



**VISION 2017**  
A CRUCIAL YEAR





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## Foreword

It's not a mystery to anyone that the world outlook has radically changed. For this reason, and over and above the statistics, it is crucial to understand the determining factors behind economic and social activity. At the same time, new risks and opportunities have arisen that we must observe with close attention as they could impact us in different ways.

Just as we expected, we close 2016 with even lower output and employment indicators than previous years, but also with lower inflation levels. Looking forward, together with contained inflation we forecast a recovery in domestic product and moderated unemployment. However, the optimism is relative as we cannot be satisfied while we grow at around 2.0%.

2017 will be a decisive year from various points of view. On the one hand, our economy will face a challenging external scenario in which, while there will be latent risks such as increased funding costs, higher fuel prices and even potential trade barriers, there will also be an additional stimulus for our key export products, mainly from Asia, and a positive terms of trade performance. This would lead to an increase in disposable income, contributing to leverage the dynamism of private consumption and providing the basis for economic activity to grow. Likewise, we expect the labor market to gradually improve and, as a result of this, consumer and business confidence indicators to also do so. Internally, we estimate an heterogeneous sectorial expansions in which 2016's less dynamic sectors will show a recovery.

Finally, in 2017, we will have new elections to decide the next President of the Republic and a portion of Congress.

As can be seen, for various reasons we will face an uncertain year but one that should be more dynamic than the previous one, albeit with the same economic and social structural challenges, which will require us to look ahead.

This document represents the vision of the Research Unit of Banco Santander's Finance Division on the upcoming outlook in economic, political and social terms, and it seeks to contribute to public discussion and the development of efforts to build a better country for everyone.

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## Executive summary

### External outlook

Global growth will be boosted by a more lax US fiscal policy and the consequent reaction of China. In this context, there will be greater demand for raw materials, especially copper, benefiting exports.

U.S.: The economy has been dynamic and should be reflected by at least two hikes to the Fed Fund Rates in 2017. This pace will continue in 2018, steepening the yield curve, with the resulting increase in external financing costs in Chile.

In addition, there is uncertainty regarding the impact of the President-elect's program implementation as it will depend on the timing and intensity of the reforms. We forecast a GDP growth of 1.6% YoY and 2.3% YoY in 2016 and 2017, respectively.

Eurozone: The monetary union's economy will continue to show limited activity. We forecast annual growth of 1.6% YoY in 2016 and 1.5% YoY in 2017. Political uncertainty in Europe is an element that must be considered. Meanwhile, the European Central Bank will continue with its expansionary monetary policy.

China: The Asian giant's economic activity has remained stable. This strength has been supported by an expansionary monetary policy that is reflected by greater debt and a fiscal policy that has focused on the real estate sector. Our growth estimate for 2016 is 6.7% YoY and 6.5% YoY in 2017.

Latin America: this group of countries is expectant regarding the direction that will be taken by the large global powers and international trade.

Brazil's economy will contract by 3.3% YoY in 2016 but will grow again in 2017 (2.0% YoY). However, the biggest challenge is fiscal consolidation and the reduction of public spending. In particular, reforms are urgently needed to the pension system.

Meanwhile, Mexico will be awaiting decisions by its main trade partner and neighbor, where the chain value across industries are strongly connected between both countries.

Asia: We forecast that Japan will grow at 0.5% YoY in 2016 and 2017. Higher growth is expected in India with 7.6% YoY in 2017 and the rest of the regional economies of around 5.0% YoY.

Copper: The price rebound has various causes but Chinese demand will be the main factor in the coming months. As a result, we estimate prices of USD2.40/lb in 2017.

Oil: Prices have rebound due to the output cut agreement by OPEC and Russia. Prices could continue rising if the U.S.'s new energy policy is more focused on traditional energies. In 2017, we estimate a price of USD50/bbl.

## Domestic outlook

We forecast GDP growth of 2.0% and 2.7% respectively in 2017 and 2018. The estimate is based on improved internal confidence and the terms of trade that will rise after a number of years.

Private consumption will maintain a slight but continued increase over the next two years, while government spending will adjust. We note that our forecasts show for the first time that, after various quarters, consumer growth will be higher than labor income.

Total investment (gross fixed capital formation and inventory changes) will show a substantial contraction in 2016, mainly due to the depletion of inventories, which should be reversed in 2017.

Gross fixed capital formation will grow 0.3% in 2017 and 2.6% in 2018. GDP performance below its long-term potential is behind this low activity.

In the case of the construction sector, we forecast a decline of 1.5% in 2017 and an expansion of 1.0% growth in 2018. This is because mining investment has been stagnant for several quarters and real estate investment, particularly housing, will slow after the boom in "Sales without VAT".

In contrast, we forecast an upward trend for machinery and equipment of 3.5% in 2017 and 5.5% in 2018. This is due to the need to replenish capital stock and also because of the development of new energy projects.

The contribution of net exports to GDP, which in 2016 was positive, will disappear because the evolution of exports and imports will be similar going forward. In particular, after three years of contractions, imports will grow again in real terms by 1.7% in 2017 and 2.6% in 2018. Meanwhile, exports will show increases of 1.9% and 3.0%, respectively. Finally, the current account will show a moderate deficit, increasing the negative balance of -1.8% of GDP in 2016 to -2.0% in 2017 and -2.1% in 2018.

The effective fiscal deficit in 2017 will be 2.7% YoY. In the medium-term higher committed spending than structural income is noted which means that debt will continue growing, closing 2017 at 25% of GDP and possibly reaching 30% in 2020.

In 2017 we estimate an average unemployment rate of 6.4%. However, behind the stability of the figure, lies a deterioration in the labor market that does not show signs of reversing.

For December 2017 we forecast an annual inflation rate of 2.8% YoY. Going forward, imported inflation will rebound and non-tradable inflation will remain relatively high.

The main upward inflation risks are the higher than expected depreciation of the exchange rate due to external factors, and a generalized increase in external inflation, mainly food and energy prices. For its part, the main downward inflation risk is a deterioration in wages leading to lower pressures on services inflation.

In 2017, we forecast an average exchange rate of CLP 683, representing a slight depreciation compared to previous year's levels. However, specific political and economic events will cause volatility.

We expect the Central Bank to reduce the Monetary Policy Rate (MPR) according to the downward inflation trend. The MPR cut should be, at least, 50 basis points (bp).

## Social and political perspective

The political agenda will be marked by three key dates: the primaries will be held on July 2nd; the presidential and congressional elections will be held on November 19; and a potential president runoff will be held on December 17.

The new electoral map, which replaced the old binomial system for a proportional one, increased the number of deputies to elect from 120 to 155, and the number of senators from 38 to 50.

This new configuration will mean a fragmentation of political parties' alliances and strategies, although it should not make a substantial difference to the current representation of traditional blocs.

## Santander forecasts

**Table 1: International baseline scenario**

	2015	2016	2017	2018
LME copper price (USD/lb, aop)	2.49	↑2.21	↑2.40	2.50
Brent oil price (USD/bbl, aop)	54	48	↑50	52
Major trading partners' GDP (% YoY)	3.3	2.9	↑3.4	3.6
Terms of Trade (% YoY)	- 4.5	-0.1	↑4.1	1.6

Source: Bloomberg, Central Bank and Santander.

**Table 2: Domestic outlook**

	2015	2016	2017	2018
GDP (% YoY)	2.3	1.6	2.0	2.7
Domestic demand (% YoY)	2.0	2.2	2.0	2.5
Inflation (% eop)	4.4	2.7	2.8	3.0
Inflation (% aop)	4.3	3.8	2.6	2.9
Unemployment rate (% aop)	6.2	6.5	6.4	6.4
MPR (% eop)	3.5	3.5	3.0	3.5
Exchange rate (CLP/USD, eop)	707	667	679	690
Exchange rate (CLP/USD, aop)	654	677	683	688
Current account (% GDP)	-2.1	-1.8	-2.0	-2.1

Source: Central Bank, National Institute of Statistics (INE) and Santander.

**Tabla 3: GDP Components (% YoY)**

	2015	2016	2017	2018
Total consumption	2.5	2.6	2.5	2.5
Private consumption	1.9	2.0	2.1	2.2
Public consumption	5.8	6.0	4.6	4.0
Fixed investment	-1.5	0.4	0.3	2.6
Construction	1.9	-0.7	-1.5	1.0
Machinery and equipment	-8.2	2.6	3.5	5.5
Exports	-1.9	0.8	1.9	3.0
Imports	-2.8	-1.2	1.7	2.6

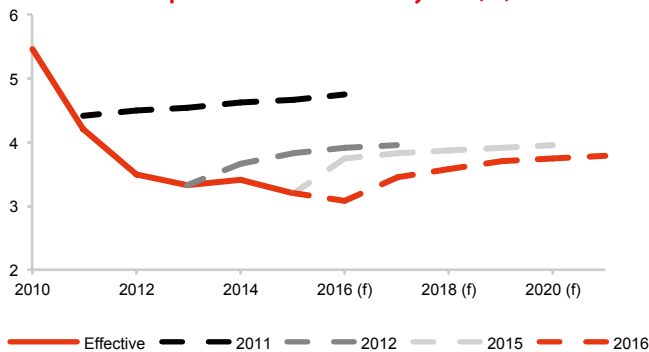
Source: Central Bank and Santander.



## Global outlook

The world has been showing a slower pace of growth since the beginning of the decade. Among the reasons are the limited dynamism of emerging economies, especially China, due to demographic and population aging factors, high debt levels, the decline in world productivity, among others.

**Graph 1: Global growth and expectations correction by IMF (%)**

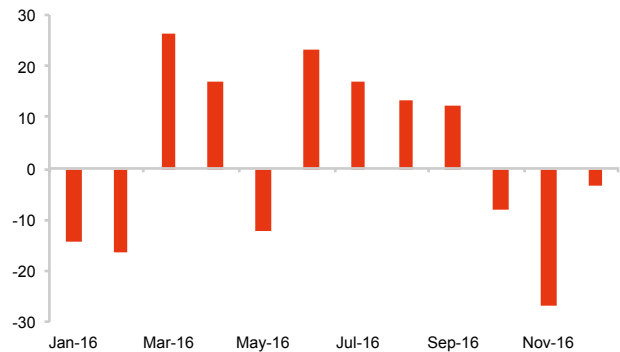


Source: IMF and Santander.

Although there is no single cause, world growth forecasts in recent years have always been corrected downwards. Unfortunately, this weak global growth view extends to at least 2020.

To the above, we must add that the last months of 2016 have brought us further external uncertainty which, while having some costs, could also bring positive benefits for our country.

**Graph 2: Portfolio Flows to emerging markets (USD billion)**



Source: IIF and Santander.

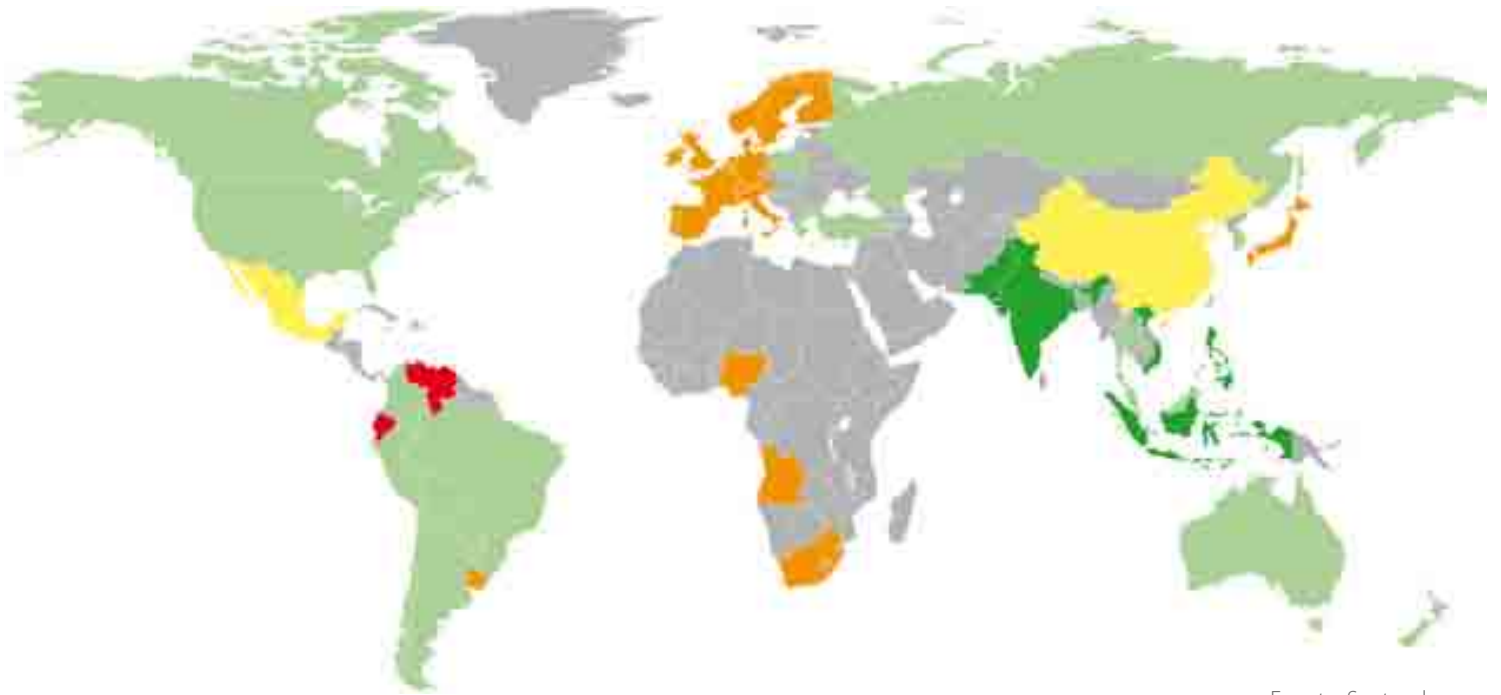
The performance of the new authorities in the U.S. will be crucial, as will political developments in Europe and China's reaction to this situation.

World growth will be stimulated by a more lax fiscal policy in the U.S. and China's reaction. In this context, as a result of decisions by world powers, we will see a revival of trade activity, which would benefit small and open economies like Chile.

In particular, the greater demand for commodities, especially copper, and a recovery of Latin American growth will dominate 2017.

Thus, for the first time since 2010, we forecast a recovery in the terms of trade. Likewise, exports are expected to benefit from the greater dynamism of our trading partners, especially due to the competitiveness gained in recent years, partly due to the depreciation of the Chilean peso.

*Heatmap relevant for Chile*



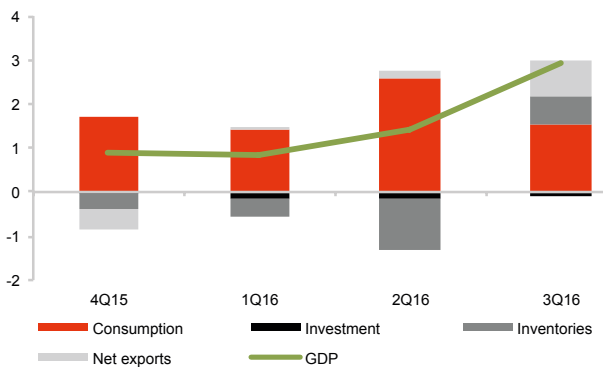
Fuente: Santander.

Angola	China	Ireland	Pakistan	Sweden
Argentina	Colombia	Italy	Paraguay	Switzerland
Australia	Denmark	Japan	Peru	Taiwan
Austria	Ecuador	Korea	Philippines	Thailand
Belgium	Finland	Malaysia	Poland	Turkey
Bolivia	France	Mexico	Portugal	U. K.
Brazil	Germany	Netherland	Russia	U.S.A.
Bulgaria	Greece	New Zealand	Singapore	Uruguay
Canada	India	Nigeria	South Africa	Venezuela
Chile	Indonesia	Norway	Spain	Vietnam

## U.S.

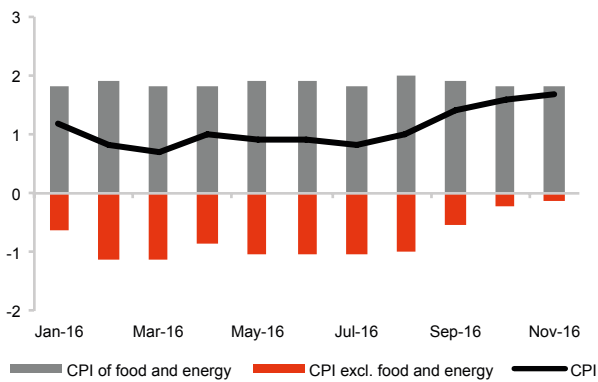
Recently the U.S. economy has maintained its pace (3.5% annualized QoQ in the third quarter), generating new jobs while inflation has converged to the Federal Reserve's target (2.0 % YoY).

**Graph 3: Contribution to GDP growth by components (%)**



Source: Bloomberg and Santander.

**Graph 4: CPI Inflation and components (% YoY)**



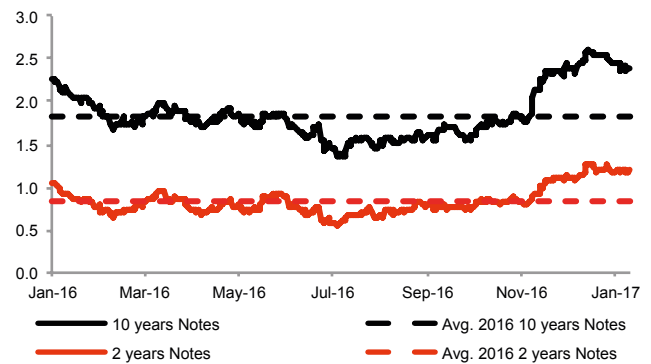
Source: Bloomberg and Santander.

We expect that the normalization process of the interest rate will continue in 2017 with at least two further hikes of 25 basis points. This rhythm will continue in 2018. Over the coming years, the Fed will experience some changes. Initially, Janet Yellen will remain in charge until February 2018, but the gamut of government



reforms could alter the entity's ability to freely act. Our main scenario assumes higher interest rates and a steepening of the yield curve, with the consequent rise in external financing cost

**Graph 5: US Notes yield (%)**



Source: Bloomberg and Santander.

As for the President-elect Donald Trump's campaign pledges, regulatory changes would have an unknown impact that will depend on the intensity and timing of the reforms, although U.S. banks' shares performance suggest a great dynamism and optimism of market players. On the other hand, changes in trade and

immigration policies could have a negative effect, although it is premature to anticipate specific measures. Global trade follows a logic of integration that makes it difficult for changes to business conditions not to be harmful to consumers and businesses, with repercussions on prices and value chains.

The infrastructure plan will reflect a more expansive fiscal policy that will not be without difficulties. Certainly, fiscal dynamism will be determined by the cut in tax rates, as well as by other incentives.

It is clear that any relevant reform will have associated costs in both political and popularity terms.

Just as a positive demand shock is anticipated as a result of the greater fiscal stimulus, the question is how the supply will respond.

Consumption will be the driver of growth. The tightness of the labor market and the rise in wages provide a positive outlook for this component. In addition, it would also be supported by the expected tax cuts.

Meanwhile, investment should revive in 2017 if the announced infrastructure plan materializes. Incentives to repatriate capital of U.S. companies may give rise to new capital investments too.

Thus, for at least a part of 2017, we expect economic momentum and positive demand impacts to predominate over the negative ones that could come on the supply side.

We estimate growth of 1.6% YoY in 2016 and 2.3% YoY in 2017.



## Eurozone



The monetary union's economy continues to perform weakly, growing an annualized 1.6% (0.3% QoQ) during the third quarter. Economic activity should follow a similar pattern during the rest of the year leading to growth of 1.6% YoY. Looking forward to 2017, we expect the current macroeconomic scenario will slow growth to 1.5% YoY.

After the Brexit decision, anti-European sentiment has increased, leading to an element of political uncertainty in Europe. This has hindered the capacity to undertake the necessary reforms to bring about economic recovery.

There will be a series of important elections in Europe that will add to the recent and conflictive events for the stability of the union. In February, Switzerland will hold a referendum on immigration quotas. In France, a new government will be elected in which the far-right (Marine Le Pen) has invoked a nationalist discourse that threatens the permanence of this country in the European Union (EU); Le Pen and François Fillon (moderate right) have the best chances of contending for government at the ballot box.

Finally, there will be elections in Germany in which Angela Merkel will run for a fourth term; although it is expected she will win and form a government, this would involve a major negotiation with her political rivals. Merkel has been a fierce defender of the EU and its cohesion.

With regards to Brexit, it is estimated it will be a costly process (€20,000 million) and starts in the first quarter of 2017 when the British government invokes Article 50 of the Treaty of Lisbon.

Once the formal request to leave the European Union has been made, there is a two-year deadline to negotiate the terms of the exit. If no agreement is reached and there is no extension, all deals with the EU will be void which, although unlikely, would be the worst scenario.

Meanwhile, the High Court has ruled that Prime Minister Theresa May cannot trigger Article 50 without the backing of Parliament, although this decision is being appealed before the Supreme Court which will only announce soon. The process could become yet more cumbersome as a ruling by the European Court of Justice is not ruled out.

While Brexit is already a fact, the details are important. If Parliament eventually has a greater participation, the exit terms could be less disruptive.

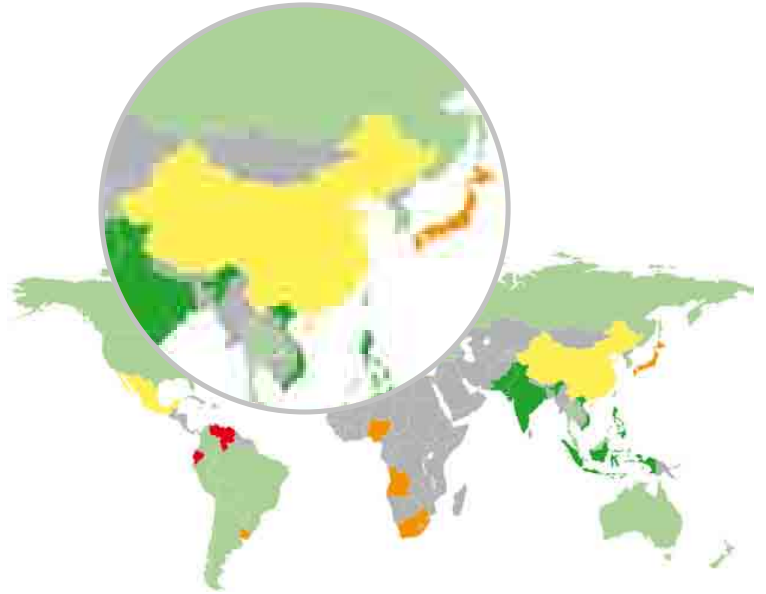
For its part, inflation will slowly return to the target rate (2.0% YoY), although not prior to 2018 as excess capacity continues to moderately depress domestic prices.

Meanwhile, the European Central Bank (ECB) will continue its expansionary monetary policy. Interest rate levels will remain stable until at least the end of 2018.

The monetary easing program was prolonged until December 2017 but the extension reduced the amount of purchases (€60 thousand million a month).

Political uncertainty will put to the test the strength of the ties that join the Eurozone.

## China



The Asian giant's economic activity has remained stable, growing by 6.7% YoY during the third quarter. This strength has been supported by an expansionary monetary policy which is reflected by greater debt and a fiscal policy that has focused on real estate.

The investment-based "old economy" has had a dominant role in recent activity, leaving aside the necessary reforms to guarantee sustainable growth.

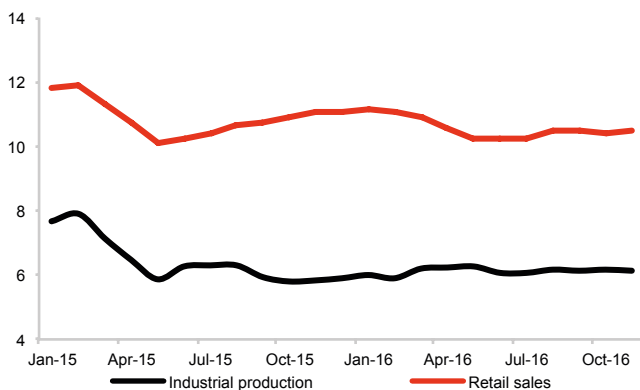
Our growth estimate for 2016 is 6.7%. In 2017 the need to restrict indebtedness, liberalize some markets and restructure certain public companies should slow the pace of economic activity to growth of around 6.5%. This reduced activity may last for the next few years.

A key element in 2017 will be the response to the U.S.'s new foreign policy. It is likely that China will take the opportunity to expand its influence and fill the gaps left by the North American country. China's initial reactions to the U.S.'s possible exit from the Trans-Pacific Partnership (TPP) appears to reinforce this idea.

In particular, if China implements a more aggressive trade policy accompanied by new investments, it would guarantee a revival in demand for primary materials. This would not only be beneficial for Chile, but for the rest of the region as well.

Thus, the uncertainty added by China is based on how it will respond politically to the U.S.'s new role and foreign policy.

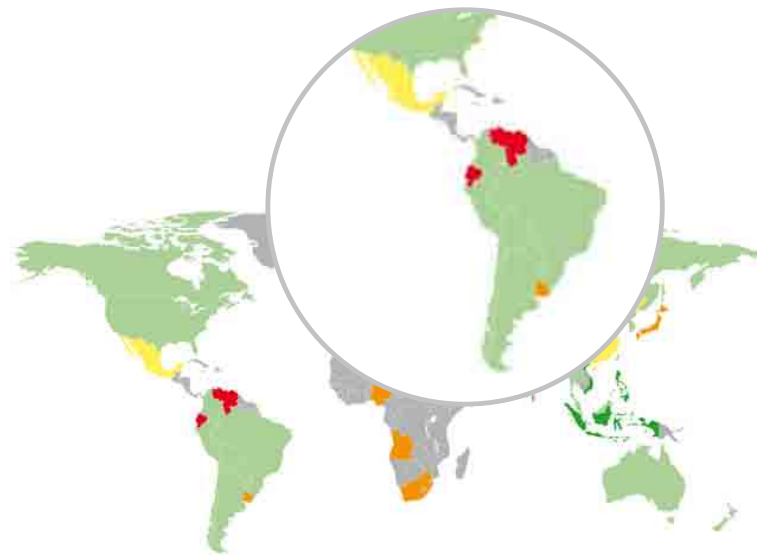
**Graph 6: Sectorial growth in China**  
(% YoY, quarterly moving average)



Source: Bloomberg and Santander.



## America



In recent months, a number of countries in the region have benefited from capital inflows and a less stormy external environment. Together with economic and political decisions, this will enable the region as a whole to leave the recession behind in 2017. Recently, we have observed a reversal of capital flows towards the U.S. which has affected stock markets but not funding. However, there are still challenges such as the need to improve infrastructure and - despite the fact that in recent years, Latin American countries have improved their institutions and deepened their financial markets and access to financing - structural development plans are lacking in order to consolidate this area.

Brazil's economy will contract by 3.3% in 2016 but will grow again in 2017 (2.0%). However, the great challenge is fiscal consolidation and to reduce public spending. In particular, reforms are urgently needed to the pension system, which is politically very complex.

If the aforementioned occurs, Central Bank of Brazil would have an opportunity to implement a more expansionary economic policy and, therefore, to cut its Selic benchmark interest rate.

There will also be political definitions in 2017 in preparation for upcoming elections in 2018, for which there is a fairly uncertain outlook.

Meanwhile, Mexico will be awaiting decisions by its main trade partner and neighbor, which would support the relationship between both countries leading to the integration of the value chain across different sectors.

The main uncertainty arises from the most significant NAFTA treaty because as the trade agreement has not been ratified by the Senate, the U.S. President has the power to annul it. However, this is complex because the integration of Canada, the U.S. and Mexico is huge; the agreement's economic interdependence comprises USD 200 billion.

Mexico's level of dependency on the U.S. means that 30-40% of formal employment is linked directly or indirectly to NAFTA. Meanwhile, there are 6 million jobs in the U.S. that depend on the relationship with Mexico.

From a geographical point of view, Mexico is the main trade partner of ten U.S. States and the second most relevant trade partner for another 14 States.

In addition, the reaction is not yet known of the third main player, Canada, which would also be negatively impacted by changes to NAFTA.

However, the outlook is not all negative as the renegotiation of NAFTA would open up new opportunities. It is an old agreement (1992) and would therefore benefit from incorporating new areas such as technology and the energy market, among others, and improving existing arrangements for other markets.

Meanwhile, the Andean region will improve its economic activity, in particular Peru, thanks to its external sector, as will Colombia due to the implementation of an infrastructure plan.

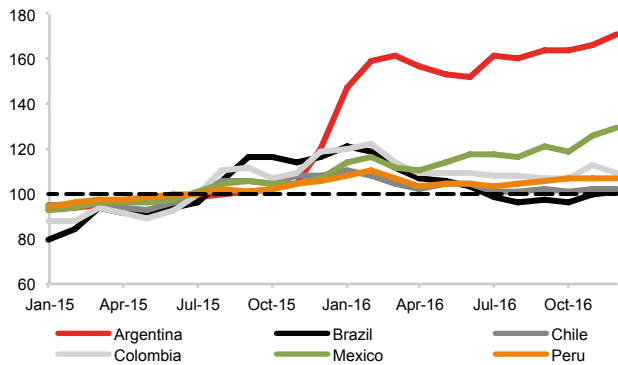
Thus, Latin American countries as a whole will be expectant of the direction taken by the large countries. Undoubtedly, the coming years will be key to confirm the model of export development and global openness that some of the region's countries have adopted and which have brought them greater welfare.

For the world's open economies, a recovery in world trade and greater integration are both key, and hence the decisions that will be made in these areas in the coming years will be essential.



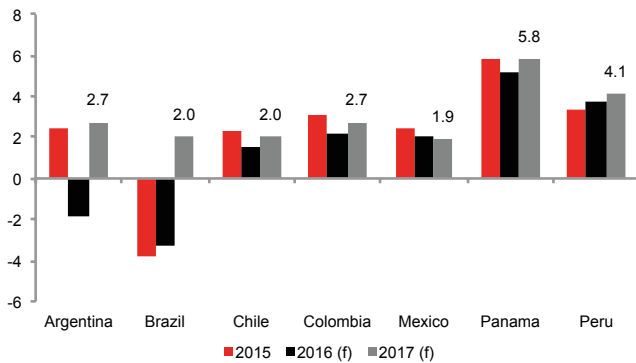


**Graph 7: Latin-American's currencies (average 2015 = 100)**



Source: Bloomberg and Santander.

**Graph 8: Latin-American's GDP (% YoY)**



Source: IMF and Santander.

## Japan

In the third quarter, economic activity surged by 2.2% QoQ on an annualized basis, well above estimates (0.9% QoQ). While the figure is encouraging, the reasons for the increase appear to be mainly one-off. There was an increase in exports for specific shipments, as private consumption grew by only 0.2% QoQ, while investment increased 0.1% QoQ.

Weak internal demand hinders a rise in domestic prices, and will make it difficult and slow to achieve in the coming years the Bank of Japan's inflation target of 2.0%.

To achieve stronger domestic demand, the labor market must continue to improve and wages continue to increase. This can only be achieved by more structural reforms in the Japanese economy, since both fiscal and monetary policy have little room to remain expansive. We expect the country to grow 0.5% in 2016 and 2017.



## India and rest of Asia

As usual, Asian countries will grow above the world average at around 5.0%, excluding China, Japan and India.

These countries have benefited from greater trade integration with China and its demand growth, which has enabled greater development of its industry.

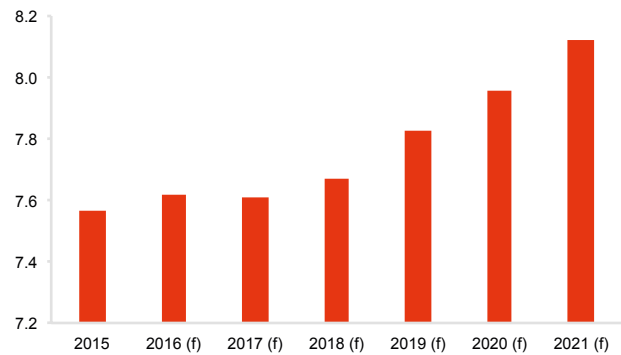
The turbulence that might impact the world economy will hardly have a significant impact on these nations. Only a crisis in China could trigger a deterioration in emerging Asia's economic activity.

India's economy continues to benefit from the reforms implemented in the past, which has allowed it to free up resources to make greater investments in infrastructure and welfare, in order to improve the country's institutional framework.

Meanwhile, the terms of trade should remain favorable, as well as the dynamism of its trading partners.

India's economy will grow at around 7.6% in 2017 and will show higher levels of growth in the coming years, sustained by domestic demand as well as trade.

**Graph 9: India's GDP (% YoY)**



Source: IMF and Santander.



## Commodities

### Copper

At the end of 2016, the price of copper showed values not seen since 2015. This positive news has several causes. On the one hand, there is the infrastructure plan promised in the U.S. presidential campaign, which would generate a still unknown increase of copper demand. It should be noted that the U.S. represents only 8% of total world copper demand, far less than China's 51%.

Meanwhile, China's real copper demand has exceeded expectations. Demand growth of 3.0% was estimated at the beginning of the year but is actually around 5.0%, representing greater than estimated consumption of 227 TMT, the equivalent of half of Chile's monthly production. In addition, China has again approved new infrastructure spending for the next few years.

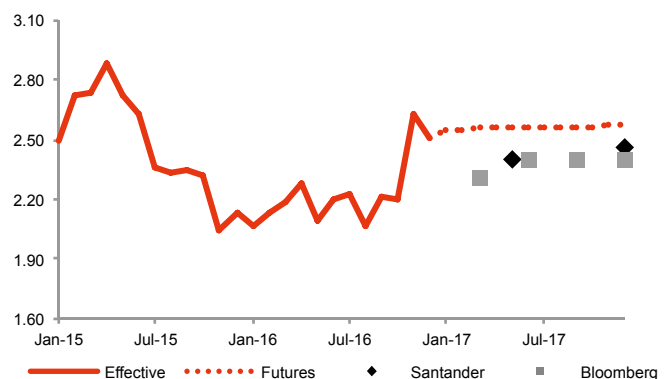
Finally, the increase in long-term interest rates has caused bonds to become less attractive as a saving instrument. As a result, the repositioning of investment portfolios has favored base metal prices, either due to higher demand or stored value.

Thus, although recent price rises have been partly influenced by speculation, we expect that there are real variables indicating that the copper market is tighter than was expected.

This supports our upward revision of forecast copper prices to an average of USD2.40/lb in 2017 and USD2.50/lb in 2018.

As always, the downside risks to price and demand are associated with how the developed world's political decisions can alter the pace of economic activity and its consequent impact on the demand for primary materials.

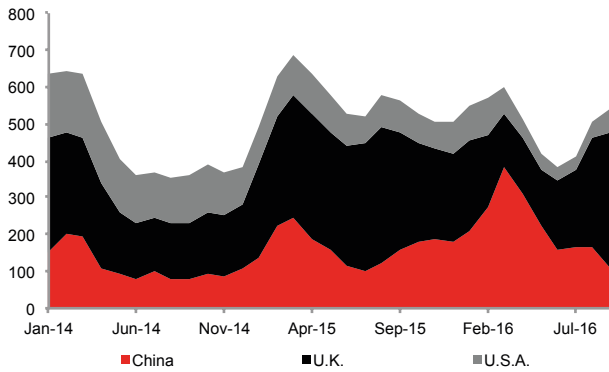
**Graph 10: Copper price and forecasts (USD/lb)**



Fuente: Bloomberg y Santander.



**Graph 11: Copper's inventories (TMT)**



Source: Bloomberg and Santander.

## Oil

After recording minimum prices not seen since the beginning of the century, oil has begun an upward trend ahead of the agreement by oil-exporting countries (OPEC) to cut daily production by 1.2 million barrels, while non-OPEC members (Russia among others) have agreed to reduce production by 600,000 barrels. The agreement is historic and will help to boost crude oil

prices and reduce high levels of inventories.

Another factor is the fall in shale oil production in the U.S., which could revive with higher prices.

Undoubtedly, higher prices will be determined by supply constraints, as the market still has excess capacity and inventories exceed historic highs.

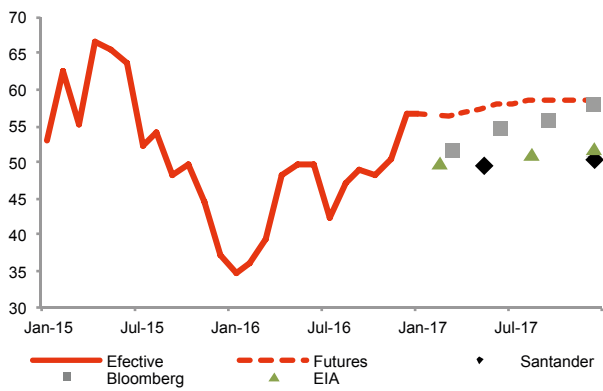
Recently, the world's largest shale oil well was found in the U.S. State of Texas, with reserves of 20 thousand million barrels.

Another relevant issue will be whether U.S. energy policy changes and seeks to use traditional energies more intensely. This could lead to a significant increase in demand.

Overall, over the next few years we expect oil price pressures to remain contained as the market slowly tightens.



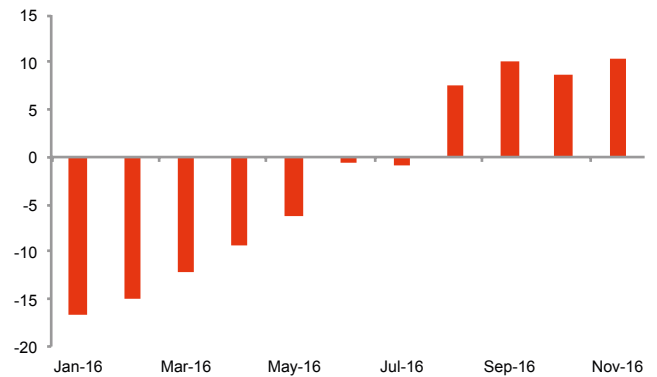
**Graph 12: Brent oil price and projections (USD/bbl)**



Source: Bloomberg, EIA and Santander.

Looking ahead to 2017, the cereal market will tighten, as demand is expected to continue rising while supply should contract considering the lower yields of major producers such as China, Russia, the U.S. and Brazil.

**Graph 13: Food price index (% YoY)**



Source: FAO and Santander.

## Food products

The price of food products has increased, in line with the evolution of raw materials. This trend responds to real factors such as restrictions on the supply of some products and higher demand for food products from developing countries.



## Domestic Outlook

### Demand

2016 was not the best year for Chile with a GDP growth of 1.6%, well below its potential output (3.5%). For some time, there was even speculation that the country could enter a technical recession (two consecutive quarters of contraction compared to the previous period).

Meanwhile inflation, which has finally waned, was for a long time higher than the Central Bank of Chile's (BCCh) target range, rendering it impossible to implement a more expansionary monetary policy. Although price dynamics have slowed, non-tradable inflation remains high, suggesting monetary authority to act with extreme caution.

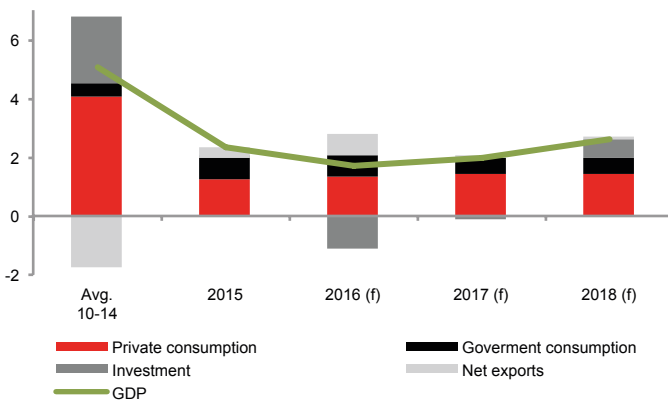
For 2017 and 2018, we expect GDP growth of 2.0% and 2.7%, respectively, based on a scenario of a gradual recovery of consumer confidence and the positive evolution of the terms of trade.

In our baseline scenario, we expect private consumption to experience a modest but steady rise over the next two years, while government consumption will normalize towards its average spending.

On the other hand, total investment (gross fixed capital formation and inventories), showed a substantial contraction in 2016, mainly due to the depletion of inventories, but we expect this to disappear in 2017 and become positive from 2018.

Finally, the contribution of net exports to GDP was positive in 2016 but will disappear as the performance of exports and imports balance each other out going forward.

**Graph 14: Contribution to GDP growth (% YoY)**

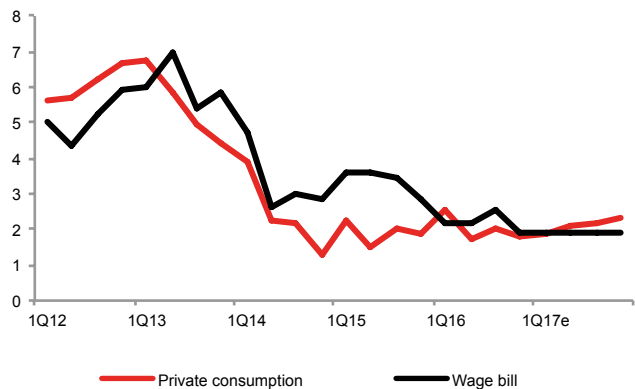


Source: Central Bank and Santander

### Consumption

We note that our forecasts show that for the first time, after various quarters, consumption growth will be higher than labor income. Thus, we would be leaving behind a period of precautionary saving and families would be betting on a more prosperous future. However, this does not mean that we are entering a period of over-indebtedness because the gap between private consumption and the labor income growth will remain tight and is compensated for by the performance of the recent past.

**Graph 15: Wage bill and private consumption (% YoY)**

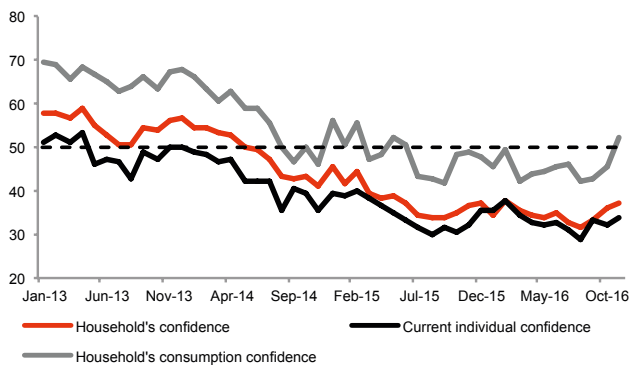


Source: Central Bank, INE and Santander.

This improved consumption performance is preceded by a rebound in economic expectations which despite having been through historic lows show an upward trend. In general, all confidence measurements for both the present and the future indicate an improved outlook going forward.



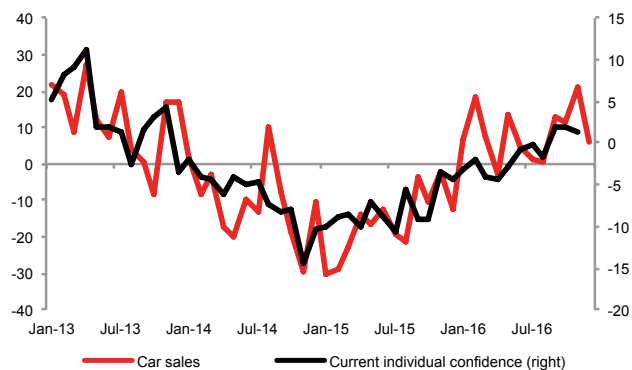
**Graph 16: Consumers confidence index (neutral = 50)**



Source: Adimark and Santander.

economy. This is a pattern which indicates a link between confidence levels and car sales.

**Graph 17: Confidence index and car sales (% YoY and YoY)**



Source: Adimark, ANAC and Santander.

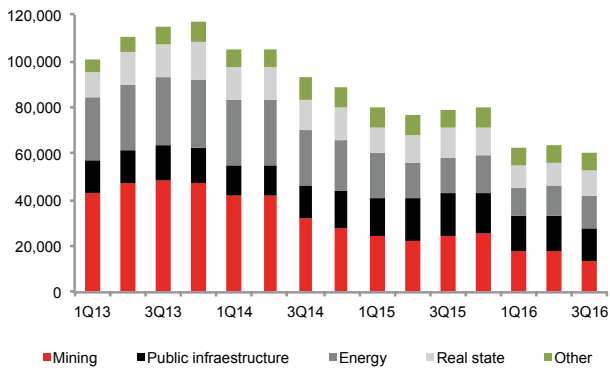
Consequently, household spending on durable goods is growing. In particular, new car sales that had fallen over the past two years will show a significant expansion for the

## Investment

The better performance of consumption will be offset by slowing investment. In our forecast, gross fixed capital formation will grow 0.4% in 2016 and 0.3% in 2017, providing one reason for the country's output to remain below its potential.

In particular, we note that investment projects for the next five years remain at low levels. This has been accompanied by a change in the composition of investment portfolios. Until recently mining projects dominated investment, while now the mining sector has moved to third place, behind energy and public works.

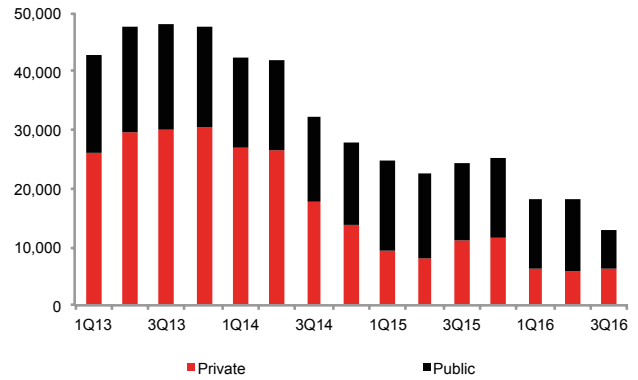
**Graph 18: Five-year investment portfolio (USD million)**



Source: Capital Goods Corporation (CBC) and Santander.

However, it is worth noting that the latest decline in mining investment is due to state-owned copper miner because is reprogramming its portfolio. Until now, Codelco had lagged behind private miners' rapid response to the decline in copper prices. In contrast, although slight, the portfolio of private investment projects has seen a modest increase.

**Graph 19: Five-year public and private mining investment (USD million)**

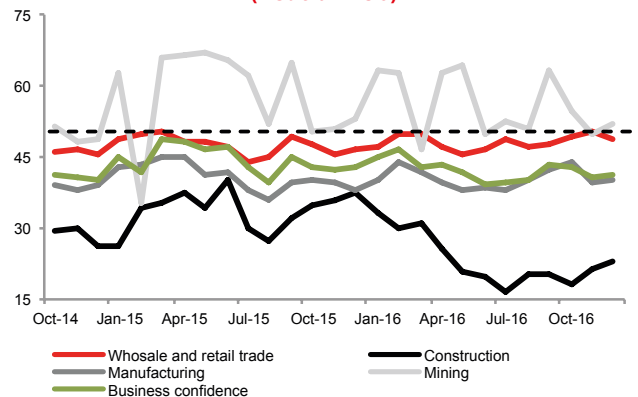


Source: CBC and Santander.

Although business expectations have improved in recent months, they still remain at pessimistic levels. On the positive side, it should be noted that expectations about business developments, in general, are several points above expectations regarding country's developments and close to a neutral level. This tells us that while the macroeconomic environment may be perceived as weak, the business environment is better evaluated. As a result, the emergence of a positive catalyst could move the economy towards a more dynamic scenario.

In summary, the actual reality of each company looks moderately good, and if the global environment improves, the economy could move rapidly towards a higher growth phase.

**Graph 20: Business Confidence Indicator (neutral = 50)**

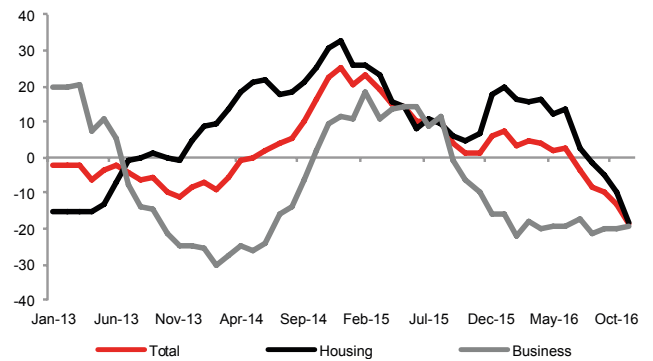


Source: Icare and Santander.



Despite this, there are some specific sectors that will show signs of contraction, such as construction, where we forecast a decline of 0.7% in 2016 and 1.5% in 2017. This is due to investment in mining, which has been stagnant for several quarters, and real estate, particularly housing. The latter experienced a sharp expansion in 2015 due to the change in the VAT regime. In 2016 and the following years, we will observe a gradual return to average levels.

**Graph 21: Building permits for new developments (% YoY, yearly moving average)**

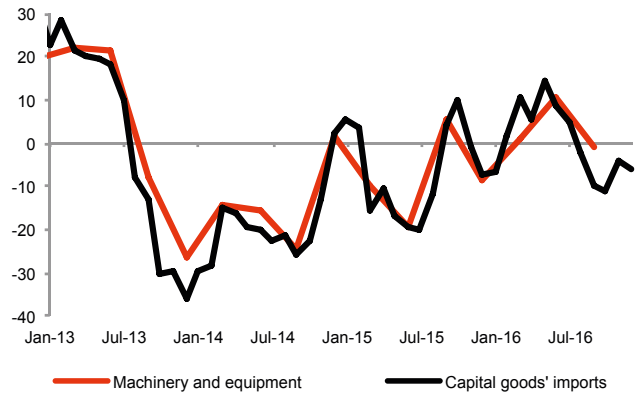


Source: INE and Santander.



In contrast, we expect machinery and equipment to grow in 2016 (2.6%) after three years of contraction. We forecast an upward trend of 3.5% in 2017 and 5.5% in 2018. This is basically due to the need to replenish capital stock and also to develop new energy projects that will require wind turbines and solar panels. Imports of capital goods usually show a strong correlation with the performance of machinery and equipment, which was stronger in 2016. This momentum will continue in 2017, together with imports of railcars for the new lines of the metropolitan subway being built in Santiago.

**Graph 22: Capital goods imports and machinery and equipment (% YoY, quarterly moving average)**



Source: Central Bank and Santander.

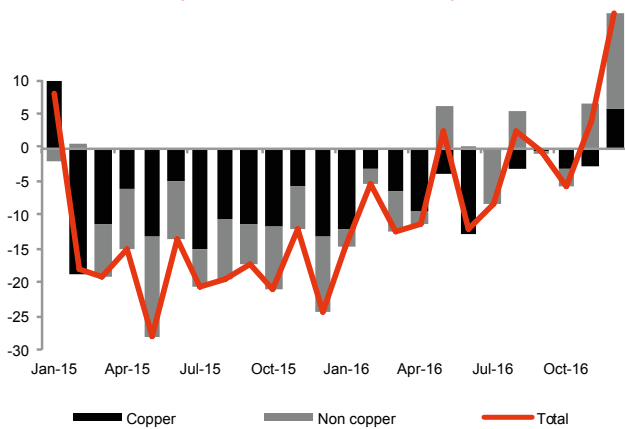


## External sector

As a small and open economy, Chile has a large volume of foreign trade supported by free trade agreements with countries which, together, account for almost 85% of global output. However, since the subprime crisis international trade has experienced a slowdown, and recently the emergence of nationalist movements and some election results augur a resurgence of protectionist positions.

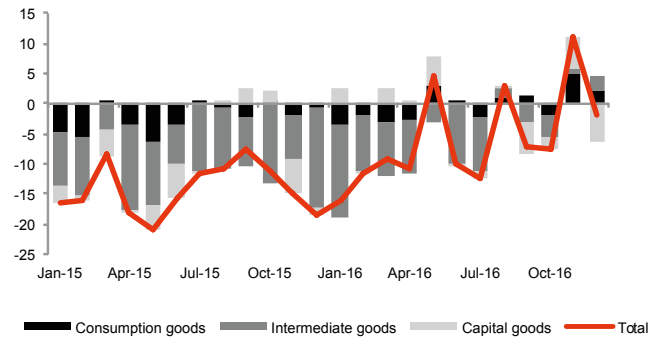
Forecasts of volumes as well as total amounts of international trade are positive, although modest. In particular, we believe that after three years of contractions, imports will grow again in real terms by 1.7% in 2017 and 2.6% in 2018. For their part, exports will grow by 1.9% and 3.0%, respectively for the same periods. Particularly, copper exports, which represent half of total exports, will recover due to greater Chinese and U.S. demand. Thus, there will be a slight trade balance surplus, which will be rather stable.

**Graph 23: Nominal exports by type of good (% YoY and contributions)**



Source: Central Bank and Santander.

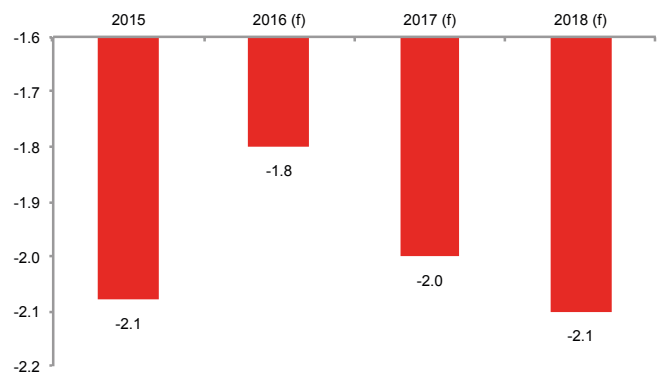
**Graph 24: Nominal imports by type of good (% YoY and contributions)**



Source: Central Bank and Santander.

Finally, the current account will continue to be in deficit, increasing the negative balance of -1.8% of GDP in 2016 to -2.0% in 2017 and -2.1% in 2018. This result is due to increased capital flows to Latin America than previous years, together with economic recoveries in Brazil and Argentina. Thus, the improvement in net exports will not be able to compensate for the increase in the country's indebtedness.

**Graph 25: Current Account (% GDP)**

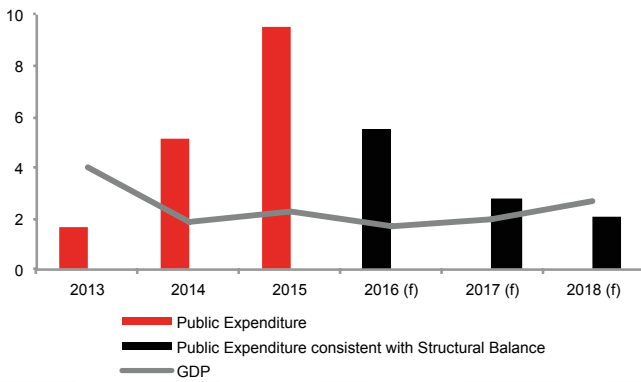


Source: Central Bank and Santander.

## Public sector

In the context of an economy that is growing below its potential and a copper price that is lower than its trend value, public spending growth must be higher than country growth to cushion slower economic activity and act in a countercyclical manner. However, it is also true that the speed of public debt growth must be monitored, above all to protect credit ratings and keep financing costs low. In this sense, restraints are not yet seen on public debt growth which could close 2017 at a debt-to-GDP ratio of 24.9%, possibly reaching almost 30% in 2020.

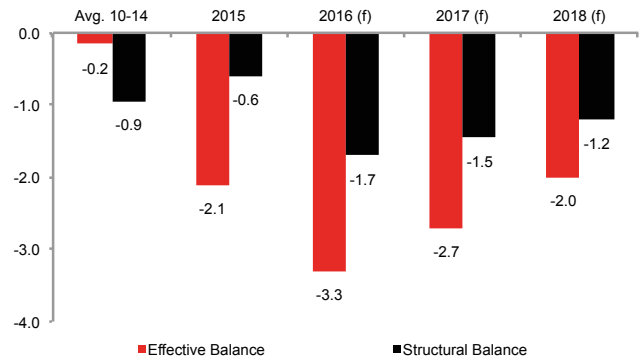
**Graph 26: Public expenditure and GDP (% YoY)**



Source: Government's Budget Office (Dipres) and Santander.

This is why a public spending growth rate of 2.7% in 2017 is regarded as appropriate. It should be noted that this rate has only been lower in two previous budgets since 1990. To finance this level of expenditure, next year the Government is authorized to borrow up to USD10.5 billion.

**Graph 27: Public Debt (% GDP)**



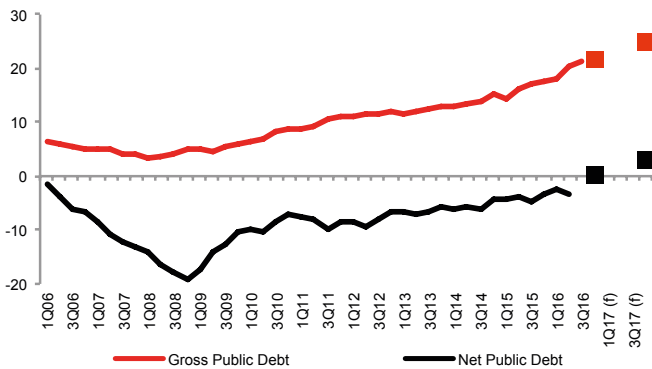
Source: Dipres and Santander.

As a result, next year's actual deficit will be 2.7% of GDP. In the medium term, there are committed expenditures that exceed what can be financed by complying with the structural fiscal balance rule.



In addition, the change in the tax regime has not benefited investment, so a new mechanism to reverse this situation needs to be considered.

**Graph 28: Effective and structural public balance (% GDP)**



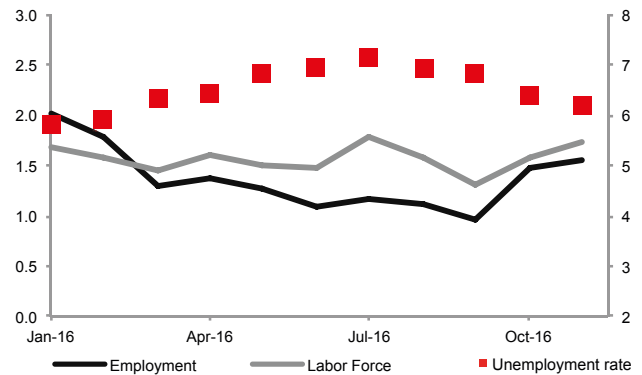
Source: Dipres and Santander

## Labor market

The labor market will remain, in aggregate, stable. We estimate an unemployment rate at the end of the year of 6.4%, with an average of 6.5% for 2016. The pace for 2017 is stable with an average of 6.4%. This is explained by employment growth that, although meagre, surpasses the growth of the labor force from March 2017.

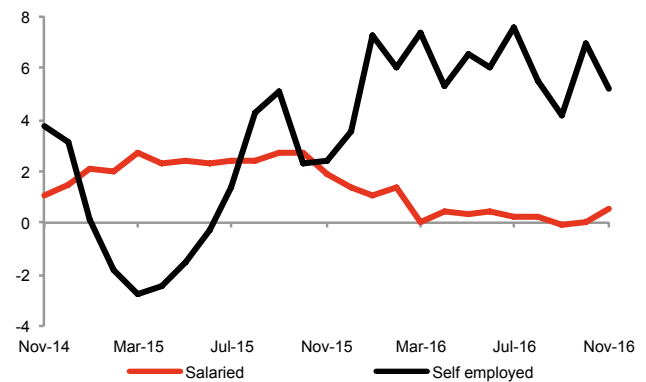
However, behind the stability in the figures, there is a deterioration in the labor market which has not shown signs of reversing. In fact, during the year self-employment has grown on average by 6.3%, while waged employment has done so by 0.4%, and even registered negative growth in September.

**Graph 29: Unemployment rate (%)**



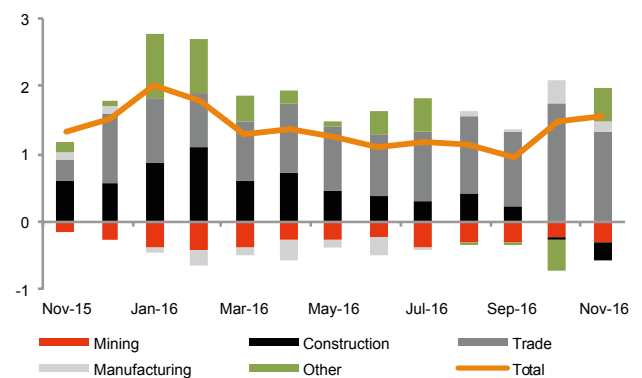
Source: INE and Santander.

**Graph 30: Job creation by category (% YoY)**



Source: INE and Santander.

**Graph 31: Job creation by sector (% YoY)**



Source: INE and Santander.

## Economic sectors

Based on expected GDP growth rates, we forecast performance by sector using nested models. Perhaps the biggest news is mining that stopped contracting after two years and will return to copper production levels similar to 2015. In contrast, the services sectors which were among the most dynamic in 2017 will slowdown. Meanwhile, construction will register a contraction in 2017 due to the mean reverse after the housing boom.

### Farming and forestry

Food commodity prices will continue to show a normalization after years of high prices. As a result, investments have slowed in the sector's projects. However, favorable climate forecasts will drive an upturn, especially in the fruit sector.

The stability of the exchange rate and the containment of labor costs will help to maintain the competitiveness of a sector that is clearly export-oriented.

### Fishing

After a difficult 2016 due to natural phenomena that affected production, 2017 is looking more promising. Undoubtedly, higher salmon prices explain this forecast. However, the industry still requires consolidation to take better advantage of the economies of scale, which would imply significant investments.

### Mining

Mining contracted in 2016 partly as a reaction to lower copper prices, restructuring plans, and lower ore grades. In addition, the start-up of a project at the country's main mine which impacted national production in 2016 will be reverted. As a result of the rebound in the price of copper, which we estimate will average USD2.40/lb in 2017, its first increase after five years, and the recovery in production, we forecast the mining sector will grow by 1.2% in 2017. It is worth mentioning that this figure is lower than expected by public and private associations.

As risk factors for the sector, we note that there will be various collective bargaining processes which will impact company results. Meanwhile, national investment will remain sluggish as long as mining infrastructure does not improve.



## Manufacturing

The manufacturing sector will contract in 2016 but will expand slightly in 2017. Weak internal demand is behind this result. In addition, some Chilean companies have established businesses abroad rather than exporting from the country.

By subsector, the metal industry and machinery and equipment will be the most dynamic, sustained by the development of the new subway lines of Santiago's metropolitan train and the better performance of the sector's main export destinations such as Argentina and Brazil.

## Electricity, gas and water

Good public policy management has helped this sector take the lead among investment projects for the next five years, a position usually held by mining. Among the important changes observed, better energy tender processes have been designed and both of the country's main grids have been integrated into only one (it will begin operation in 2018).

In addition, the threat presented to the country's competitiveness by high energy costs has dissipated. However, there is some reasonable concern that the winners of the most recent tenders may have excessively tight margins. Nonetheless, the introduction of Non-Conventional Renewable Energies (NCREs) has taken place smoothly. The risk of greater intermittence entailed by these means of generation must be assumed by plants that can start-up rapidly. However, the mechanism through which the market will pay for this type of service (backup energy) has yet to be redesigned.

Looking to the future, the way to promote the entry of small hydroelectric run-of-river plants is being evaluated, for example, through tenders by zones according to the season of the year. This is because run-of-river plants are very active during winter months but not in the summer.

We forecast a sector with stable growth of about 2.0% in 2017 and which will strengthen in 2018.

## Construction

Construction will see a slight contraction this year that will sharpen the following year. This is because the housing sector will revert to its mean performance after the "VAT effect" has passed which caused a temporary housing boom. Building permits, which are an early indicator of the sector's performance, show a contraction this year of around 25%.



Additionally, it should be noted that the regulation imposes new costs, for example, through the new law requiring contributions to public spaces that could mean an increase of around 10% in final construction costs.

Meanwhile, employment in this sector will be decimated (one of the country's largest employers), accompanied by increasingly precarious employment contracts, for both payroll and contractor workers.

### Wholesale and retail trade

Once again commerce will grow more than GDP and, although at lower than historical rates (approximately 5.0%), an expansion of almost 4.0% is feasible. Despite the determinants of sector sales - labor income, which remains stable, and economic expectations, which are still at pessimistic levels - there are already signs of improvement. For example, payroll employment has increased, something which had not been seen for several months and monthly indicators are showing a more dynamic recent performance.

### Restaurants and hotels

According to the World Economic Forum, Chile is the second most competitive tourist destination in South America. The government's goal is for this activity to represent 6% of GDP by 2020, almost double current levels. To this end, the government is offering state land for tourism investment.

However, the number of tourism investment projects has fallen sharply making it almost impossible to achieve this goal. In addition, labor market flexibility is a key requirement for this sector's development and regulatory changes along these lines are urgently needed. For this reason, we forecast slightly lower growth than GDP for this sector in 2017.

### Transport

This has been one of the sectors that surprised us on the upside during 2016 and we believe that, although it will slow marginally, transport will grow around 4.0%. It is a sector that has benefited from fuel prices.

In Santiago, however, the financial problems presented by Transantiago remain to be solved, and they require a thorough improvement of the system.





## Communications

In contrast to transport, the communications sector has performed substantially less well than we predicted a year ago, but, according to our models, the pace will quicken in the next two years.

In general, there have been major shifts in consumption trends due to the introduction of new technologies and regulatory changes. There is a tendency to prioritize the use of mobile services and data transfer services over voice services. Despite this, fixed internet connections continue to increase.

## Financial services

The performance of financial services has slowed and in 2017 we expect growth of around 3.0%. There are lower levels of credit and deposits due to the slower economy. In particular, mortgages and sight deposits show lower growth.

Interest rates remain at tight levels although we expect the cost of long-term financing to increase in the coming months due to faster than previously expected monetary normalization in the U.S.

## Business services

We continue to correct downwards the expansion of business services which will grow at half the rate of GDP in 2017. In general, everything associated with investment projects has been quite weak, and inspection activity of both projects in construction and projects in development has diminished. On the other hand, larger numbers are participating in tenders and the tender offers have lower margins.

## Dwelling services

Dwelling services are usually sluggish and, therefore, their performance has been very similar to the previous year, and slightly improved because people are buying fewer new houses and allocating more resources to their current homes.

On the other hand, the real estate market is healthy. Although rental prices have stagnated, they are expected to recover in response to higher demand.



## Personal services

In line with greater resources spent on education and health, the strength of personal services has been remarkable. We estimate growth of 6.1% in 2016 but it is not sustainable in the medium term. Thus, we forecast a weaker performance in 2017 with growth closer to its historic average (3.8%).

## Public administration

The containment of public spending provided in the 2017 Budget Law implies that the sector will expand at a rate close to 3.0%. However, it will be necessary to monitor that the evolution of non-budgetary spending is kept under control in the context of a presidential election year.

**Table 4: Growth by economic sector (var. % YoY)**

	Avg. 10-15	2016 (f)	2017 (f)
Agriculture & forestry	1.5	3.5	4,1
Fishing	5.5	1.5	7.0
Mining	1.3	-2.8	1.2
Manufacturing	2.8	-1.0	0.5
Electricity, gas & water	6.6	2.1	2.2
Construction	4.1	-0.5	-0,9
Wholesale and retail trade	7.4	3.9	4.0
Restaurants and hotels	5.3	1.0	1.5
Transport	6.3	4.2	4.0
Communications	8.0	0.6	2.0
Financial services	7.1	3.5	3.0
Business services	4.0	0.6	1.0
Dwelling services	1.9	1.9	1.7
Personal services	4.8	6.1	3.6
Public administration	3.0	3.5	2.9
Gross Domestic Product	4.0	1.6	2.0

Source: Central Bank and Santander.

## Productivity

The country's economic outlook shows a relative stagnation in growth. This subdued performance contrasts with the economic boom experienced a few years ago, and is explained by the sustained decline in total factor productivity (TFP). For example, the Latin American Center for Economic and Social Policies' (CLAPES UC) productivity indicators (TFPs) record the longest stretch of productivity decline since the existence of quarterly records. For its part, although labor productivity is performing better, it makes a limited contribution compared to leading countries in these matters.

As such, in the current scenario it is critical to implement policies - in the public and private sphere - that increase productivity and turn this situation around. To this end, the National Productivity Commission and the Productivity Commission of Chile's Production and Trade Confederation (CPC) worked in 2016, generating a list of more than 130 measures. As a result, some progress has been made. However, the measures with the greatest impact are those that require legal modifications, and it is these measures that require more rapid progress.

## Inflation

The main news regarding prices is the return to annual inflation rates of around 3.0% after more than two years of rises higher than the ceiling of the Central Bank's target range. In fact, we started 2016 with an annual variation of 4.8%.

A fundamental factor behind this adjustment was the evolution of the exchange rate which stopped depreciating at the rates seen in 2014 and 2015. In fact, in 2016 there was annual depreciation of less than 1%.

Another factor that has contributed to lower price variations is the sluggish activity of the labor market, which has led to fewer upward pressures on wages along with the slow recovery of imported inflation.

In the coming months, we expect prices will continue to decline on an annualized basis until at least June 2017. This is due to specific factors that influence inflation, giving a high base of comparison.

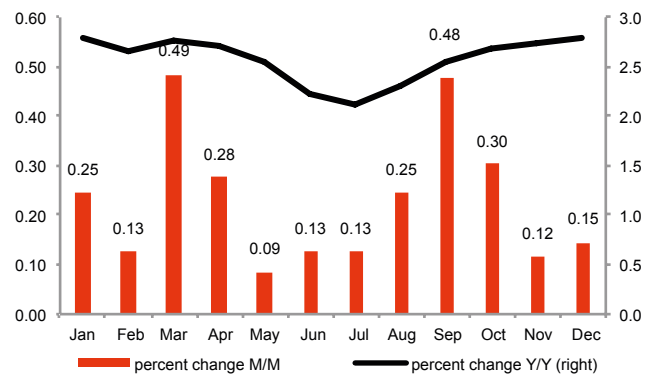
Imported inflation will rebound and non-tradable inflation will remain relatively high. Likewise, we are confident of the gradual recovery of domestic demand, which will result in the creation of better quality employment. On the other hand, the tax reform will come into force in 2017, introducing a corporate tax rate of 27%, which will impact company margins. For these reasons, we forecast a rebound in inflation toward the middle of the year, closing the year at a rate of around 3.0%.

The main risks for increased inflation are the higher than expected depreciation of the exchange rate due to external factors and the generalized increase in external inflation, mainly food and energy.

For its part, the main downside risk is a deterioration in wages that leads to lower pressures on services sector inflation.

In short, we expect to close 2017 with an annual inflation rate of 2.8%.

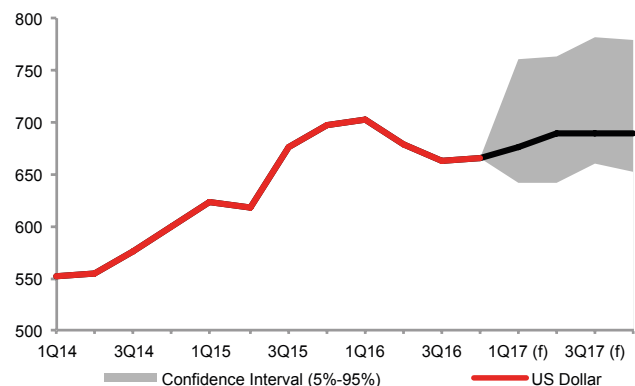
**Graph 32 : Projected 2017 inflation path (%)**



Source: National Institute of Statistics and Santander.

## Exchange rate

**Graph 33 : Exchange rate evolution and forecast (CLP/USD)**



Fuente: Banco Central y Santander.

We expect the nominal exchange rate to follow a depreciative course until the first half of 2017, correcting slightly to an upward trend towards the end of that year. Thus, we estimate the dollar will trade at around CLP670 at the end of 2016, marking an annual average of CLP677. Meanwhile, in 2017 we forecast an annual exchange rate of CLP683, representing a slight depreciation against 2016 levels. Notwithstanding this stable trend, there

will be volatility around specific events, both political and economic.

In addition, the large volume of capital flows to advanced economies due to the upward trend of these economies' interest rates, especially in the U.S., will have an impact on the currency's short-term movements. The evolution of the copper price must also be taken into account, in particular if the hike observed in the last part of 2016 is transitory or in fact permanent.

### Interest rates

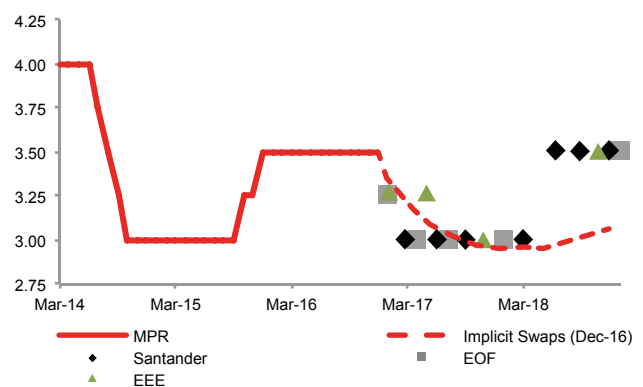
Expectations have varied considerably regarding the movements of the monetary policy rate (MPR). In March 2016, the market expected the Central Bank to announce a rise in benchmark interest rates during the year but this changed to anticipated downward adjustments as time passed. This is largely explained by inflation's (rapid) convergence towards the Central Bank's target range and later to the middle of this range.

So far the monetary authority has maintained the MPR, noting that it was better to be cautious in the face of possible erratic events, especially due to the uncertain international outlook. While 2017 does not appear to be any quieter than previous year, given the reduction of inflationary pressures, showed by the expected inflation which will get near to the lower bound of the policy

range in the second quarter, we expect the Central Bank to reduce the MPR by 50 bps during the first quarter. After that, the authority will likely maintain the interest rate unchanged for the whole year, starting reducing the impulse during 2018.

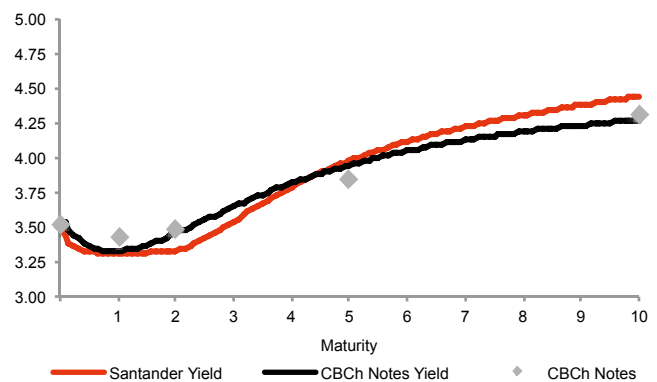
Under that scenario the implicit cash curve is somewhat fair against what the market is pricing with Central Bank bonds.

**Graph 34 : MPR expected path (%)**



Source: Bloomberg and Santander.

**Graph 35 : Yield Curve in CLP (%)**



Source: Bloomberg and Santander.



## Outlook for the stock market

In 2017 we expect the stock market to maintain previous year positive performance, although not without volatility. Thus, we estimate a stock yield of slightly higher than 10% above our estimate for the end of 2016 of 4,250 points.

Fundamentally, we see that the valuations of Chile's IPSA stock market index are in line with its historical average (at 15.4x p/u) and we do not expect greater risks in terms of profit estimates.

On the contrary, we believe that the significant downward surprises of profit estimates over the last four years, except for 2016, have been largely explained by the negative impact of the emerging currency depreciation and a markedly below-potential performance of Chilean companies' operations in the rest of Latin America, which is relevant given the significant investments of Chilean companies abroad in the last decade. This is why an improvement in regional economic perspectives will lead to a normalization of results which, combined with efforts

to improve efficiency in national operations, could lead to better medium-term results (2017-2018).

On the other hand, it is important to take into account the 2017 electoral landscape, which will be as or more important than the short-term fundamentals of the local stock market as foreign investors have become increasingly optimistic about the region.

At the sector level, it is worth noting those companies that have a high exposure to the region: electric power companies with a presence in Argentina in view of the potential regulatory changes; retail companies due to the improvement in consumer confidence in Peru; and also in the telecommunications and banking sectors. On the other hand, we remain cautious about the electric power sector because of the sharp drop in energy prices in recent months following the entry of renewable energy companies and greater competition.



## Social and political perspective



## Presidential elections

2017 will be an intense year for socio-political topics. After the results of the municipal elections and electoral analysis in 2016, the administration of President Michelle Bachelet faces its last part of government as we approach the upcoming presidential and parliamentary elections. The election process presents major challenges. Although the new Electoral Law had its first test in the recent municipal elections, it must now respond to the greater challenge and to the complexity of low turnout and citizens' growing disinterest in political issues. In addition to these factors is the impact that the vote of Chileans abroad could have.

The political agenda will be marked by three key dates: on July 2nd, each sector must hold primaries to decide who will officially represent each coalition in the presidential elections and in Congress; on November 19th, presidential and congressional elections will be

held; and on December 17th, a potential ballottage for the presidential election is programmed.

## Parliamentary elections

The new electoral map, which includes the replacement of the old binominal system with a proportional system (D'Hondt's method), modified the composition of electoral districts, increasing the number of deputies to elect from 120 to 155 and, reducing the number of districts which each deputy must represent from 60 to only 28.

In the case of the Senate, each region of the country will become a constituency. The number of senators to be elected will increase from 38 to 50. It is important to note that in these elections only the constituencies corresponding to odd-numbered regions will be renewed (regions have names and numbers). In addition, a quota



system will be used whereby the proportion of male candidates may not exceed 60% of the total number of candidates for deputy or senator.

This new configuration of the system could lead to a fragmentation of political parties' alliances and strategies, as well as a larger number of independent candidates who have managed to strongly position themselves in recent times. However, it should not make a substantial difference to the representation of traditional political blocs, at least on this first occasion.

## Public agenda

In government matters, President Bachelet's administration will seek to consolidate the policies promoted in its initial program, which will not be easy because they are deep reforms. Currently, there is a list of 156 pieces of legislation that should be considerably reduced to achieve a viable legislative agenda until the end of the government's term. First, one of the government program's main pillars, the Constitutional Reform (constituent process) bill is in the pipeline. Another complex initiative will be the Education Reform and the final free education bill, which has already begun the legislative process but has not yet

been promulgated into a law due to the multiple political differences that it generates. Meanwhile, the ethical discussion about the decriminalization of abortion on three causes will provoke a new debate that could delay the rest of the agenda. Finally, there remain the bills to create a state pension fund administrator, an issue that has not progressed due to questions over its real contribution to Chile's pension system, and the new immigration policy.

In terms of the capital markets and consumer protection agenda, the bill to improve the General Banking Law should be submitted and the parliamentary process on consolidated debt and the consumer protection law should be completed or at least continued.

At citizen level, there are focus areas that will be broached in the 2017 election campaigns, such as the opposition of certain groups to the pension fund system (AFPs), public workers' demands for salary readjustments, as well as a series of collective bargaining processes, especially in large mining companies. Although, they have not demonstrated the cohesion of the past, students will be anticipating the pending education reform laws. A date to take into account is April 19, when the new National Census will be carried out and declared a holiday.



## Appendix

### Heatmap methodology

The global heatmap was developed to evaluate the economic performance of our major trading partners and the potential demand for our exports in 2017.

It was considered that the most significant variables to take into account were expected economic growth - measured as Gross Domestic Product - and another variable that reflects macroeconomic stability and also consumers' welfare; both factors fit well in the Okun misery index.

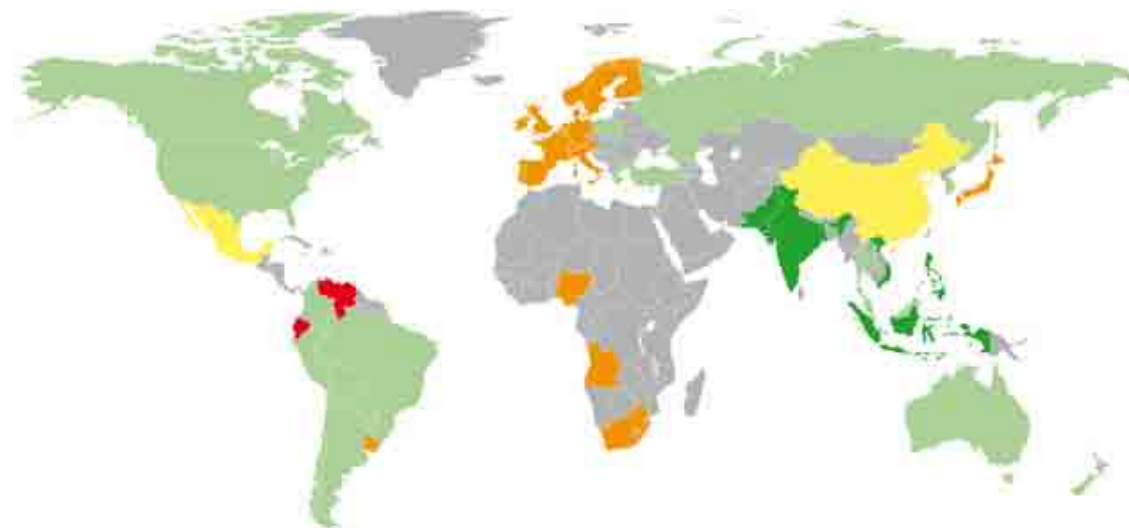
The IMF's forecasts for inflation, GDP and unemployment rate were used as sources, except in the case of Chile where our own estimates were used.

- To assess the growth potential of our trading partners we considered in two dimensions: the first is the real growth of the economy, and the other is the "momentum", calculated as the difference in annual variations between how much each country's economy grew in 2015 and the growth estimated for 2016 and 2017. The results of GDP growth and momentum were normalized to build a joint distribution of both variables.
- The Okun misery index was calculated as the sum of inflation and the expected unemployment rate for the countries under consideration. Subsequently, this metric was also normalized.

The result was calculated as the joint distribution of what was obtained in our growth indicator and the Okun index, assigning a weight of 75% to the first variable and 25% to the second, considering that in order to evaluate the increase trade with our country, the growth impact would be more relevant.

Finally, the values were sorted from highest to lowest and were classified by color as follows: dark green for those countries that are one standard deviation above the mean; light green for those that lie between the mean and up to one standard deviation above the mean value; orange for countries that are between the mean and one standard deviation below it; and red for those that are below one standard deviation away from the mean.

China was treated in a different way, given its relative importance, as was Mexico because of the challenges that it is facing. For this reason, an additional category was defined, classified as yellow for both countries.



<b>Felipe Bravo</b> <i>felipe.bravo@santander.cl</i>	Chief Economist
<b>Gabriel Cestau</b> <i>gabriel.cestau@santander.cl</i>	Economist
<b>Álvaro González</b> <i>alvaro.gonzalez@santander.cl</i>	Economist
<b>Camilo Vio</b> <i>camilo.vio@santander.cl</i>	Economist
<b>Daniela Ulloa</b>	Statistician

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