



Rabobank

Chile: economic reality holds back reforms

Country Report
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The Bachelet government is facing popular discontent on both the left and the right as well as a deteriorated economic environment, prompting it to moderate its reform ambitions.

Strengths (+) and weaknesses (-)

(+) Strong institutions

Chile has strong institutions, especially - but not only - by Latin American standards. The quality of governance is high and corruption is low.

(+) Good fiscal position

The government has committed itself to a structural fiscal surplus rule since 2001. Fiscal prudence has led to small public deficits and has kept public sector debt low, at 36% of GDP in 2014.

(-) Dependence on commodity (copper) exports

Chile is the world's largest copper producer and the metal accounted for 47% of total exports in 2014.

(-) Relatively high level of inequality

Although inequality has fallen in the past two decades, it remains relatively high. In recent years, social demands have been on the rise, particularly in the field of education.

Key developments

1. Reforms are held back by Bachelet's low popular approval rates and economic reality...

The central-left coalition of President Bachelet, which took office in March 2014, had ambitious plans to address Chile's high level of inequality and raise its long-term growth rate, but economic headwinds and low popular support have forced the government to moderate its ambitions. This is proof of Chile's relative consensual political climate, but on the other hand reduces the government's chances to improve the country's fundamentals.

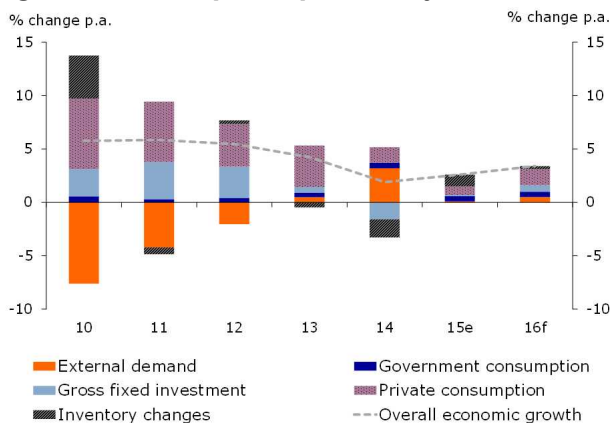
Headwinds to the reform agenda originate first of all from low economic growth which has increased pressure on government expenditures and lowered revenues. Secondly, business confidence and as a result private investment has suffered largely over the past year and part of this seems to be caused by discontent about or at least uncertainty over the reform agenda. Finally, Bachelet faces very low (<30%) approval rates, reflecting disappointment on the left and disapproval on the right. These factors have prompted President Bachelet to announce that reforms will need to be prioritized. It is expected that focus will be on further education reforms and labour reform. The President also changed her cabinet in May. In particular the appointment of a new minister of Finance – considered to be committed to fiscal sustainability – was well received by the right and the business community. In August, the government yielded to another matter of concern to the business community by announcing it will address the complexity of the tax bill it approved only last year, by simplifying the corporate tax regime.

2. ... and while the economy seems to have passed its 2014 trough, the recovery remains modest and risks are tilted to the downside

After GDP growth fell sharply to 1.9 % in 2014, mainly due to a sharp fall in private investment, growth has picked up modestly in 2015 on the back of expansionary fiscal and monetary policy. The setback to growth in 2014 reflected the large decline in prices for Chile's number 1 export product, copper, as well as adjustment costs and uncertainty about the government's structural reform plans. In 2015, the government employed available fiscal space to support growth, inter alia through high infrastructure expenditures, while the central bank kept an accommodative stance. Lower oil prices offset some of the negative effects of lower copper prices by sustaining private consumption and the weaker peso supported non-mining exports. While inflation had risen sharply in 2014 as a result of the depreciation of the peso, in 2015 it has moderated to around 4 % (at the upper limit of the inflation target range of 2-4%) and is expected to decline further in 2016, providing the monetary authorities with space for continued loose policy in support of the economy. Current projections for 2015 growth stand at 2.6% for 2015 and 3.4% for 2016.

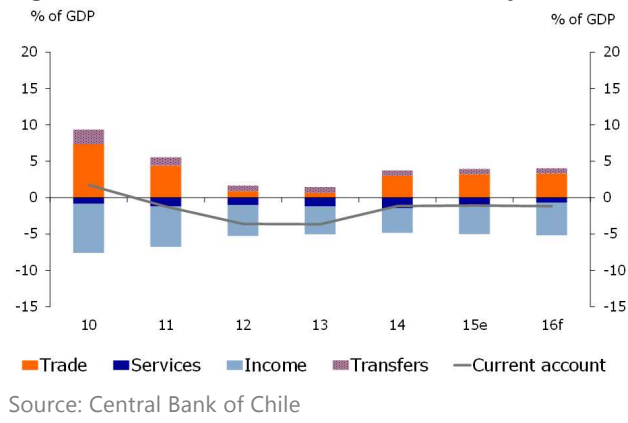
Main risks to the outlook are a further decline in copper prices (especially when the slowdown in China intensifies) and persisting weakness in private sector confidence and investment over the government's reform plans. More volatile global market conditions would especially hurt the highly leveraged and foreign exchange dependent corporate sector. In the longer term, growth could be negatively influenced by the feed-through of the recent large decline in copper prices (about 50% down from their 2011 peak as of end July 2015). On the other hand, the government's structural reforms could have a positive impact on longer term growth, especially by bridging development gaps in education and (energy) infrastructure. Labour market reform, by strengthening the position of unions and collective bargaining, could decrease income inequality but might also increase labour market rigidities. At this point in time, it is not yet clear how far-reaching especially labour reforms will be and their impact on potential growth therefore remains to be seen.

Figure 1: Growth picks up modestly...



Source: EIU

Figure 2: ...while the current account adjusts



Source: Central Bank of Chile

3. Chile's external position is reassuring

The current account has continued to improve, and latest Central Bank data show surpluses in Q1 and Q2, decreasing risks of disorderly adjustments. The current account remains mostly financed by relatively stable FDI inflows. Reserves are at an adequate level of 6 months import cover. A matter of some concern is the rapid growth in external debt in the last few years, up to a level of 57 % of GDP in 2014, with most of the increase concentrated in the nonfinancial corporate sector. But the associated risks are mitigated by the fact that net foreign currency exposure seems to be small, based on data for the 20 largest Chilean corporations (IMF), and a substantial part is (less volatile) FDI-related.

Factsheet of Chile

Chile			
National facts		Social and governance indicators	
Type of government	Republic	Human Development Index (rank)	41 / 187
Capital	Santiago	Ease of Doing Business Index (rank)	41 / 189
Surface area (thousand sq km)	756	WEF Global Competitiveness Index (rank)	33 / 144
Population (millions)	17.8	Corruption Perceptions Index (rank)	21 / 175
Main ethnic groups	White, white-Amerindian(95%) Mapuche (4%)	Press Freedom Index (rank)	43 / 180
Main religions	Roman catholic (70%) Evangelical (15%) Jehovah's Witnesses (1%)	Gini index (income distribution)	50.84
Head of State (president)	Michelle Bachelet	Population below \$1.25 per day (PPP)	0,83%
Head of Government (president)	Michelle Bachelet	Foreign trade	
Monetary unit	peso (CLP)	2014	
Economy		2014	
Economic size		Main export partners (%)	
	<i>bn USD</i>	<i>% world total</i>	<i>Main import partners (%)</i>
Nominal GDP	258	0.33	China 25
Nominal GDP at PPP	397	0.37	US 12
Export value of goods and services	87	0.37	Japan 10
IMF quatum (in m SDR, 2013)	856	0.39	Brazil 6
Economic structure		Main export products (%)	
	<i>2014</i>	<i>5-year av.</i>	
Real GDP growth	1.9	4.0	Copper 50
Agriculture (% of GDP)	3	3	Fresh fruit 6
Industry (% of GDP)	35	38	Salmon & trout 6
Services (% of GDP)	62	59	Cellulose 5
Standards of living		Openness of the economy	
	<i>USD</i>	<i>% world av.</i>	<i>2014</i>
Nominal GDP per head	14,522	124	Export value of G&S (% of GDP) 34
Nominal GDP per head at PPP	22,337	138	Import value of G&S (% of GDP) 32
Real GDP per head	9,865	113	Inward FDI (% of GDP) 8.5

Source: EIU, Central Bank of Chile, CIA World Factbook, UN, World Economic Forum, Transparency International, Reporters Without Borders, World Bank.

Background information

With a per capita income of USD 14,139 (or USD 22,564 at PPP) in 2014, almost twice its level a decade earlier, Chile is one of Latin America's richest countries. By regional standards, Chile has strong institutions, sound macroeconomic policies and a good business environment. Actually, Chile scores better than the OECD average on both the Ease of Doing Business and the WEF Global Competitiveness Index. Since the end of 1999, a full-fledged inflation targeting regime has been in place and the country is fiscally prudent. Chile's economy is very open and diversified. Chile's financial system is large and strongly interrelated with both the domestic real economy and global markets, rendering Chile vulnerable to developments in international financial markets. Chile has concluded free trade agreements with many other countries. Furthermore, Chilean companies have strongly increased their investments in neighbouring countries in recent years.

In the late 1960s and 1970s, political polarization culminated in the 1973 coup d'état by the military that overthrew the Allende government. A military dictatorship led by general Pinochet ruled Chile until 1990. The political landscape has been dominated by centre-left governments ever since, bar the 2010-2014 period, when a centre-right coalition ruled. Since 1990, Chile has managed to reduce its traditionally high inequality, but the level remains high. In recent years, opposition to the economic and political elite has grown and support for the two voting blocks that have ruled Chile since 1990 has weakened. The large-scale 2011 student protest were a reflection of this trend. Nevertheless, politics has remained relatively consensual by Latin American standards.

Economic indicators of Chile

Chile							
Selection of economic indicators	2010	2011	2012	2013	2014	2015e	2016f
<i>Key country risk indicators</i>							
GDP (% real change pa)	5.8	5.8	5.5	4.2	1.9	2.6	3.4
Consumer prices (average % change pa)	1.4	3.3	3.0	1.9	4.4	4.1	3.5
Current account balance (% of GDP)	1.7	-1.2	-3.6	-3.7	-1.2	-1.1	-1.2
Total foreign exchange reserves (mln USD)	27,816	41,932	41,636	41,084	40,438	38,390	37,570
<i>Economic growth</i>							
GDP (% real change pa)	5.8	5.8	5.5	4.2	1.9	2.6	3.4
Gross fixed investment (% real change pa)	11.6	15.0	11.6	2.1	-6.1	0.5	2.5
Private consumption (real % change pa)	10.8	8.9	6.1	5.9	2.2	1.2	2.3
Government consumption (% real change pa)	4.6	2.5	3.5	3.4	4.4	4.0	4.0
Exports of G&S (% real change pa)	2.3	5.5	0.1	3.4	0.7	1.7	4.1
Imports of G&S (% real change pa)	25.5	16.0	4.8	1.7	-7.0	1.3	2.4
<i>Economic policy</i>							
Budget balance (% of GDP)	-0.3	1.5	0.6	-0.6	-1.6	-2.0	-1.0
Central government debt (% of GDP)	9	11	12	13	15	16	16
Public sector debt (% of GDP)*	26	35	35	34	36	39	40
Money market interest rate (%)	3.1	5.3	5.0	4.5	3.0	3.0	3.5
M2 growth (% change pa)	9	18	8	15	9	14	11
Consumer prices (average % change pa)	1.4	3.3	3.0	1.9	4.4	4.1	3.5
Exchange rate LCU to USD (average)	510.2	483.7	486.5	495.3	570.4	637.4	672.4
Recorded unemployment (%)	8.3	7.2	6.5	6.0	6.3	6.4	6.6
<i>Balance of payments (mln USD)</i>							
Current account balance	3,770	-3,088	-9,624	-10,125	-2,995	-2,750	-3,020
Trade balance	15,942	11,039	2,332	1,820	7,768	8,090	8,480
Export value of goods	71,109	81,438	77,790	76,477	75,675	72,610	77,230
Import value of goods	55,167	70,399	75,458	74,657	67,907	64,530	68,750
Services balance	-1,897	-3,073	-2,745	-3,404	-3,757	-2,820	-1,820
Income balance	-14,683	-13,922	-11,220	-10,560	-8,712	-9,830	-11,520
Transfer balance	4,411	2,865	2,059	2,187	1,852	1,810	1,840
Net direct investment flows	6,265	3,192	7,902	8,956	9,950	8,490	8,830
Net portfolio investment flows	-13,680	3,621	-9,834	-93	-5,593	-3,770	-4,870
Net debt flows	11,168	15,428	24,236	12,044	13,550	7,090	9,150
Other capital flows (negative is flight)	-4,987	-5,036	-12,974	-11,338	-15,559	-11,110	-10,900
Change in international reserves	2,535	14,117	-295	-556	-646	-2,050	-820
<i>External position (mln USD)</i>							
Total foreign debt	81,435	96,245	120,118	132,347	145,811	151,410	159,850
Short-term debt	14,869	17,164	21,436	18,574	18,239	16,380	16,540
Total debt service due, incl. short-term debt	29,074	30,315	35,733	43,627	41,759	42,900	42,740
Total foreign exchange reserves	27,816	41,932	41,636	41,084	40,438	38,390	37,570
International investment position	-29,632	-31,709	-42,155	-38,203	n.a.	n.a.	n.a.
Total assets	235,084	254,513	291,530	305,971	n.a.	n.a.	n.a.
Total liabilities	264,716	286,222	333,685	344,174	n.a.	n.a.	n.a.
<i>Key ratios for balance of payments, external solvency and external liquidity</i>							
Trade balance (% of GDP)	7.3	4.4	0.9	0.7	3.0	3.2	3.3
Current account balance (% of GDP)	1.7	-1.2	-3.6	-3.7	-1.2	-1.1	-1.2
Inward FDI (% of GDP)	7.2	9.3	10.7	7.0	8.5	8.3	8.5
Foreign debt (% of GDP)	37	38	45	48	57	60	62
Foreign debt (% of XGSIT)	87	92	119	133	150	161	160
International investment position (% of GDP)	-13.6	-12.6	-15.9	-13.8	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	31	29	35	44	43	46	43
Interest service ratio incl. arrears (% of XGSIT)	2	2	3	3	4	5	5
FX-reserves import cover (months)	4.9	5.8	5.5	5.4	5.9	5.8	5.4
FX-reserves debt service cover (%)	96	138	117	94	97	89	88
Liquidity ratio	110	115	105	100	107	106	106

Source: EIU, IMF

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