CHILE ECONOMIC UPDATE

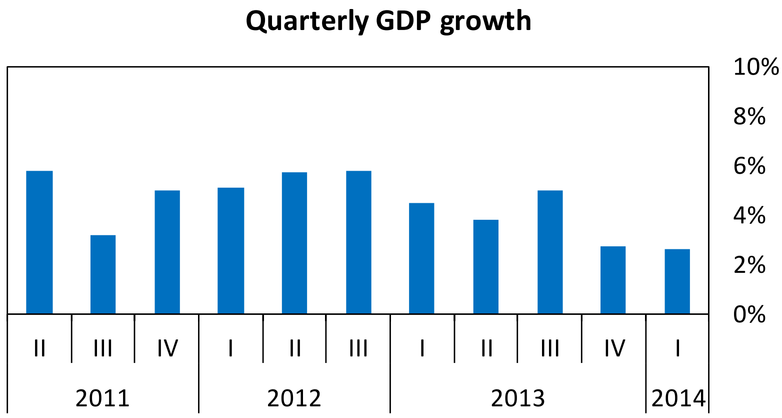
British Embassy
Santiago

Quarter Two, 2014

Summary

- The Chilean economy has plateaued following its sharp slowdown in the last quarter of last year
- Government tax receipts are decreasing due to the decelerating economy, which makes it more difficult for the new government to implement its programme
- Progress on this programme has been rapid, with draft Bills already submitted on tax and education reforms, and new Agendas on Energy and Productivity. Good implementation will be key to impact

1. **The sharp economic slowdown at the end of last year has levelled out.** Year-on-year growth remained around 2.5% in the first quarter, half the rate a year ago. Leading indicators such as capital imports, credit growth and electricity consumption imply growth will remain sub-potential in coming months. Analysts are predicting year-end growth of around 3%.



2. **The slowdown is being driven by a contraction in investment.** Q1 investment fell 5%, continuing the negative figures from the second half of last year. Analysts attribute the fall to bottlenecks in attaining investment permits, the lower price of key primary exports and uncertainty over the new government's tax reform (see below). Consumption has decelerated, but is still a healthy contribution to growth. Exports have maintained their support to growth, particularly copper, volumes of which are growing at 15%. However, maintaining such export dynamism will depend on economic performance of key export partners in months to come, particularly China.

3. **Job creation continues, but is increasingly being driven by growth in self-employment, a less stable form of employment expansion**. Combined with weaker wage growth, this could indicate lower consumption growth in the coming quarters.

4. **The decelerating economy is leading to a reduction in government tax receipts,** with the government now predicting $2bn less revenue compared to when the budget was drawn up with optimistic growth assumptions. A lower tax take makes it more difficult for the new government to implement its ambitious programme, and removes room for fiscal stimulus should the slowdown worsen.

New administration priorities: tax reform

5. **The new government is advancing in its legislative agenda, which has a strong focus on equality, and therefore has a significant economic component**. The equality focus is relevant given Chile has the 15th highest income inequality globally.

6. **The lower Chamber in Congress last month approved President Bachelet's ambitious programme of tax reforms, which have advanced to the Senate.** The reform is intended to raise the fiscal revenues ($8bn) needed to fund the rest of the programme for government, and reduce inequality. In summary, it includes a gradual increase in corporate tax (from 20 to 25%), the replacement of an incentive to corporate re-investment of profits, the elimination of a seldom-used mechanism for foreign direct investment, the introduction of green taxes on power plants, industrial plants and diesel cars and an increase in taxes on alcoholic beverages.

7. The opposition and private sector have criticised the reform, which they say will reduce growth and investment. The uncertainty of tax rules around investment has probably led some companies to defer investment. And the increase in corporation tax rates could reduce growth in the short term. However, the majority of the revenue from the tax reform will be invested, particularly in education, which could improve Chile's education quality, and so increase human capital and growth rates in the medium term.

8. **The tax reforms will have a limited affect on British companies and exports**. British companies based in Chile that repatriate their profits to the UK will not feel any additional tax burden, as there is a withholding tax on profit repatriation of 35%, which already takes into account the corporate tax paid. The FDI mechanism is little used by British companies and will therefore not have a large effect. The proposed new taxes on diesel cars and alcoholic beverages (including whisky) could have an impact on sales, but are not discriminatory to UK companies.

Other reforms

9. After the tax reform, the second main axis of President Bachelet's programme is **Education** reform. Details of the first part of this reform have been submitted to Congress, along with new Agendas on **Energy** (where prices are very high and a bottleneck to growth) and **Productivity, Innovation and Growth.**

10. On **Education**, the government has focused on schools initially, despite the fiercest protests in recent years being on university education. The aim is to improve quality and equality in school education. This will be achieved by ending student selection and private profit in public education and moving the current semi-private schools (state funded but where parents pay a top up) into the full public sector, by increasing state funding. Reform of the university sector will be left for next year.

11. On **Energy,** the government has outlined a plan to reduce energy prices, develop new energy projects (particularly in natural gas and renewable energy), improve energy efficiency and draw up a long term Energy Roadmap next year. The Agenda has reaffirmed the goal of 20% renewable energy (excluding large hydro, which accounts for

another 30%). The Agenda was put together with significant consultation of industry and civil society and has been well received.

12. On **Productivity, Innovation and Growth**, the government has outlined an Agenda which includes strategic investment in key economic sectors; infrastructure development; financing, especially for SMEs; promoting innovation and entrepreneurship, reducing red tape and improving competition policy. It will also create a permanent Productivity Council, an independent entity to advise the government on competitiveness.

Focus on...trade policy

The new Chilean government will **continue the strong commitment to free trade**, both through multilateral processes and through the negotiation of further bilateral free trade agreements (FTAs). There is a strong political, social and economic consensus on this policy in Chile. Chile has the largest network of FTAs in the world, with 23 agreements covering 61 countries.

However, the new government has tweaked the focus of trade policy, putting more emphasis on regional neighbours. This is particularly visible in the approach to the **Pacific Alliance**, a pragmatic economic and trade integration initiative with Colombia, Peru and Mexico, started in 2012. The new government will continue to support the initiative, and continue the integration efforts. However, Chile wants to see more outreach to other near neighbours, such as Brazil and Argentina. Chile will be tabling a proposal for greater integration with Mercosur during the Pacific Alliance summit this week, but due to the different visions, will be pragmatically focusing on co-operation in areas such as student exchanges and freer movement of people. The new government has also been at pains to change the presentation of Chilean participation in the Alliance, highlighting its non-exclusive nature.

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Chile is one of the negotiating parties in the **Trans-Pacific Partnership**, but is in the unique position of already having FTAs with all other parties. The new government understand this means there are notable challenges in finding space for economic gains for Chile, but will continue to be part of the initiative. It will remain robust against pressure on taking on further commitments, for example in intellectual property rights.

Chile wants to update its older trade agreements, such as the **Association Agreement with the EU**. In this context, the new government will continue in the same direction as the previous administration, which last year officially requested an upgrade to the EU-Chile agreement.

Chile also wants to begin **bilateral FTA negotiations** with new partners, including Indonesia, Philippines and **Russia**.