



Foreign &
Commonwealth
Office



FCO COUNTRY UPDATES FOR BUSINESS

Chile: Economic Update, Q2 2012

British Embassy Santiago

July 2012

The purpose of the FCO Country Update(s) for Business ("the Report") prepared by UK Trade & Investment (UKTI) is to provide information and related comment to help recipients form their own judgments about making business decisions as to whether to invest or operate in a particular country. The Report's contents were believed (at the time that the Report was prepared) to be reliable, but no representations or warranties, express or implied, are made or given by UKTI or its parent Departments (the Foreign and Commonwealth Office (FCO) and the Department for Business, Innovation and Skills (BIS)) as to the accuracy of the Report, its completeness or its suitability for any purpose. In particular, none of the Report's contents should be construed as advice or solicitation to purchase or sell securities, commodities or any other form of financial instrument. No liability is accepted by UKTI, the FCO or BIS for any loss or damage (whether consequential or otherwise) which may arise out of or in connection with the Report.



Embajada Británica
Santiago

ECONOMIC UPDATE

Q2 2012

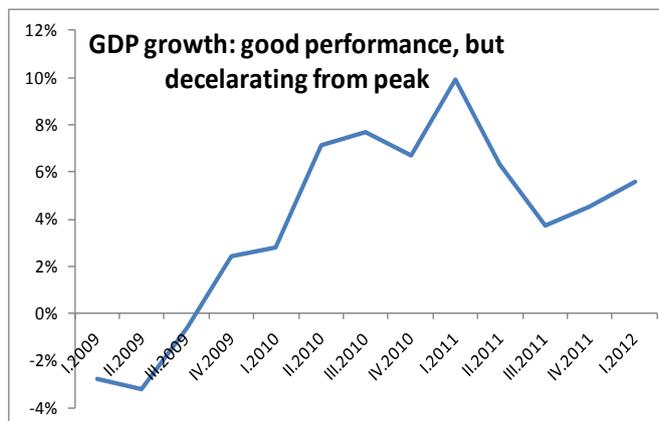
Summary

Chile's economy is set to grow at a healthy 4.5 - 5% in 2012. A deceleration from previous years, but an impressive performance given the negative external situation. Solid domestic consumption and construction are pushing growth, and copper prices are likely to be supportive. The international outlook is the main risk, though the government has a contingency plan.

Economic reform has continued under this government, particularly a programme to increase competitiveness. Energy remains a big concern for the longer term picture. Focus on inequality and education, following the student protests over the last twelve months.

Detail

1. **Chile's economy is performing well, but decelerating.** Economic growth was 5.6% year-on-year in Q1 and analysts predict 4.5-5% for the year as a whole. A deceleration from the 6% seen in each of the previous two years, but expected, as the economy returns to normalcy following the catch up growth after the 2009 financial crisis and the 2010 earthquake, and given the negative shocks in the world economy.



2. **Domestic demand is expanding at a good pace**, driven by healthy credit expansion, wage growth, and record low unemployment (which currently stands at 6.5%, the lowest for 14 years). Many analysts consider Chile to be at full employment, and anecdotal evidence suggests difficulties hiring skilled labour. Construction is growing rapidly. However, investment in machinery and equipment fell sharply in Q1, perhaps showing firms are deferring spending in an uncertain global environment.

International headwinds: be prepared

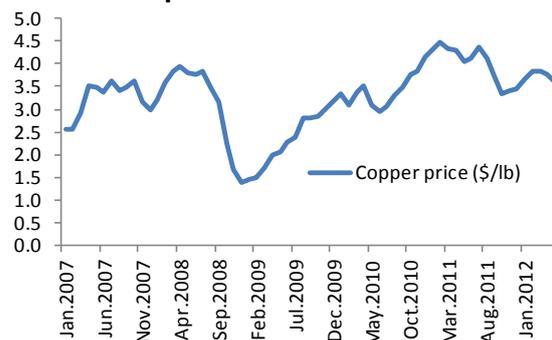
3. **There is considerable local concern over the international economic outlook, given Chile's highly open economy.** Many of our contacts are pessimistic about prospects for the Eurozone. However,

Chile's diversified trading partners and well capitalised and regulated banks play in its favour. Exports to Europe only comprise 20% of total exports. The Chilean banking sector has a capital ratio of 14%. Spanish banks have a significant presence here, but are locally funded operations. The Finance Ministry has noted that the authorities are not concerned about solvency, but rather liquidity in the banking sector, especially considering liquidity reduction during the 2009 crisis and a short but acute problem last December. Chile has deep domestic capital markets but economists in the private and public sectors warned that an implosion in Greece (the most likely scenario for quite a few) would have local consequences.

4. **The government has taken measures to ensure that Chile is well prepared** for a crisis. It has compiled a 141 page contingency plan, which has three broad aims: ensuring liquidity in financial markets, protecting employment and supporting investment. The Ministerial 'anti-crisis' committee, chaired by the President, met at the end of May to discuss it, but did not think it necessary to implement any of the components of the plan yet. Chile is well placed to act if stimulus is needed, with low public debt and \$21 billion in its Sovereign Wealth Funds (SWFs).

5. Analysts and policymakers from the Central Bank President downwards are **more concerned about China's economy than Europe's**. China is Chile's number one trade partner and purchased a third of Chilean copper exports in 2011. Given China's impact on the copper price, there are serious concerns here about the possibility of a hard landing in China. Recent weak Chinese economic data has fuelled concern. The copper price has fallen recently, and is now at 16% below its 2011 average. However, most analysts consider this to be due to short term risk aversion, and are confident about the medium term outlook for copper, given the constraints in supply and a predicted continuation of high demand. The copper price in this year's budget is below market price, so no immediate pressures. Copper represents 26% of government revenues but the whole Chilean economy is associated with the copper cycle and will always be in spite of valuable efforts to diversify the economy.

Copper prices: recent downturn, analysts predict return to trend



Domestic policy: easier for Central Bank, harder for Finance Ministry

6. Over the last couple of months, **the Central Bank has faced a balancing act**. External negative shocks have argued for a lowering of the policy rate, whilst internal price pressures have argued for a raise. However, inflation has decreased over the last couple of months, particularly due to reductions in international food and energy prices, and is now at 3.1%, almost exactly on target. The Central Bank President believes monetary policy is currently neutral, and the Bank may keep rates on hold over the next few months due to international uncertainty. At least one analyst thought that the Central Bank should be starting to lower interest rates as soon as this year.

UNCLASSIFIED

7. On fiscal policy, the Chilean government will run a small surplus (0.4%) this year, but will still have a structural deficit (1.4%). Following the financial crisis and the 2010 earthquake, Chile's fiscal rule of targeting a 0% structural deficit¹ was loosened to 1%, and the government predicts it will be back on track for this in 2014. Opposition economists had advocated balancing the books earlier in order to avoid overheating. But now they are equally frightened with the world scenario and agree with spending more if need be. With record high tax receipts last year, low financing costs and low-yielding savings in the SWF, clamors for greater spending are increasing. Our contacts in **the Finance Ministry suggest that spending will continue to increase, but at restrained rates**. This corresponds to the recent tax 'reform', which provided some extra resources to the state for education, but did not comprehensively reform the system or raise significant extra revenue.
8. One important asset in Chilean politics is that politicians are only prepared to spend more money on a permanent basis provided the sources of income are permanent as well. So there is little risk that the USD 21 billion saved will end up paying higher teachers' salaries.
9. Over the past year, **Chile has implemented the 'Competitive Push' initiative**, to increase competitiveness and reduce bureaucracy. 41 of the original 50 measures have been implemented, with the rest to be completed over the next two months, and 10 additional measures by the end of the year. The measures focus on speeding up or eliminating bureaucracy, reducing unnecessary taxes, opening up markets to greater competition and investing in science and English. **We judge that 13 of the 60 measures will have positive impacts on UK companies**, mostly through making it easier to do business here or reducing costs, but in some cases by opening new market opportunities. The initiative is now looking towards monitoring and evaluation of the measures, and trying to quantify how they affect the economy. The consensus is that these measures go in the right direction but are not a breakthrough in the Chilean economy.

Longer term outlook

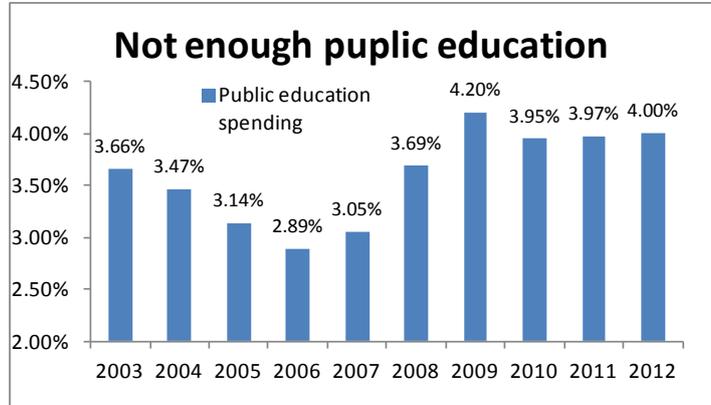
10. Looking longer term, the **overall picture for Chile is optimistic**. It has stable macroeconomic management, natural resources, strong investment prospects and a prosperous middle class driving consumption. However, there are challenges, and areas where reform is needed to sustain growth.
11. The **main constraint** mentioned by most interlocutors is **energy**. Chilean businessmen expect that people may face blackouts as soon as in two years if things do not move on quickly. Chile's growing economy means that energy demand will treble over the next 20 years. Many energy projects in the pipeline are beset by delays, due to the complexity of securing the necessary permits and energy investment is becoming increasingly a judiciary matter. Frustrations are mounting that the government is neither doing enough to clear the path for project developers nor showing sufficient direction. The

¹ This takes into account the economic cycle and the copper price, meaning the government is forced to save when growth is above trend and/or the copper price is higher than USD 3.02 per pound.

UNCLASSIFIED

most recent manifestation was the decision of the partners in Chile's most emblematic hydroelectric project, HydroAysen, to put the project on hold. Furthermore, in order to accomplish its goal of increasing the proportion of renewable energy, Chile needs to speed up renewables deployment, currently at just 4% of electricity.

12. **Further constraints can be seen in education, labour and science and innovation.** Education coverage here is good, but quality is very variable, with implications for inequality (see box). The state only spends 4% of GDP on education and there are clamors for greater spending. With unemployment so low, Chile is starting to see scarcity of labour. Low female participation rates



do not help matters: although it has been increasing, female participation is still below 50%. Government policies on extending maternity leave and expanding childcare provision should help. There are talks of reforming the labour laws, but while there is always room for improvement, Chile's labour law is probably more flexible than that of other regional players. Finally, Chile needs to further diversify its economy away from raw materials. The government understands this and is expanding spending on science and innovation (\$600m this year) in an attempt to focus on knowledge industries. Chile is still fairly poor at commercialising its research, something the government recognises and is addressing through a new Innovation Strategy.

13. One area for reform that Piñera has not yet paid attention (and is unlikely to) is the bureaucracy. It is widely accepted that below very capable ministerial teams (including special advisors) there is a lack of professionalism in Chilean civil service (with exceptions in areas such as diplomacy, central bank and others). While corruption is not a widespread problem in Chile, there is some concern about large companies having their regulators in their pockets.

Focus on: Inequality and Education

Latin America has a reputation as a region of high inequality, and Chile is no different. Chile's GINI coefficient is 0.50 (0 = perfect equality, 1 = perfect inequality), compared to the UK's 0.34 and is the worst score in the OECD . Furthermore, the before and after tax scores are very similar, indicating that the tax system does not redistribute income (the new tax 'reform' does not improve this and some, including the director of economics at one of the Oxbridge equivalents, argue that it is a pro-rich change).

There is inequality of opportunity in Chile, with a hierarchical elite that is hard to break into. The two-tier education system reinforces this, with good private schools leading to good university degrees for the elite and mediocre schools providing fewer higher education opportunities for the rest. Expensive university fees and lack of government support for students compounds the issue.

Faced with a situation of inequality, and greater empowerment through economic progress, Chileans have been more willing to voice their displeasure with the situation. Student protests over education have been taking place for over a year. In March there were protests in the South over regional inequality. Faced with protests the government has made concessions, further encouraging more protests. This has made it more difficult for the government to carry out its programme, and has led to some analysts accusing President Pinera of 'governing by twitter'.

On education, government reforms have extended the student loan system and increased the number of scholarships available, which should increase access to higher education, and consequently inequality. However, educational inequality starts in schools. The government is increasing funding for poorer children, and reforming teacher careers, both positive steps, but there is still more to do to raise educational quality across the board.