"Impact of COVID-19 on the economy and FDI"

This report provides an update of specific points in the report on "Impact of COVID-19 on the economy and FDI" published by InvestChile's Competitive Intelligence Unit in June 2020 and available on www.investchile.gob.cl.

Global economic impact of COVID-19

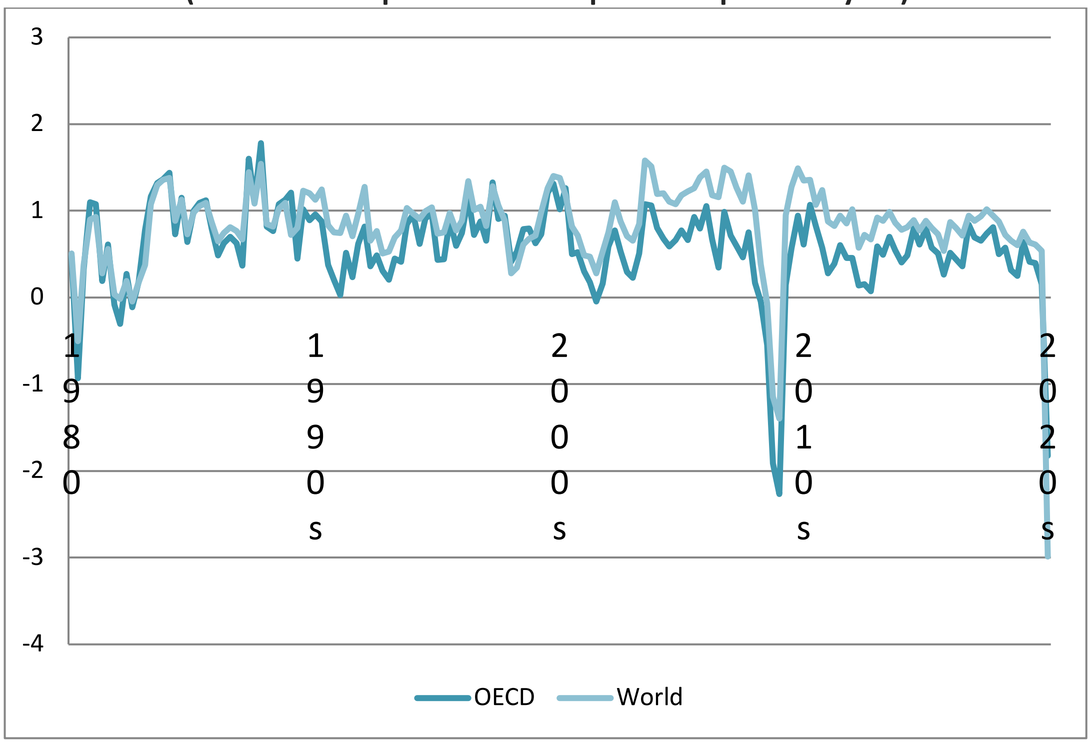
Downward revision of growth forecasts

The impact of the COVID-19 pandemic has been more negative than initially anticipated and, according to forecasts, economic recovery will, therefore, be more gradual than previously expected.

In the second quarter, the overall impact of shutdowns and paralyzations further reduced world output. Unexpected supply-side disruptions have impacted many companies because the shutdown of non-essential activities and travel restrictions have made it difficult to operate effectively and have complicated relations with key suppliers.

Demand has also weakened sharply, particularly in the case of consumer goods and services where there is close contact between producers and consumers as well as travel and tourism services. This has caused large revenue losses and an important liquidity shock for a significant number of companies.

Figure 1: Quarterly GDP, 1980-2020
(Variation compared to same quarter in previous year)



Source: OECD

In addition, the sharp decline in consumer confidence and higher unemployment are restricting household consumption and contributing to precautionary savings.[1] Small and medium-sized enterprises (SMEs) have been particularly affected, especially since many operate in the service sectors most impacted by shutdowns and have limited financial reserves with which to address the sharp fall in turnover.

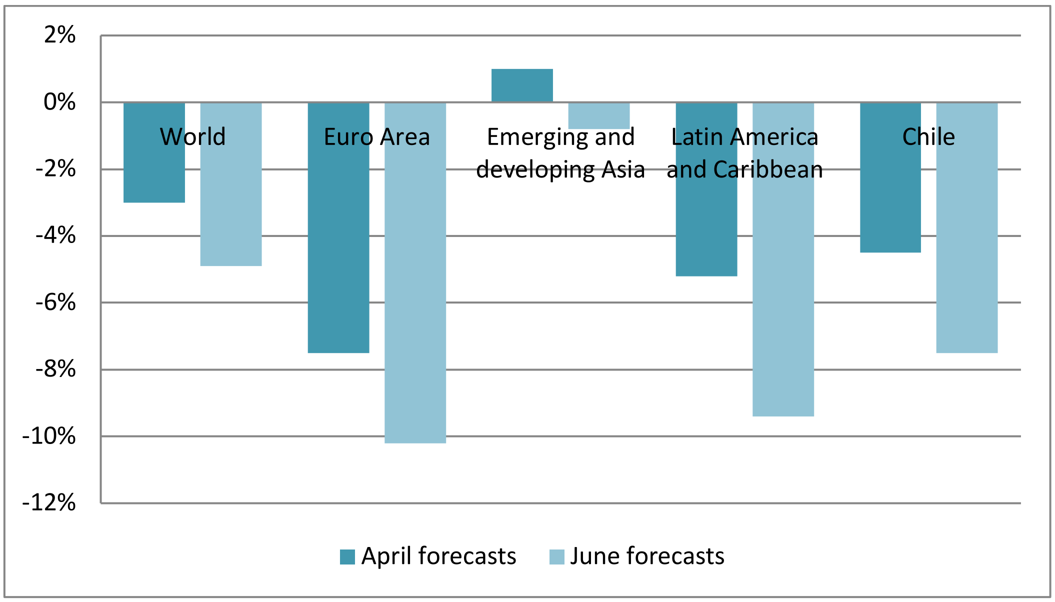
In line with this, the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD) and other international institutions have revised their forecasts downwards. The IMF's current forecast of a 4.9% contraction of the global economy in 2020 represents a drop of 1.9 percentage points on the forecast in its World Economic Outlook (WEO) report of April. For 2021, it is forecasting world growth of 5.4%, implying that global GDP in 2021 would be around 6.5 percentage points down on the IMF's forecasts in January[2] before the COVID-19 pandemic.

[1] World Economic Outlook, June 2020, IMF.
[2] World Economic Outlook, June 2020, IMF.

In particular, the growth of consumption has slowed in most economies in response to a deeper than expected disruption of domestic activity. Forecasts of weakening private consumption reflect the combination of a large adverse aggregate demand shock from social distancing and a rise in precautionary savings. [3] Investment is also expected to weaken as companies defer capital expenditures amid high uncertainty.[4] Policy support is partially offsetting the deterioration in private domestic demand.

As with the IMF's April forecasts, its current forecasts are subject to uncertainty and depend on the depth of the contraction in the second quarter and the magnitude and persistence of the adverse shock.

Figure 2: Forecasts for growth in 2020



Source: World Economic Outlook, June 2020, IMF

In the specific case of emerging and developing economies, this downward revision reflects the intensification of spillovers from weaker external demand and, particularly, the drop in Chinese demand.[5] The IMF is currently forecasting a contraction of 3.0% for the group of emerging market and developing economies in 2020, two percentage points below its April forecast.

[3] OECD Economic Outlook, June 2020.
[4] World Investment Report, June 2020, UNCTAD.
[5] World Economic Outlook, June 2020, IMF.

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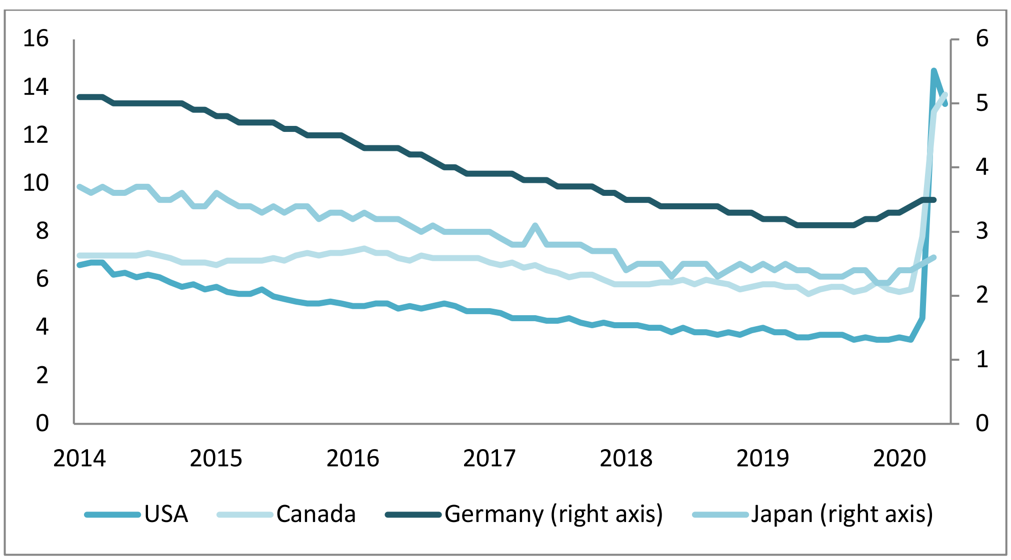
For the first time, all regions are projected to experience negative growth in 2020. There are, however, substantial differences across individual economies, reflecting the evolution of the pandemic and the effectiveness of their containment strategies and differences in economic structure, reliance on external financial flows, including remittances, and pre-crisis growth trends.[6]

The OECD has adjusted its forecasts based on two scenarios. The first assumes a single wave of the virus while the other considers the possibility of a second wave. Under these two scenarios, real growth of the global economy would range between -6% and -7.6% in 2020 and, in the case of the OECD member states, between -7.5% and -9.3%. In 2021, global growth would recover to between 2.8% and 5.2% and, for OECD member states, to between 2.2% and 4.8%.[7]

Marked deterioration in global labor market conditions

The marked drop in activity has had an important impact on the global labor market. Some countries, especially the large European economies, have contained the impact through effective short-term work programs, particularly for workers with permanent contracts, who represent some 20-25% of the labor force. However, according to the International Labour Organization (ILO), the global decrease in hours worked in the first quarter of 2020, compared to the last quarter of 2019, was equivalent to the loss of 130 million full-time jobs.

Figure 3: Unemployment rate in developed economies (%)



Source: Central Bank of Chile

[6] OECD Economic Outlook, June 2020.
[7] OECD Economic Outlook, June 2020.

In the United States, the labor market shock is without precedent. Since late March, unemployment insurance claims have risen exponentially to a total of over 40 million. Similarly, the number of non-farm payroll jobs in May was 13% lower than in February, undoing all the job growth of the past decade. In this context, the unemployment rate in the US rose to over 14% in April and May, its highest level since the Great Depression.

The decrease in employment in the second quarter is likely to have been equivalent to more than 300 million full-time jobs. In the case of economies that have been reopening, activity appears to have bottomed out in April, as suggested, for example, by the May report on employment in the US, which shows that workers provisionally declared unemployed are rejoining the workforce in some of the sectors most affected by confinement.[8]

In many countries, an increase in remote work has mitigated the drop in hours worked but a series of surveys suggest that less than half of workers are able to work remotely on a regular basis.

Despite the irruption of remote working, a large proportion of the labor force, particularly the least skilled workers, cannot work from home, either because they lack the minimum conditions to do so or because their job requires their physical presence. The impact on the labor market has, therefore, been particularly marked among this group.[9]

Income losses appear to have been unequally distributed by gender: among the lowest-income groups, women have been hardest hit in some countries. The ILO estimates that almost 80% of the approximately 2,000 million people who work in the informal sector globally have been significantly affected.

Abrupt drop in world trade

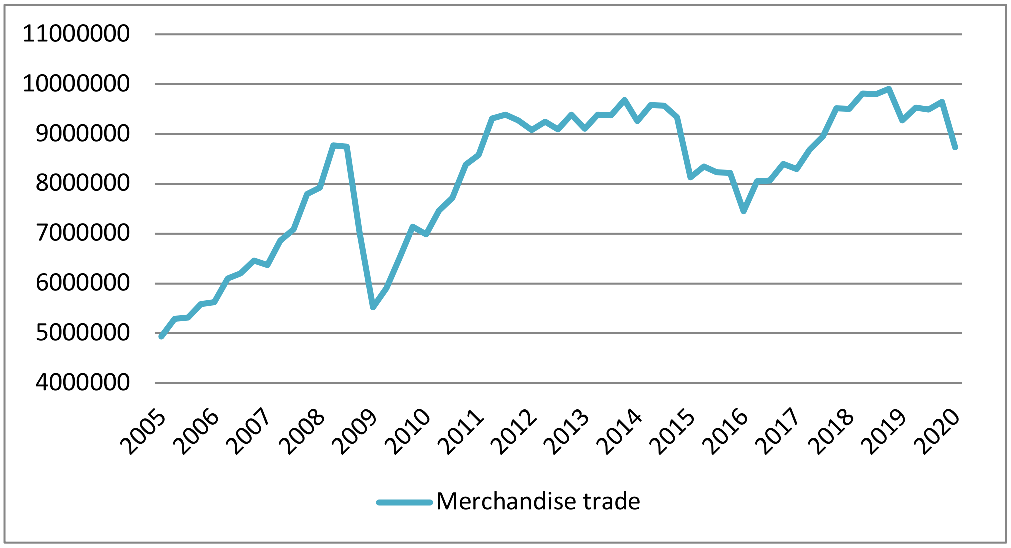
World trade has also contracted sharply. According to the World Trade Organization (WTO), the volume of merchandise trade, which fell by 3% year-on-year in the first quarter, went on to contract by 18.5% in the second quarter.

The figures confirm that, in the second quarter, when mass confinements were implemented around the world, global trade suffered an enormous impact. Air traffic was particularly affected and, in April, the international movement of passengers was down by 98% on the same month in 2019. Similarly, international cargo traffic in April was close to 30% below its level in April 2019. Supply interruptions, due to confinement measures and the interruption of international travel, have compounded the impact of the collapse of demand. In April, global export orders fell to their lowest level on record and remained exceptionally weak in May, with all countries reporting significant drops.

[8] World Economic Outlook, June 2020, IMF.
[9] World Economic Outlook, June 2020, IMF.

These reductions have been especially marked in Europe and some emerging market economies, particularly India and Indonesia. Even in countries where containment measures have been relatively light, many companies have been seriously affected by a sharp drop in external demand.

Figure 4: Nominal world merchandise trade, 2005-2020
(Quarterly, US$ million)



Source: WTO

The WTO estimates that, while the volume of trade will decline sharply in 2020, the most adverse scenario forecast in April, which would have meant a 32% contraction, is now unlikely. Initial estimates for the second quarter point to a year-on-year decrease of approximately 18.5%, implying that 2.5% quarterly growth over the rest of the year would suffice to meet the optimistic projection of a 13% contraction over the whole year.

International financial stability

In economies with important financial sectors, equity markets have recovered from March lows and have, on average, returned to approximately 85% of their level in mid-January. Although some equity markets have fully recovered from their losses, others remain 25% below mid-January levels.[10]

The measures adopted by central banks have played a crucial role in the recovery of markets and have, in general, boosted investors' appetite for risk. Some countries have opted to make further

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[10] Global Financial Stability Report, June 2020, IMF.

reductions in their monetary policy interest rate and investors anticipate that interest rates will remain very low for some years.[11]

There has also been a notable improvement in investor attitudes towards emerging market economies. Following unprecedented capital outflows at the beginning of the year, portfolio investment flows to these economies have stabilized.

This generalized recovery in financial markets has been accompanied by increased investor optimism about the prospects for early economic recovery. This market attitude has been reinforced by the reopening of some economies and the relaxation of confinement measures related to COVID-19. Investor optimism is, moreover, based on strong support from countries' monetary and fiscal policies amid great uncertainty about the magnitude and speed of the economic recovery.

However, recent economic data, presented in June in the IMF's updated forecasts, shows a deeper decline. This has led to divergences between risk assessment in financial markets and the economic outlook since investors are counting on central banks to maintain their unprecedented support measures. This tension is apparent, for example, in the rebound in the US stock markets and, on the other hand, the sharp drop in consumer confidence.[12]

Global fiscal outlook

Faced with the economic impact of COVID-19, governments have had to implement fiscal measures to offset the drop in people's income and companies' revenues. This has led to an increase in public debt and fiscal deficits.

[11] Global Financial Stability Report, June 2020, IMF.
[12] Global Financial Stability Report, June 2020, IMF.

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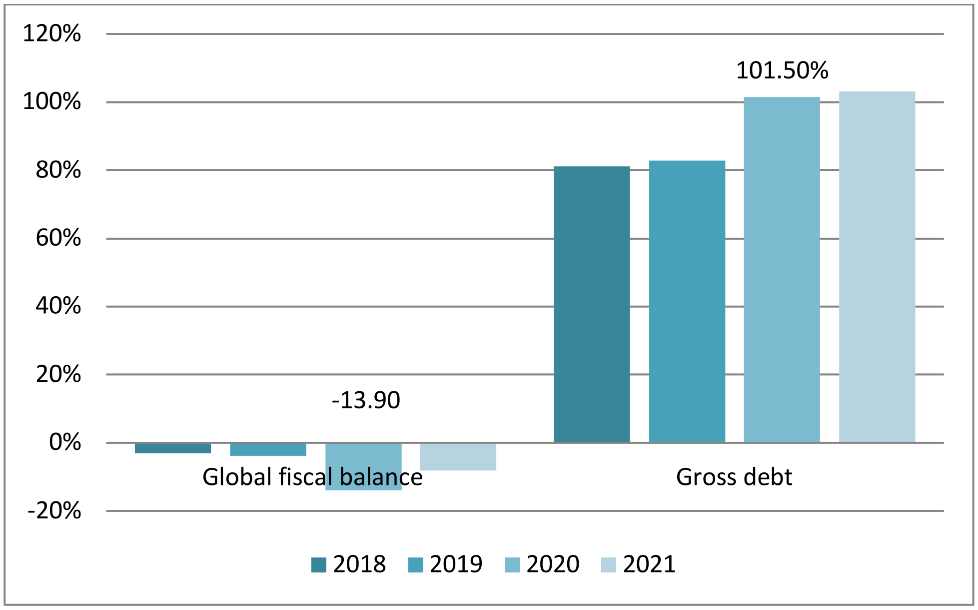
Figure 5: General government fiscal balance and gross debt, 2018-2021 (% of GDP)



Source: World Economic Outlook, June 2020, IMF

The IMF anticipates that, in the baseline scenario, global public debt will reach a record of more than 101% of GDP in 2020-21, up by 19 percentage points on a year ago. It also expects that the average global fiscal deficit will rise to 14% of GDP in 2020, ten percentage points above its level last year.

One of the main reasons behind the increased deficit will be a drop in fiscal revenues. They are expected to contract by more than output and to be an average 2.5 percentage points of GDP lower than in 2019.[13] This reflects a reduction in revenues from taxes on individuals and companies as well as the impact of the sharp drop in private consumption on VAT collection.

Global FDI flows

The COVID-19 crisis has had an immediate impact on foreign direct investment (FDI) and will continue to affect it in the short, medium and long term. The supply and demand-side shocks, combined with political reactions to the crisis around the world, have a series of consequences for FDI:

- Immediate impacts[14]: Confinement measures (the closure of factories and other workplaces) in order to contain the spread of the virus cause immediate delays in the implementation of investment

[13] World Economic Outlook, June 2020, IMF.
[14] World Investment Report, June 2020, UNCTAD.

projects. Delays have also been observed in the finalization of mergers and acquisitions (M&As) and could result in cancelations.[15] The number of new projects announced in March and the number of cross-border M&A agreements in April were down by more than 50% on their monthly average in 2019.

- Short-term impacts[16]: Subsidiaries of overseas companies are facing exceptionally challenging operating, market and financial conditions and their earnings are expected to show a sharp drop in 2020. The world's 5,000 main multinationals anticipate that their earnings will drop by an average of 36%, which is potentially serious because reinvested profits account for 50% of FDI flows.

- Medium-term impacts[17]: In June, all growth forecasts were adjusted downwards to take account of the pandemic's greater-than-expected impact in the first half of the year. A deeper contraction in demand, combined with the uncertainty about the economic outlook and the financial difficulties of companies due to a lack of liquidity, could, therefore, mean that projects which had been announced or were underway have to be suspended indefinitely.

- Long-term effects[18]: The pandemic will prompt multinationals to examine ways of increasing the resilience of their supply chain and this could favor policies to ensure more national or regional self-sufficiency in the production of critical supplies and possibly a broader strategic industrial capacity. The pandemic has already led to tighter restrictions on international trade and investment and this could negatively impact FDI.[19]

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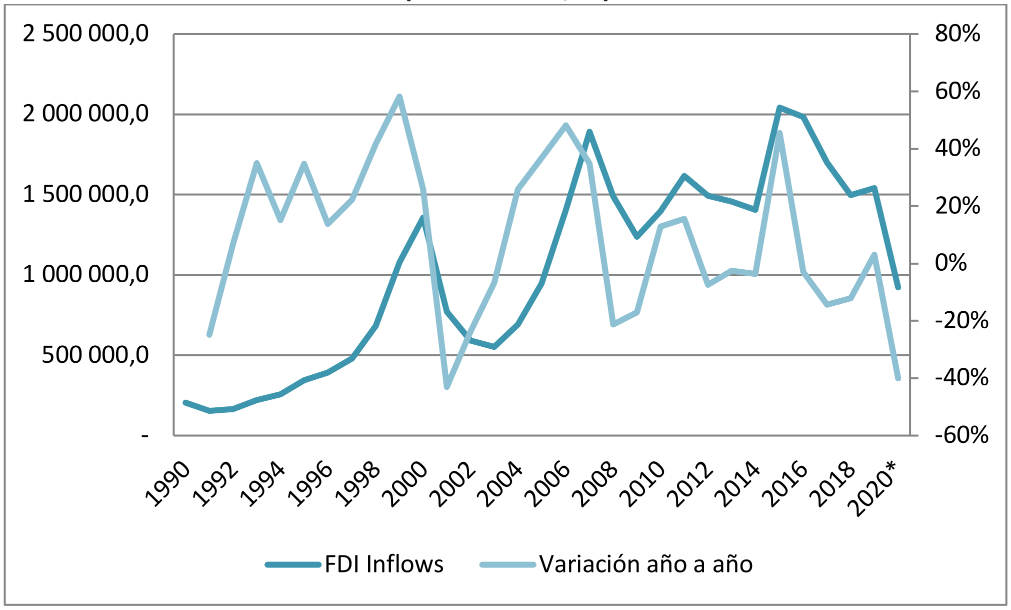
[15] Examples of delays in finalizing M&As include the acquisition of Deliveroo (UK) by Amazon (US) and of Embraer (Brazil) by Boeing (US).
[16] World Investment Report, June 2020, UNCTAD.
[17] World Investment Report, June 2020, UNCTAD.
[18] World Investment Report, June 2020, UNCTAD.
[19] The European Union (EU) presented guidelines on investment by non-member economies for the protection of the strategic assets of member states; Australia introduced changes on investment to protect the national interest and local assets.

Figure 6: Global FDI inflows, 1990-2020*
(US$ million, %)



Source: UNCTAD

These impacts explain why the UN Conference on Trade and Development (UNCTAD) is forecasting that COVID-19 will cause an enormous drop in FDI in 2020 and 2021. It anticipates that global FDI flows will decrease by up to 40% this year from their level of US$1.54 trillion in 2019, taking them to below US$1 trillion for the first time since 2005, and that this will be followed a further 5-10% contraction in 2021.

In terms of countries' income level, UNCTAD expects that, in developing economies, the contraction will reach between 30% and 40%. Developing economies are more vulnerable because their production and investment matrices are less diversified, making them more exposed to systemic risks. In addition, because of their more limited fiscal space, policy responses and support measures are significantly weaker than in developed economies.[20]

Latin America and the Caribbean are expected to experience the largest reduction in FDI inflows, with a contraction of between 40% and 55% in 2020. A large part of FDI in the region is in extractive industries and the collapse of oil prices, together with the pandemic-related demand shock and its effect on the prices of most raw materials, are impacting the FDI outlook more than in other regions.

[20] World Investment Report, June 2020, UNCTAD.

Structural vulnerabilities and political uncertainty also increase the region's exposure to the negative effects of the pandemic.[21]

Economic Impact of COVID-19 in Chile

Second quarter estimated to have brought historic contraction

In the first quarter of this year, economic activity in Chile grew by 0.4% compared to the same period in 2019. This positive, albeit low, figure reflected the fact that more restrictive pandemic-related measures, in terms of social distancing and the closure of non-essential activities, were introduced only in the last two weeks of March. However, less activity was seen in sectors such as personal services, commerce, transport, restaurants and hotels. From the standpoint of spending, this was mainly reflected in a significant decrease in household consumption.

As from May, the spread of the virus called for containment measures that have been more restrictive and prolonged than those implemented in March and April. In particular, the lockdowns implemented in a large part of the Santiago Metropolitan Region since mid-May and in a significant part of the Valparaíso Region since mid-June point to a deep drop in figures for economic activity in the second half of the year. In April, an average 11% of the population was under lockdown and this figure rose to 28% in May and 42% in June.[22]

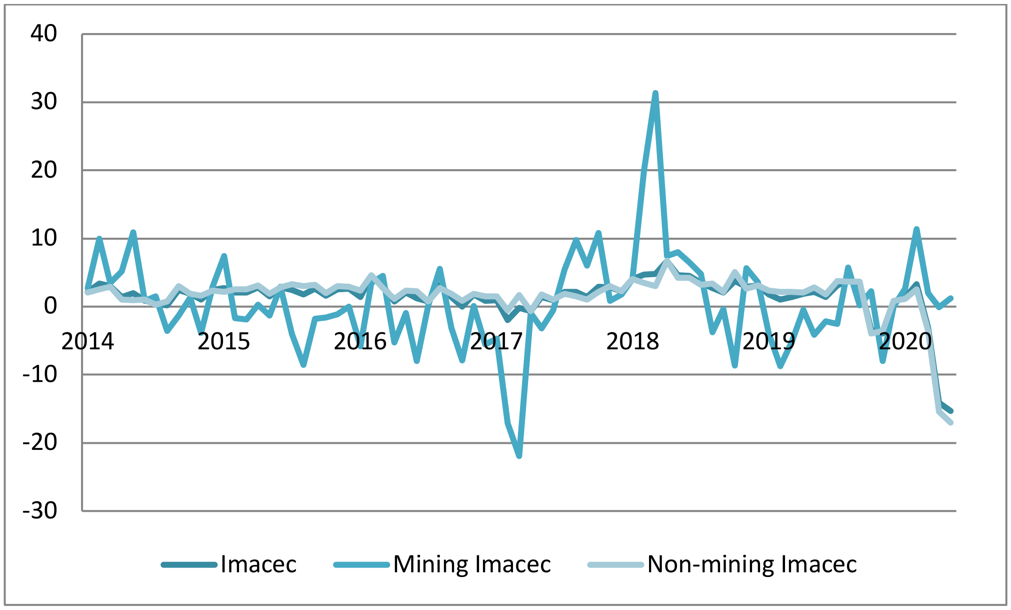
The Central Bank's Monthly Index of Economic Activity (IMACEC), Chile's main early indicator of GDP growth, showed historic falls in April and May when it was down by 14.1% and 15.3%, respectively. The figure for May would have been even more negative but for the mining sector, which expanded by 1.2%, slightly offsetting the 17% drop in the non-mining IMACEC.

Given the maintenance of restrictions, the IMACEC for June is expected to be similar to that for May. This would imply around a 15% contraction of GDP in the second quarter, the largest in 30 years.

As indicated at the beginning of this report, both the OECD and the IMF have reduced their growth forecasts for Chile in light of the data for April and May.

[21] World Investment Report, June 2020, UNCTAD.
[22] Monetary Policy Report, June 2020, Central Bank of Chile.

Figure 7: Monthly Index of Economic Activity (IMACEC), 2014-2020 (%)



Source: Central Bank of Chile

The OECD is currently forecasting a contraction of between 5.6% and 7.1% for Chile in 2020, depending on whether there is a second wave of the virus. Among the OECD member states, only Australia and South Korea are expected to experience a smaller contraction, positioning Chile as one of the least hard hit member countries in terms of GDP growth.

The IMF has reduced its growth forecast for Chile in 2020 from -4.5% to -7.5%. Compared to other Latin American and Caribbean countries, Chile would be the least affected. The IMF is forecasting a contraction of 10.5% for Mexico, 9.1%, for Argentina and 13.9% for Peru and an average contraction of 9.4% for the region as a whole.

These forecasts are in line with local projections. In its latest Monetary Policy Report, released in June, the Central Bank estimated that GDP will contract by between 5.5% and 7.5% in 2020 while, in its latest Report on Public Finances, the Finance Ministry forecast a contraction of 6.5%.

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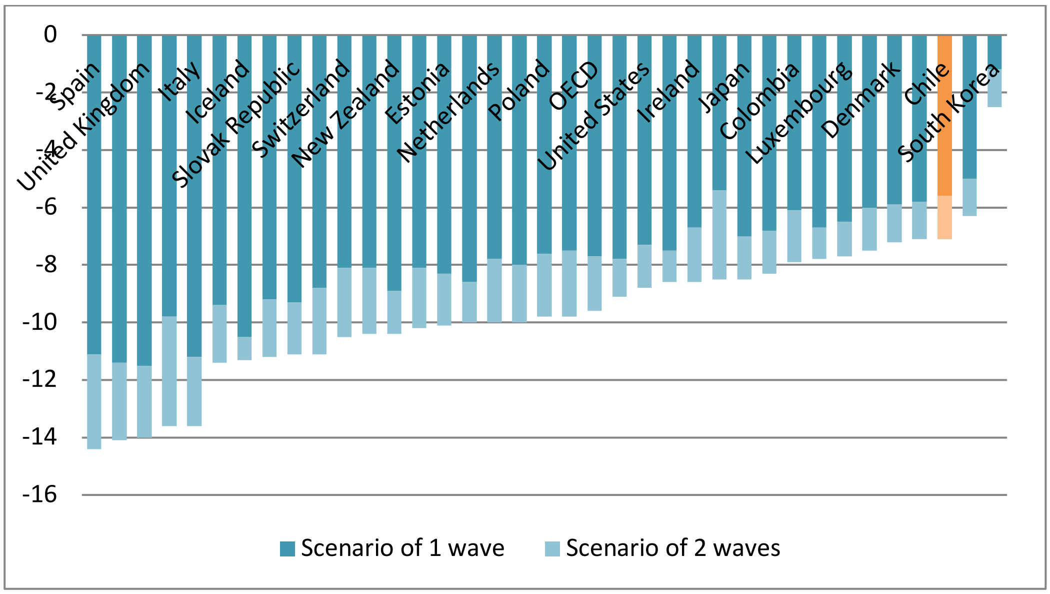
Figure 8: Growth forecasts: OECD member states (US$ million, %)



Source: OECD

In 2021, growth in Chile is expected to recover to between 4.75% and 5.25%.

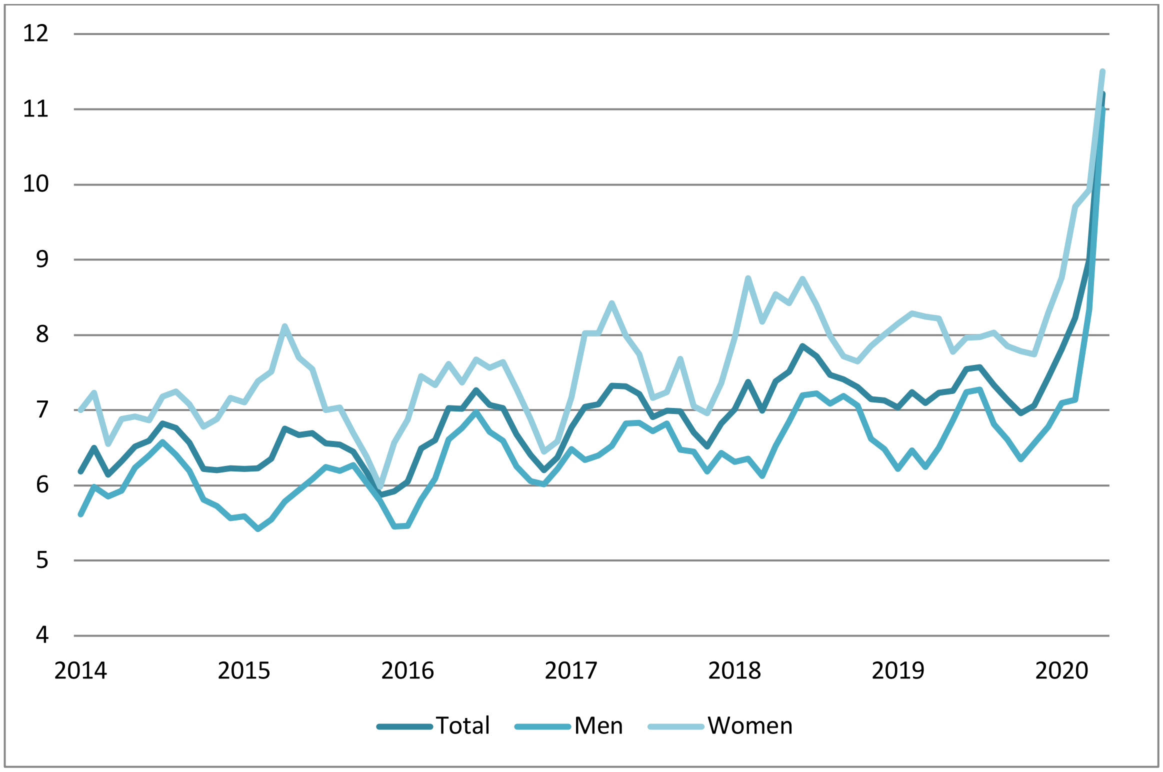
Unemployment continues to rise

In the labor market, the number of jobs and people's income have shown an important reduction in recent months. According to the National Statistics Institute (INE), the rolling average unemployment rate reached 11.2% in March-May, its highest level since 2010. This represented an increase of 4 percentage points on a year earlier, with a 12.8% drop in the labor force more than offset by a 16.5% reduction in employment. The number of people unemployed rose by 35.1%, due exclusively to an increase in the number of workers losing their job (44.3%).

In the case of employment, the 16.5% reduction was explained largely by a drop in the number of women in work, which was down by 19.8% on a year earlier. The number of workers furloughed under the Employment Protection Law[23], who accounted for 15.4% of employed people, rose by 149.8%, equivalent to 689,278 workers.

[23] To be classified as furloughed, employees must continue to have a work relationship and receive some income from the job or return to work within a maximum of four weeks.

Figure 9: Unemployment rate, 2014-2020
(Quarterly rolling average, %)



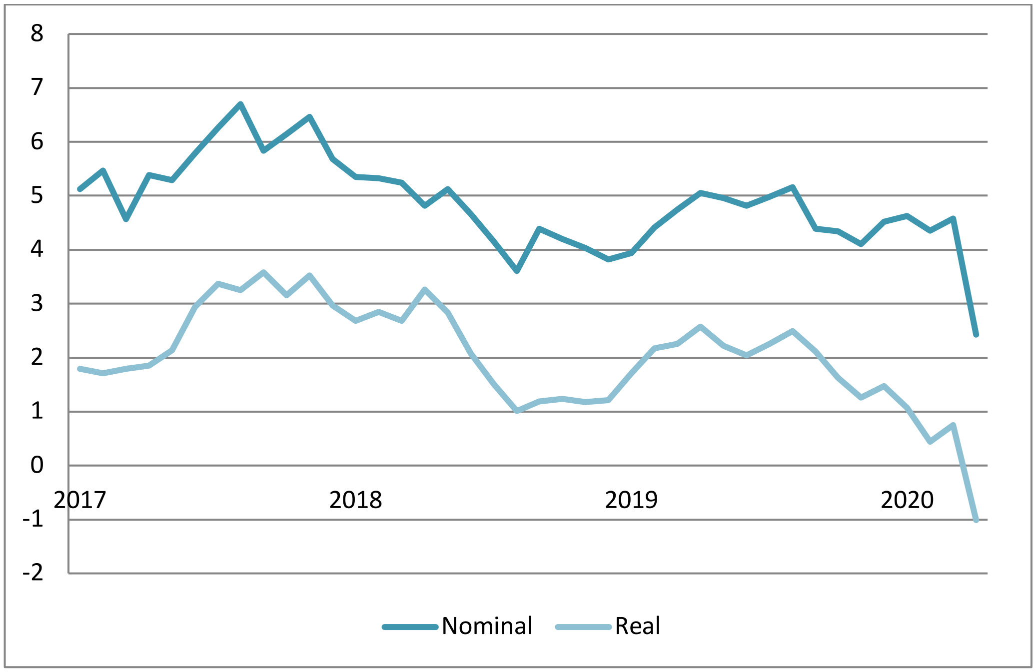
Source: INE

By sector, the most significant reductions in employment occurred in commerce (-19.4%), accommodation and meal services (-42.2%) and construction (-23.1%). By occupational category, the largest drop was among the self-employed (-29.5%), followed by payroll employees (-8.4%).

The deterioration of the labor market has led to a reduction in workers' income. The annual growth of nominal wages reported by the INE - the labor cost index (ICMO) and the wage index (IR) - fell to 2.2 and 2.6%, respectively. This reflected a 27% decrease in total hours worked while the average number of hours worked decreased by 12.5% to 33.6 hours.

Wages fell across most sectors but the transport, commerce and construction sectors were particularly affected. As a result, real annual wage growth, as measured by the ICMO and the IR, fell by 1.2% and 0.8%, respectively. The drop in income has been partially offset by the subsidies and support programs established during April and May.

Figure 10: Wages, 2014-2020
(Simple average of IR and ICMO, annual variation, %)



Source: INE

Drop in exports and imports

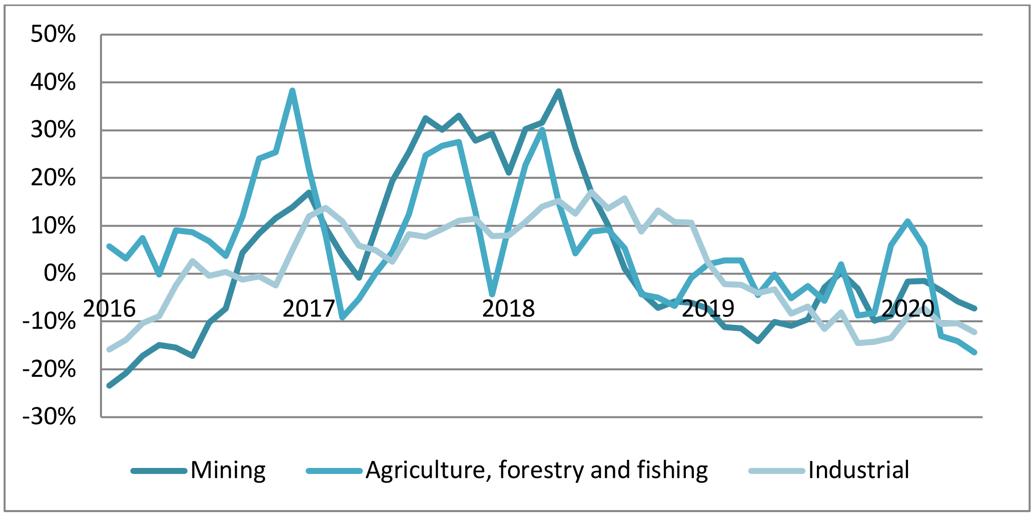
Throughout 2019, foreign trade was affected by the trade war between the United States and China. However, the sharp drop seen in the last quarter of 2019 was largely a result of the social unrest in Chile. This was followed in the first quarter of this year by the important impact of the pandemic on production, logistics chains, value chains, and therefore, international trade.

In the first quarter, exports of goods decreased by 7.5% in nominal terms compared to the same period in 2019 and the figures for April and May are consistent with a deepening of this trend. In May, exports were down by a nominal 15.2% on May 2019.

Exports of all types have been affected, but particularly industrial exports such as cellulose, metal products and chemicals as well as agricultural and fishing products. Exports of minerals such as copper and iron have shown a relatively better performance.

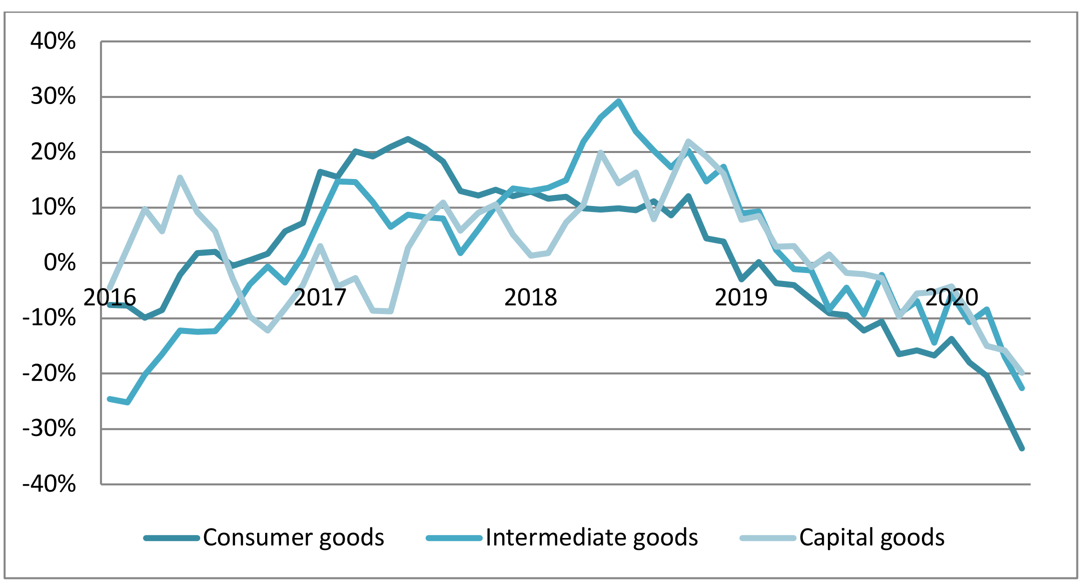
Over the first five months, exports reached US$27,474 million FOB, equivalent to a drop of 8.8% in nominal terms.

Figure 11: Exports of goods, 2016-2020
(Quarterly rolling average, nominal figures, %)



Source: Central Bank of Chile

Figure 12: Imports of goods, 2016-2020
(Quarterly rolling average, nominal figures, %)



Source: Central Bank of Chile

In the case of imports of goods, the drop has been even more abrupt. In May, at US$4,145 million CIF, they were down by 35% in nominal terms on May 2019, and, over the first five months, reached US$23,766 CIF, equivalent to a drop of 19.5% in nominal terms on the same period in 2019.

This important contraction of imports, particularly of non-essential consumer goods and capital goods, will mean a larger current account surplus this year.

Data on exports and imports of services is published quarterly and there is, therefore, no new information to add to that contained in the previous version of this report. However, it is important to note that, in the first quarter, service exports, at US$2,155 million, were down by a nominal 14.7%, while service imports, at US$3,280 million, were down by 12%.

In its latest Monetary Policy Report, the Central Bank forecast that, over the whole year, exports will drop by 0.3% and imports by 14.1% before going on to expand by 3.2% and 11.2%, respectively, in 2021.

Investment and FDI

Investment has also shown an important contraction, due both to lockdown-related work stoppages and the adjustments companies have had to make to maintain liquidity.

In the case of the "construction and other works" component of gross fixed capital formation (GFCF), the survey carried out by the Capital Goods Corporation (CBC) for the first quarter of this year found a substantial drop in investment planned for 2020, due to a rescheduling of projects to the coming years.[24]

There has also been an important drop in investment in the real estate sector. The April report by the Chilean Chamber of Construction (CChC) forecast a 10.5% decrease in construction investment in 2020. New home sales in Greater Santiago continued to decline sharply in the first quarter and, given that the supply has not changed, this has increased the time needed to sell the existing stock to over 30 months (versus around an average of 20 months between 2015 and 2019).[25]

With regard to the machinery and equipment component of GFCF, nominal capital goods imports, one of the early indicators of the behavior of GFCF, have continued to decline steadily. Similarly, different surveys of participants in the Central Bank's Business Perceptions Report suggest that most investment projects not considered essential for business operations have been put on hold and that

[24] Monetary Policy Report, June 2020, Central Bank of Chile.
[25] Monetary Policy Report, June 2020, Central Bank of Chile.

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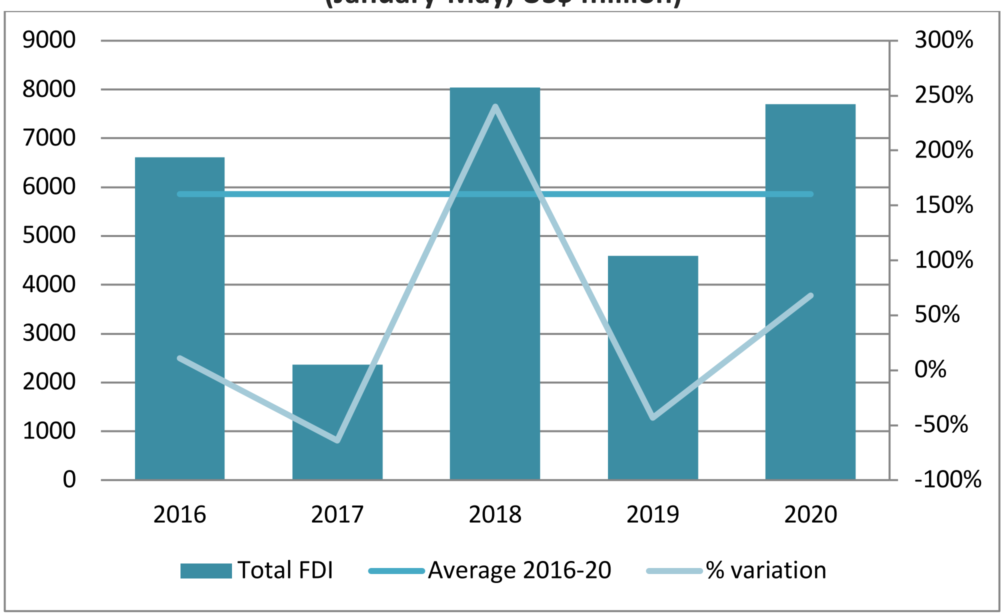
credit applications in the next six months will be allocated to solving cash flow problems, rather than investment. [26]

In light of the paralyzation of new investment projects and projects in the construction sector, the Central Bank anticipates that GFCF will contract by 15.9% in 2020 while, for 2021, it is forecasting an 8% expansion.[27]

In the case of foreign direct investment (FDI) in Chile, figures released by the Central Bank on July 7 indicate that, in the first five months, the country received a net inflow of US$7,696 million, representing an increase of 68% on the same period in 2019. This was also 31% up on the average for the past five years and 29% up on the average for the period since comparable records began (2003-2020).

It was the highest figure for the first five months in 2003-2020. In May, the inflow reached US$540 million.

Figure 13: Foreign direct investment, 2016- 2020
(January-May, US$ million)



Source: Central Bank of Chile

[26] Monetary Policy Report, June 2020, Central Bank of Chile.
[27] Monetary Policy Report, June 2020, Central Bank of Chile.

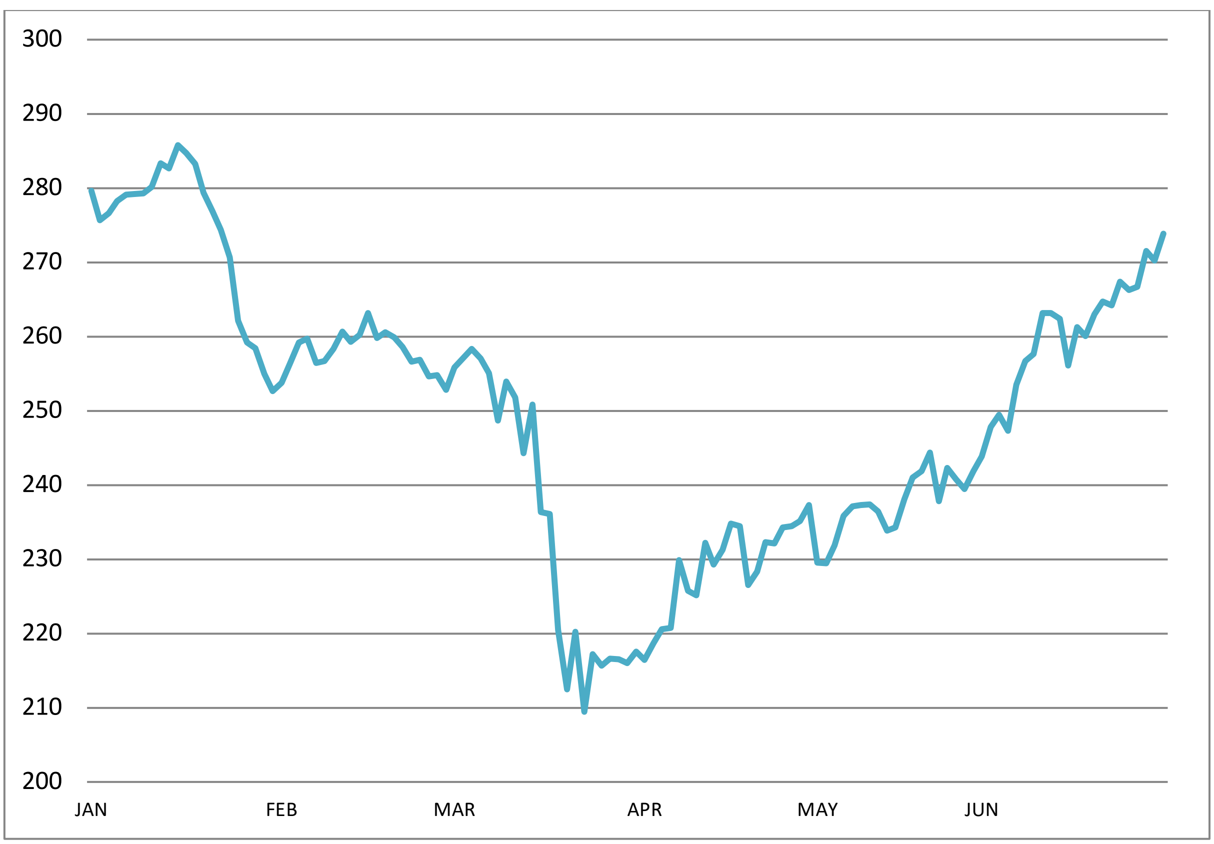
The most important component of FDI in January-May was equity, which represented an inflow of US$3,943 million. It was followed by reinvested earnings (US$2,349 million) and related borrowing (US$1,404 million).

The most important operations reported were the acquisition of 20% of Latam Airlines through the stock market and the purchase of the communications towers of Entel.

Copper production and price

From levels of around US$2/lb in March, the price of copper has shown a recovery, particularly in June, and, as of end-June, was 30.8% up on its low of March 23 (US$2.094/lb). In June alone, the price of copper increased by 12.3%, closing the month at US$2.73/lb, a price not seen since January 2020.

Figure 14: Nominal daily copper price, 2020
(¢/lb)



Source: COCHILCO

The main factors in the June increase were:

- The gradual normalization of productive and commercial activities in China. In June, the manufacturing sector, which is the main source of demand for copper, showed its strongest growth since the outbreak of the virus began.[28]

- Increased expectations of a drop in international copper supply in the short term. On June 20, Codelco, the world's largest producer, announced that it was temporarily shutting down its Chuquicamata smelting and refining complex as a preventive measure to contain the spread of COVID-19. It did not indicate how long the complex would remain out of operation.[29] Although copper production in Chile has not so far been affected by the pandemic, a reduction is expected in the coming months and, if the spread of the virus is not contained, could be significant. Reductions have also occurred in the other main copper-producing countries such as Peru and Mexico.

[28] The Purchasing Managers' Index (PMI) for China's manufacturing sector provides an indication at the beginning of each month of activity in the sector. In June, it reached 50.9, up from 50.6 in May. The 50-point mark indicates the dividing line between expansion and contraction on a monthly basis.
[29] Weekly Copper Report, June, COCHILCO.

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