Chile

A question of reforms

GDP growth rebounded in 2018, buoyed by higher copper prices and the renewed confidence of investors following the election of Sebastian Piñera. Over the course of his mandate, President Piñera's ambition is to implement fiscal policies that will boost growth and stimulate investment while consolidating public finances, but this could prove to be harder to achieve than expected. The president's party lacks a congressional majority, and is struggling to push through the fiscal and pension system reforms that have been presented so far. Even so, economic growth prospects will remain rather favourable over the next two years and fiscal consolidation should continue.

Growth rebounds in 2018

After reporting GDP growth of less than 2% since 2014, when a low investment rate and the loss of investor confidence exacerbated the effects of the decline in copper prices, Chilean growth rebounded in 2018 to 4%. Real GDP growth was particularly vigorous in the first half, rising 4.8% year-on-year (y/y). The main growth engines were copper exports, investment (+5% y/y, driven by the mining sector) and household consumption. Lower copper prices and the slowdown in non-mining exports strained activity in the second half.

Averaging 2.4%, inflation was mild in 2018, and has remained low since the beginning of the year (less than 2% on average in the first 3 months according to the new index based on 2018). Under this environment, the central bank should be able to pursue its prudent policy of normalising key rates, which were raised by 25 basis points on two occasions, in October 2018 and January 2019, to 3%.

Prospects for the next two years are rather favourable, even though GDP growth will slow slightly in 2019 and 2020, before levelling off at around 3.5% (the growth trend estimated by the central bank). Several factors will boost growth, including the improvement in the labour market and the steady realisation of numerous public and private investment projects, assuming they are completed on time. There are still major downside risks: an intensification of the US-China trade war and a sharper-than-expected slowdown in Chinese growth could strain copper prices and undermine growth. The diversification of the economy has been painfully slow, and the copper sector still accounts for nearly 10% of GDP, 25% of fiscal revenues and 50% of total exports.

The reforms in question

Excessive dilution of the government's proposed reform projects could undermine the vigour of domestic demand. President Piñera, the head of the centre-right Chile Vamos party (CV), is encountering a few difficulties just one year after taking the helm. Right after his election, the president announced that the priority of his mandate would be to simulate private investment and growth, while consolidating public finances.

Although Sebastian Piñera was elected with a comfortable lead over his rival heading the centre-left coalition, his party does not hold a majority in either of the two houses of parliament, and has had a hard time forming coalitions to support the government's actions.

The government has already been forced to make a few concessions by maintaining certain measures implemented by the previous administration, notable concerning education reform. The president also had to renounce plans to lower the corporate tax rate, one of his campaign promises.

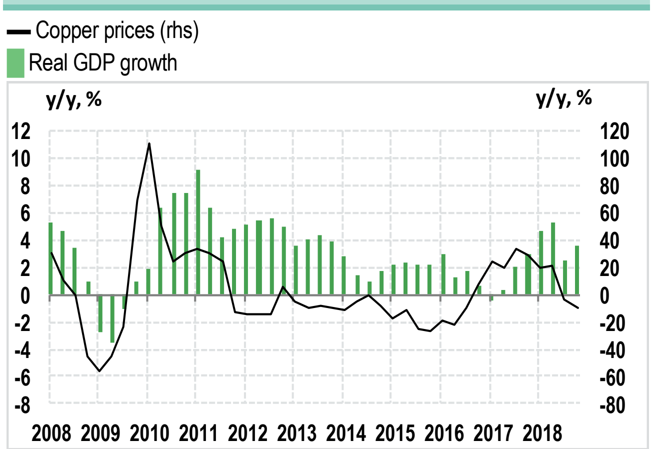
Last August, a vast fiscal reform project was presented that largely calls into question the measures taken by Michelle Bachelet in 2014. The main three measures propose to simplify and unify the existing tax regimes, modernise the fiscal administration (through the generalisation of online tax collection, for example) and stimulate private investment, by setting up a series of corporate incentives targeting SME in particular. The government said it hoped the

1-Forecasts

	2017	2018e	2019e	2020e
Real GDP growth (%)	1.5	4.0	3.6	3.2
Inflation (CPI, year average, %)	2.2	2.4	2.4	2.9
Central Gov. balance / GDP (%)	-2.8	-1.7	-2.0	-1.8
Public debt / GDP (%)	23.6	25.7	26.7	27.5
Current account balance / GDP (%)	-1.5	-3.1	-3.0	-2.7
External debt / GDP (%)	65.5	62.0	63.5	63.5
Forex reserves (USD bn)	39.0	39.9	39.9	40.5
Forex reserves, in months of imports	7.9	7.6	7.8	8.0
Exchange rate USDCLP (year end)	615	696	695	698

e : estimates and forecasts BNP Paribas Group Economic Research

2- Real GDP growth and copper prices



Source: National Accounts, LME

reform could be adopted as quickly as possible so that the measures could be integrated in the 2020 budget, but the text is still being debated by Congress.

In November, the government presented its pension system reform proposal. This announcement was expected since modifying the pension system has been at the centre of public debate for numerous years. Basically, the Chilean pension system is built around three core pillars: the first pillar, created in 1981, is a private pension system (the total value of private pension funds now accounts for nearly 70% of GDP). In 2008, during Michelle Bachelet's first mandate, a second "solidarity" or redistributive pillar was introduced, guaranteeing among others a minimum pension and subsidies for low income workers. Lastly, a third voluntary pillar authorises workers to round out their mandatory contributions with voluntary pension savings.

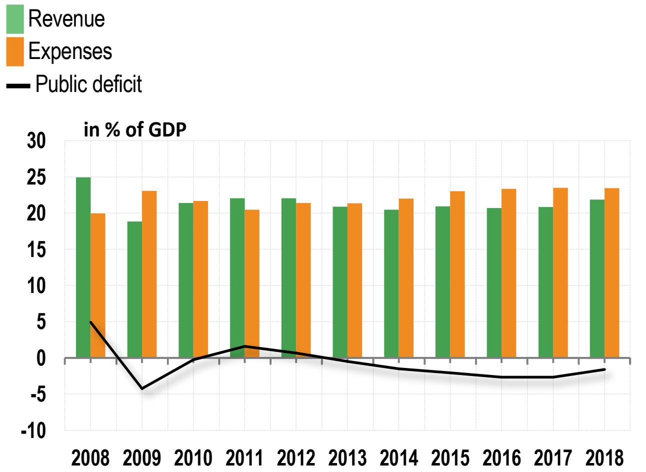
The pension system has encountered a lot of criticism. Several factors have diluted the amount of pension benefits, including an aging population, a low contribution rate (equivalent to 10% of the wages of Chilean employees, compared to an OECD average of more than 18%), high management fees (which significantly reduce the amount of benefits), and low wages. Moreover, the amount of the minimum pension and the subsidies for low-income workers are deemed to be insufficient.

The broad outlines of the government's proposals build on suggestions formulated by Michelle Bachelet's team during her second mandate in 2015, including the need to increase both the individual contribution rate (the reform calls for employers to increase the contributions made on behalf of their employees, bringing the total to 14% of wages) and the fund covering the "solidarity" pillar. Contrary to the proposed fiscal reform measures, the pension reform is closely aligned with the measures supported by the opposition party. Even so, the proposal is still stuck in debate.

Fiscal consolidation continues, but its scope is likely to diminish in the years ahead

In 2018, the fiscal deficit was reduced to 1.7% of GDP (from 2.8% in 2017), the lowest level since 2014[1]. Yet deficit reduction was mainly achieved through higher tax revenues derived from the mining sector, and through an exceptional tax on the Chilean mining group SQM. As the government promised, expenditures have been relatively stable as a percentage of GDP. The deficit could swell again in 2019-2020 (but hold close to 2% of GDP), since the additional revenue from the SQM tax was a one-off event that will not to be repeated.

3- Public deficit



Source : Ministry of finance

Fiscal consolidation is expected to continue in the medium term, even though the government seems to have very little manoeuvring room. According to the authorities, the impact of the fiscal reform should be neutral, while pension reform will gradually increase public expenditure to 1.1% of GDP (2018) in 2030. Of all the reforms the government is considering, this seems to be the most costly one, although the government intends to fund the increase in spending on a year-by-year basis.

According to the government's preliminary estimates, the structural deficit (defined by the medium-term fiscal rule) should steadily narrow to 1.2% of GDP in 2021. This reduction should lead to a mild consolidation, although to achieve this objective, the government did not specify whether new fiscal measures would be proposed or whether it would change the parameters used to estimate the fiscal deficit (i.e. the potential growth rate and the price of copper).

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[1] Since 2001, Chile's fiscal policy framework has been guided by a medium-term fiscal rule, which aims to reduce the volatility of growth through countercyclical policies. Application of the rule resulted in the accumulation of fiscal surpluses between 2001 and 2014, but since 2015, the decline in the potential growth rate and copper prices have led to an increase in the public deficit and debt.