Economic Scenario Overview (*)

		2016	2017	2018		2019		2020
Real GDP	%	1.3	1.5	**3.8**	↑	**3.4**	↓	**3.5**
Private Consumption	%	2.2	2.4	**4.0**	↑	**3.2**	=	**3.4**
Gross Capital Formation	%	-0.7	-1.1	**5.0**	↑	**4.5**	=	**4.5**
Gov. Consumption	%	6.3	4.0	**3.9**	=	**2.5**	=	**2.5**
Exports	%	-0.1	-0.9	**6.1**	↑	**3.0**	↓	**4.0**
Imports	%	0.2	4.7	**7.8**	↑	**6.0**	=	**6.2**
Consumer Prices (dec)	%	2.7	2.3	**2.9**	↑	**3.0**	=	**3.0**
Policy Rate (dec)	%	3.50	2.50	**2.75**	=	**3.50**	=	**4.25**
Exchange Rate (dec)	CLP/US$	670	615	**640**	↑	**620**	↑	**620**
Fiscal Deficit	% GDP	-2.7	-2.8	**-2.0**	↑	**-1.4**	↑	**-1.2**
Current Account	% GDP	-1.4	-0.8	**-2.3**	↓	**-2.6**	↓	**-2.5**
Copper Price (dec)	US$/Lb	2,52	3,31	**2,85**	↓	**3,10**	↓	**3,20**
WTI Price (dec)	US$/b	54	60	**65**	=	**62**	↑	**58**

(*) The arrows show the change on the previous report.
Sources: Bci Research, Chilean Central Bank and Bloomberg.

Due to monetary conditions that will become less positive and a fiscal impetus that will moderate, by 2019 and 2020 the US economy could slow down to transitorily attain growth somewhat below its potential. Europe's economic activity figures have been slightly less favorable. Its economy has slowed down faster than expected, which has led the European Central Bank to be more cautious with its policy. Although it will soon scale back the purchase of sovereign bonds and fully eliminate them in early 2019, thereby ending the liquidity injection it has kept up by this means in the last seven years, it could only start gradual interest rate hikes by the middle of that year. Japan is growing by around 1% and its central bank will maintain heavy liquidity injection to get inflation to increase. The Chinese economy has continued its gradual slowdown process, which has been tested by the trade tension with the United States. To assure a seamless path, the Chinese authorities have announced a greater fiscal stimulus and liquidity injection through the banks, which have allowed for currency depreciation of around 10%. They are once again resorting to old methods that will lead to economic growth of 6.6% this year and somewhat lower next year.

Uncertainly still lingers in Latin America. Although the signs from Mexico are positive, due to messages by president-elect López Obrador of consensus and thereby spooking the ghosts of populism, in Brazil there is still no clear political definition almost one month off elections. The focus in this case should be on fiscal adjustments that control the excessive growth of its government debt. The new president of Colombia will focus on cutting taxes and driving public works with the idea of enhancing growth of the economy. The Argentine economy could decline somewhat in the next few months, in line with a sharp fiscal adjustment and high interest rates, which have allowed for greater currency depreciation control. By next year, the Argentine economy could recover and have lower inflation.

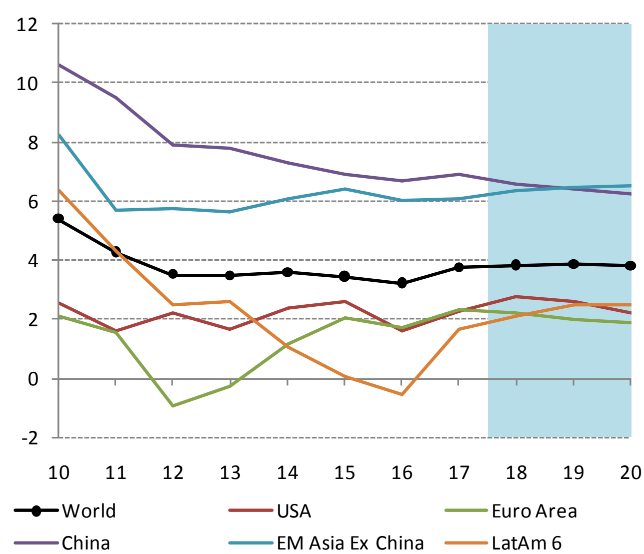
Commodity prices have had mixed changes. The highlight has been the sharp drop in the copper price, due to alarm about a trade war, which could lead to a decrease in global economic growth and therefore lower copper demand.

Global Growth Forecast
(Annual change, percentage)

Real GDP	2016	2017	2018		2019		2020
USA	1.6	2.3	2.8	↑	2.6	↑	2.2
Euro Area	1.7	2.3	2.2	=	2.0	↑	1.9
Japan	1.0	1.7	1.0	↓	0.9	=	0.8
China	6.7	6.8	6.6	=	6.4	=	6.3
India	6.6	6.7	7.3	↓	7.5	↓	7.5
Thailand	3.2	3.9	3.9	=	3.8	=	3.6
Korea	2.7	3.1	3.0	=	2.9	=	2.8
LatAm	-0.9	1.2	1.6	↓	2.3	↓	2.5
Chile	1.5	1.5	3.8	↑	3.4	↓	3.5
Argentina	-2.0	2.9	1.0	↓	1.9	↓	2.1
Brazil	-3.6	1.0	1.8	↓	2.5	↓	2.2
Colombia	2.0	1.8	2.5	=	3.1	=	3.6
Mexico	2.1	2.0	2.2	=	2.1	↓	2.2
Peru	3.9	2.5	3.5	=	3.7	=	3.9
World (PPP)	3.0	3.9	3.8	↓	3.9	=	3.8

Sources: Bci Research, Consensus Forecasts and the IMF.

Economic Growth by Geographical Zone (*)
(Annual change, percentage)



((*) The shaded area is a forecast.
Sources: Bci Research, Consensus Forecasts and the IMF.

In any case, we can see a recovery in the next few months, which could lead to a year-end price of US$2.85/lb due to demand that will continue to increase, and which will in fact lead to a drop in global copper inventories this year. The crude oil price is below US$70/barrel, on account of global supply that will increase less than estimated because of the new sanctions imposed by the United States on Iran, and OPEC that has remained more stuck to the limitations defining its production quotas. In the next few months, we can see some price decrease, because of the sharp increase of around 10% in US crude oil output and which could continue in the next few years.

Terms of trade for the Chilean economy have therefore deteriorated in the last three months, but which might tend to improve in the next few months.

The drop in the copper price and moderation of economic expectations have led to a large increase in the exchange rate in Chile. In the next few months, however, we can see a drop in the value of the dollar, in line with a copper price that could be higher. Inflation will continue to rise, due to dynamic domestic demand, a higher exchange rate and fuel price increases. By December, we expect annual inflation of 2.9%. In 2019, it could be above the 3% target for some months to close that year at 3%. In line with this trajectory, the Chilean Central Bank will increase interest rates by 25 basis points in the December meeting of this year and then hike interest rates three more times in 2019. This could lead to an estimated neutral value of 4.25% by mid-2020.

The economic growth forecast for this year envisages a very dynamic mining industry, but this will tend to decline in the next few years. The retail sector will be much more dynamic compared to previous years, based on a recovery of private consumption. After prolonged stagnation in the last few years, the manufacturing sector is picking up, particularly related to the food and chemicals industries. This is being driven by the higher growth of demand in Chile and from Latin America, to where most of the exports of this sector go. Services will grow more, in line with an economy that is gradually becoming more sophisticated. On the domestic demand side, investment is the component that drives growth most, with a forecasted increase of 5% this year and 4.5% next year. Private consumption could grow 4.0% in 2018 and 3.2% in 2019. A somewhat delayed recovery of the labor market could explain this more moderate increase in consumption in relation to that in prior economic cycles. The rigidity of the labor market leads to employment increasing less than anticipated. Exports could grow by 6.1% this year and less next year. The good global growth upholds the evolution of this GDP component, despite global tensions.

Regarding risks, we can see a negative balance of economic activity by next year and a balance this year. In effect, the risk of a trade war has increased due to the tariffs slapped on by the United States and China retaliating similarly. The sharp divergences regarding this between the two largest economies in the world could lead to an escalation of tension with protectionist policies, greatly hitting global growth. This could lead to lower copper price prospects and a shrink in growth for the Chilean economy. At the same time, the crisis in Turkey has caused alarm in emerging markets, particularly in those with weak fiscal fundamentals that are the most exposed to global uncertainty. Chile is well prepared to handle these shocks but there could be fallout channeled through financial markets. Regarding Chile, on the positive side a more dynamic economy is not to be ruled out as more structural policies, particularly modernization of the tax system, lead to sounder recovery of expectations and the economy boasting higher growth in the next few years, in line with the greater potential that this might imply.

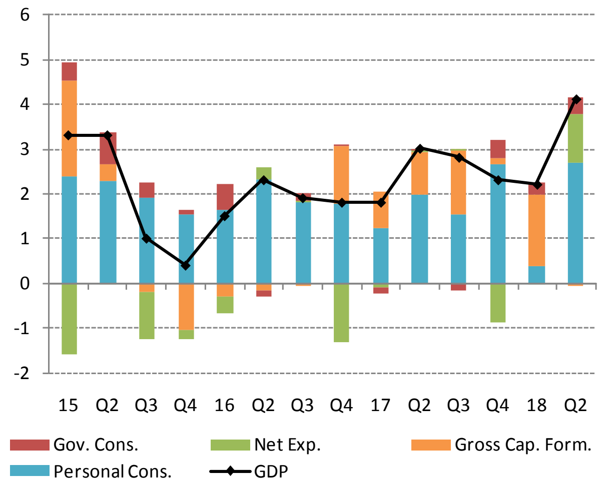
INTERNATIONAL SCENARIO

GLOBAL ECONOMIC ACTIVITY

The international scenario has become less favorable in the last few months, due to the escalation of the trade tension between the United States and China. The negotiations undertaken so far have made no progress, leading both economies to slap tariffs on imports of goods from the other country, evaluated to be around US$50bn. Special tariffs have also been slapped on steel and aluminum imports. Recently, tariffs of over US$200bn have come into force on imports of goods from China. Although at the close of this report there has been new rapprochement between the United States and China, this is still very lukewarm and there is still the risk of escalation to a trade war hitting global economic growth. It is forecasted that in this scenario global economic growth could drop by 1% to 2% accumulated in three years. Nevertheless, by 2019 we expect the most likely scenario to be that tension has eased, aware that otherwise we are all losers, including the United States itself. In any case, there is still uncertainty, greatly affecting markets and causing price decreases of financial assets and commodities. On top of this, there is the crisis in Turkey, whose fiscal accounts and current account situation reflect evident fragility. Trump has imposed sanctions on this economy, causing a sharp depreciation of its currency and tension in emerging markets, particularly in those economies with weaker fundamentals. The political and economic risks in Asia and Europe have tended to decline. Brexit continues its course, albeit slower than expected, without causing havoc to economic activity. The situation in Latin America is, however, worse than expected. Argentina is up against unyielding inflation and great mistrust, besides a sharp fiscal adjustment committed with the IMF. Political uncertainty still prevails in Brazil regarding the presidential elections to be held in just over a month. Due to this, the global growth forecast for 2018 has been downgraded by one tenth to 3.8%, whereas it remains unchanged at 3.9% for 2019.

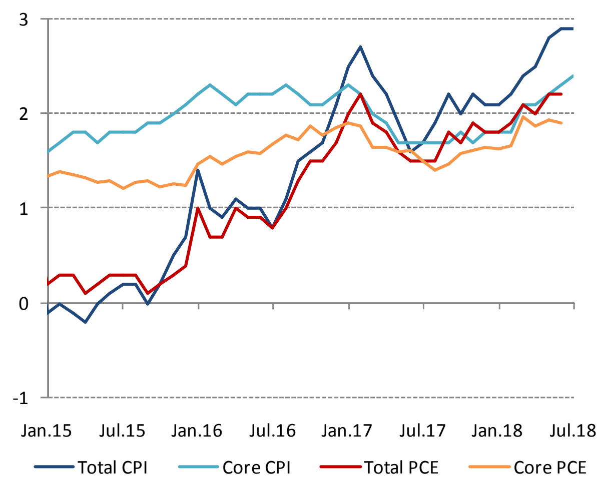
The GDP in the United States in 2Q18 was 4.1% QoQ annualized and in line with expectations, recovering sharply on the previous quarter. The main driver was private consumption that recovered on that in the first quarter. Nevertheless, gross investment had no quarterly change, as the increase in fixed investment was offset by a drop in private inventories. For the rest of this year, we should see a recovery of inventories to address robust domestic demand, and consumption could remain strong, due to a labor market that is still very dynamic. Fixed investment could remain sound, driven by the tax reform implemented a few months ago and the infrastructure plan.

USA: GDP Growth
(Contribution, annualized QoQ, percentage)



Sources: Bci Research and Bureau of Economic Analysis (BEA)

USA: Inflation Gauges
(Annual change, percentage)



Sources: Bci Research and Bloomberg

In the political area, the government has continued to make progress with the NAFTA negotiations and it is estimated these will end in October. Trade relations with China have declined significantly. Both countries have slapped tariffs of around US$50bn on certain goods and Trump has threatened to increase this amount. Before the closing of this report, there was information of a meeting between low-level representatives of both governments in Washington DC in late August. Such meeting, which is eagerly awaited by the market, is expected to take the first steps to start a new round of negotiations and thereby end the trade war.

The labor market has kept up the dynamism of early in the year with an unemployment rate of below 4.0% for the fourth month running, despite the increase in the labor force. Regarding job creation, so far this year an average of over 200,000 jobs a month have been created, which is very high for an economy in full employment. As of 2017, experts have said that job creation should ease and be 100,000-150,000 jobs a month in this condition of the economy, but the stimulus made by Trump and a market saying that wages are not increasing have increased the turnover of people seeking better wages, which have had no major changes.

Prices have increased sharply in the last few months. The total CPI has been just below 3% a year in the last three months, driven by crude oil prices, but the underlying CPI has also recovered and is close to 2.5% a year. The personal consumption expenditure (PCE) has had somewhat more limited increases but with a clear upward trend and it is already 2.2% per annum.

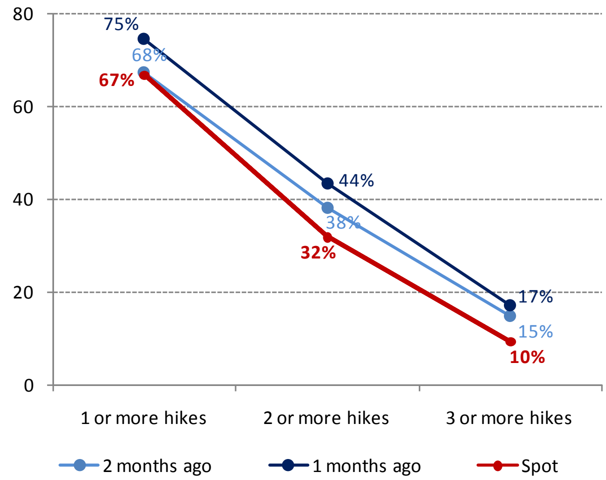
The Fed has continued its monetary normalization process, hiking interest rates to the 1.75-2.00% range in June, stating its intention of raising interest rates twice more this year with three increases in 2019. Due to the current inflationary scenario, the interest rate hikes in 2018 have been fully assimilated by the market. Our forecast concurs that interest rates will end up in the 2.50%-2.75% range and that there could be three hikes in 2019. This is due to a higher and more permanent fiscal deficit than estimated, an economy that is growing above its potential with positive margins, and a labor market with an unemployment rate of below its natural rate.

Accordingly, we have upgraded our forecast for 2018 to 2.8% and 2.6% for 2019.

The Euro area had growth of 0.4% QoQ in 2Q18 and in line with expectations. This result reveals that economic activity is maintaining its growth rate. It is estimated that private consumption and investment could have eased and that exports might have recovered compared to the previous quarter. The outlook remains positive but there are still political risks.

US: 2019 Fed Funds Increase Forecast

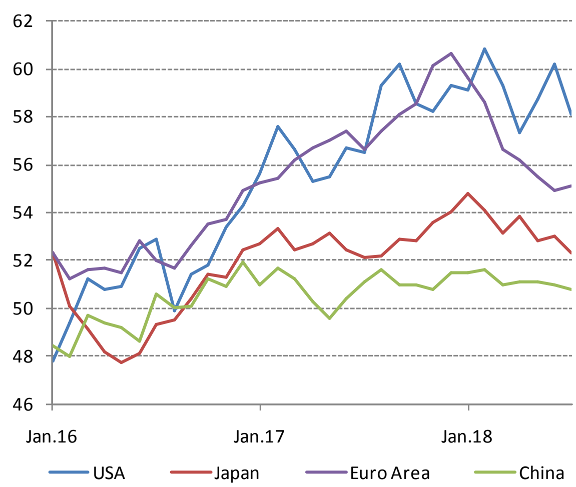
(Percentage)



Sources: Bci Research and Bloomberg.

Manufacturing Sector Expectations

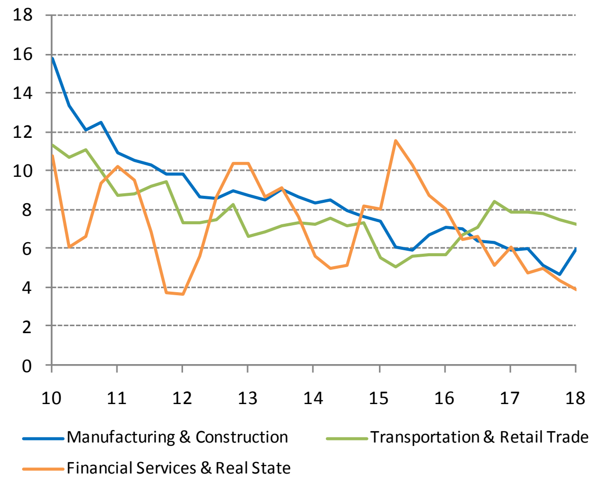
(Index, pivot 50)



Sources: Bci Research and Bloomberg.

The government in Spain has continued its economic management, providing stability to markets. In Italy, the coalition formed by two eurosceptic movements, the Northern League and Five Star Movement, is on the verge of delivering the 2019 budget, which is already showing signs of increased fiscal spending despite the high government debt. Agents are watching to see how big the discrepancy will be between the budget and guidelines of the European Community and its commitment to fiscal consolidation. Brexit has continued and its fallout has been lower than expected. The negotiation process should end in March 2019. We thereby maintain our growth forecast for the Euro area at 2.2% for this year and have upgraded it for 2020.

China: GDP Growth
(Annual change, percentage)

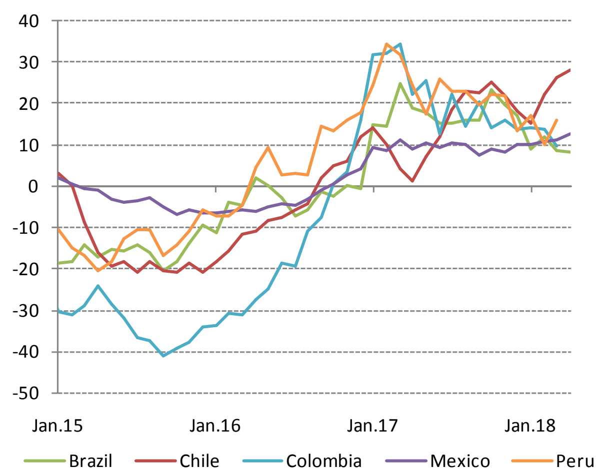


Sources: Bci Research and Bloomberg

The labor market is once again improving, albeit at a lower rate. The unemployment rate, which has again dropped to 8.5%, is at its lowest rate since December 2008. The number of people unemployed has also fallen, but it is still over 13 million people, and wages are growing at very low rates revealing that there are still margins. This is also evident in inflation. Although this has increased recently and was 2.1% annually in July, energy and food prices have been the drivers of this. The underlying inflation gauge is 1.4% per annum.

Regarding monetary policy, the European Central Bank (ECB) has made no changes to interest rates or its monetary program. In the September meeting it is expected to announce the end of its monetary program by the end of the year, but the possibility of extending it to March 2019 is not fully ruled out due to the economic activity figures. There could be interest rate changes in 3Q19, when the capacity margin has already started to close up and there are signs of somewhat higher inflation. All this is a gradual process.

Latin America: Exports
(3-month moving annual change, percentage)



Sources: Bci Research and Bloomberg.

China had growth of 6.7% in 2Q18, in line with forecasts and slightly lower than the previous quarter. The services sector kept up its rate compared to the previous quarter and grew 7.6% YoY. The financial services activity recovered strongly on prior quarters and transportation made the greatest contribution to the sector. The industrial sector continues to grow at similar rates to those in 2017, on average 6.4% a year, whereas the construction sector continues weak with growth of 4% a year. The latter is in line with government endeavors to cut the explosive growth in the sector.

Although the government set a growth target of 6.5% for this year, our forecast is 6.6% growth in 2018 and 6.4% in 2019, with no changes on the previous report. In the second half of the year, the economy should grow by around 6.4%, 4 percentage points less than in the first half of the year.

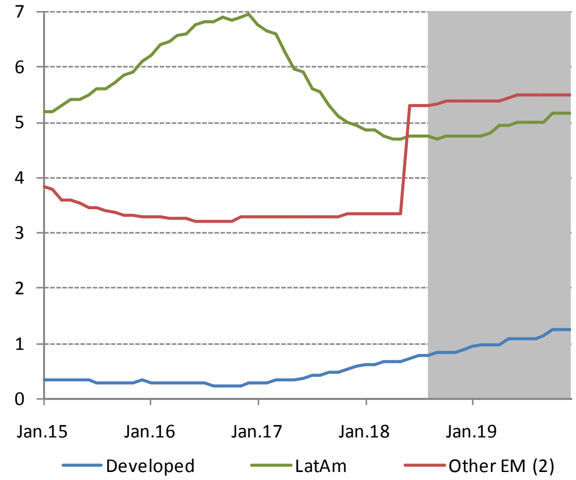
This is in line with the latest figures released, which show a slightly higher slowdown and the greater uncertainly instilled by the trade war with the United States.

We estimate that the impact of the trade war on the expectations of businesses and people, along with the economic adjustment process and change in its growth composition, are assimilated in these forecasts. Although the balance of risks is downward, there could be higher tariffs with the United States or the conflict drag on for longer. Analysts mostly forecast that the impact could shave 0.1% to 0.2% off annual growth. A greater impact is less likely due to the possibility of the government adopting greater measures to avoid a hard landing.

Latin America's economic performance has been disappointing in the last few months. In late 2017, expectations for the region were positive, but then the old structural issues have resurfaced, in line with less favorable foreign financial conditions. The political scenario will continue with great uncertainty in the next few weeks, adding volatility to markets in the region. Markets have their eyes on the forthcoming elections in Brazil, where the best-positioned candidate is paradoxically Lula da Silva, despite not being able to run due to his prison sentence. It is highly likely that the winner will be defined in a run-off election from among the candidates, for whom the electorate is now showing little intention of voting. The key is their commitment to rectify the heavy fiscal deficit to make government debt in Brazil viable, which requires a major reform of pensions. Argentina continues to undergo a demanding fiscal consolidation process, with inflation of near 30% a year, which has led to great tension in its markets. There is more tranquility in Mexico, where the recently elected president Andrés Manuel López Obrador has caused surprise with a more inclusive message, aiming at seeking consensus which has led to a better performance of its markets.

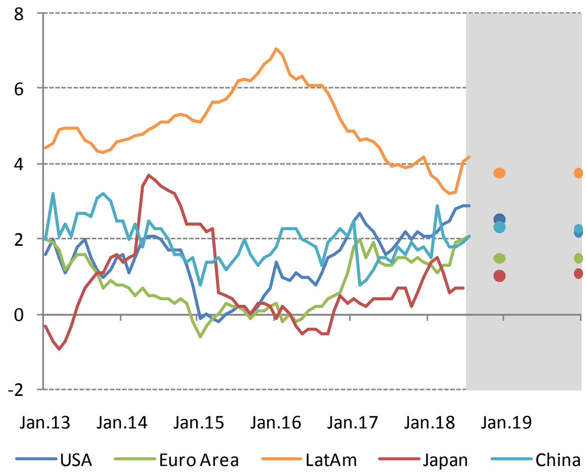
In line with this, the growth forecasts for the region have been downgraded to 1.6% this year, 0.3% lower than that envisaged in the previous report. By 2019, there could be an improvement in the Latin American growth rate but still below its potential. The international scenario has become less favorable due to fears of a trade war, the effects of contagion of the crisis in Turkey and the prospects of interest rate hikes. The internal risks of each economy continue. In the light of this, the balance is tipped towards the negative.

Interest Rates (1)
(Percentage)



1) The shaded area is a forecast. (2) Includes China, Korea, Poland, Taiwan and Turkey.
Sources: Bci Research and Bloomberg

Inflation and Forecasts (*)
(Annual change, percentage)

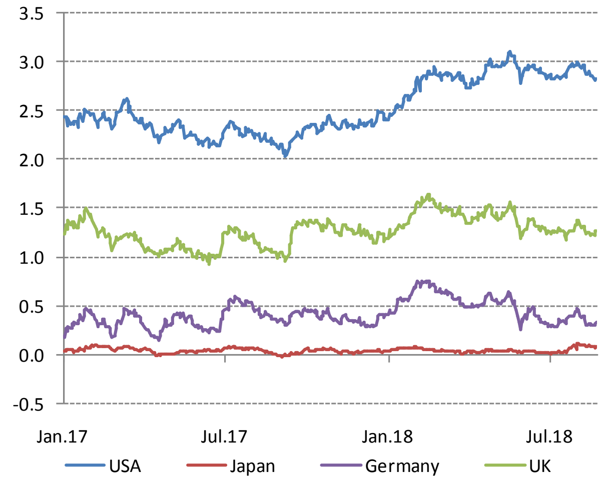


(*) The shaded area is a forecast.
Sources: Bci Research and Bloomberg

FINANCIAL MARKETS

Since the previous report, international financial markets have undergone large adjustments due to fears of a trade war between the United States and China. There has been capital flight from emerging countries, particularly those with weaker fundamentals. Recently, the crisis in Turkey has added pressure to financial markets. Stock markets have had a mixed performance in the last few months, with the highlight being large decreases in Turkey (-14%), China (-12%) and Argentina (-8%), whereas Mexico is out in front with an increase of 10%, also highlighting the 7% increase in the US stock market due to sound growth of that economy. This has been accompanied by greater volatility, which although is not fully reflected in the more classic indicators, it is evident in political uncertainty indicators. The escalation of trade tension between China and the United States has maintained investor flight-to-quality for some months now.

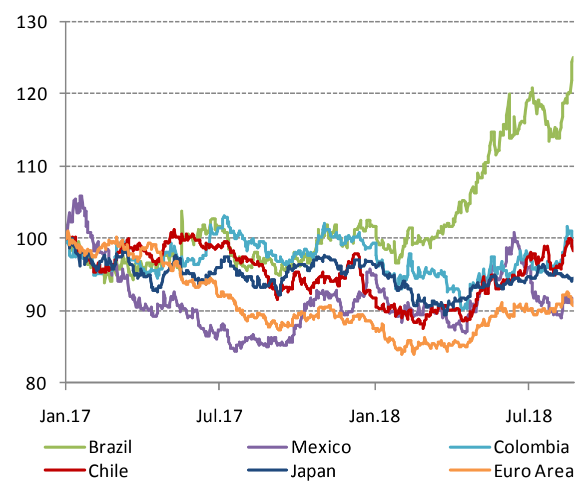
10-Year Sovereign Bond Yields
(Percentage)



Sources: Bci Research and Bloomberg

Risk premiums have risen considerably, highlighting the sharp increases in Turkey and Germany of around 200 basis points, which are precisely the economies with greater macroeconomic weakness and are exposed to marked internal imbalances. The currency highlight is the appreciation of the global dollar, which hit a high of around 3% last quarter. This is due to the flight-to-quality observed, which has led investors to take positions in safer assets in dollars. Nevertheless, this has declined lately on account of the internal political events in the United States regarding Trump's more complex legal situation. The euro has had no major changes, whereas currencies in the region are depreciating in general, with the exception of the Mexican peso. The Argentine peso has plummeted 22%, mostly dragged down by the Turkey debacle, and the Brazilian real has dropped around 10%.

Nominal Exchange Rate Evolution
(1 January 2013 index =100)



Sources: Bci Research and Bloomberg

Regarding interest rates, developed countries have been somewhat more volatile. The US 10-year Treasury bond reached its highest level of around 3.0% in early August. Nevertheless, the search for safe havens led to another drop in yields in the last few weeks. Due to the uncertainty now prevailing, rates could be pressured downwards but temporarily and not increase in line with macroeconomic fundamentals. Our forecasts are that, in our baseline scenario of Fed Funds rate hikes in 2018, 2019 and 2020, the outlook of a higher fiscal deficit, greater inflation, and a slight decompression of term and risk premiums, the 10-year Treasury yield could be around 3.0% by the end of this year and about 3.8% by late 2019.

COMMODITY MARKETS

COPPER

After a good start to the year, there has been a large price decrease, particularly last month, and mainly due to factors related to the trade war between China and the United States, leading to a price of around US$2.70/lb. Besides this, there are expectations that the Chinese economy could grow less strongly in the second half of the year, which has been assimilated in some indicators.

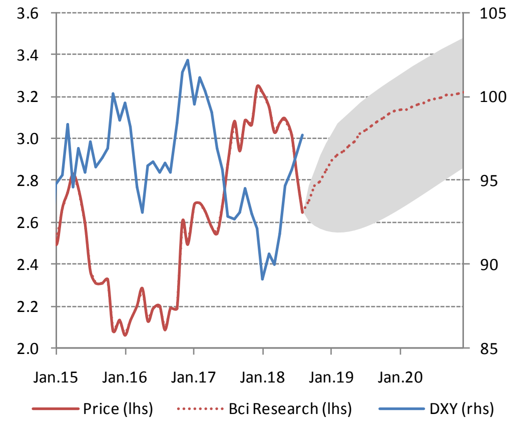
Regarding supply, production has managed to stabilize in the last few months after large recovery in the first part of the year, due to interruptions in 2017. Production is therefore expected to increase by about 2% this year. On the other hand, the risk of interruptions due to strikes has declined. Escondida reached an agreement with its workers, which sets a precedent for the collective bargaining processes to come, starting with Codelco next year. In 2019, there are around five important projects that could boost output, with most of them however being expansions of existing projects to address the lower ore grades, so supply could grow by around 2.8%. By 2020 and 2021, there could be a larger number of projects, but which in terms of the quantity produced are small. Only one or two would be greenfield projects, so supply might be more restricted in the medium term with an increase of about 2%. The main problem for these kinds of projects has been technical and political in regard to each project and country and not the price incentive. In the last five years, China has greatly increased its smelter capacity which is one of its strategic economic pillars. The active capacity is more than enough to absorb the increase in the concentrate supply. China has therefore really increased its demand for concentrate and ore.

Demand has continued without any major setbacks, accelerating somewhat lately but within that expected this year. Demand for refined copper has taken off in the last few months due to China's restrictions on scrap metal imports, but by 2019 should have stabilized. The trade tension between the United States and China has really hit the copper price, due to fears of the effects on global growth. The different reports state that the tariffs applied so far will have no major direct or indirect impact on the copper market

Our forecast is an easing of global tension. Until that happens, price pressure will continue. This has been reflected by sharp decreases in speculative copper positions.

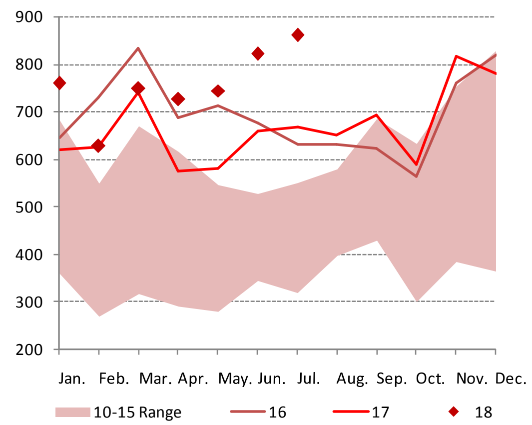
In a scenario of lower trade tension, the outlook for demand is favorable for the next few years. This could lead to a slight deficit in the copper market equilibrium for 2019-2021. With a Chinese economy that has managed to keep up the rebalancing of its economy towards greater consumption, by 2019 demand for concentrate could continue to increase and that for refined copper will be more stable. In the longer term, as of 2024 onwards the electric car market will have a major impact on the copper market.

Copper Price and Multilateral Dollar
(US/lb; index)



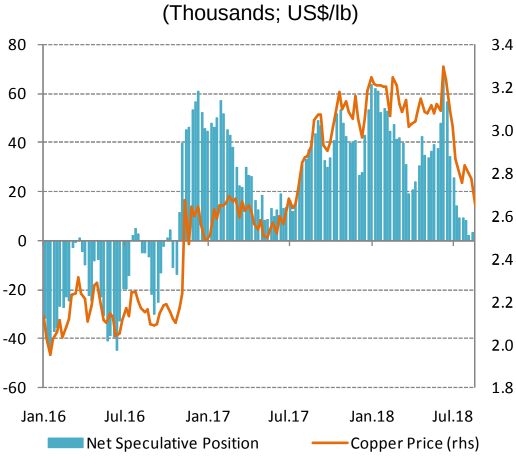
Sources: Bci Research and Bloomberg

China's Copper Imports
(Thousands of metric tons)



Sources: Bci Research and Bloomberg

Speculative Positions and Copper Price
(Thousands; US$/lb)



Sources: Bci Research and Bloomberg

We have therefore downgraded our copper price forecast for 2018 and 2019 and the price will close this year at around US$2.85/lb and then increase slowly to US$3.10/lb by late 2019. The balance of risks for the copper market is downward.

CRUDE OIL

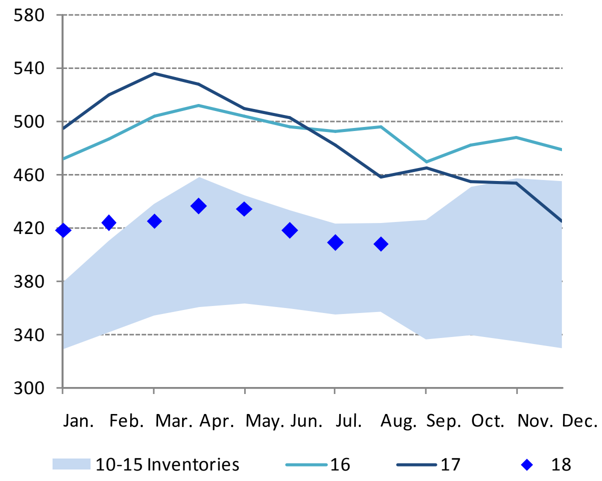
Crude oil prices plummeted in the third quarter after a large increase in prior quarters. The sanctions imposed by the United States on Iran spurred the upward price pressure, largely due to a geopolitical risk premium and lower supply than forecasted, along with a favorable outlook for global economic growth. This, however, has changed recently. The geopolitical risk premium is reflected in the reference price spread between Brent (Europe) and WTI (United States) crude oil, which was US$11/b in June, the highest level since the bouts of social and political tension in the Middle East in 2011 and 2013. In this scenario, crude oil prices were around US$75/b in the second quarter, the highest price since late 2014.

There was, however, a large price decrease in the third quarter, mainly because of higher crude oil production and a drop in the geopolitical risk premium to about US$6/b. Global crude oil output rose 2.2% January through July this year, with total production of 98 millions of barrels per day (mbpd), a record high. This has pushed down the reference prices. Despite some internal discussions, OPEC has maintained its commitment to jointly produce about 32 mbpd. There was somewhat higher output from other member countries as a way of compensating for Iran's lower production.

Non-OPEC countries, however, continue to increase the crude oil supply. Favored by a higher price, US shale oil producers have increased output to around 11 mbpd, well above the 9.7 mbpd early in the year. The price decrease is therefore explained by greater global supply, which suggests equilibrium prices of around the marginal production cost of the US production, estimated to be about US$60/b.

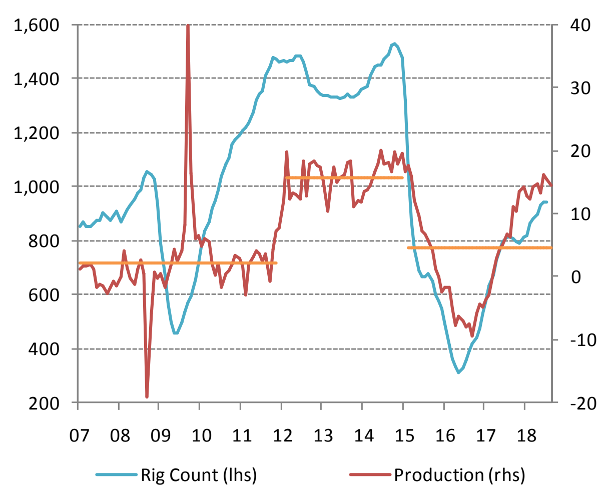
Based on this scenario, the WTI crude oil price is close to equilibrium levels and is around US$65/b. Forecasts are a crude oil price of about US$62/b by 2019. The risks in this scenario are, however, downward. A deterioration of the international scenario, related to the US protectionist policy, could drive global crude oil price increases, considering that tariffs are slapped on US crude oil exports to Chinese markets, in retaliation to US tariffs on products from China. In the short term, however, US crude oil inventories have dropped, which could lead to upward price pressure, considering the very dynamic US economy at present.

Oil Inventories in the USA
(Thousands of barrels)



Sources: Bci Research and Bloomberg

Oil Rigs and Production in the USA
(Number; annual change, percentage)



Sources: Bci Research and Energy Information Administration (EIA)

CHILEAN ECONOMY

The Chilean economy grew 5.3% YoY in the second quarter of this year, the highest growth since 2013. The highlight was the annual 7.1% increase in investment due to machinery and equipment. We deem the growth rate will moderate by the end of the year.

ECONOMIC ACTIVITY

The Chilean economy grew 5.3% YoY in the second quarter of this year, again beating market forecasts of 5.2% growth. As in the first quarter, economic activity was mostly driven by non-mining sectors, highlighting retail, the manufacturing industry and services. The mining industry had lower growth than in the first half of the year, slowing down compared to the previous quarter. At expense component level, the highlight was the large 6.0% YoY increase in domestic demand, the highest level since early 2013.

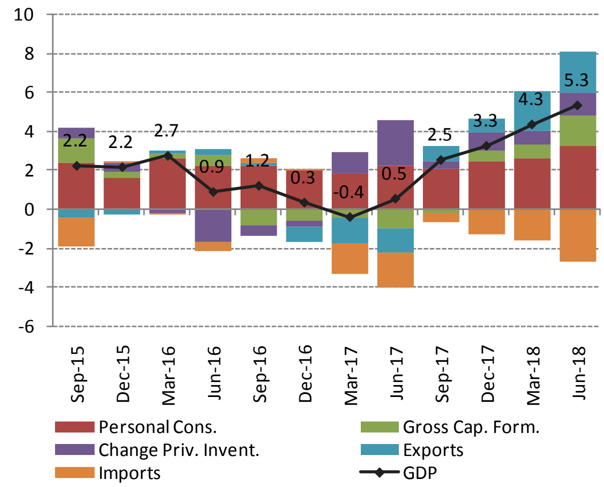
The highlight of domestic demand was the large 7.1% YoY growth of gross fixed capital formation. This larger increase in investment was driven by the higher growth of machinery and equipment with this component increasing an annual 12.5%. On the other hand, total consumption grew 4.2% YoY, and such figure is mainly explained by the higher private consumption in the period and somewhat greater government consumption.

Total consumption grew 4.2% YoY in the second quarter of 2018, increasing 1.1% QoQ quarter in deseasonalized terms. With this figure, this aggregate contributed 3.2 percentage points to GDP growth in the quarter. At component level, private consumption increased 4.5% YoY and government consumption 2.8% YoY. The latter had a 1.5% quarterly increase, which could moderate in the next few quarters. At private sector level, durable goods consumption increased 13.3% YoY, that of non-durable goods 2.6% YoY, and services 4.5% YoY. The large growth of durable goods is a phenomenon that is also evident in other more frequent figures like retail sales published by the National Bureau of Statistics (INE, according to the Spanish acronym) and durable goods imports. These figures endorse that most of this growth could be explained by higher car sales in the period.

In the services area, the recovery of this consumption component accounted for around a 1.4% contribution to GDP growth based on an annual increase of 4.5%. This boost from service consumption is evident in the higher recovery of the GDP explained at sector level and in employment generation in this sector.

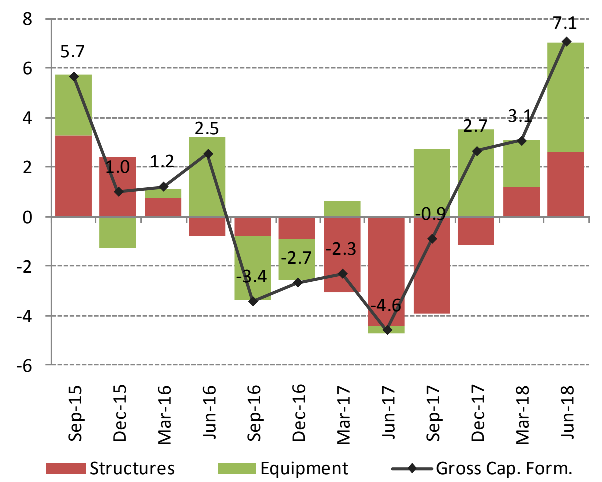
On the other hand, the gross fixed capital formation in the second quarter was one of the domestic demand aggregates with the highest growth. It grew 7.1% YoY, the highest growth since the first part of 2013.

Quarterly Contribution to GDP Growth
(Annual variation, percentage)



Sources: Bci Research and the Chilean Central Bank

Contribution to Investment Growth
(Annual variation, percentage)



Sources: Bci Research and the Chilean Central Bank

Within this aggregate, there was a 12.5% YoY increase of machinery and equipment, which made the greatest contribution to investment growth. Nevertheless, in the opinion of the Chilean Central Bank this increase might rather be a response to demand of replacing unreplaced machinery with the usual frequency and not to new projects and/or those with a greater scope. Due to this, we might see a decrease in this investment component in the next few quarters. The construction and works component grew 4.0% YoY, confirming the recovery in 1Q18 and reverting seven consecutive quarters of annual contraction ending in 2017.

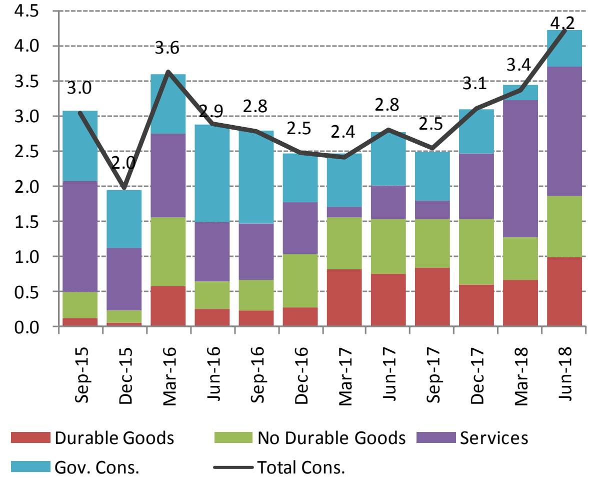
Unlike the previous quarter, the balance of trade made a negative contribution to growth, due to higher imports. Exports abroad grew 7.5% YoY and imports increased 10%. Exports contributed 2.1% and imports 2.7%. In disaggregated terms, the highlight was the copper export increase of 9.1% YoY (13.8% in 1Q18) and industrial exports growing 9% YoY (6.8% in 1Q18). The highlight in the import area was the 12.1% YoY increase of industrial imports and 41.4% growth of agricultural imports.

At sector level, as in the first quarter, the highlight this quarter was non-mining sectors making the largest contribution to growth. The GDP rest grew 5.5% YoY (3.3% in 1Q18), whereas the mining GDP increased 4.8% YoY (19.1% in 1Q18). At quarterly acceleration level, the mining GDP decreased 4.2% deseasonalized and the GDP rest had a quarterly increase of 1.3% deseasonalized. Disaggregated by activity, the manufacturing industry was the economic sector that made the largest contribution to growth in the quarter, increasing 7.3% YoY (3.2% in 1Q18). This sector was followed by retail with growth of 8.1% YoY, and personal and business services that increased 4.5% and 5.4% YoY, respectively.

Another important issue to be considered in the recovery of economic activity is the recent performance of investment aggregates. The large recovery of this variable, particularly in the second quarter, has led to more detailed analysis of its performance. At component level, construction and works had annual growth of 4.5% in 2Q18, which consolidates the recovery observed in the first part of the year and reverts seven consecutive quarters of contraction ending in 2017. On the other hand, the machinery and equipment component had a recovery of 12.5% YoY, reflecting impressive acceleration. Nevertheless, the latest report of the monetary policy meeting in July revealed a more incredulous position regarding the sustainability of this figure, arguing that it is growth in response to demand for replacing unreplaced machinery with the usual frequency rather than new projects and those of greater scope. On the other hand, the last survey report of 2Q18 by Corporación de Bienes de Capital (CBC) reveals that the stock of public and private projects to be undertaken this year remained relatively close to US$15bn, with a transfer being made by 2019 and 2020, which showed a stock of US$12bn and US$8bn, respectively.

Sectorial Contribution to Consumption Growth

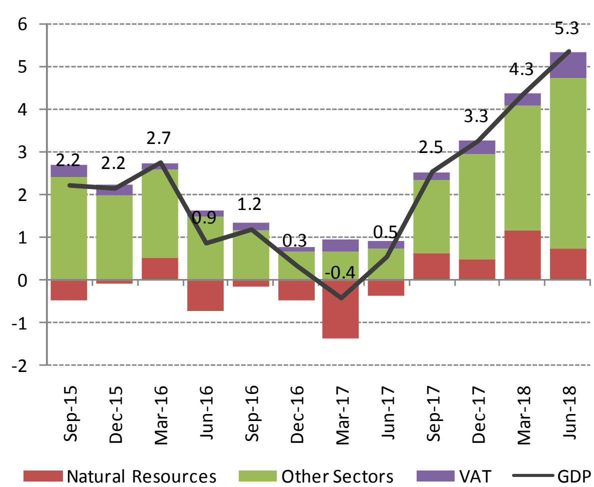
(Annual change, percentage)



Sources: Bci Research and the Chilean Central Bank

Sectorial Contribution to GDP Growth

(Annual change, percentage)



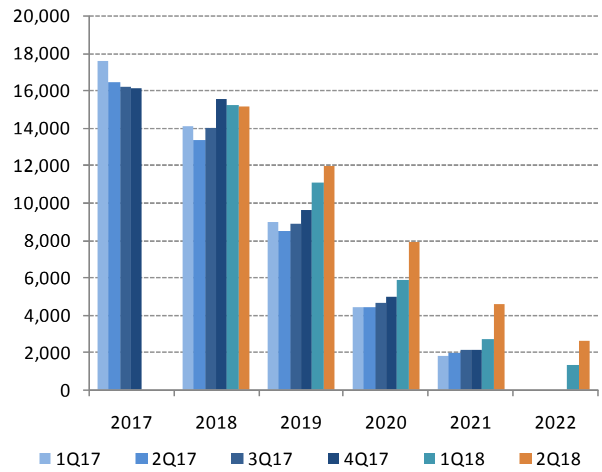
Sources: Bci Research and the Chilean Central Bank

One possible explanation of this factor of delaying the execution of projects could be related to expectations of tax modifications.

Our vision is that we expect the large economic recovery in the last few months to moderate slightly by the latter part of this year, due to more demanding comparative bases. Despite this, we estimate that the expectations of economic agents will remain optimistic, and this situation has continued in the last few months. Regarding consumers, Chile's Economic Perception Index (IPEC, according to the Spanish acronym) once again increased in July to 50 points. However, this index dropped on previous figures, which could be related to greater uncertainty about the international area. Concerning business, the monthly business confidence index (IMCE, according to the Spanish acronym) was 52.16 points in the July gauge, also dropping on the highs early in the year. Disaggregated by economic sector, construction is the only sector on this index that is still in the pessimistic zone.

Lastly, in the next few months we expect the monthly economic activity index to have a lower annual change compared to the first quarter. Altogether, our vision for this year is growth of 3.4% and 3.6% in 2019.

Stock of Public and Private Investment Projects to be Undertaken
(Millions of USD)



Sources: Bci Research and the Chilean Central Bank

PRICES

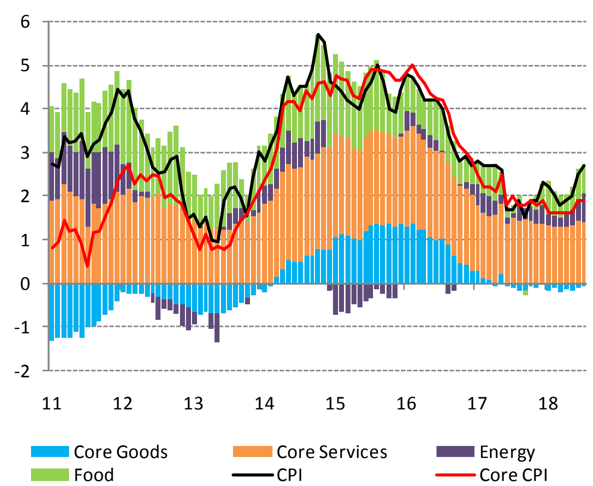
Inflation is rising gradually, mainly explained by the prices of gasoline and some foods. Moreover, upward pressure on transportation prices, due to the higher exchange rate, has caused increases in the price index in the latest figures. Despite the fact that inflation perspectives are around 3.0% for the medium and long term, underlying inflation (excluding food and energy) is still in the low part of the target range.

This is for two reasons: the annual variation of core goods inflation has been negative for longer than forecasted, and core services inflation is at a low level from a historical perspective. With the large increase in the exchange rate, goods inflation, which accounts for around 30% of the CPI basket, was around 5% annually in 2015 and then dropped in line with the normalization of the exchange rate.

Despite this, as of the second quarter of 2017 this index has been negative, assimilating the imported goods price adjustment. In the third quarter of 2018, in line with the recent increase in the exchange rate and comparative base, the forecast is that the annual variation of core goods inflation will start to be positive, reaching 1% in the next few months. It should be noted that the historical average of the goods CPI is around 0% YoY.

Core services inflation remains low from a historical perspective. The average annual variation for this index is about 4.2%.

Annual Inflation Effect
(Percentage)



Sources: Bci Research and National Bureau of Statistics (INE)

In 2018, services inflation is around 3.2% YoY, in a downward trend as of mid-2016. Factors related to economic activity and the labor market are the cause of the evolution of service prices.

The closing up of capacity gaps in the economy might put upward pressure on service inflation, as real wages are pushed up in a context of greater generation of employment. The outlook, however, is a gradual improvement in the labor market indicators that steadily raise service inflation by 2020.

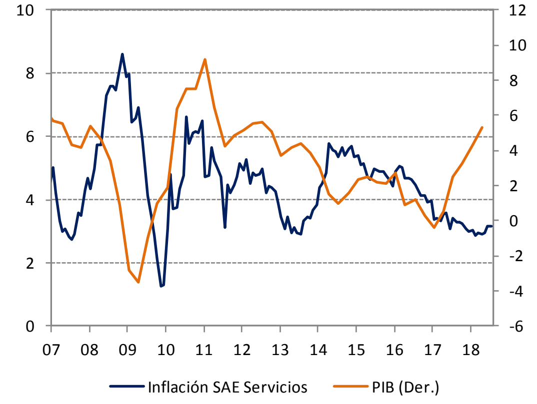
Altogether, the evolution of goods prices and some inflationary pressure from food and energy prices could lead to inflation of 2.9% in December 2018. In longer terms, inflation might, however, be around 3.0%. Underlying inflation could rise at a slower rate, in line with the lag of service prices. Core inflation could be slightly below 3.0% in the next few years.

The balance of risks in this scenario is balanced. A deterioration of the international scenario could put transitory upward pressure on the exchange rate and cause higher increases of goods prices than estimated. Improvements in the labor market, which result in wage pressures, could lead to normalization of service prices to their historical average in less time than incorporated.

INTEREST RATES

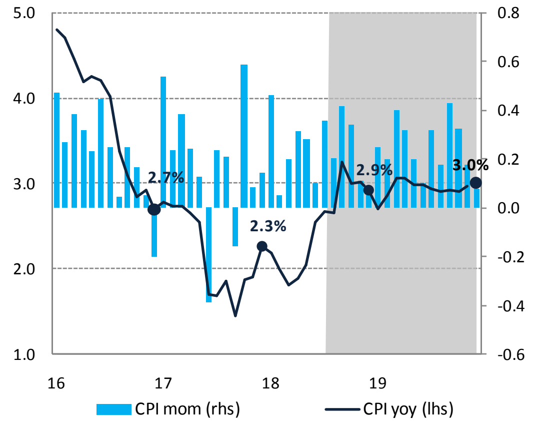
With no surprises with what we forecasted in our last report, the Chilean Central Bank Council decided to hold interest rates at 2.50%. Nevertheless, unlike last quarter inflation has increased significantly to near the 3% target. Despite this, the debate within the Council has been focused on sources that have caused this increase in prices, and the uncertainty generated by the international scenario, particularly the trade tension between the United States and China, and the impacts of there being a risk scenario regarding Chilean variables. Firstly, it is evident that the increase in inflation has been dominated by more volatile factors like the exchange rate and fuel prices, and that underlying inflation has remained at historically low levels, shaving points off total inflation. On the other hand, there is evidence upholding the risk scenario that the labor market continues to be very undynamic, and particularly wages have tended to grow less. Secondly, the recent trade tension has not been the main focus of debate, this has been more on the impacts an escalation of the trade war scenario could have for Chilean variables. In this reference framework, we see the most likely scenario as being the launch of the monetary normalization process by late 4Q18, and such decision might continue in 2019 with three further hikes in the benchmark rate. For the time being, one policy option is to start the normalization process and not raise interest rates by 25 basis points to more subtly introduce the intention of reducing the monetary stimulus. We deem that the publication of the next monetary policy report could be the right time to consolidate expectations about this scenario.

Service Inflation and GDP Growth
(Annual change, percentage



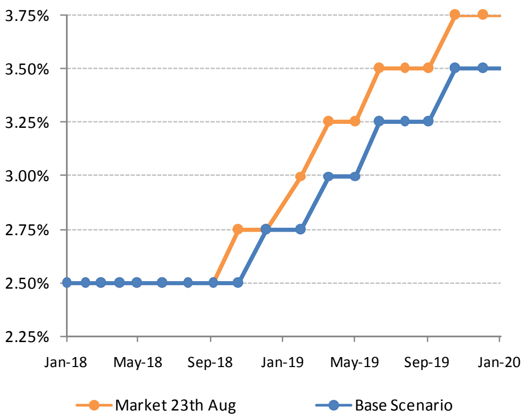
Sources: Bci Research and and the Chilean Central Bank

Inflation Evolution and Forecast
(Variation, percentage)



Sources: Bci Research and National Bureau of Statistics (INE)

Monetary Policy Rate
(Percentage)

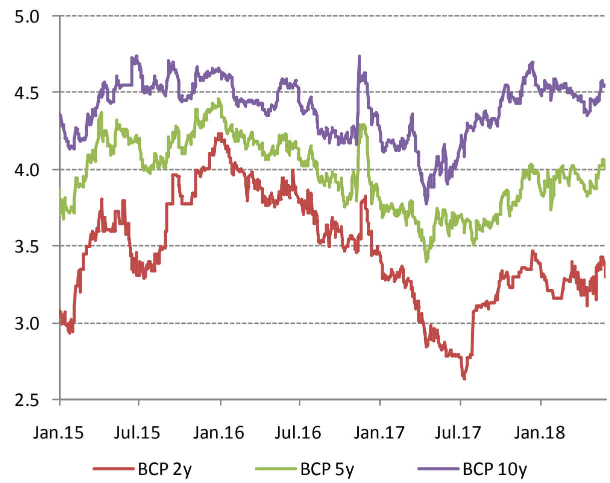


Sources: Bci Research and the Chilean Central Bank

On the other hand, financial asset prices still incorporate expectations of an interest rate hike before the end of the year, whereas long-term bond rates, particularly the 10-year bond, are still giving a yield of about 4.5% at the close of this report. In the international area, longer-term yields have maintained the levels at the close of the previous quarter, with the US 10-year Treasury bond being 2.83% at the close of this report..

In this instrument, the greatest market convincement about forthcoming Fed Funds rate hikes, along with limited decompression of term premiums, has enabled the increase seen up to now. Although the transfer of international rates to Chilean rates has been unstable over time, we see Chilean long-term rates as a major risk, a phenomenon of a higher increase in international rates during the course of the year. Regarding this, our baseline scenario envisages an increase in the 10-year Treasury yield to just over 3.4% by the end of this year.

Nominal Rate Evolution
(Percentage)



Sources: Bci Research and the Santiago Stock Market

FISCAL POLICY

According to data provided by the Treasury Budget Office, the closing of the budget execution for the first quarter of this year revealed that the central government's total revenue had a real 6.5% increase on the same period in 2017. On the other hand, spending increased a real 5.4% annually, amounting to a central government deficit of 0.1% of the GDP estimated for this year.

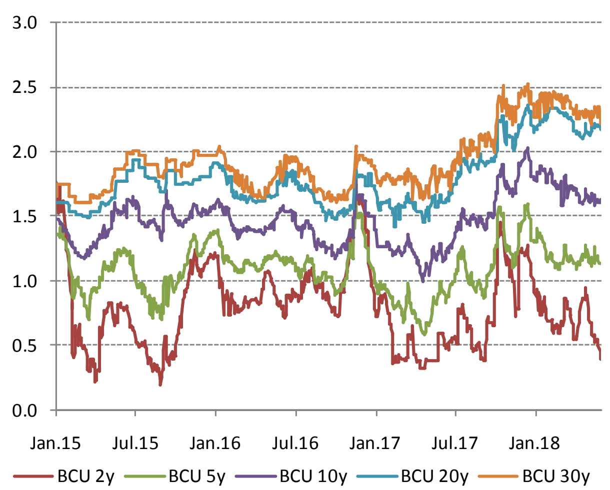
In disaggregated terms, fiscal revenue increased a real 6.5% annually in the first half of the year, accounting for an accrued 10.9% of the GDP estimated for this year by the tax authority. Net tax revenue had a real annual increase of 4.7%, which is broken down into a 1.4% real annual increase in tax revenue from non-mining taxpayers, and 186.4% increase in revenue from the large private mining industry. The total revenue result is largely due to the greater transfers from the private and state mining industry. This is mainly because of the copper price increase, which averaged US$2.7/lb in the first half of 2017, whereas in the first half of 2018 it averaged US$3.2/lb.

Total central government spending grew a real 5.7% annually in the first half of 2018. The spending execution rate at the close of 1H18 had 46.7% progress regarding the Budget Law, slightly higher than the 46.5% in the same period in 2017.

At the close of 1H18, the Economic and Social Stabilization Fund (ESSF) had accumulated US$14,636.9 million, and the Pension Reserve Fund US$9,870.6 million. The balance of financial assets of the Treasury amounted to US$29,430 million.

Our baseline scenario envisages a 4.3% real increase in central government spending.

Real Rate Evolution
(Percentage)



Sources: Bci Research and the Santiago Stock Market

This, along with greater fiscal revenue of around 8% due to the higher copper price and increased economic activity, could lead to an effective deficit of 2% of the GDP in 2018. Regarding the cyclically adjusted balance, we forecast a structural deficit of 1.5% of the GDP. Lastly, we estimate a debt stock that could be 24.7% of the GDP in 2018.

EMPLOYMENT

The unemployment rate has risen to over 7.0%, the highest level since mid-2011. According to INE figures, the labor force grew 2.4% YoY in the first part of the year, slightly above average growth in the decade (1.7%). Employment increased 2.2%, just above the average for the same period (1.8%). This situation leads to a higher unemployment rate due to the delay in the job creation rate of absorbing the higher growth of the labor force.

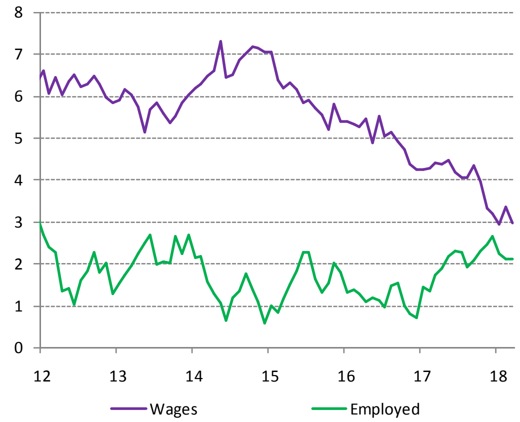
The employment rate is around 60%, slightly above its historical average, in line with the prospects of higher economic growth. The recent evolution of the labor market is marked by public sector employment. In 2017, public administration employment on average grew close to 6.0% YoY, well above other economic sectors. The measures to reduce fiscal spending have led to a reversion of the employment created in this sector. In 2018, for example, there has been job destruction of about 1% on average. Private sector employment is growing at a low rate and cannot offset the drop in public sector employment.

By economic sector, the services sector continues to widely lead annual job creation, explaining virtually all the jobs generated. There has been a deterioration of employability in the manufacturing sector, contrary to the better economic activity figures in the sector. This could indicate productive efficiency endeavors. Employment in the retail sector has had no job creation after a marked period of job destruction. The construction sector is showing incipient signs of greater job generation.

As the prospects of economic growth are reflected in greater employment in sectors related to the cycle, the unemployment rate could gradually drop in the next few quarters. The unemployment rate might be 6.5% by the end of the year and around 6.2% by 2020. The employment composition will, however, be marked by the shift from public sector employment to private sector employment or to self-employment. The latter is showing signs of an increase.

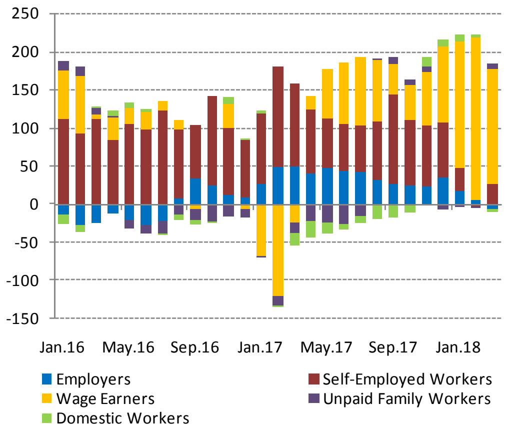
Based on the margins and rigidities of the labor market, nominal wages are under downward pressure. Corrected by inflation, real wages are growing by about 1%, the lowest change since early 2016. The dynamism of the private wage earner sector will consequently be decisive to establish gradual improvements of job creation and the evolution of wages. The risks of this scenario are, however, downward.

Wages and Employment
(Annual change, percentage)



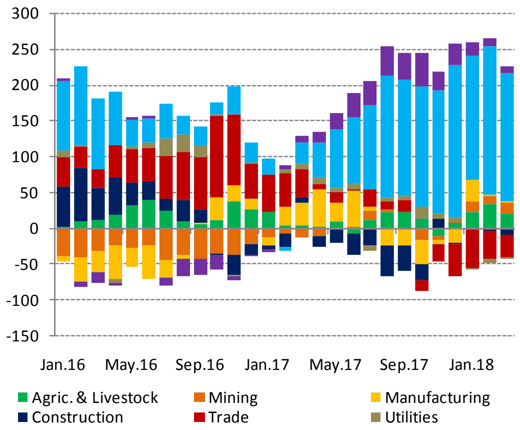
Sources: Bci Research and INE

Job Creation by Employment Category
(Annual change, thousands)



Sources: Bci Research and INE

Job Creation by Sector
(Annual change, thousands)



Sources: Bci Research and INE

EXCHANGE RATE

The Chilean peso has depreciated sharply against the US dollar in the third quarter of 2018. The international scenario is becoming more complex and lower investor appetite for emerging economy currencies prevails. The positive US economy figures, the protectionist trade policy of the United States towards China, along with bouts of financial stress in Argentina and Turkey, have led to large appreciation of the dollar at multilateral level recently.

Moreover, there are lingering doubts about China's economic growth in the short term, which has been evident in price decreases of metal commodities, particularly the copper price. The exchange rate has therefore climbed to highs in the year, assimilating adverse market sentiment about emerging economies.

The fundamental indicators of the foreign exchange market, i.e., the evolution of the real and multilateral exchange rates, reveal that these are still slightly below their long-term averages. The real effective exchange rate (REER) is the nominal exchange rate adjusted by the evolution of Chilean and foreign prices. The latter has helped to contain the REER, but this indicator will align to its historical average in the next few months, subject to the inflationary outlook and a reversion of the nominal exchange rate.

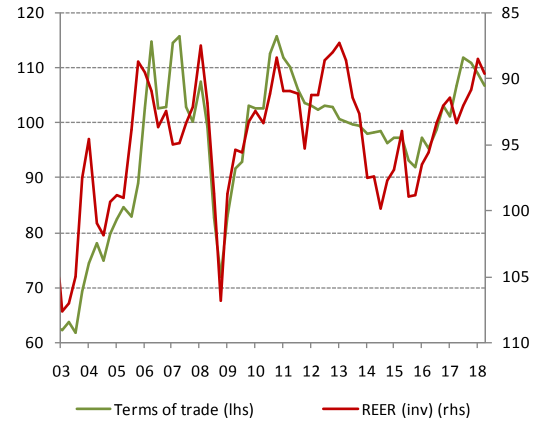
The multilateral exchange rate (MER) reflects the transversal strength of the US dollar against the rest of the currencies of developed and emerging economies. The MER has been slightly below the latest averages in this economic situation. In line with an allaying of the foreign risks, the dollar could stop appreciating at multilateral level, favoring a recovery of the value of emerging economy currencies.

Terms of trade, however, deteriorated in the first half of the year. The increase in the crude oil price in the first part of the year, and the drop in the copper price in the second quarter have led to a decrease in the terms of trade index that have caused gradual pressure on the real exchange rate, but with more pressure on the nominal exchange rate.

The Chilean peso flows reveal less foreign investor appetite for the Chilean currency. As of the second quarter, there has been carry trade dismantling of around US$9bn, capital flight only comparable to some bouts in 2013, which has boosted the depreciation of the Chilean peso against the US dollar.

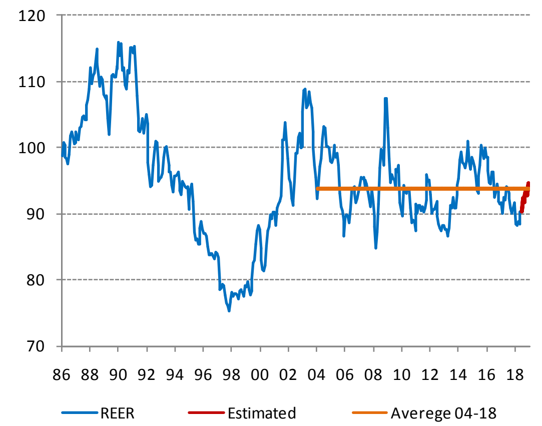
The economic fundamentals are, however, in line with appreciation of the Chilean peso by the end of the year. This incorporates moderation of the risks of the trade situation between China and the United States, driving a renewed appetite for emerging country assets. The copper price, assimilating its market fundamentals, could increase to US$2.90/lb. The exchange rate might therefore drop to Ch$640/US$ by December 2018 and be Ch$620/US$ in 2019. The risks of this scenario are, however, negative.

Trade Terms and REER
(Trade terms index 2013:100, REER 1986:100)



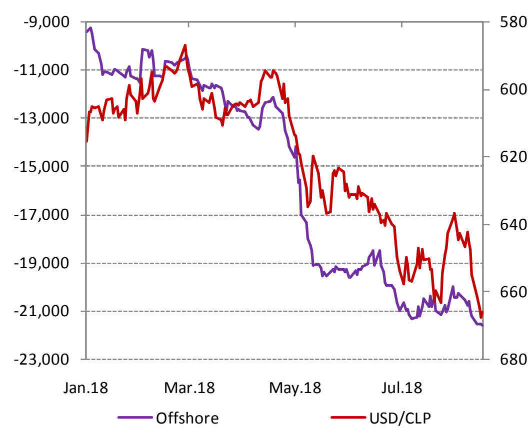
Sources: Bci Research and Bloomberg.

Real Exchange Rate
(1986:100)



Sources: Bci Research and the Chilean Central Bank.

Offshore Positions and Chilean Peso
(Millions of USD, Ch$/US$)



Sources: Bci Research and the Chilean Central Bank.

RISKS FOR THE CHILEAN ECONOMY

There is a higher risk of a trade war being unleashed, due to the tariffs imposed by the United States so far and similar retaliation announced by China. There are still great divergences on this issue between the two leading economies in the world, so if this tension continues, there could be a greater slowdown of global economic activity than forecasted. This might lead to lower prospects for the copper price and a shrink in growth of the Chilean economy. The crisis in Turkey has hit emerging economies, particularly those with weak fiscal fundamentals that are more exposed to global uncertainty. Chile is well prepared to handle these shocks, but there could be some fallout channeled through the financial markets.

Regarding Chile, on the positive side a more dynamic economy is not to be ruled out as more structural policies, particularly modernization of the tax system, lead to sounder recovery of expectations and the economy boasting higher growth in the next few years, in line with the greater potential that this might imply. The labor market is less dynamic in regard to the economic cycle, which could limit consumption growth in the next few quarters.

Altogether, we perceive that the balance of risks for Chile's growth is balanced for this year and downward in 2019 and 2020, particularly based on how the high current trade tension debacle plays out.

Alternative Forecast Scenarios

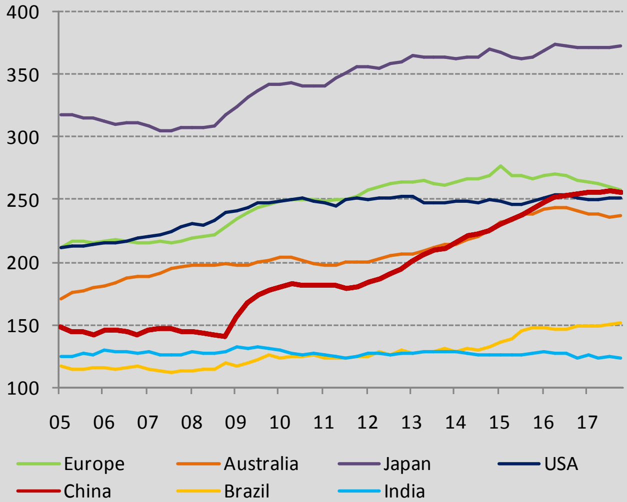
		Baseline Scenario		Optimistic Scenario		Adverse Scenario	
		2018	2019	2018	2019	2018	2019
Probability		50%		25%		25%	
Real GDP		3.4%	3.6%	3.8%	4.0%	3.0%	3.0%
Personal Consumption		3.1%	3.2%	3.4%	3.7%	2.8%	3.0%
Gross Capital Formation		4.0%	4.5%	4.5%	5.0%	3.0%	3.2%
Goverment Cons.		3.9%	2.5%	3.9%	2.5%	3.9%	2.5%
CPI	dec	2.7%	3.0%	2.9%	3.2%	2.5%	2.6%
Policy Rate	dec	2.75%	3.50%	2.75%	3.75%	2.50%	3.00%
Unemployment	dec	6.5%	6.5%	6.2%	6.0%	7.0%	7.0%
Copper Price (US$/lb)	dec	3.20	3.30	3.40	3.70	3.00	3.00
WTI Price (US$/b)	dec	65	60	70	65	60	55
Chilean Peso (CLP/US$)	dec	620	610	600	590	650	660

Source: Bci Research

BOX 1. CHINA'S CHALLENGES IN A MORE COMPLEX GLOBAL SCENARIO

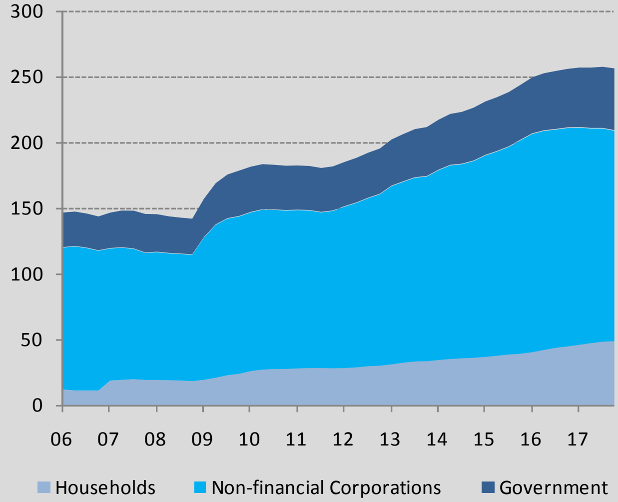
China is in a transition process. Not only regarding the rebalancing of its GDP growth sources but also the financing of its economic activity. By means of its high savings rates - about 45% of the GDP according to IMF figures - and the large size of its state banking system, it has given priority to credit growth as a source of financing. With the global financial crisis in 2008, China's political and economic authorities opted to boost the use of debt as a way of preventing a major deterioration of economic activity. The leadership of Hu Jintao and Wen Jiabao attained average GDP growth rates of around 10% in 2009 and 2013. The growth of credit in the same period, however, rose from 140% to 200% of the GDP, according to the figures of the Bank for International Settlements (BIS)

Debt Evolution
(% of the GDP)



Sources: Bci Research and BIS.

China's Debt Composition
(% of the GDP)

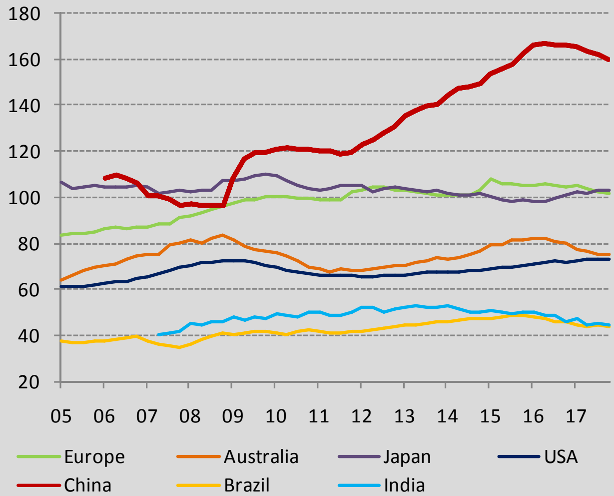


Sources: Bci Research and BIS.

When Xi Jinping came into power in March 2013, the challenges were to moderate credit growth but without causing any disruptions to economic growth. This started the first efforts to control the rate of loans in the banking sector. The banks, however, use alternative off-balance-sheet investment vehicles to address the growing demand for credit, which led to shadow banking. The Chinese economy's debt rate thereby continued to rise to 250% of the GDP in 2016, a similar percentage to advanced economies in the West, like the United States and Europe.

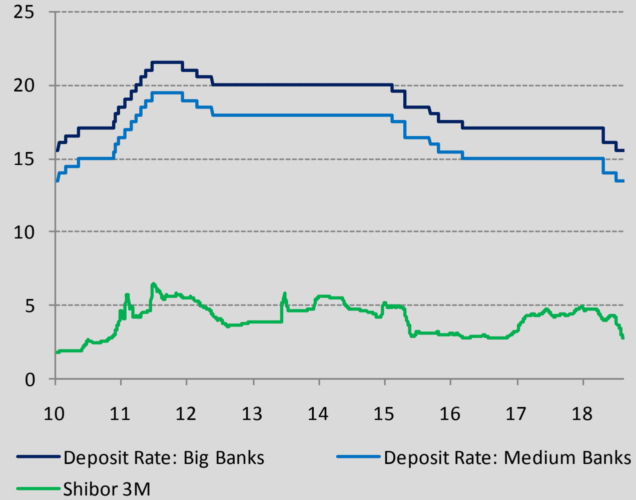
Economic growth has undergone a more gradual slowdown, financed, among other factors, by unsupervised credit growth. According to the BIS, total credit to non-financial corporations was 165% of the GDP in the third quarter of 2016, well above other developed and emerging economies, and is mainly absorbed by its banking sector. Due to this, prices of real and financial assets were pressured upwards in that period. By enhancing the macroprudential policies and measures to address shadow banking, debt started to stabilize in 2017, with even slight decreases in early 2018, without causing any major downward impact on economic activity. Short-term interest rates therefore increased in the first part of the year.

Credit Evolution of Non-Financial Corporations
(% of the GDP)



Sources: Bci Research and BIS.

China's Short-Term Interest Rates and Bank Reserve Requirement
(Percentage)

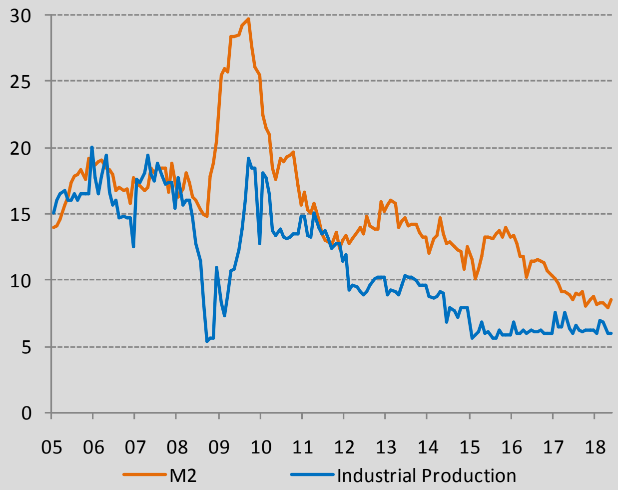


Sources: Bci Research and IMF.

The current economic situation, however, drastically modified the economic deleveraging approach. The US protectionist policy and it slapping tariffs on Chinese imports could be a threat to China's short-term growth, and in a context of greater restrictions on access to domestic credit. Some financial reports have warned of the fragility of China's non-financial corporate sector to meet its debt obligations. Financial stress scenarios even indicate a major negative impact on the payment capacity in the case of a hard landing of the economy or large increase in interest rates. The monetary authority has therefore decided to prioritize economic activity in the current situation, injecting massive amounts of liquidity into the financial markets. Short-term interest rates are dropping and the People's Bank of China (PBoC) has cut the bank reserve requirement rate by 150 basis points for large and smaller banks.

China's International Reserves and Yuan Evolution
(CNY/USD, billions of USD)

China's Industrial Output and M2 Float
(Annual change, percentage)



Sources: Bci Research and Bloomberg.

With a closed capital account, the authority has allowed for large depreciation of the yuan recently. As of June, the currency has accumulated a decrease of around 8% against the dollar, the largest rate of depreciation of the yuan in contemporary history. Financial decisions therefore reflect that once again keeping up the rate of economic growth has again become a priority for the short term, moderating the endeavors to control the debt level. The depreciation of the yuan enables the country to address the US trade barriers but acknowledging uncertain effects on the balance of payments.

Altogether, the perspectives are that the yuan depreciation trend and the injection of liquidity ease soon to prevent disruption to its financial system and avoid further credit growth. The authorities could therefore opt for another kind of economic stimulus, including fiscal stimulus measures to deal with the pressure of lower dynamism in the short term.

Recent global developments have led to lower investor appetite for emerging economies, due, among other factors, to doubts about China's economic dynamism. The baseline scenario incorporates easing of the tension caused by the trade spat between China and the United States. This, along with possible announcements of economic stimulus, could revert market sentiment for emerging assets. The challenges might therefore again be to cut the debt levels.

BOX 2 MEDIUM-TERM FISCAL SCENARIO

The recent downgrade of Chile's credit rating by Moody's, in addition to that made by Fitch and S&P in 2017, was based on the core argument of the deterioration of the fiscal condition in the last few years. Beyond wading into the debate as to whether the management of public finance by one government or another has caused such deterioration, it is important to assess the evolution of these variables in accordance with the macroeconomic variables of our baseline scenario. That is why this aims to estimate the fiscal policy scenario in line with the variables presented in this report, supposing compliance with the current structural balance target defined by the Treasury. Pursuant to Fiscal Policy Decree Nº743 of last June, this sets a target of reducing the structural deficit by about 20 basis points of the GDP per year, starting with a structural deficit of 1.8% of the GDP this year to reach that of 1% of the GDP by 2022. Unlike prior fiscal compliance targets, it sets a structural deficit objective instead of a structural balance one, with an annual reduction that is somewhat lighter than in previous versions, allowing for certain discretion about the drafting of forthcoming Budget Laws and government spending increases.

I. Effective Balance

According to the latest update submitted by the Budget Office, GDP growth this year will be 3.8%, a lot higher than the 3.0% growth with which this year's Budget Law was drafted. It also upgraded the copper price from US$2.88 to US$3.12/lb, leading to the assumption that due to these concepts there will be a higher than estimated increase in fiscal revenue this year. Nevertheless, such report shows a 2.4% drop in tax revenue from non-mining taxpayers based on an unfavorable result of this year's income tax operation, associated with the effects of the tax reform and a tax base that is growing 7%, less than that estimated in the drafting of the Law. The authorities therefore estimate an effective 1.7% deficit of the GDP this year.

Chile: Macroeconomic Scenarios of DIPRES and Bci Research
(Annual change and contribution, percentage)

		2017	2018 Budget	2018 Dipres	BCI Research Proyection				
					2018	**2019**	**2020**	**2021**	**2022**
GDP	(yoy, %)	1.5	3.0	3.8	**3.8**	**3.4**	**3.5**	**3.2**	**3.2**
Internal Demand	(yoy, %)	3.1	4.1	4.8	**4.3**	**4.3**	**4.3**	**4.3**	**4.3**
CPI	(average, %)	2.2	2.6	2.4	**2.5**	**3.0**	**3.0**	**3.0**	**3.0**
CLP	($/US$)	649	650	631	**640**	**620**	**620**	**620**	**620**
Copper Price	(cUS$/lb.)	280	288	312	**300**	**320**	**320**	**320**	**320**

Sources: Bci Research and the Chilean Budget Office (DIPRES)

Based on our vision, in a baseline scenario of 3.8% growth this year and an average copper price of US$3.00/lb, our forecast for the effective deficit is -2.0% of the GDP. 7.9% growth of total revenue and a 4.3% increase in total spending are inferred from this scenario. The explanation for this greater deficit mainly lies in a higher average copper price this year, related to the impact of an escalation of trade tension between the United States and China. The generation of tax revenue from private mining and Codelco is therefore lower than recently estimated by the DIPRES.

Chile: Effective Deficit Estimate
(Millions of Chilean pesos 2018)

	2017	2018 Budget	2018 Dipres	BCI Research Proyection				
				2018	**2019**	**2020**	**2021**	**2022**
REVENUES	38,372,385	41,476,580	42,056,704	41,438,701	43,900,414	45,528,356	46,853,489	47,952,594
OUTLAYS	43,438,490	45,198,536	45,384,535	45,343,610	46,930,637	48,338,556	49,547,020	50,785,695
DEFICIT (-) or SURPLUS	-5,066,105	-3,721,956	-3,327,831	-3,904,909	-3,030,223	-2,810,200	-2,693,531	-2,833,101
DEFICIT (-) or SURPLUS (% of GD	-2.8%	-1.9%	-1.7%	**-2.0%**	**-1.4%**	**-1.2%**	**-1.1%**	**-1.1%**

Sources: Bci Research and DIPRES.

II. Structural Balance

Considering the structural parameters of tendential growth of 2.6% this year, according to the parameters of the Committee of Experts that convened in June 2017, and an effective GDP of 3.8%, the gap is 1.8% as a percentage of the GDP. Moreover, the copper reference price is estimated to be US$2.77/lb. With these parameters there is a forecasted structural deficit of 1.8% of the GDP as a starting point for meeting the structural target already defined.

Chile: Comparison of DIPRES and Bci Research

Data Underlying Structural Balance 2018									
			2017	2018 Budget	2018	2019	2020	2021	2022
Dipres	Copper Price	(cUS$/lb.)	257	277	277	277	277	277	277
	Potential GDP	(yoy, %)	2.6	2.6	2.6	2.7	2.8	2.9	3.0
	Output Gap	(% of Potential GDP)	2.9	2.2	1.8	1.2	0.5	-0.1	-0.6
Bci Research	Copper Price	(cUS$/lb.)	300	-	300	300	300	300	300
	Potential GDP	(yoy, %)	2.75	-	2.75	2.75	2.75	2.75	2.75

Sources: Bci Research and DIPRES.

In an assessment exercise, we estimated what the structural situation would be considering our long-term parameters. Our forecast for the tendential GDP is therefore 2.75% and US$3.0/lb for the long-term copper price. In this scenario, our structural deficit would be -1.5% of the GDP, slightly higher than the -1.4% of the GDP stated in the latest Budget Law. Based on this new starting point, we estimate that reduction to a structural deficit of 1% of the GDP by 2022 would require, in the current conditions and GDP growth scenario and copper price we estimate, a real annual public spending increase of 2.9% on average for the next four years.

Chile: Structural Deficit Estimate
(% of the GDP)

	2018	2019	2020	2021	2022
STRUCTURAL BALANCE	**-1.5%**	**-1.5%**	**-1.4%**	**-1.3%**	**-1.1%**

Sources: Bci Research and DIPRES.

III. Tax Modernization Proposal

The recent presentation of the tax modernization proposal establishes a single integrated system, which would generate an incentive for higher investment, besides simplifying the current system. This is key to attaining a greater investment to GDP ratio that will boost potential growth. The change in the system will provide lower tax revenue of around US$700 million, which would be financed in the medium term by higher growth, a tax on digital platforms and lower tax evasion with the use of electronic receipts. In the shorter term, there will be fiscal revenue from capital repatriation abroad, which would have a special rate of 10%, and a 30% tax on withdrawal of profits still held in the taxable profits fund (FUT, according to the Spanish acronym).

The highlights are the transitory incentives for investment with accelerated depreciation mechanisms, and the 25% tax cut for SMEs, particularly those with billing of less than UF50,000/year. This covers around 97% of the enterprises but only about 10% of the total sales in Chile. These enterprises employ approximately 35% to 40% of the workers. This therefore creates a more favorable scenario for SMEs and could boost the labor market.

We expect there to be technical debate in Congress and agreements to be reached to drive investment and growth of the economy. This would also lead to a boost in confidence with the consequential positive short-term effects on economic activity.

Tax Announcement Highlights
Unique 100%-integrated tax system
Corporate tax rate of 27%, and SMEs with a 25% rate (up to UF50,000 of sales a year)
Instantaneous depreciation of 50% of fixed assets in a year (this measure will be effective for two years)
Instantaneous depreciation of 100% for the Araucanía region (this measure will be effective for two years)
10% tax on digital services that provide foreign platforms
Repatriation of capital with a 10% rate for a one-year term
Increase from UF2,000 to UF4,000 in the price of housing with a mortgage of 45% of the VAT
30% rate to declare profits of the historical taxable profits fund (FUT, according to the Spanish acronym)
No changes in specific taxes
Fiscal neutrality

GLOSSARY

Appreciation	Increase in the value of the currency of a country compared to another currency or a currency pool.
BCCh	Chilean Central Bank
Bond Purchase Program	Associated with an expansionary monetary policy, in which the monetary authority adds liquidity to markets by purchasing debt instruments and/or assets.
Brent Crude Oil	Benchmark oil for the European market .
Capital Goods	Goods necessary to make products. Machinery, infrastructure, real estate, etc.
Commodities	Physical goods with no added value and needed to make more complex products. They are associated with raw materials.
Contractionary Monetary Policy	Policy of the monetary authority to reduce the size of the monetary supply .
CPI	Consumer Price Index.
CPI-LFE	CPI less food and energy. Core CPI.
Default	Financial condition of debt nonpayment.
Depreciation	Decrease in the value of a country's currency compared to another currency or currency pool.
DIPRES	Chilean Budget Office.
Domestic Demand	GDP component by expenditure. Includes private consumption, government consumption, gross formation of fixed capital and variation of inventories.
Dovish	This means a monetary policy of growth.
Durable Goods	Reusable goods or which can be used many times
ECB	European Central Bank
Economic Recession	Decline of economic activity. It is associated with two consecutive quarters of inter-annual contraction.
EPI	Economic Perception Index.
Expansionary Monetary Policy	Policy of the monetary authority to increase the size of the monetary supply
FED	US Federal Reserve.
Fed Funds Rate	Monetary policy rate in the USA- Federal Funds Rate.
Fiscal Surplus	Financial situation in which the State's income is higher than the expenses incurred.
FOMC	Monetary policy meeting in the United States - Federal Open Market Committee.
Frictional Unemployment	Unemployment that occurs between the time a worker leaves a job and finds the next.
GDP	Gross Domestic Product
Glut	Excess production or supply in regard to demand for a product, service or instrument.
Government Bonds	Debt instruments issued by State entities.
Gross formation of fixed capital	Investment of more than a year needed for a productive process.
Haircut	This is associated with creditors reducing the amount of the debt.
Hawkish	This refers to a contractionary monetary policy.
Headline Inflation	Total inflation. It includes all the products of the price measurement basket.
IMF	International Monetary Fund.
Independent work	Independent work of an employer.
Inflation	Sustained increase in the prices of goods and services.
Inflationary Target	Monetary system to seek a target level for inflation within a timeline.
Investment Funds	Collective investment to be able to invest in large financial instruments.
Investment Grade	Credit rating given to a debt issuer by risk rating agencies. It is associated with the high capacity to discharge its obligations.
IPoM	Chilean monetary policy report.
Junk Bond	Fixed-income instrument with a high probability of nonpayment.
Manufacturing Industry	Productive process of transforming raw materials into manufactured products. Secondary sector.
MBCI	Monthly Business Confidence Index.
Monetary Normalization	Process in which the monetary policy reaches neutral levels.

Fiscal Deficit	Financial condition in which expenses incurred by the State are higher than income received.
MPR	Monetary Policy Rate.
Multilateral Dollar	Value of the US dollar in regard to a currency pool.
Nominal Instruments	Financial instruments that exclude inflationary effects.
Notch	Minimum difference between two risk ratings.
OPEC	Organization of Petroleum Exporting Countries.
Potential GDP	Short-term GDP. It can be affected by transitory shocks.
Private Consumption	GDP component by expenditure. Consumption of homes and private non-profit institutions (IPSFL). Excludes government consumption
Public Spending	Government consumption, related to the money spent by the State. It is a component of the GDP by expenditure.
Real Exchange Rate	Ratio of the currency of a country in regard to another currency or currency pool, incorporating local and foreign inflation.
Real Instruments	Financial instruments that include inflationary effects.
Retail Sales	Retail trade, retail sales.
Self-Employed	Employment not dependent on an employer.
Shale Oil	This is extracted by means of a sedimentary formation of non-conventional hydrocarbons.
Sovereign Debt/Public Debt	Series of debts a State has with another creditor.
Tendential GDP	Medium-term GDP. It is not affected by transitory shocks.
Total Consumption	GDP component by expenditure. Includes government consumption.
Treasury	US government bonds.
Unemployment Rate	Level of unemployment of the economically active population.
Wage Earner	Person who receives a wage for work. Non- employer.
Workforce	People of a working age who can be working or unemployed. Economically active population.
WTI Crude Oil	Benchmark oil for the United States - West Texas Intermediate

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Chilean Economic Outlook

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