Fitch Affirms **Chile** at 'A+'; Revises Outlook to Negative

Fitch Ratings-New York-13 December 2016: Fitch Ratings has affirmed Chile's Long-term Foreign- and Local-currency Issuer Default Ratings (IDRs) at 'A+' and 'AA-', respectively, and has revised the Outlook to Negative. The issue ratings on Chile's senior unsecured Foreign- Currency bonds are also affirmed at 'A+'. The Short-term Foreign- and Local-currency IDRs have been affirmed at 'F1+' and the Country Ceiling at 'AA+'.

KEY RATING DRIVERS

The revision of Chile's Outlook to Negative reflects prolonged economic weakness, which is contributing to a relatively rapid deterioration in the sovereign balance sheet. In Fitch's view, the policy response has helped buffer the economy and preserve credibility, but it has not prevented a substantial rise in the public debt burden from the low levels that underpinned the upgrade to 'A+' in 2011.

Fitch projects growth will decelerate to 1.6% in 2016, from 2.3% in 2015. Mining output has fallen on declining ore grades, strikes, and lower prices. Non-mining activities have also slowed, reflecting low confidence restraining investment appetite and weakness in regional trading partners. Fitch projects further modest growth of 1.9% in 2017, balancing some improvement in external conditions and confidence with a subdued investment pipeline.

As Chile's slowdown has appeared increasingly to be structural in nature, potential growth estimates have been cut (e.g. to 3% in 2016 from 4.8% in 2013 by the independent budget committee) and prospects for per-capita income convergence with the 'A' median have dimmed. The reform agenda aims to address bottlenecks in human capital and social equity, but businesses have reacted negatively as the near-term implications for profitability (due to higher taxes and new labor laws) have overshadowed the potential long-term benefits. Progress on the energy agenda and micro-reforms could help, but their impact remains uncertain.

The fiscal position has deteriorated gradually against this weak economic backdrop. Copper royalties and taxes are officially projected to fall close to zero in 2016, from 2% of GDP in 2011, and could even be negative from private miners due to loss carry-back provisions in the tax code. The revenue boost from the 2014 tax reform is mostly offsetting this impact but is being used as intended primarily to fund higher health and education outlays. Fitch projects the central government deficit will widen to 3% of GDP in 2016 and 3.3% in 2017, from 2.2% in 2015.

Sluggish growth is presenting difficult fiscal trade-offs. Last year, the government watered down its goals for free higher education and consolidation. Its new approach to the fiscal rule targets a trajectory for structural deficits (a reduction of 0.25 percentage points of GDP per year) instead of levels, avoiding the need for further consolidation efforts as cuts to the parameters (potential growth and long-term copper prices) have lifted structural deficit estimates. The 2017 budget achieves structural deficit reduction and social spending goals by cutting investment. In 2018, the boost from the tax reform will offer room for some progress on both goals. Consolidation looks tougher after 2018, given the tax reform will be fully phased in, social pressures could remain high, and appetite for new tax measures or investment cuts could be limited.

Chile's sovereign balance sheet remains its key strength relative to peers, but it is experiencing the most rapid erosion of any sovereign in the 'A' category. Rising debt levels reflect fiscal deficits and additional financing needs including recapitalization of public companies and legacy public pension obligations. The financial strain at Codelco could add to sovereign borrowing needs should it require capitalization beyond the USD4 billion already authorized, or lead to legal changes that reduce its mandated fiscal contributions.

Fitch projects general government debt will reach 21.4% of GDP at end-2016, double the level in 2011 when Chile was upgraded to 'A+'. Debt could surpass 30% by 2019, still well below the 'A' median of around 50%, but converging with the 'A' median as a share of revenues given a narrower revenue base. Chile's local market is well positioned to support higher sovereign borrowing needs. Stabilization funds worth 6% of GDP represent an additional financing buffer in the face of uncertainties in global borrowing conditions.

The IDRs also reflect the following key rating factors:

Chile's ratings are supported by a credible macro policy framework centered on an inflation-targeting regime, flexible exchange rate, and sovereign balance sheet that remains relatively strong despite the on-going deterioration. Favorable governance standards support the stability of the policy framework. These strengths counterbalance Chile's low per-capita GDP and high commodity dependence relative to peers.

A robust and flexible policy framework has helped avoid macroeconomic imbalances amid the economic slowdown. Inflation fell back into the target range (3%+/-1pp) in August after several years above-target, and inflation expectations remained well anchored over this period. Banks have maintained solid asset quality and capitalization against the weak economic backdrop. Chile's external position adjusted early to the terms-of-trade shock, and the current account deficit has been stable at moderate levels and fully financed by foreign direct investment.

Fitch expects broad macro policy continuity into the next administration following general elections in late 2017, although the focus of the social agenda and the consolidation strategy could vary depending upon who is elected.

SOVEREIGN RATING MODEL (SRM) and QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Chile a score equivalent to a rating of 'A' on the Long-term FC IDR scale. Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to rated peers, as follows:

Macro: +1 notch, to reflect Chile's strong macro policy framework centered on rules-based fiscal policy, credible inflation-targeting regime and a flexible exchange rate. While this has preserved macro and external stability, it has not prevented a sustained weakening in economic performance; consequently, Fitch views Chile's relative strength for Macro to be on a declining path.

Fitch's SRM is the agency's proprietary multiple regression rating model that employees 18 variables based on three year centered averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

RATING SENSITIVITIES

The main factors that could, individually or collectively, lead to a downgrade are:
--Sustained deterioration in public debt metrics and/or fiscal policy credibility;
--Failure of growth and investment to recover materially.

The Outlook is Negative. Consequently, Fitch does not currently anticipate developments with a high likelihood of leading to a positive change in the rating. Developments that could, individually or collectively, result in a stabilization of the Outlook include:

--Fiscal consolidation that improves the outlook for stabilization of debt metrics;
--A material improvement in growth prospects.

KEY ASSUMPTIONS

--Fitch's base case assumes that China's economy slows in a sustainable and orderly manner and that copper prices will not deviate substantially from recent levels despite recent volatility.
--The investment plans of Codelco and other private sector companies are sufficient to maintain broadly steady copper production.

Contact:

Primary Analyst
Todd Martinez
Associate Director
+1-212-908-0897
Fitch Ratings, Inc.
33 Whitehall Street
New York, NY 10004

Secondary Analyst
Shelly Shetty
Senior Director
+1-212-908-0324

Committee Chairperson
Paul Gamble
Senior Director
+44 203 530 1623

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526,
Email: elizabeth.fogerty@fitchratings.com.

Additional information is available on www.fitchratings.com