CHILE

REFORMS AGAINST A BACKDROP OF RECESSION

Chile is unlikely to escape a recession in 2023. The slowdown in global demand will weigh on exports, while domestic demand continues to be eroded by high inflation and interest rates due to restrictive monetary policy. The investment outlook remains closely linked to the political climate in the country, and in particular to the implementation of the two principal reforms announced by the government: the new constitutional process (which is expected to continue throughout 2023), and the implementation of pensions reform.

RECESSION IN 2023

After weak growth in 2022, the economy is likely to contract in 2023 (GDP already fell by 1.2% q/q in Q3 2022). Inflation has slowed but remains high, at 12.8% year-on-year in December 2022. As a result, monetary policy will continue to be restrictive. The Central Bank (CB) has steadily raised its interest rate over the course of 2022 to 11.25% (a cumulative rise of 725 basis points since January) and inflation expectations remain well above the inflation target (3%), over both 12 months and 24 months. Although the CB announced the end of its rate increase cycle in October, further hikes in the key rate cannot be ruled out.

A sharp slowdown in consumer spending is therefore expected. Despite the support measures announced recently by the government (to help the most vulnerable households compensate for the effects of inflation), household purchasing power is likely to continue to be eroded in the coming quarters. Investment is also expected to slow, despite the number of government support measures (facilitating access to financing for Chilean investors, tax incentives for foreign investors, increase in the number of public-private partnership projects). Any recovery in investment will be limited by the tightening of monetary policy and will be conditional on changes in the political climate and the progress of the various structural reform measures announced by the government. The slowdown in global growth will weigh on the export sector, which in particular is being impacted by the fall in global demand.

The next two years will be characterised mainly by the reforms launched since Gabriel Boric took up his post a little under a year ago: the project for a new constitution and the reform of the pension system (which are a direct response to the violent demonstrations in the autumn of 2019, and more broadly to the deterioration in the political and social climate seen in the country over several decades). Implementing these reforms is proving to be particularly difficult, with the government having to deal with a reduced majority in the Congress and very high popular expectations. Furthermore, the economic and health crisis has further weakened the healthcare and social protection systems, which have been in great difficulty despite massive budgetary support over the last two years.

FORECASTS

	2020	2021	2022e	2023e	2024e
Real GDP growth (%)	-6.1	11.9	2.4	-2.0	1.5
Inflation (CPI, year average, %)	3.0	4.5	12.8	6.5	3.5
Central Gov. balance / GDP (%)	-7.3	-7.7	0.5	-3.1	-2.9
Public debt / GDP (%)	32.5	36.3	37.9	38.8	38.6
Current account balance / GDP (%)	-1.7	-6.4	-6.2	-4.5	-3.8
External debt / GDP (%)	82.6	75.4	76.8	76.3	72.2
Forex reserves (USD bn)	39.2	51.3	39.4	38.5	42.9
Forex reserves, in months of imports	5.5	5.3	4.8	5.3	4.9

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

CHILE: MONTHLY ACTIVITY INDEX

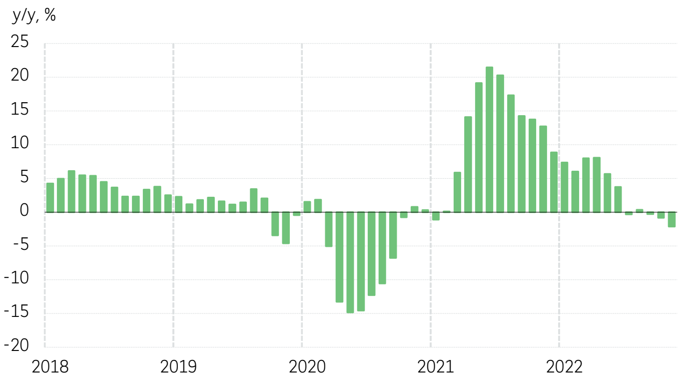

CHART 1

SOURCE: CENTRAL BANK

CONSTITUTIONAL REFORM: ANOTHER ATTEMPT

The first draft of constitutional reform was widely rejected, by 60% of voters, in the referendum held on 4 September. Since then, the process of developing a new constitution has continued. A very large majority of the population continues to favour a new constitution, and as a minimum expects amendments to the current constitution. The original draft did not propose any significant reforms of the Chilean economic model such as questioning the independence of the Central Bank or property or labour rights. However, as well as guaranteeing better access for the population to a range of social rights (housing, education, access to healthcare), the draft highlighted numerous commitments relating to the environment, women's rights and indigenous peoples (including a justice system which would have been specific to them). These latter proposals were overwhelmingly rejected by the population and the opposition parties.

After several months of debate, and a ministerial reshuffle, the President presented the new constitutional process at the start of December. As with the first draft, a constitutional Council will be elected in May. However this one will only have 50 members, compared with 155 for the previous one.

The method of voting has also been changed, potentially leaving less room for the smaller parties and the indigenous parties (there will be no quotas this time). In addition, the new council will be supported by two other bodies: a committee of 24 experts will be appointed by the Congress[1] and an "eligibility committee" of 14 lawyers (all appointed by the Senate), responsible for validating the technical points of the project.

Following a pre-draft presented at the end of January, which will serve as a basis for work, the draft must be drawn up by the end of October 2023, before being submitted for popular approval by a new vote scheduled for mid-December. It is almost certain that the new proposal will be more moderate than the first one, particularly on societal issues. However, it is highly likely that the proposals regarding social rights, and more generally a greater State presence in the economy, will be retained. Public spending is expected to increase significantly in the coming years in order to meet the demand for improved public services.

PENSION REFORM: STRENGTHENING THE SOLIDARITY ELEMENT

Reform of the pension system is part of a framework similar to that of constitutional reform. The desire to reform the Chilean pension system has been at the heart of public debates for more than 15 years. The main demands, and the essential points for reform, are an improvement in the replacement rate (i.e. the percentage of in-work earnings received by an employee when they draw their pension) and the coverage (many Chileans are excluded either completely or partially from the current system), as well as the

lack of transparent management of private pension funds. Apart from the addition of a solidarity element added in 2008 (allowing the most disadvantaged workers to access a minimum pension), and some marginal modifications, the pension system had actually remained unchanged since the ultra-liberal reform in the early 80s. The pay-as-you-go pension system had then been replaced by a compulsory pension fund system with individual defined contributions, managed by the pension fund administration companies (Administradoras de Fondos de Pensiones (Chilean Pension Fund Administrators), AFPs[2]).

The reform presented by the government at the end of November 2022 proposes several structural changes. Firstly, contributions will no longer be solely employee-based, since their contribution remains essentially unchanged (rising from 10% to 10.5% of salary) and an employer contribution of 6% of salary is introduced (allowing a stronger solidarity element to be financed, in addition to the improvement in the individual replacement rate).

CHILE: INFLATION AND KEY POLICY RATE

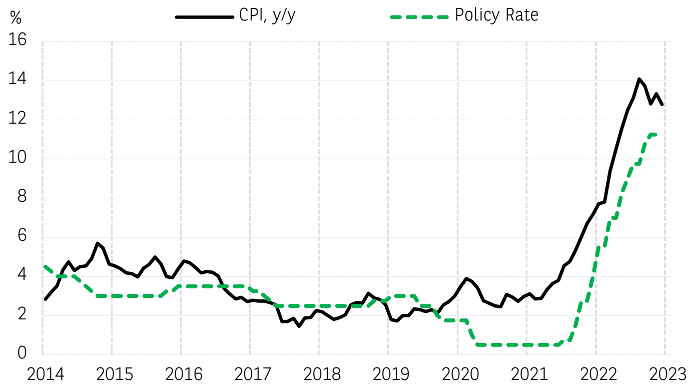

CHART 2 SOURCE: CENTRAL BANK

Secondly, going forward the role of the AFPs will be limited to fund management, with administrative management (collection, etc.) being left to a new public authority. Finally, the market for AFPs should be opened up to competition.

For the moment it is difficult to assess the fiscal consequences of these two major reforms. That said, while the public finances have deteriorated over the past two years (public debt represented almost 38% of GDP at the end of 2022, after 28% at the end of 2019), slippage in the fiscal deficit is relatively unlikely. President Boric seems determined to deliver his dual commitment of increasing public spending in order to improve social justice, while remaining "fiscally responsible". For the time being it appears that the government remains committed to its main objective (maintaining debt at a level below 45% of GDP by the end of the mandate).

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1 As a reminder, there was no-one with a majority in the Senate, and the left-wing coalition only has an advantage of two seats (out of 155) in the Senate. The two additional councils should therefore make it possible to further limit proposals deemed too radical in the first draft constitution.
2 Under this system, the pension received by each retired person only represented, in annuities calculated on the basis of an average life expectancy, their personal savings alone, the result of compulsory contributions paid solely by the employee.