CHILE ECONOMIC UPDATE

British Embassy Santiago

Quarter Three, 2014 Karl Zammit-Maempel

Summary

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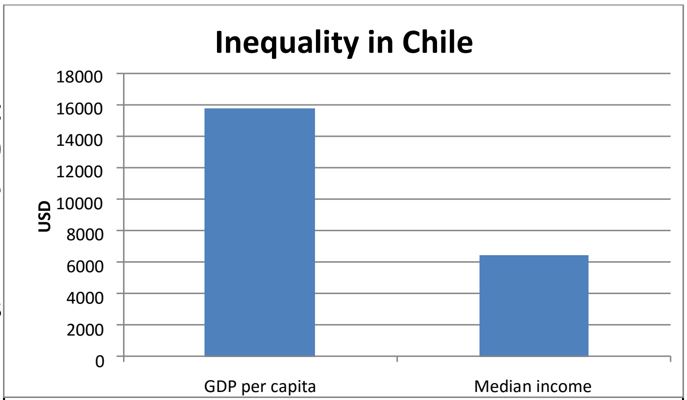
The government has passed the first of its three main reforms –tax reform

- Growth has slowed further since our last report, but the deceleration is expected to bottom out this quarter
- Chile cements its leadership position in the region on competitiveness
- The stock market regulator hands out the largest ever fine for illegal stock market transactions

Tax reform

1. **The Chilean Congress approved President Michelle Bachelet's flagship tax reform on 10 September, following five months of intense debate.** The reform is intended to raise the fiscal revenues ($8bn, or 3% of GDP) needed to fund the rest of the programme for government, as well as reduce inequality (see graph). Final agreement on the reform was facilitated by a hard-earned cross-party agreement in August, following modifications to the reform that incentivised business investment and therefore reduced resistance to the reform from the opposition parties and business.



GDP/capita, using an average, does not reflect normal people's salaries. Median income shows what the middle worker earns, if all are lined up in order. It is much less than the GDP per capita: i.e. income distribution is unequal

2. The main components of the reform are: a gradual increase in corporate tax (from 20 to 25-27%), new powers to the HMRC-equivalent to reduce tax evasion, the replacement of an old incentive for corporate re-investment of profits with a tax credit, measures to simplify the tax treatment of SMEs, the introduction of green taxes on power plants and cars, and an increase in taxes on alcoholic and sugary beverages.

3. **Businesses and the opposition have alleged the reform has contributed to Chile's decelerating economy.** The economy has slowed, by more than most analysts expected. However, this is being driven more by uncertainty about the tax treatment of investment under the reform, rather than by the impact of the measures themselves (which will not take effect until next year). Following the approval of the reform, uncertainty should decrease. Looking further ahead, although the higher corporate tax rate may reduce growth in the short term when it takes effect, the **majority of the tax reform revenue will be invested**, particularly in education, which could improve Chile's poor education quality, and so **increase human capital and growth rates in the medium term**.

4. **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 due to our Double Taxation Agreement, as the additional corporate tax can be used as a tax credit on the profit repatriation withholding tax.

<u>Economic performance</u>

5. **Growth has slowed further since our last quarterly report.** Year on year growth reduced to 1.9% in the second quarter, from 2.4% in the first. Most private sector analysts are now expecting growth of 2-2.5% this year. The central bank has halved its estimates of 2013 growth in the last 12 months. However, the latest monthly economic proxy index was much higher than analysts expected, indicating that such predictions may be overly pessimistic. Analysts predict the deceleration will bottom out this quarter, not least as business uncertainty reduces, external conditions improve and the recent depreciation of the peso boosts exports.

6. **The slowdown is now being driven by a sharp slowdown in consumption as well as a continued contraction in investment due to uncertainty.** Previously consumption was decelerating slowly, but in quarter two year on year growth halved to just 2%. Slowing wage growth and rising inflation are beginning to take their toll on consumption confidence, which has recently turned negative. External factors are also weighing on the economy, particularly lower prices for commodity exports and normalising of monetary policy in the US leading to more expensive financing.

7. **Faced with a slowing economy, the government has unveiled a $500m stimulus plan.** As well as promising the full execution of this year's fiscal budget, the plan commits to increasing infrastructure spending on key projects and further capitalisation of the state bank and copper company for expanding consumer/business lending and mining investment respectively. In a further boost to the economy, the Central Bank cut interest rates in July, August and September. Analysts are pricing in two more quarter-point cuts before the end of the year.

<u>Other issues</u>

8. **Despite the slowing economy, Chile consolidated its position as the most competitive economy in Latin America,** according to the World Economic Forum. Their Global

Competitiveness Index 2014 placed Chile in 33^{rd} position globally, one place better than last year, and top in the region. The Index underlines the strength of Chile’s institutional framework, macroeconomic environment, financial market development and low corruption levels. It also highlights the areas in which Chile could improve, including education quality, investment in innovation and labour market efficiency, particularly the costs of firing.

9. Chile's stock exchange regulator ruled this month that **two of Chile’s most influential businessmen - Julio Ponce and Leonidas Vial - must pay record fines of $70 million and $20 million, respectively, for illegal stock market transactions**. The regulator’s two year-long investigation into participation in shell company trading practices also resulted

in fines for various partners of the two businessmen, bringing the total charges to $164 million. Ponce is a former son-in-law to Gen. Augusto Pinochet and one of Chile's richest businessmen. Ponce’s co-accused, Vial, led one of the nation's most reputable brokerage house years and was a former Vice-President of the stock exchange. The suspect SQM trades reportedly cost Chile's privately held pension funds $800 million in losses.

Focus on...energy diversification

Chile's energy prices are amongst the most expensive in Latin America. This is partly as a result of rising demand, including from the energy-hungry mining industry, but also due to poor domestic conventional energy resources. Chile is one of the few countries in South America in having barely any domestic hydrocarbon resources.

However, it has **significant renewable energy resources**, including the highest levels of solar radiation and the largest marine energy resource in the world. Renewables are expanding at a rapid pace. It is predicted that this year renewable energy capacity will be doubled. And the past few months have seen the inauguration of the biggest two renewable energy projects in Chile – a 110MW wind farm, financed by London-listed mining company Antofagasta Minerals and a 100MW solar project.

The government's Energy Agenda (see last quarter's report) is looking to diversify into new energy sources. There has been progress recently:

- President Bachelet signed an **agreement to treble oil imports from Angola** during an official visit last month. In March Chile eliminated the 6% tariff barrier that previously existed for imports from Angola and several other oil exporting African nations.
- The Minister of Energy announced Chile's aim to **import US shale gas** during a mission to the US over the summer. US capacity to export shale gas could lead to greater LNG imports, in which BG is a potential supplier.
- The Minister of Energy signed **an MoU with his Argentine opposite number for the exchange of gas for electricity** through the countries' existing energy interconnections

The implications for the UK from energy diversification in Chile are:

- **Commercial opportunities for British companies, particularly in gas exports, and supporting investment in renewable energy**. British companies Actis and Rame Energy are active in renewable energy in Chile.