MOODY'S
INVESTORS SERVICE

Rating Action: Moody's changes outlook on Chile's ratings to negative; affirms Aa3 ratings

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New York, August 24, 2017 -- Moody's Investors Service has today changed Chile's ratings outlook to negative from stable and affirmed the long-term issuer, debt ratings and shelf ratings at Aa3/(P)Aa3.

The decision reflects the gradual but broad-based erosion in Chile's credit profile, which the negative outlook signals may continue. In Moody's view, Chile's GDP growth has undergone a structural shock, due to lower average copper prices and a decline in productivity, from which it is unlikely to fully recover its former strength. Lower economic growth has coincided with higher social demands that have eroded the fiscal position and led to a persistent rise in government debt. While Chile's institutions remain very strong, it is less clear that existing fiscal arrangements will effectively address the erosion that has been observed in government debt metrics. Finally, the marked and quite rapid build-up of economy-wide external indebtedness, particularly in private non-financial corporations, increases external vulnerability.

The rating affirmation at Aa3 reflects our view that Chile's credit profile retains, at least for now, important strengths, with its scores on governance and policy effectiveness broadly in line with peers in the Aa category and well above the average for regional peers. Chile's government debt ratios remain lower than many Aa rated peers, despite economic and fiscal deterioration, and the government has significant flexibility to respond to shocks, due to the accumulation of assets during high growth years.

Chile's country ceilings are unchanged. The long-term foreign currency bond ceiling remains at Aa1, the long-term foreign currency deposit ceiling at Aa3, and the long-term local currency bond and deposit ceilings at Aa1. Chile's short-term foreign currency ratings remain at P-1.

RATINGS RATIONALE

RATIONALE FOR THE NEGATIVE OUTLOOK

SLOWDOWN IN GDP GROWTH AND A LOWER TREND GROWTH

In Moody's view, GDP growth in Chile has undergone a structural shock from which it is unlikely to fully recover. Growth was 4% on average during 2008-2013 but since 2014, when copper prices began to collapse, the economy has grown on average 2%, investment has significantly declined, and total factor productivity has been negative. Moody's expects growth to remain around 2% this year and next, and sees little prospect of a return to historical growth rates thereafter.

One driver of lower growth was the decline in copper prices, which materially affected Chile since copper represents around 8% of the country's GDP and 46% of total exports. Prices have declined substantially from their peak in early 2012 and although they appear to face a rebound in 2017-18, Moody's expects them to linger below historical levels, given the deceleration and rebalancing of China's economy, the main user of base metals.

However, in addition to that externally-sourced shock, Chile's ore grades are falling, which forces producers to process more ore to produce the same quantity of refined copper, increasing the sector's costs and negatively affecting its productivity. Even though productivity in the non-mining sectors has increased by around 1% of GDP, growth remains heavily dependent on natural resources, and thus total factor productivity growth has been slightly negative since 2010. Even though Moody's expects total factor productivity to improve due both to a modest recovery in the mining sector and to the government's efforts to stimulate long-term growth in other sectors (e.g. non-financial services, agriculture), total factor productivity will remain low due to infrastructure bottlenecks, low human capital and an aging population.

Low business confidence and private investment have exacerbated those twin shocks, leading to an average growth of 1.6% in 2016-17. But even when confidence and investment improve, it is unlikely that growth will recover to the levels of 4% to 5% seen prior to the commodities shock. Investment peaked in 2012 at 26% of GDP, driven by the mining super-cycle. In Moody's view, invesment is unlikely to return to those levels, in part because of the continued negative impact of the tax, labor and possibly upcoming pension reform in companies' profit margins, labor costs and thus investment prospects, coupled with red tape. Over the medium term, growth will likely be around 3%.

DETERIORATING FISCAL AND DEBT METRICS IN THE CONTEXT OF LOWER GROWTH

The slowdown in economic growth, and consequently lower government revenues, have coincided with a higher demand for more inclusive growth and better public goods (e.g. education, health, pensions) by the growing middle class.

These trends have led to a shift in the fiscal position to deficit from surplus and to a steady rise in government debt. Total revenues shrank 1.3 percentage points of GDP on average from 2012-16 vs the 2007-11 period, despite a tax reform in 2014, while expenditures increased by 1.7 percentage points of GDP in the same period. Fiscal spending has been channeled mostly to education, health services and infrastructure.

While the debt position remains very strong, it has eroded markedly and persistently in recent years. Debt to GDP ratio has increased 17 percentage points of GDP, albeit from very low levels, in the last seven years and the interest payments to revenue has doubled in the same period, again from a very low level. Moody's expects these trends to continue, with debt to GDP reaching 25.2% this year and close to 28% in 2018, and shy of 30% by 2020. What was once a standout feature which offset weaker aspects of Chile's credit profile is becoming less marked. The negative outlook partly reflects Moody's view, as the debt position continues to erode, that weaker aspects of Chile's credit profile -- low GDP per capita relative to Aa-peers, lower growth, higher external exposure -- will assume a greater significance.

USE OF THE STRUCTURAL BUDGET RULE UNDERMINES CONFIDENCE THAT CHILE'S VERY STRONG FISCAL POSITION WILL BE PRESERVED

To date, Chile's very high fiscal strength, and Moody's high confidence that the government would take the necessary steps to preserve that strength, have been an important support to the Aa3 rating. However, that confidence has waned in recent years, in part because of the government's application of Chile's structural budget rule.

The structural budget rule is a mechanism to reduce volatility in economic growth by encouraging counter-cyclical fiscal policy. The government estimates a structural budget balance based on a calculated potential GDP growth rate and on the medium-term (10 years) price of copper, parameters that are estimated by an independent panel of experts. The rule seeks to balance structural revenues with structural expenditures, disregarding the impact on the actual fiscal position or the overall level of debt. The difference between structural and actual revenues determines if there is a need for fiscal adjustment, but the Minister of Finance determines the pace.

The implementation of the structural budget rule was very effective in achieving fiscal surpluses, and accumulating government assets, during periods of high growth. But with the economy having grown below potential since 2013, adherence to the rule has encouraged the continuous deterioration of fiscal and debt indicators, which has eroded the sovereign's fiscal position. Given our expectation of tepid growth, we expect application of the rule to continue to cause fiscal and debt metrics to deteriorate.

HIGHER EXTERNAL VULNERABILITY RISK DUE TO AN INCREASE IN CORPORATES' EXTERNAL DEBT

In parallel with these developments, Chile has experienced a marked build up in economy-wide external indebtedness. External debt levels have been rising since 2011, and grew to 64% of GDP in the first quarter of 2017, from 39.6% of GDP in 2011. The majority of gross external debt is private, owed by non-financial corporations (NFCs). More than half of NFC debt is denominated in foreign currency. Even if principally seen in the NFC sector (public sector external debt is less than 5% of GDP), the build-up in external exposure has broader implications since there are significant balance sheet linkages between NFCs, banks, insurers, pension funds and households.

A rapid build-up in external debt raises potential risks associated with global financial conditions and/or a sudden reversal of capital inflows. Even though the impact of a potentially adverse scenario is mitigated by several factors, including that a significant share of external debt is FDI-related and that Chilean firms use derivatives to hedge their exposures, the rising trend of external indebtedness in the country is moderately increasing external vulnerability risk.

RATIONALE FOR RATING AFFIRMATION AT Aa3

The rating affirmation at Aa3 reflects our view that Chile's credit profile retains, at least for now, important strengths. Institutional strength related to scores on governance and policy effectiveness remains broadly in line with peers in the Aa category and well above the average for regional peers. Debt is rising to 25% of GDP this year but metrics remain lower than peers, with the debt to GDP ratio of the Aa-median at 30% of GDP in 2016. Even though GDP growth is significantly lower than in the past, it remains in line with peers in its Aa2-A1 rating range, which averaged 2.4% in 2014-16.

In addition, the sovereign's accumulation of assets during high growth years provide the country with significant flexibility to respond to shocks. Government financial assets are close to 20% of GDP and approximately half of these (10% of GDP) are held in two sovereign wealth funds (SWFs), with 6% of GDP exclusively reserved for covering fiscal deficits or pay back public debt. The other 10% of GDP of financial assets outside the sovereign wealth funds are comprised of various funds of different public ministries and state-owned enterprises. Even though Chile is no longer a net creditor since 2016, it retains significant flexibility with net debt at only 1% of GDP. Very low financing costs, ample access to funding and a reliable domestic investor base also support the rating.

Moreover, upcoming presidential elections open the possibility that the next administration will implement a more forceful policy response to the economic and fiscal deterioration and could play a pivotal role in economic expectations. A new administration could lead to a faster paced fiscal adjustment than the one in place, with the possibility of stabilizing the debt trend in the rating horizon, which is not the base case at this time. Moreover, if the new administration is perceived as market friendly, this could prompt an improvement in business confidence sufficient to spur new investment and lead to a faster-than-expected recovery in GDP growth, possibly surpassing the new potential rate of 3%.

WHAT COULD MOVE THE RATING DOWN

The evolution of Chile's credit profile will be heavily influenced by the actions policymakers take to address the combination of slowing growth and rising public and external debt. Moody's would likely downgrade Chile's rating should the rating agency conclude that the policy response would be unlikely to arrest the continued rise in the debt burden over the medium term, and to sustain growth levels in line with Chile's potential growth rate of 3%.

WHAT COULD MOVE THE RATING UP

Given the negative outlook, an upgrade is unlikely at this time. The rating would be stabilized at the current level should Moody's conclude that the policy response is likely to be effective in addressing those challenges. The reversal could be led by a faster paced fiscal adjustment than the one currently in place, which Moody's concludes will stabilize the debt burden over the next 2-3 years with only limited increases over that period; and/or by the convergence of actual GDP growth to Chile's potential, or even an increase in potential economic growth that signals an improvement in total factor productivity and/or a resumption in income convergence with the Aa-median.

GDP per capita (PPP basis, US$): 24,113 (2016 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 1.6% (2016 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 2.7% (2016 Actual)

Gen. Gov. Financial Balance/GDP: -2.7% (2016 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -1.4% (2016 Actual) (also known as External Balance)

External debt/GDP: 66.3% (2016 Actual)

Level of economic development: Very High level of economic resilience

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 23 August 2017, a rating committee was called to discuss the rating of the Chile, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have materially decreased. The issuer's governance and/or management, have materially decreased. The issuer's fiscal or financial strength, including its debt profile, has materially decreased. The issuer has become increasingly susceptible to event risks.

The principal methodology used in these ratings was Sovereign Bond Ratings published in December 2016. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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