Ministerio de Hacienda

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Gobierno de Chile

Developments and prospects of the Chilean economy in a multi-layered transition

Chile Day New York

July 2022

Mario Marcel | Minister of Finance

Introduction

Chile is undergoing a broad transition in three overlapping dimensions:

- *Productive transition*: a mining oil-dependent economy, evolving into a green-growth supplier and service hub
- *Political transition*: from a hierarchical, centralized society, to an inclusive society with institutionalized distributed power
- *Economic transition*: regaining equilibria after the Covid-19 crisis and disproportionate policy responses

These features may be present in many other countries, but in Chile they became particularly acute due to fast-growing middle class, enhanced transparency and stagnating productivity

As suggested by attitudes towards the Constitutional Referendum, a large majority of the population wish for an institutionalized, ordered and effective change

Chile will continue being an open, market-based economy, and its future development will depend crucially on successfully completing these transitions

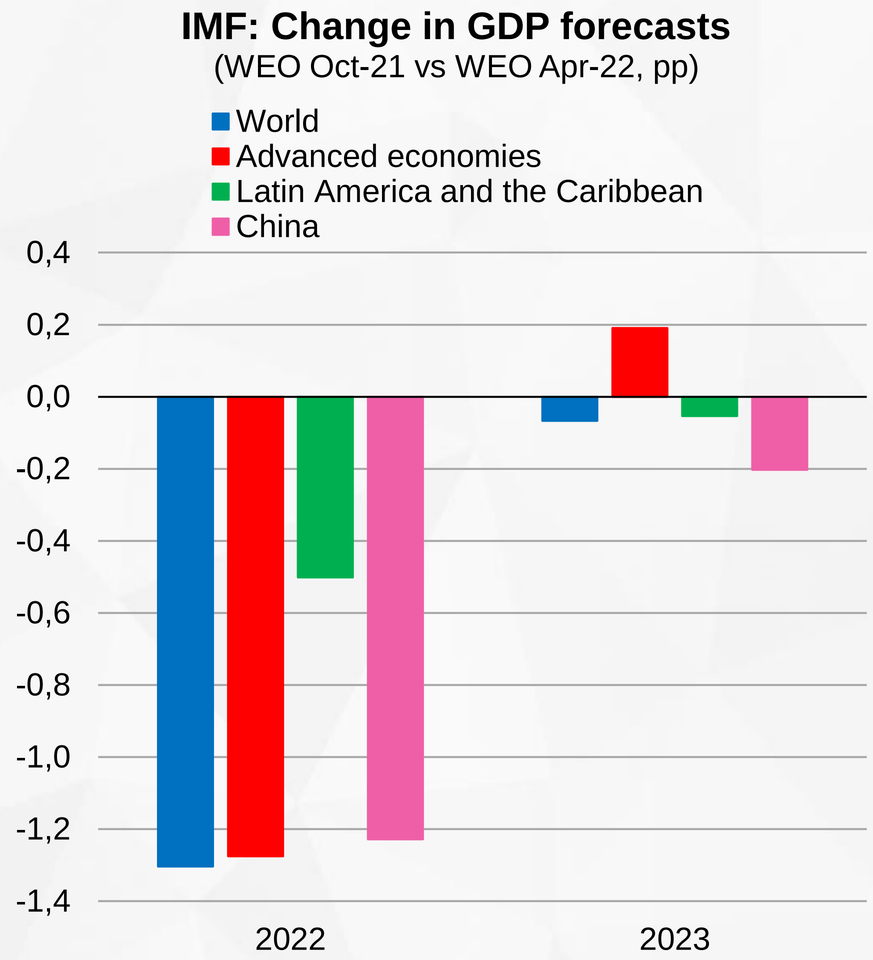
Economic policy should be an enabler of change, securing the sustainability of structural reforms. This means well-functioning markets, economic stability and fiscal discipline

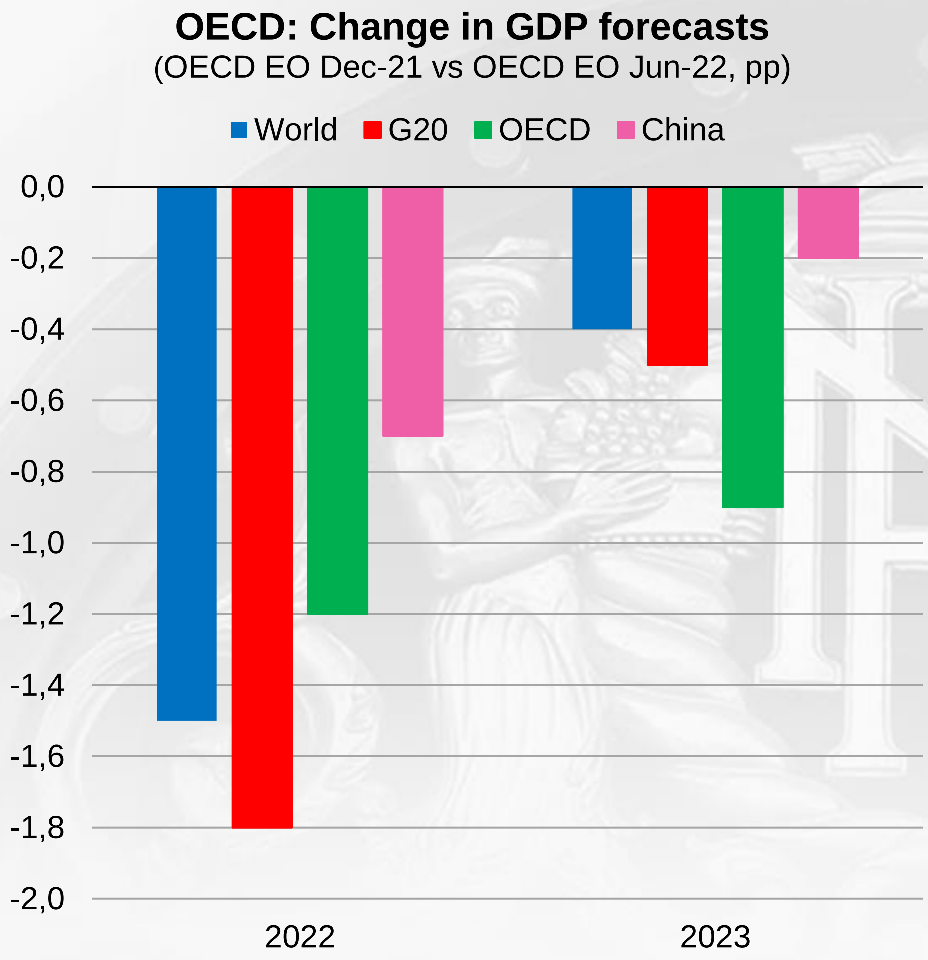
Outline

1. Macro Developments and Outlook
2. Tax Reform: a New Fiscal Pact
3. Financial markets
4. Fiscal Policy
5. Constitutional Process

Macroeconomic Developments and Outlook

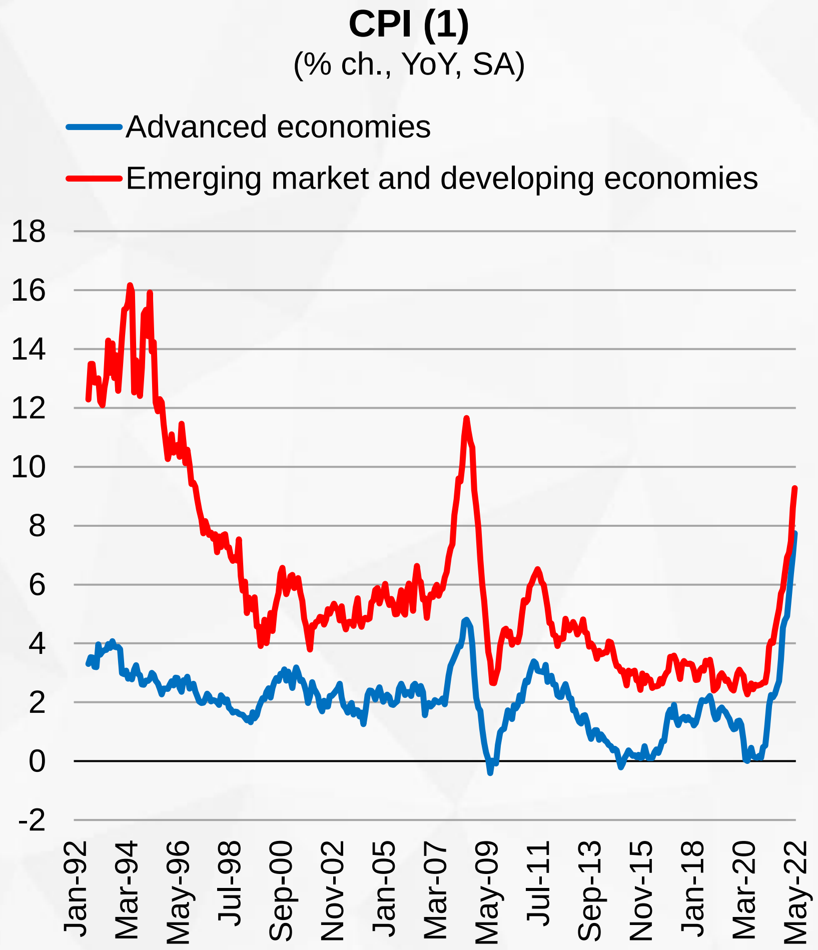
After the Covid-19 unprecedented crisis, economic recovery has suffered a number of setbacks, worsening prospects for growth, including the likelihood of a new recession

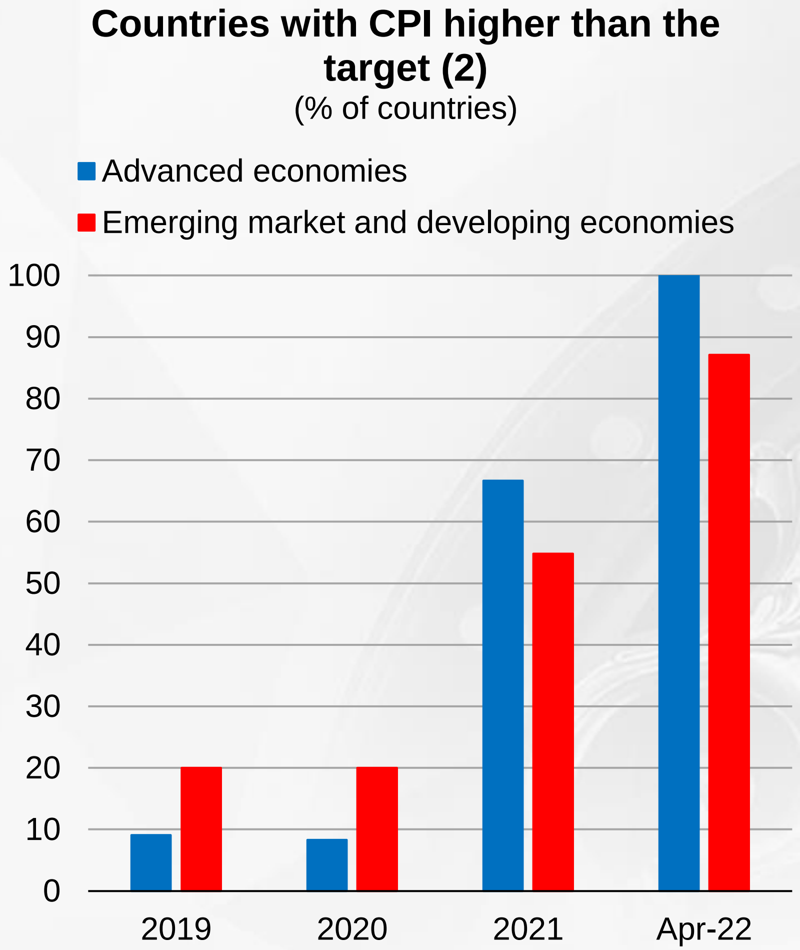


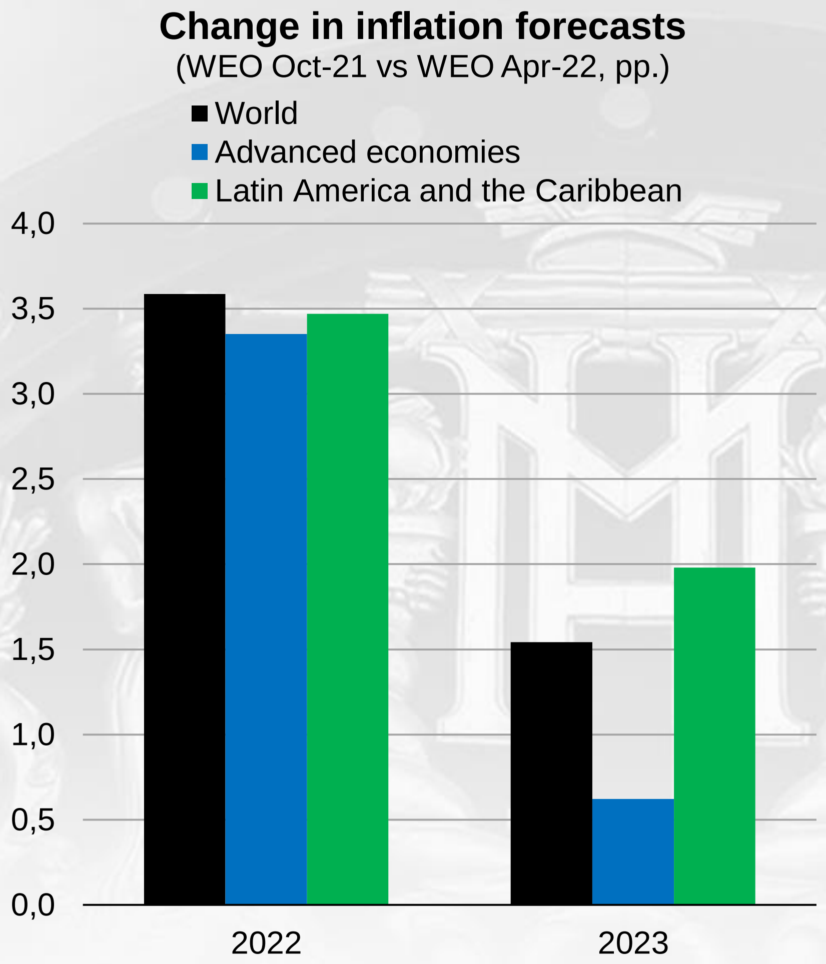


Source: IMF, OECD.

High inflation has become a global phenomenon and is putting pressure on policymakers

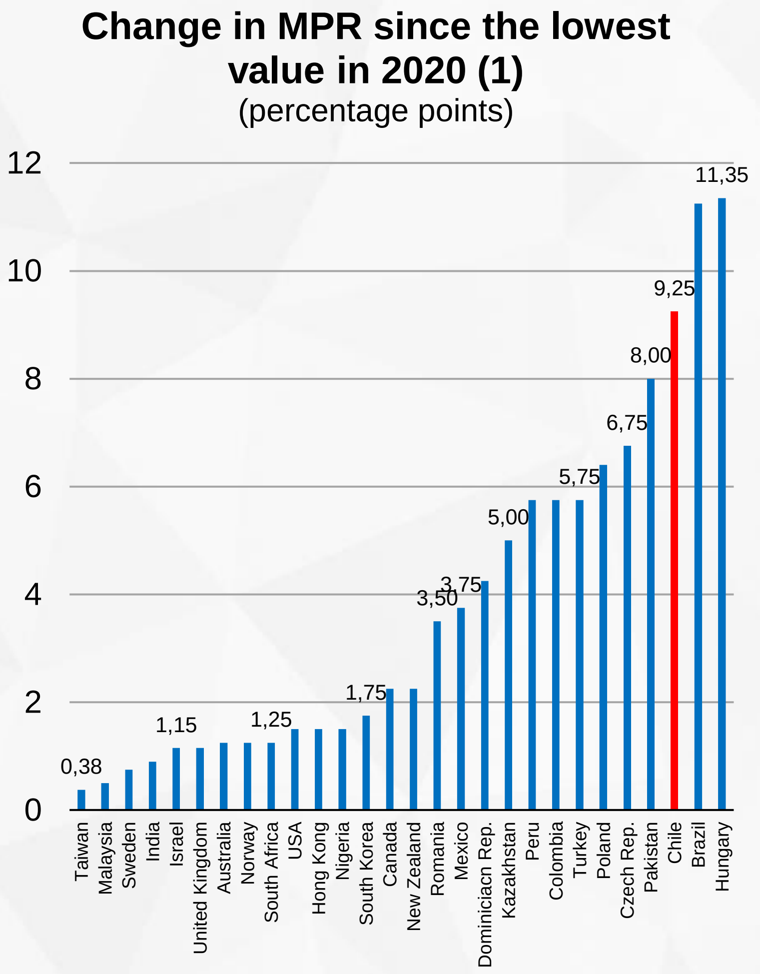


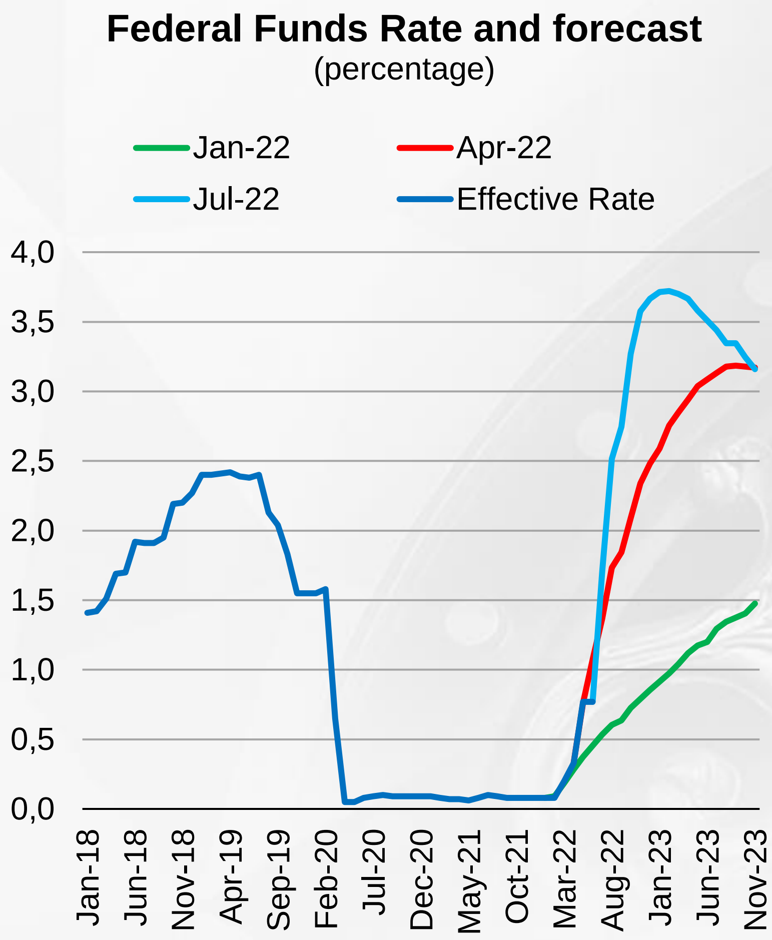


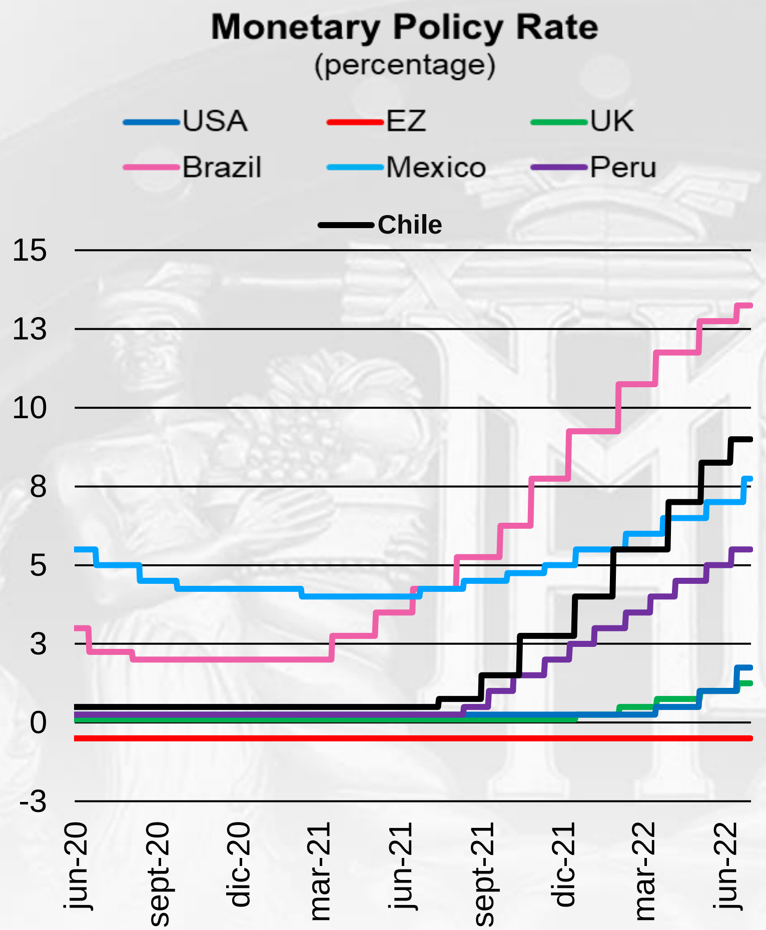


Note: (1) Weighted median. (2) Sample includes 12 advanced economies and 31 emerging market and developing economies.
Source: World Bank and IMF.

Given inflationary pressures, several central banks have been tightening monetary policy. In advanced economies, catching up is creating financial volatility

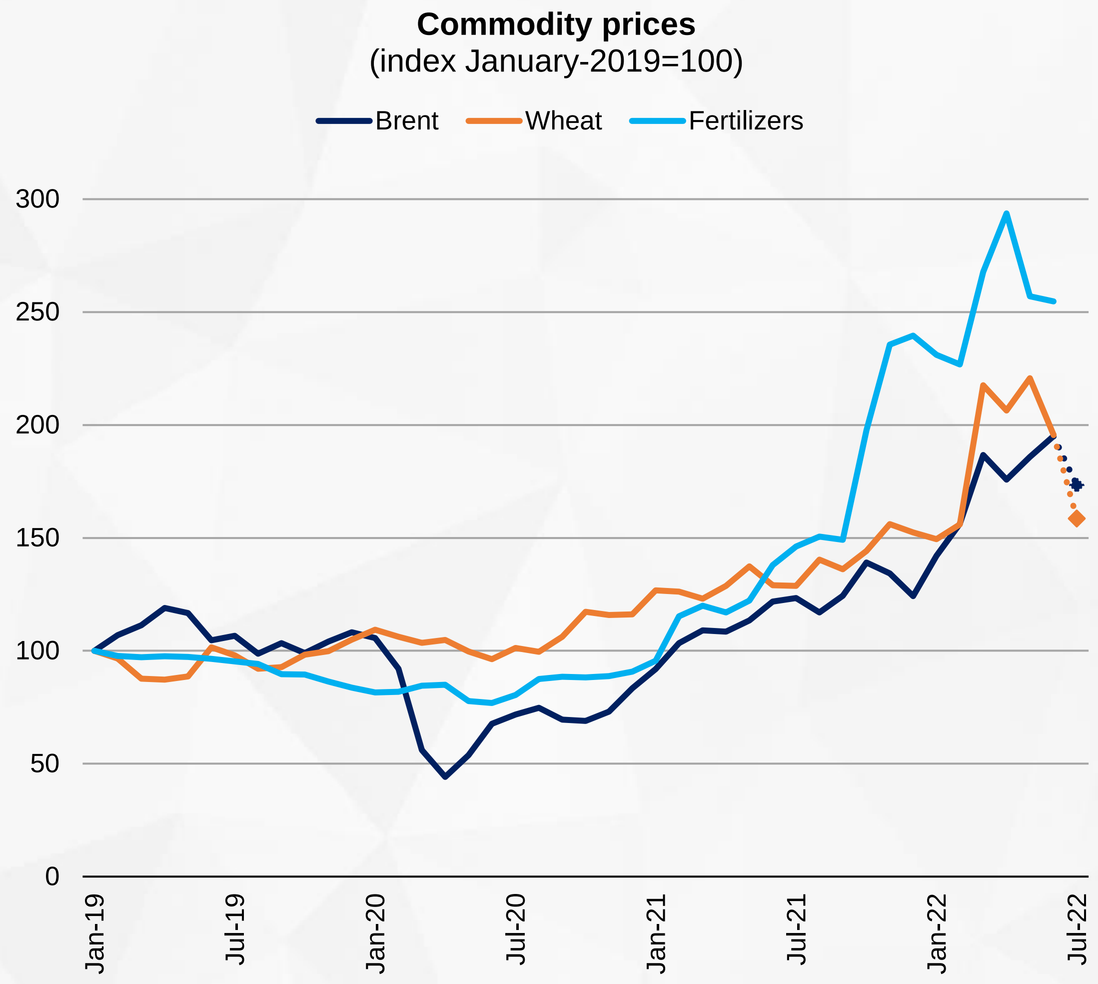


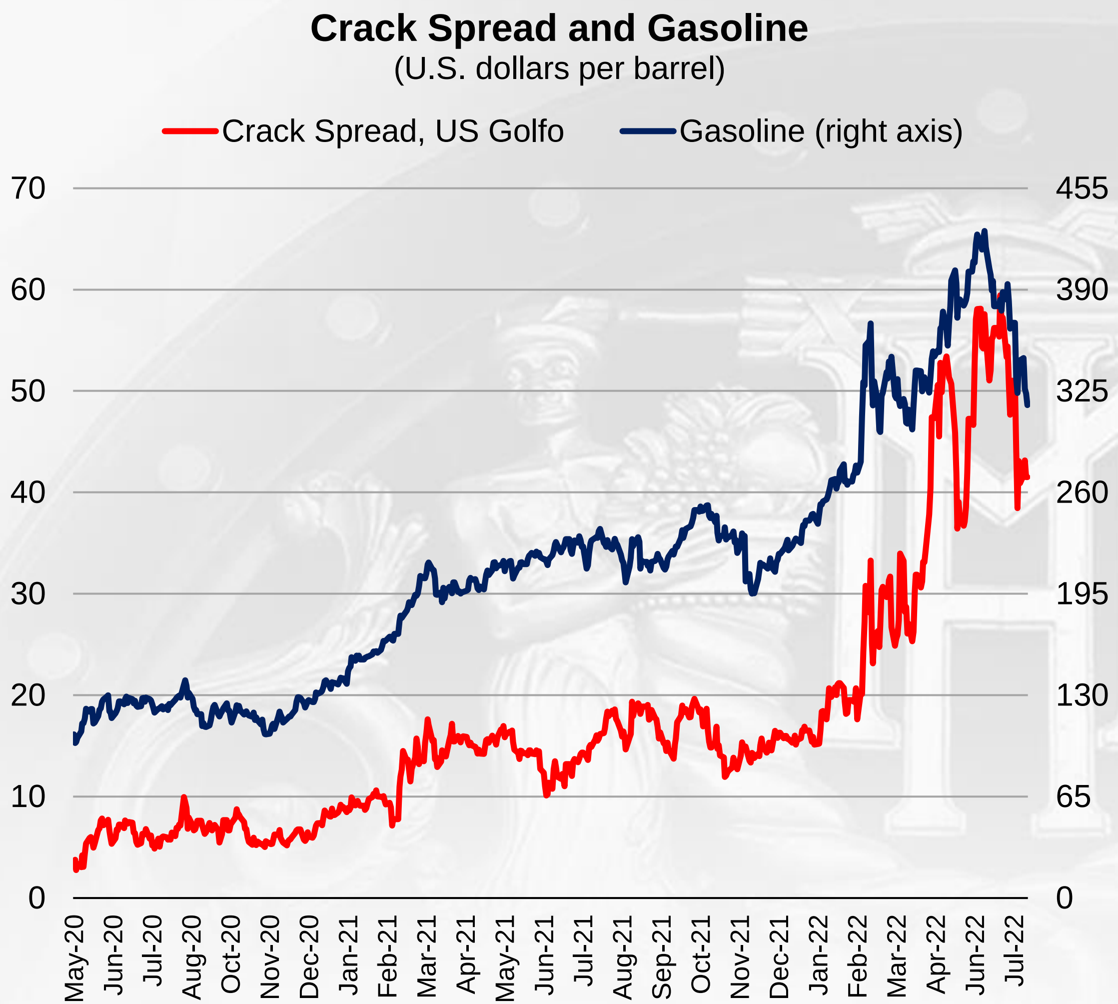




Note: (1) Change since the lowest rate value, as of Jan-20.
Source: Bloomberg.

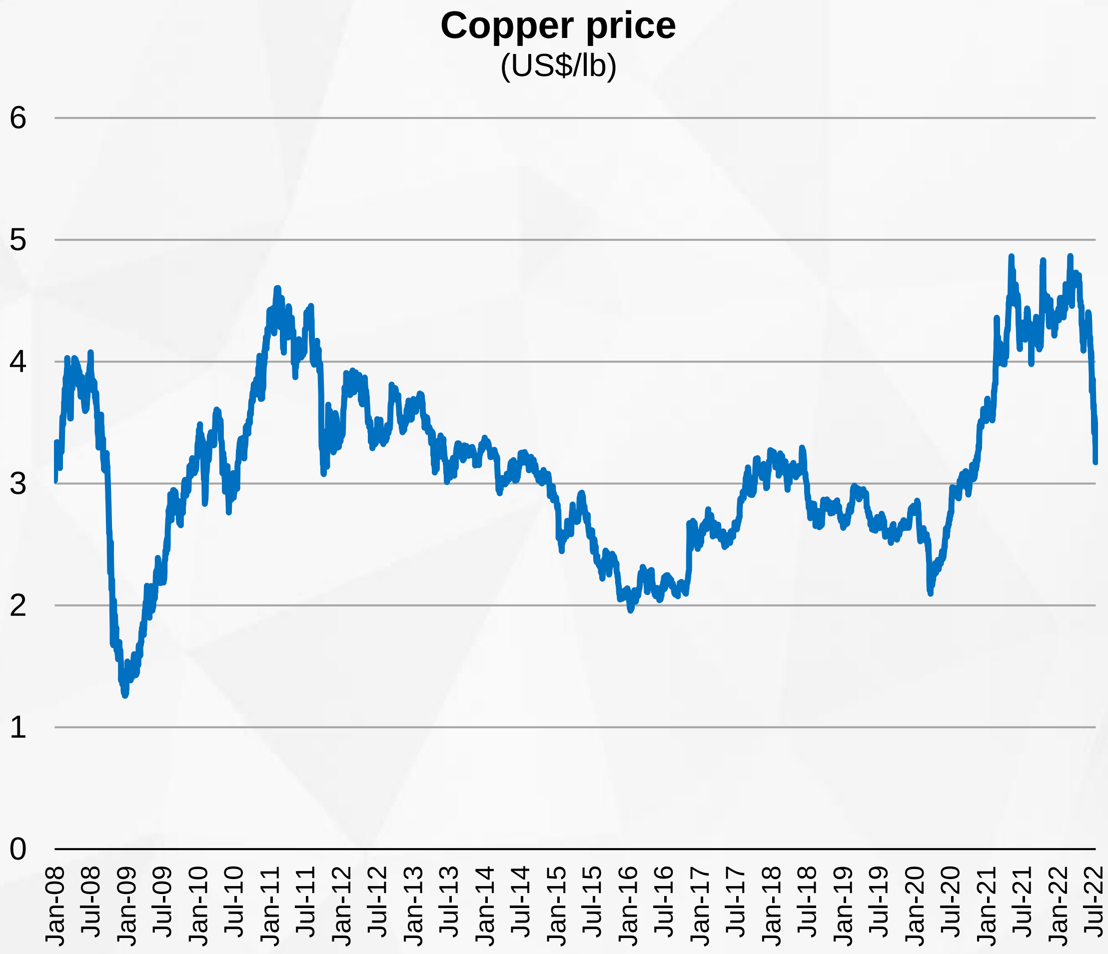
The Russian invasion to Ukraine had a significant impact on commodity prices. Yet fears of a global recession have reversed this trend in the last few weeks





Note: wheat price corresponds to the future to one month. The last point refers to the average prices until July 14th.
Source: Bloomberg.

Economic slowdown fears have had a negative impact on copper prices



Source: Bloomberg.

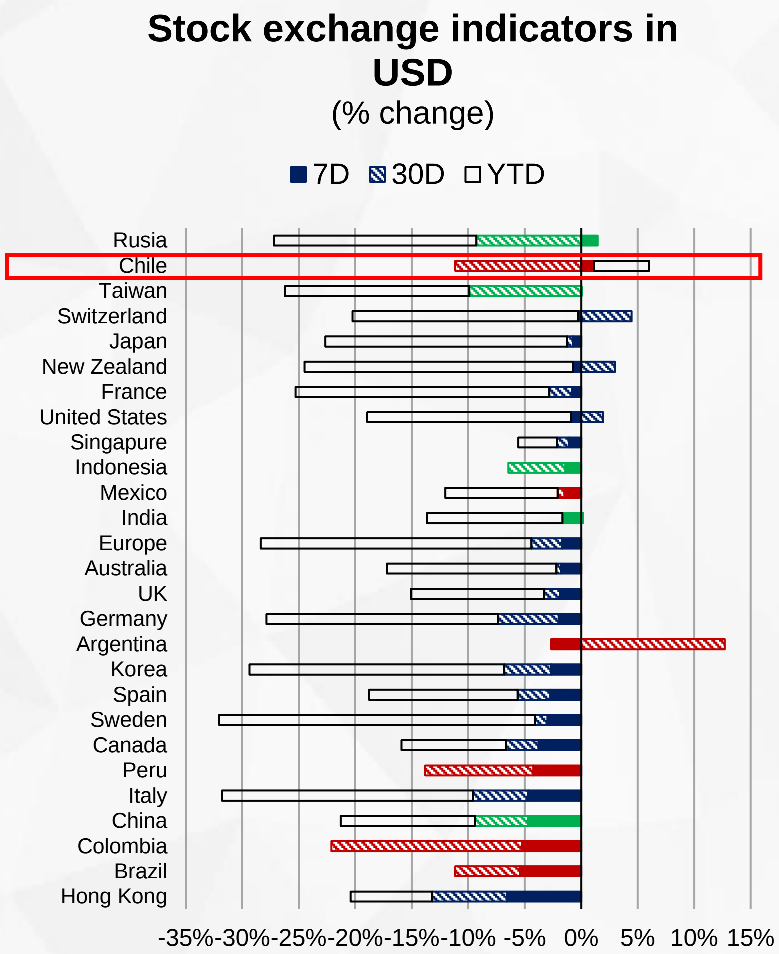
Reasons behind the recent drop in copper price:

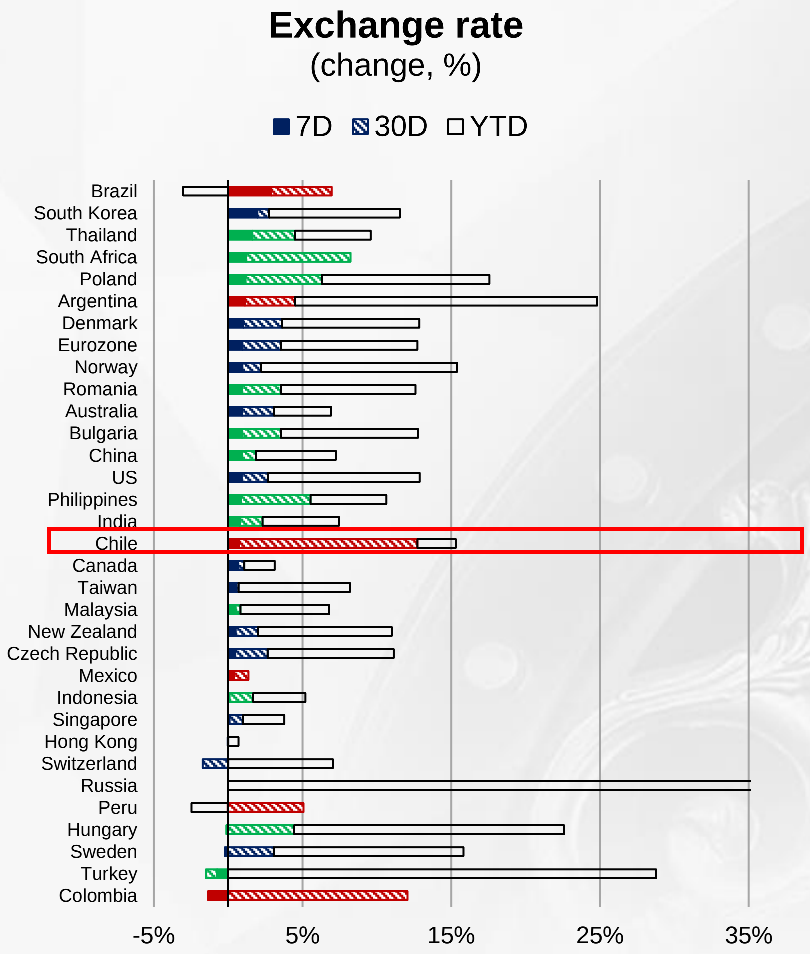
- Future increases in the US interest rate could halt economic growth.
- Covid-19 development in China and Zero-Covid policy deteriorates demand prospects.
- Rapid dollar appreciation.
- Global slowdown in the manufacturing sector.

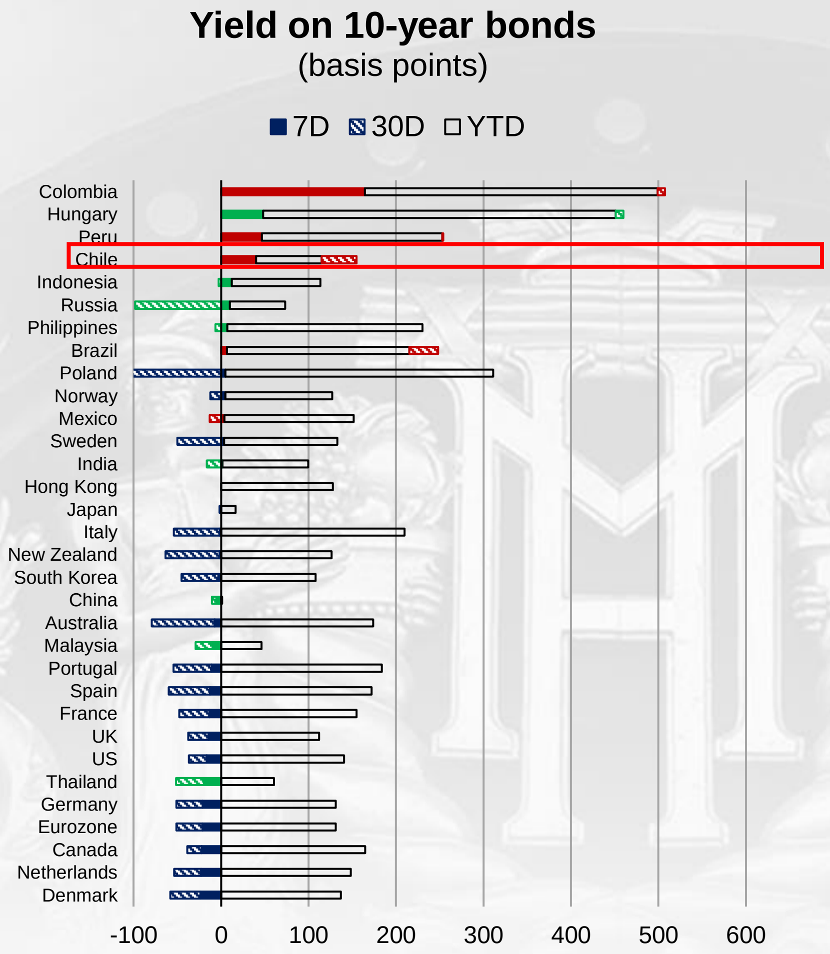
Reasons behind a positive outlook for copper price in the medium term:

- Increased demand as a result of the green energy transition.
- Lower production performance and decrease in inventories.
- Lack of new large mining projects.

In this context, financial conditions have deteriorated sharply

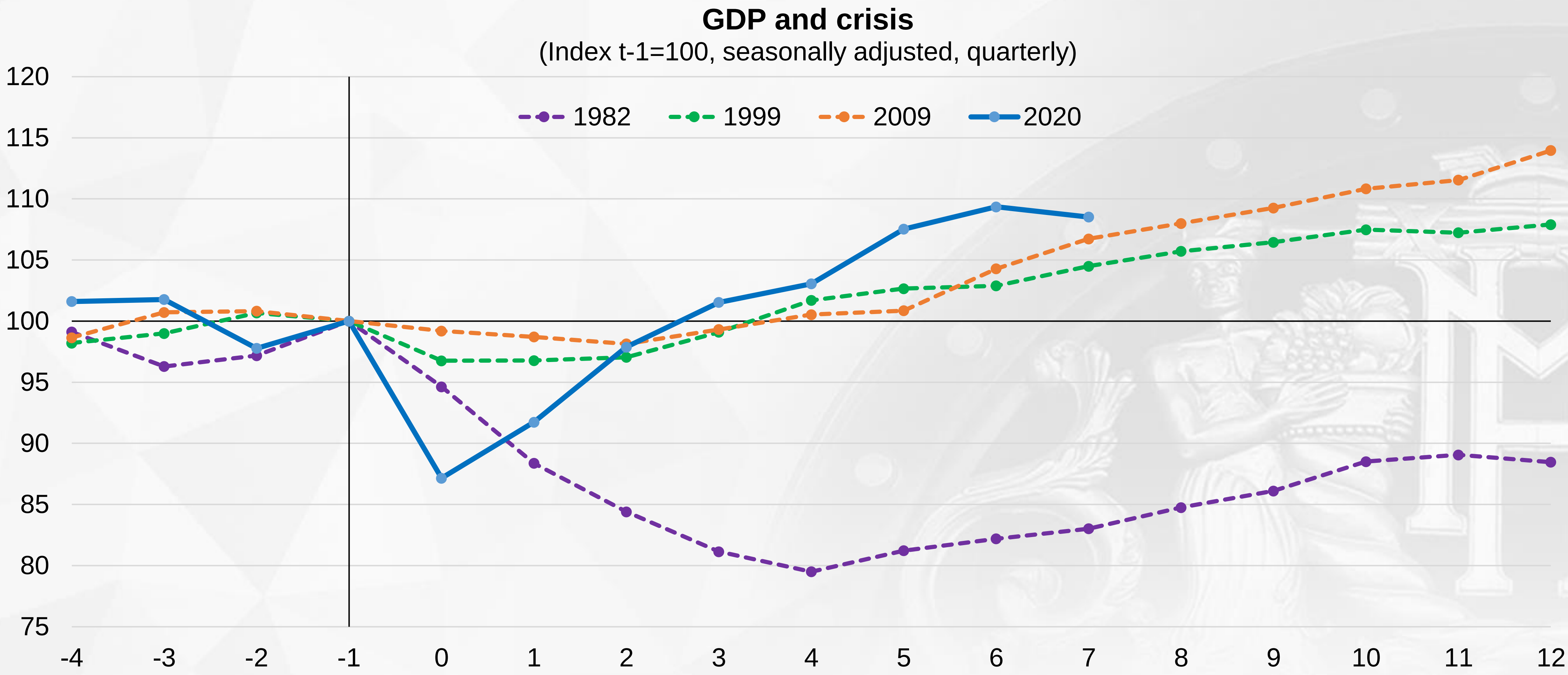






Note: The colors represent: Advanced, Emerging, and LATAM economies. The US exchange rate corresponds to DXY, for this case, an increase (decrease) shows an appreciation (depreciation) of the currency. Data up to July 15th.
Source: Bloomberg.

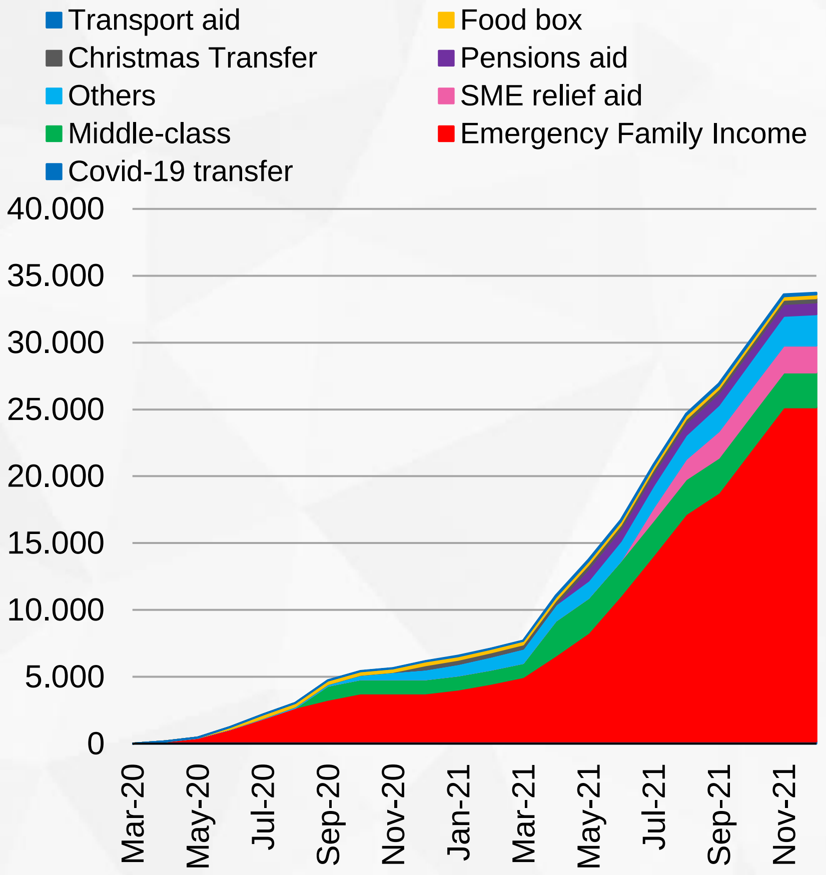
Chile recovered from the Covid-19 crisis faster than in previous episodes



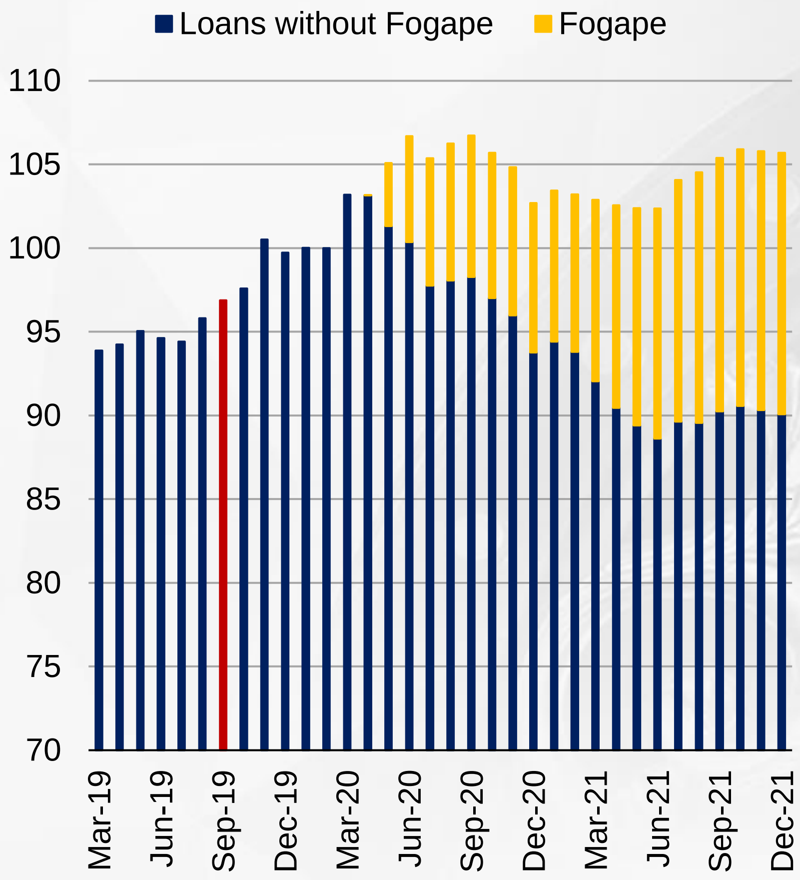
Note: T=0 in periods 1981.Q4, 1998.Q4, 2008.Q4, 2020.Q2 Official seasonally adjusted spliced series for all periods except 1982-83. For that period, the series contained in the volume “Economic and Social Indicators 1960-1988” was seasonally adjusted.
Source: Central Bank of Chile.

Fiscal transfers, accommodative monetary policy, and pension fund withdrawals largely explain a consumption-led recovery

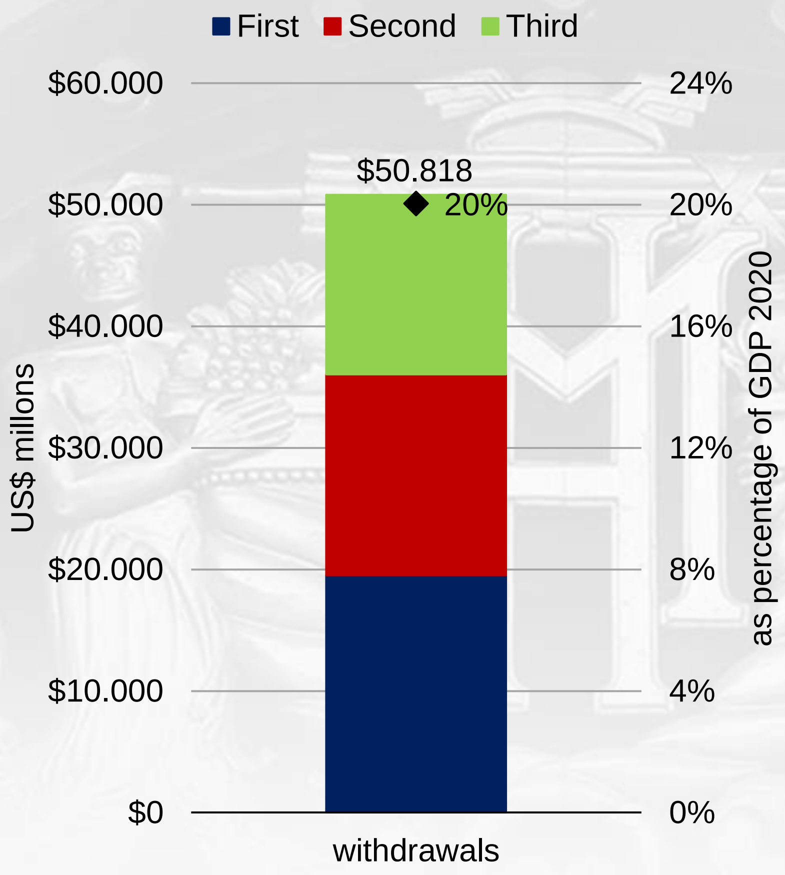
Covid-19 Fiscal Measures
(US $ million)



Real commercial loans balance
(index, Feb-20=100)

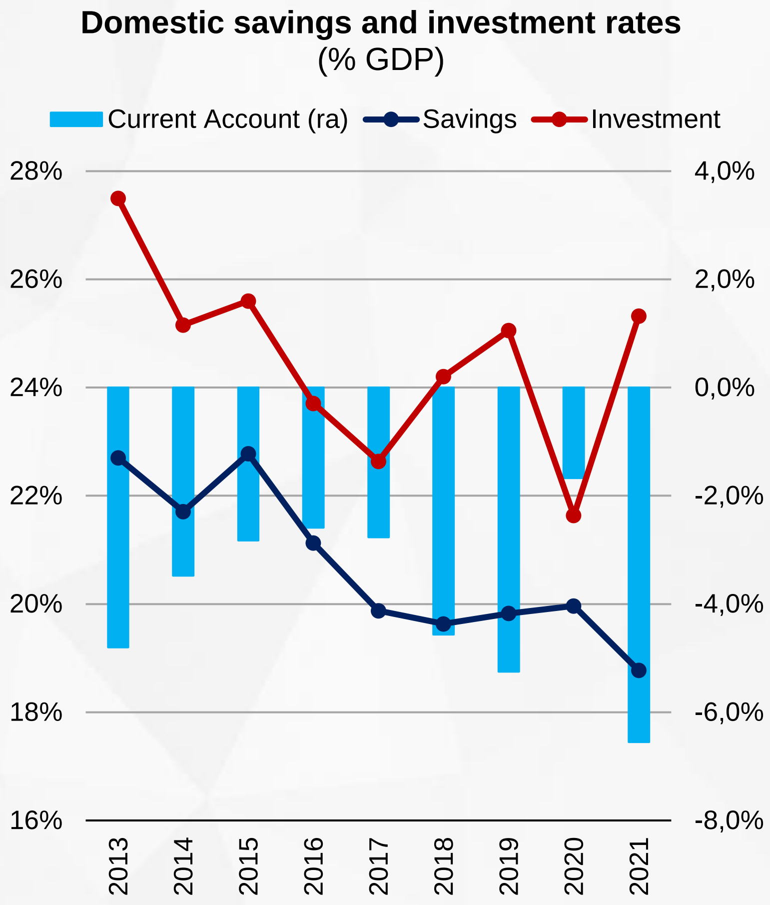


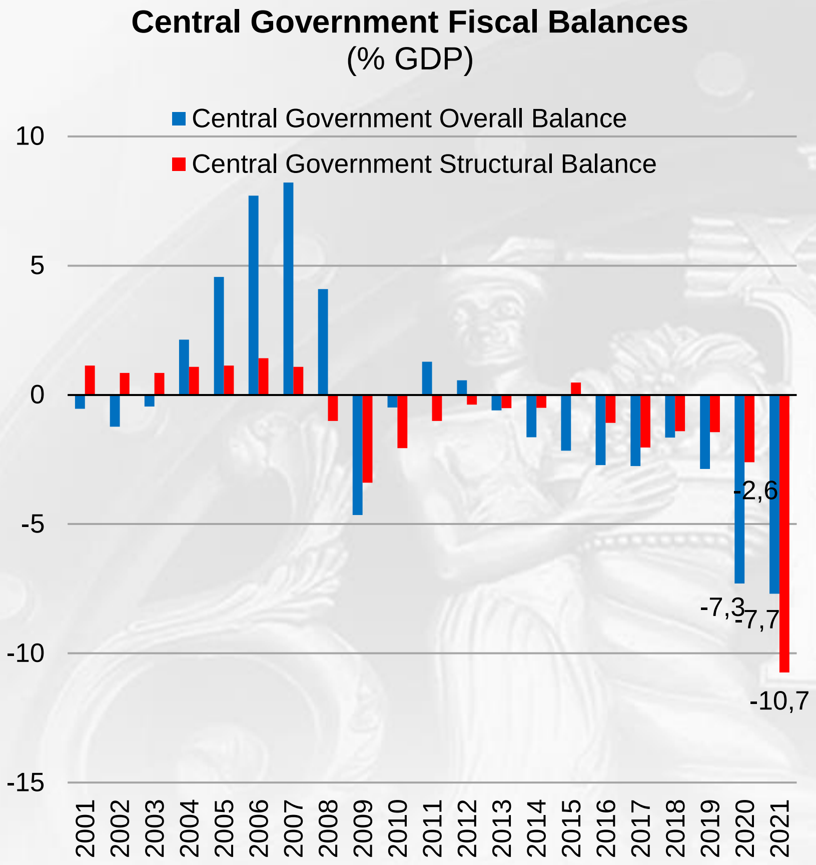
Pension funds withdrawals
(US$ millions and % as GDP 2020)



Note: The amounts are in dollars, considering an exchange rate of 800 pesos per dollar. The amounts were updated as of March 25, 2022, the latest report reported by the Pensions Supervisor.
Source: Central Bank of Chile, Pensions Supervisor, and Ministry of Finance.

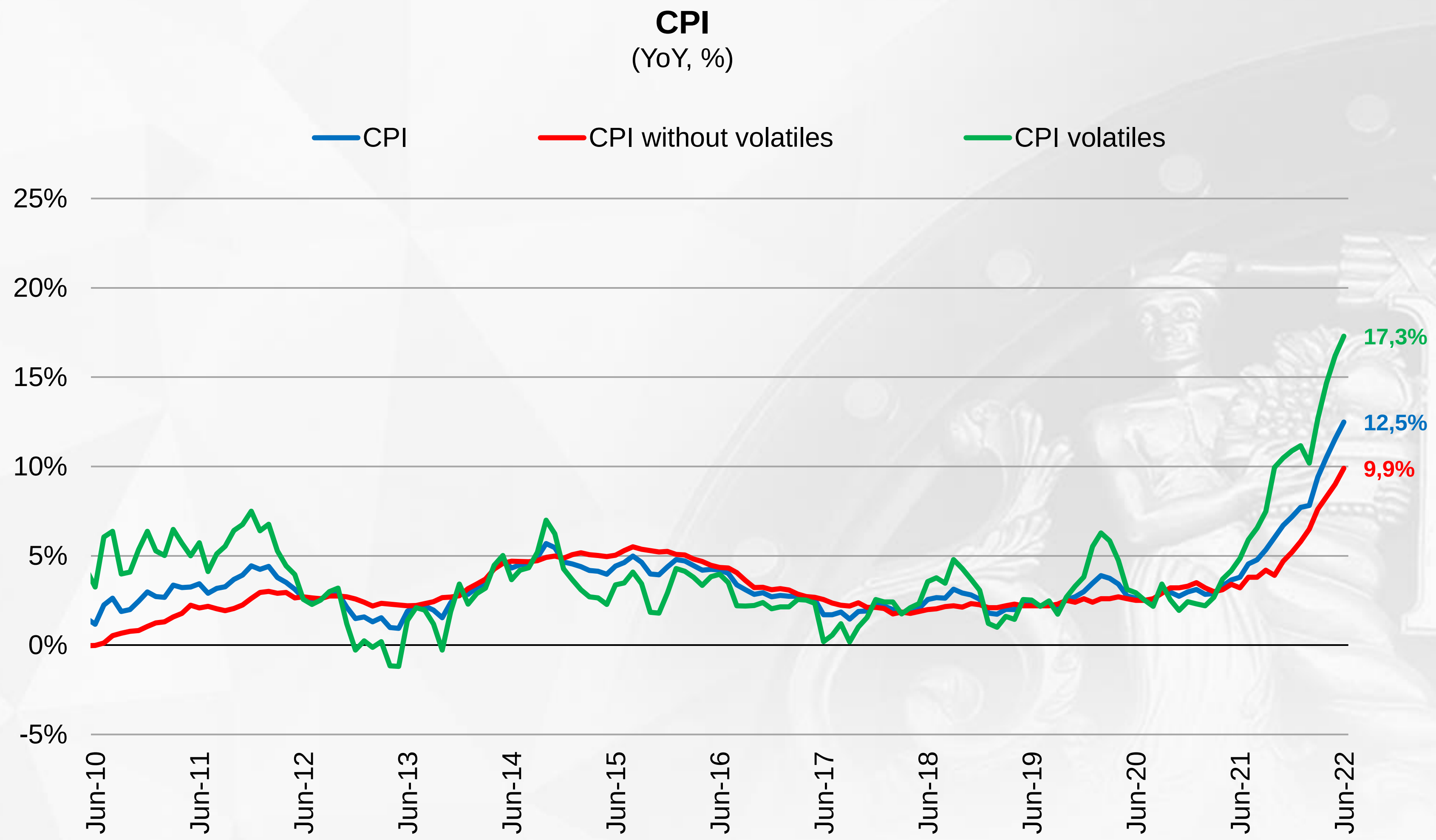
The sharp expansion in private consumption, supported by fiscal transfers, created a classical twin-deficit scenario and heavy demand pressures on inflation





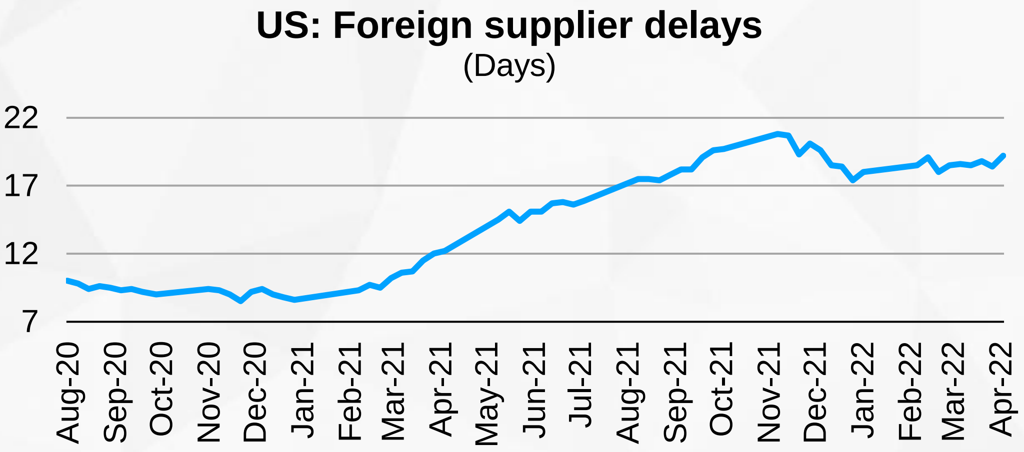
Source: Central Bank of Chile, Budget Office.

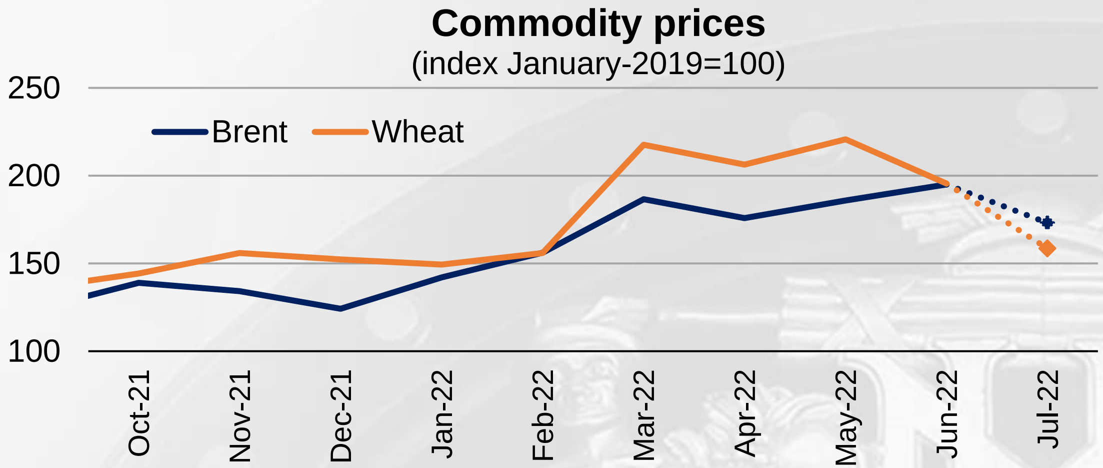
Inflation stands well above the policy target. Currently, inflationary pressures are driven primarily by food and energy prices.

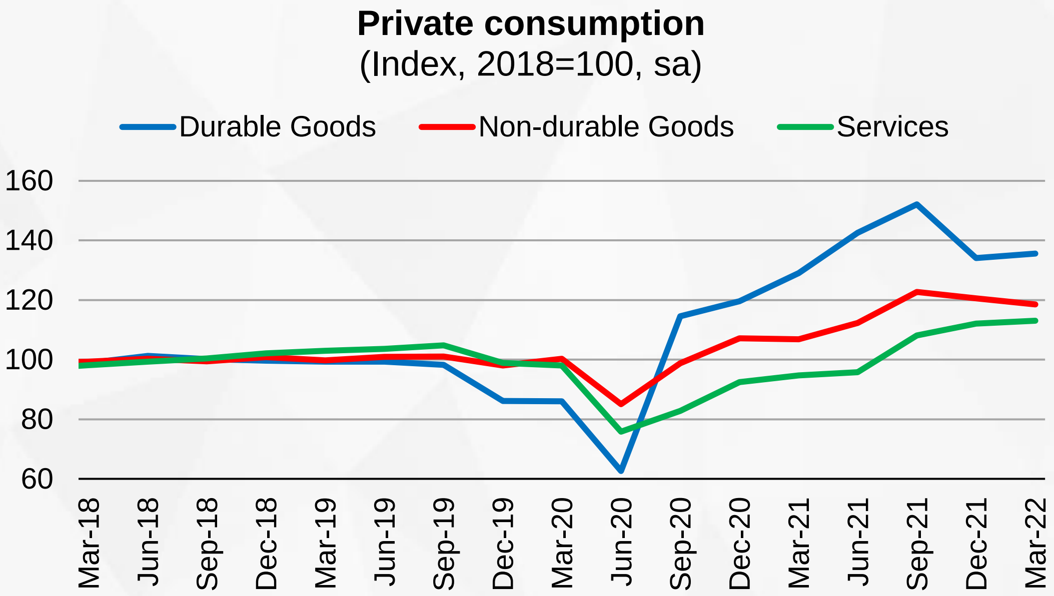


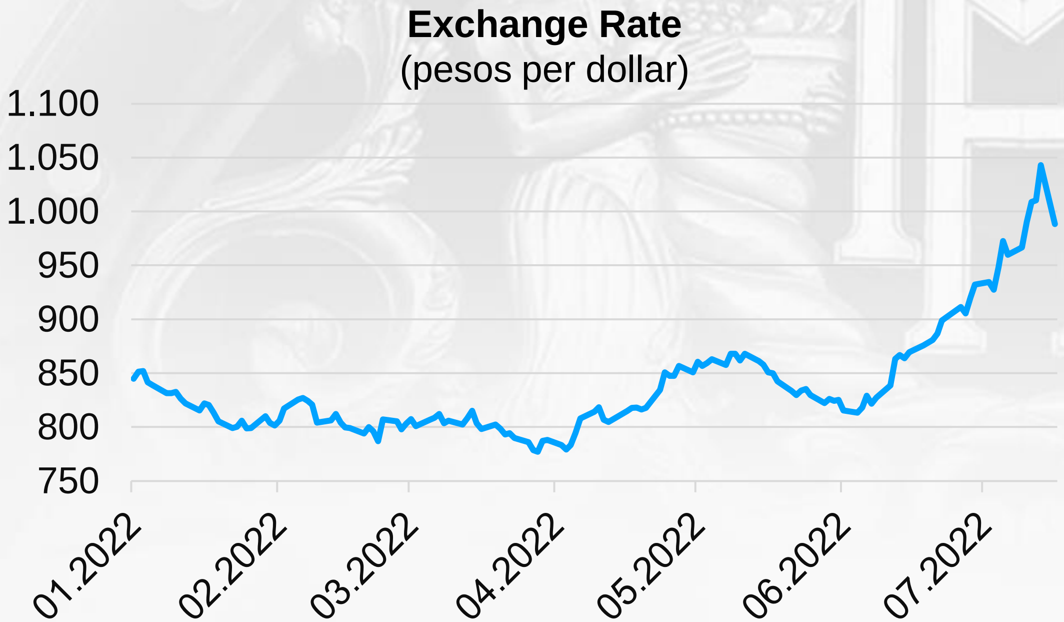
Source: INE and Central Bank of Chile.

Four drivers of Inflation: post-pandemic bottlenecks, high private consumption, increase in commodity prices, and exchange rate depreciation



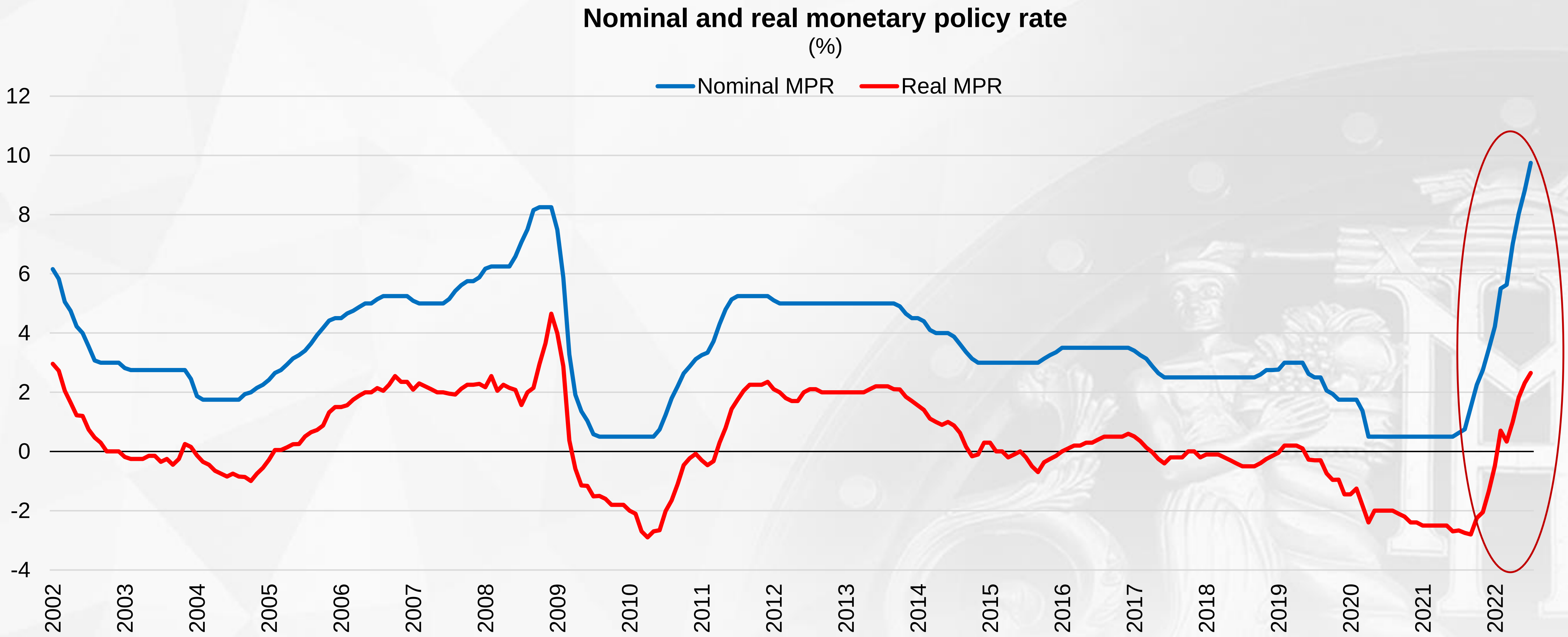






Source: Central Bank of Chile, Bloomberg

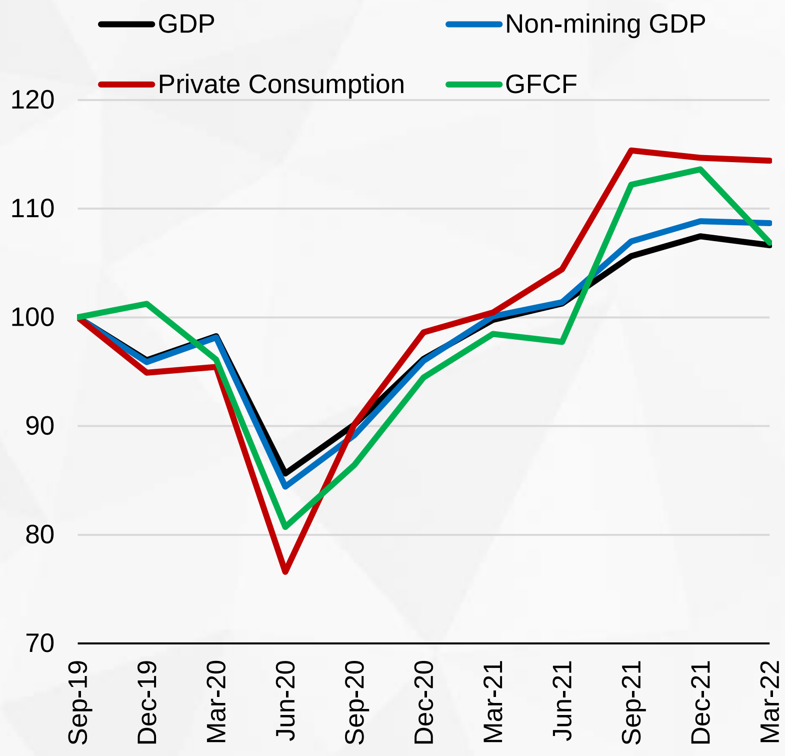
The monetary policy adjustment began in 2021. The Central bank responded on time, rapidly increasing the Monetary Policy Rate (MPR).



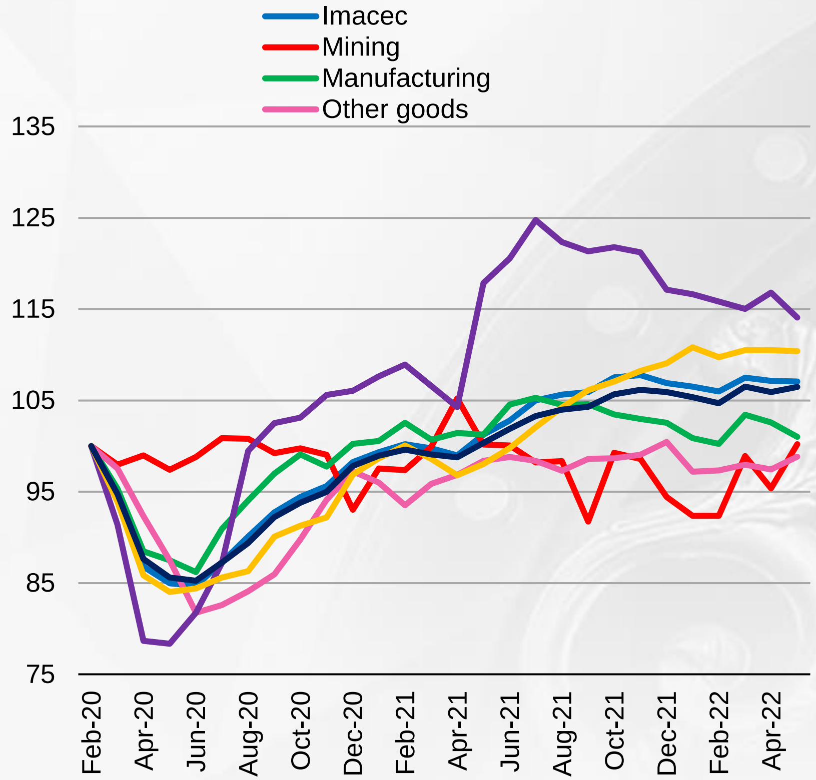
Note: The nominal MPR series shows the average of the month. For July 2022, the nominal MPR is the rate decided in the last Central Bank monetary policy meeting (9.75%). The real MPR measure considers 11-months-ahead inflation expectations from the Economic Expectations Survey (EES).
Source: Central Bank of Chile.

After peaking in 2021.Q3, economic activity has slowed down due to fiscal and monetary stabilization efforts. Commerce leads the downturn, reflecting weakening private consumption. High-frequency data supports this view.

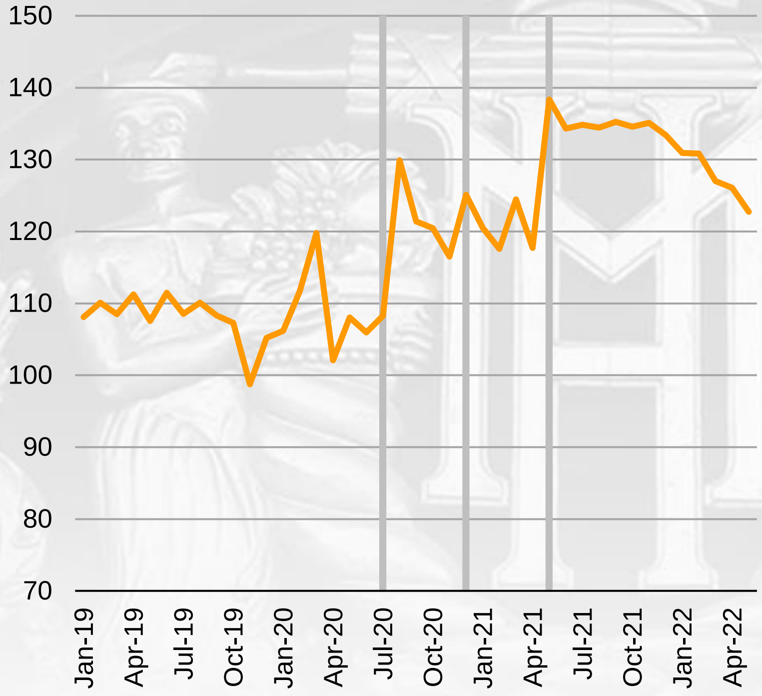
Real GDP components
(Index, 3Q.2019=100)



Imacec by Economic Sector
(index, Feb-20=100 SA)



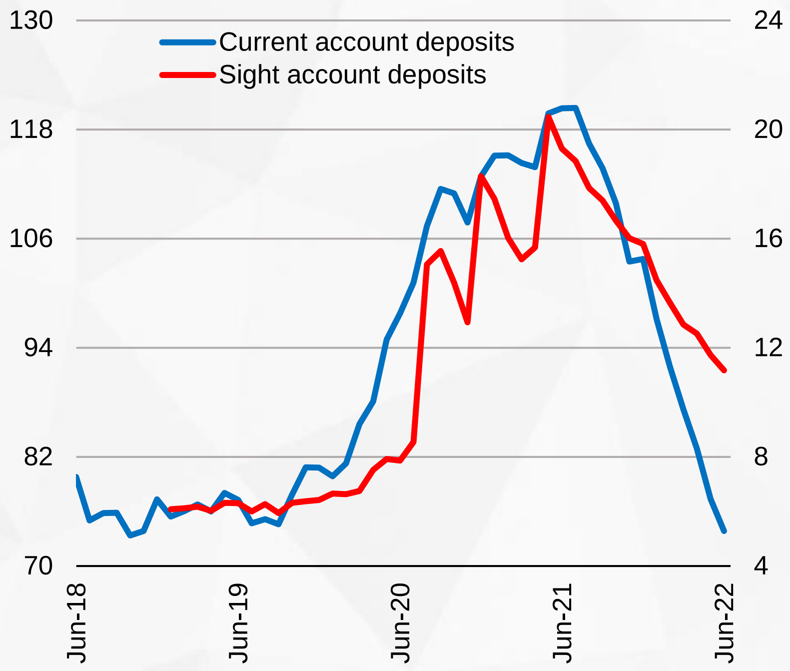
Retail and Supermaket index sales
(Index, 2014=100, SA)



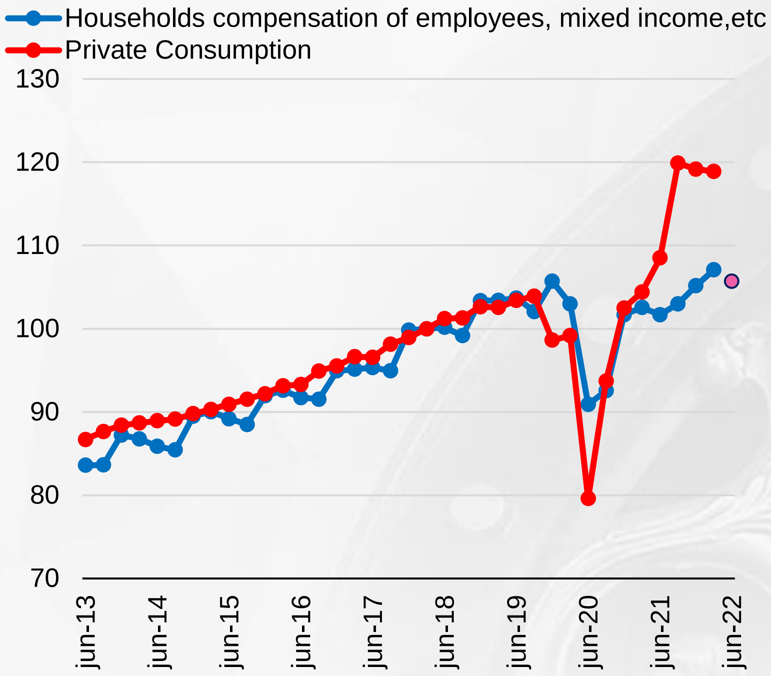
Source: Central Bank of Chile.

Shrinking household liquidity and expectations anticipate further consumption contraction

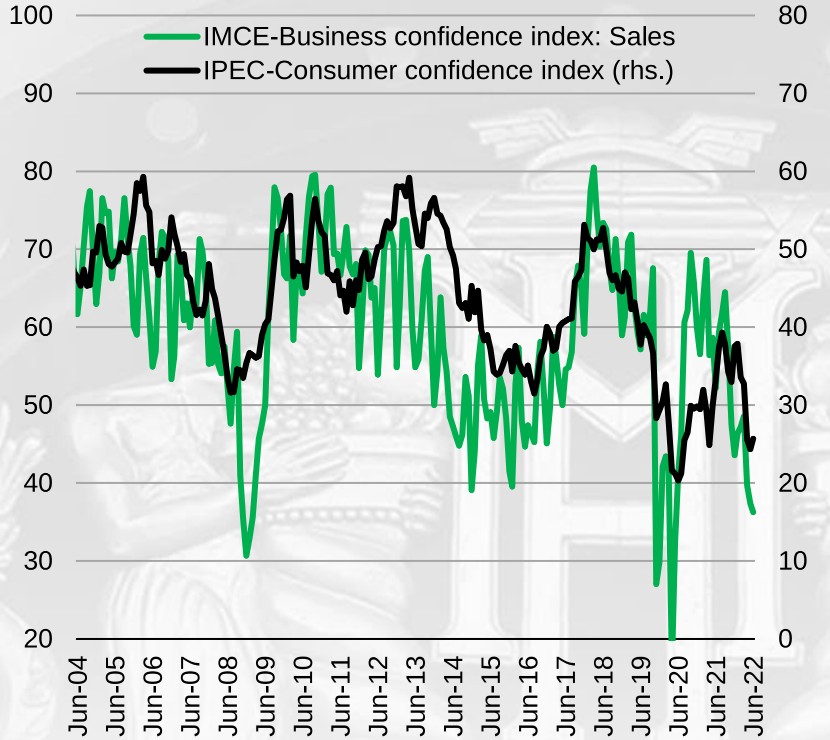
Individuals´ current account and sight accounts deposits (1)
(average balances in UF, millions)



Households income from production and Private Consumption
(index, mar.2018=100)

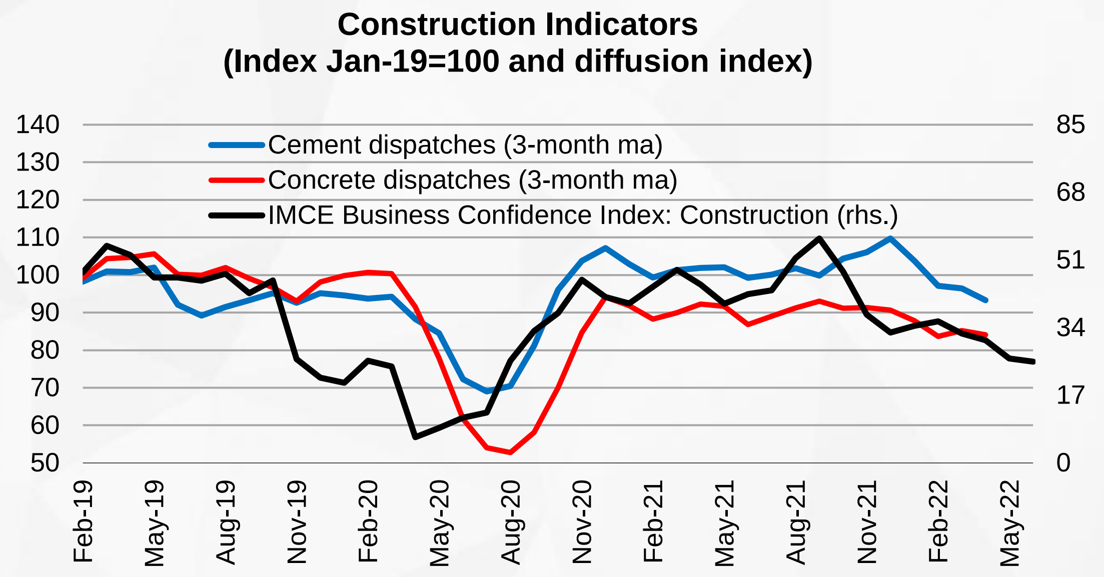


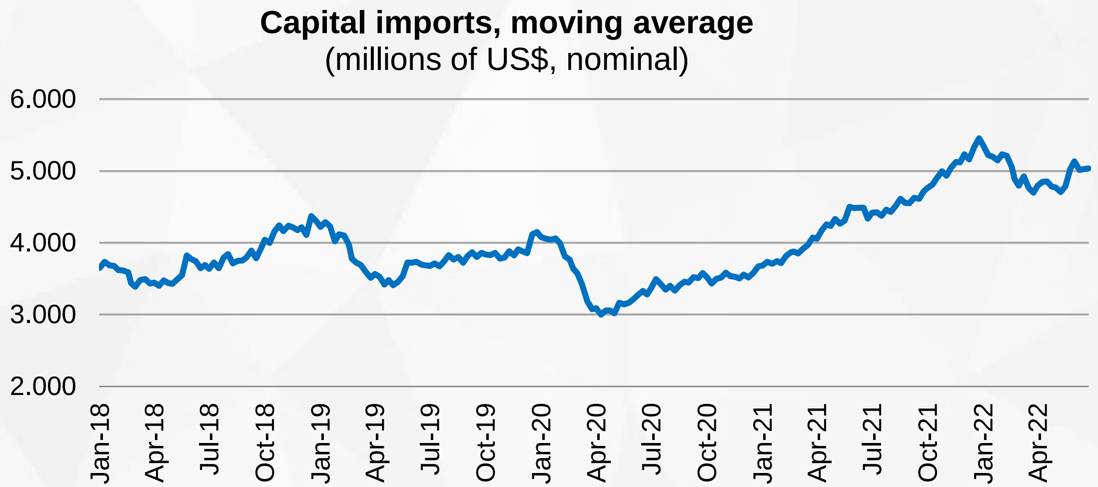
Consumer and Business Confidence
(Diffusion index)

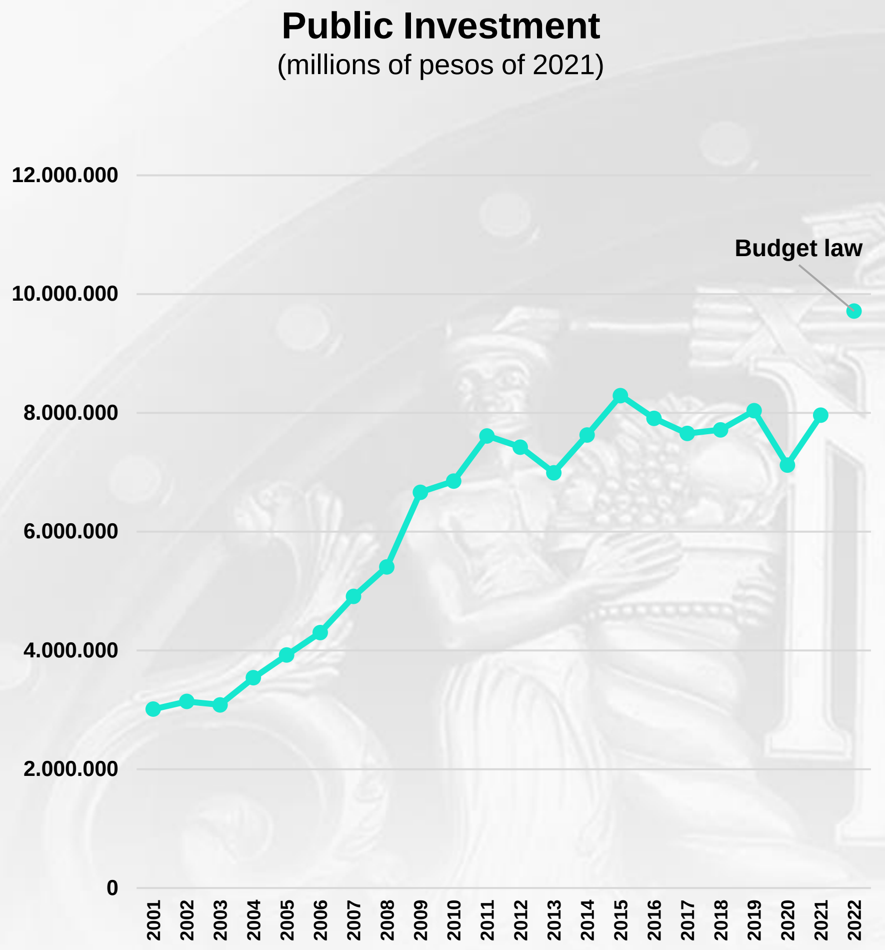


Note: (1) The balances of current account deposits and sight accounts are divided by the number of accounts using information from the Central Bank of Chile and the Financial Market Commission (CMF). The balances for May and June of 2022 are divided by the number of accounts for April 2022. (2) Last dot in Households compensation is a forecast
Source: Central Bank of Chile, Financial Market Commission (CMF), and National Institute of Statistics (INE).

Regarding investment, construction shows a bleak outlook, with a worsening of several leading indicators. Public investment plans will limit contraction in 2022.

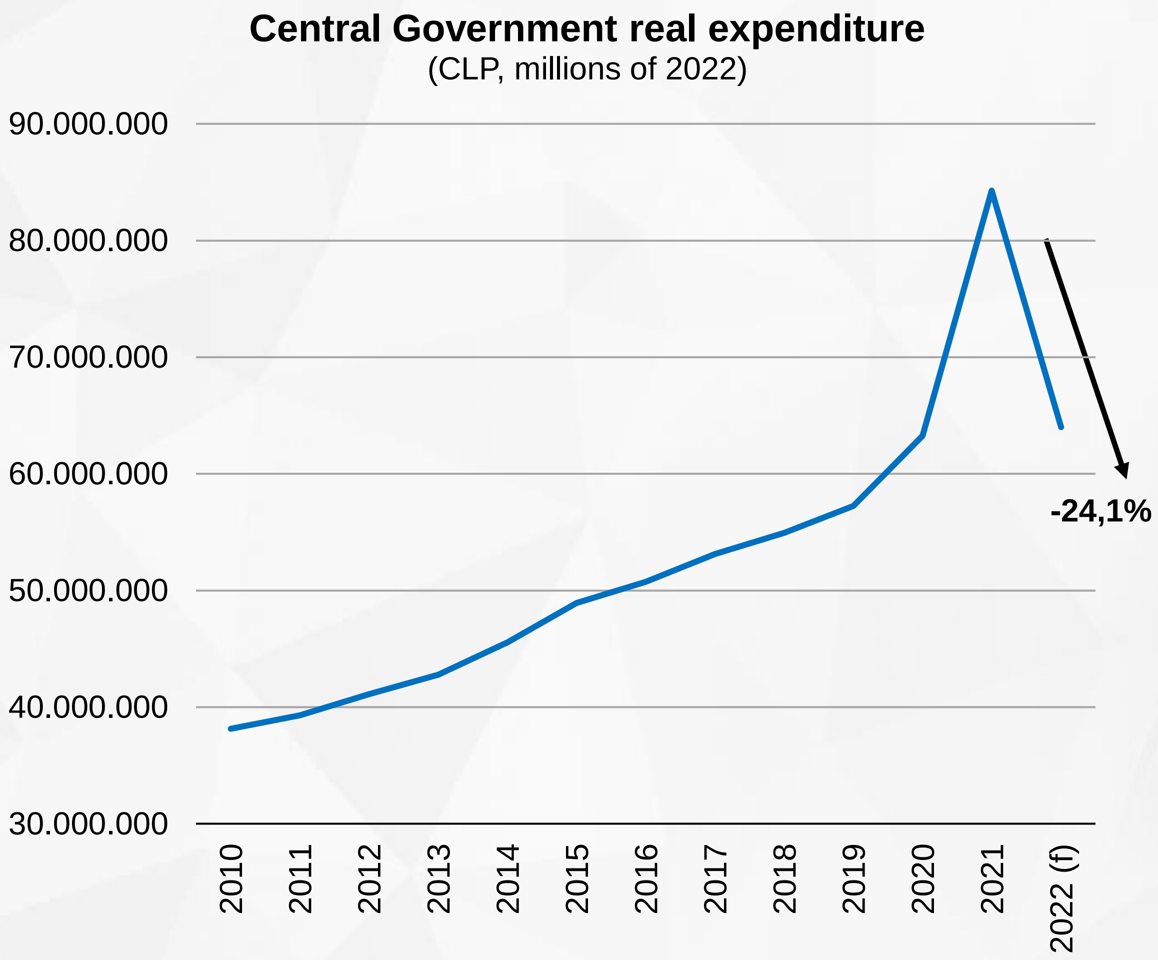


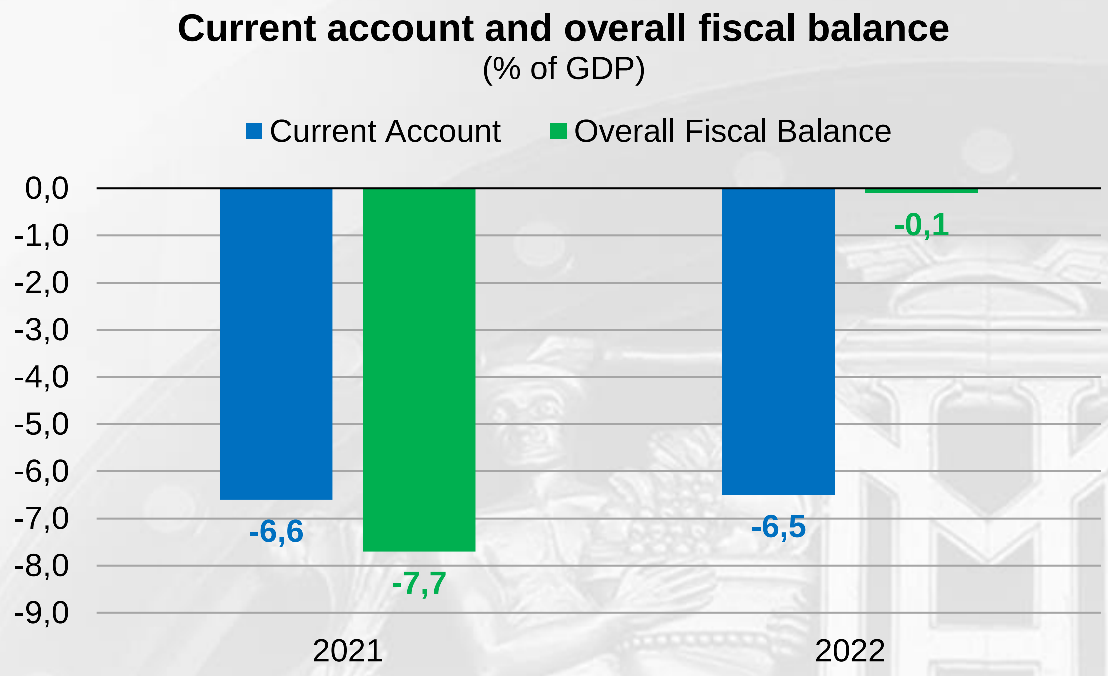




Source: Chilean Chamber of Construction, Central Bank of Chile, Dipres.

Government is undergoing major fiscal consolidation after overexpanding in 2021



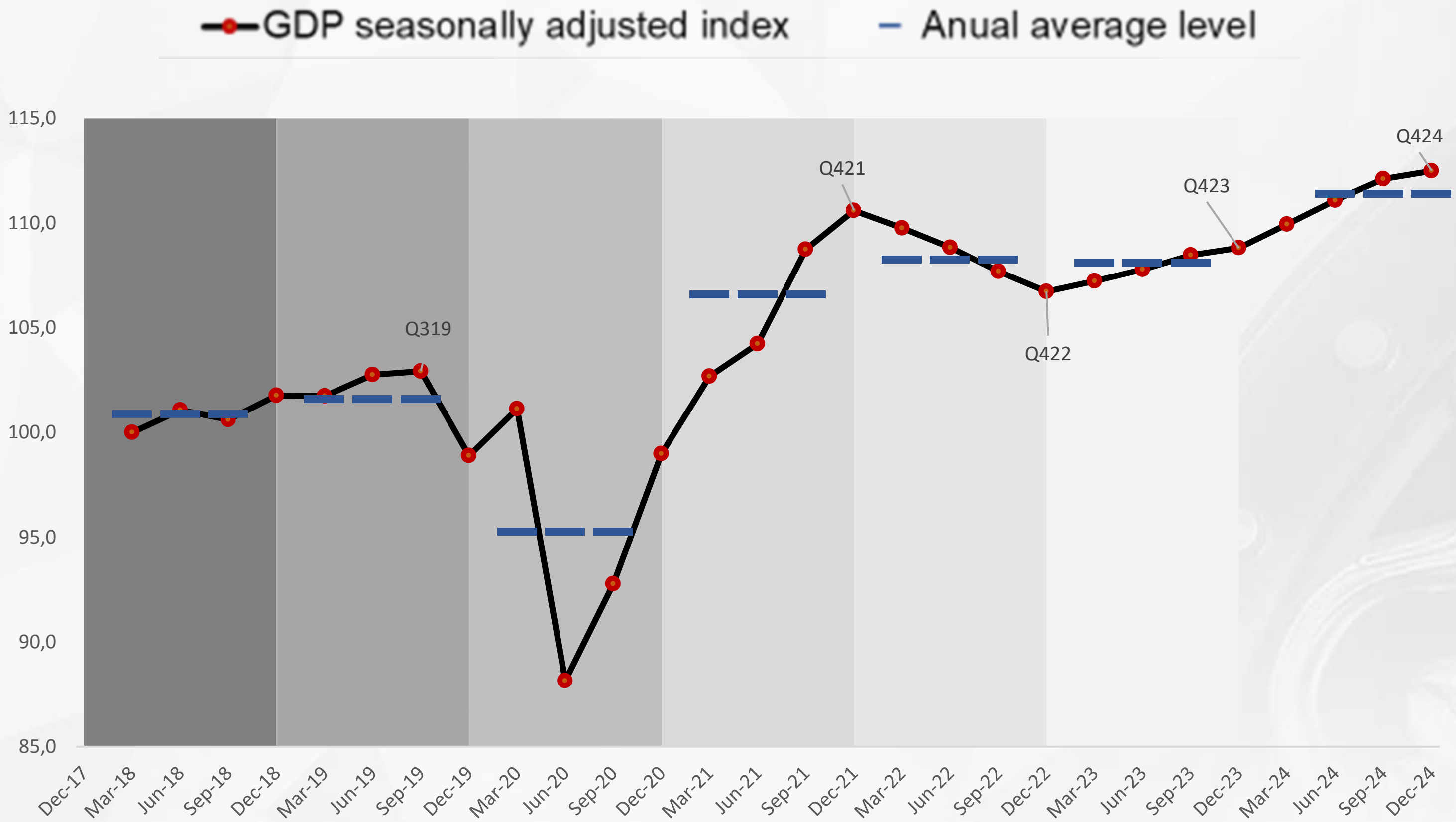


	Euro area	G7	EM Asia	EM Europe	LATAM
IMF Fiscal Fiscal Balance estimates (2022)	-4.3	-4.9	-7.6	-4.8	-4.6

Note: (f): forecasts.
Source: Budget Office (Dipres).

After cooling off in 2022, economic activity will begin to recover across 2023 and 2024

GDP
(Index Q1 2018=100, seasonally adjusted)

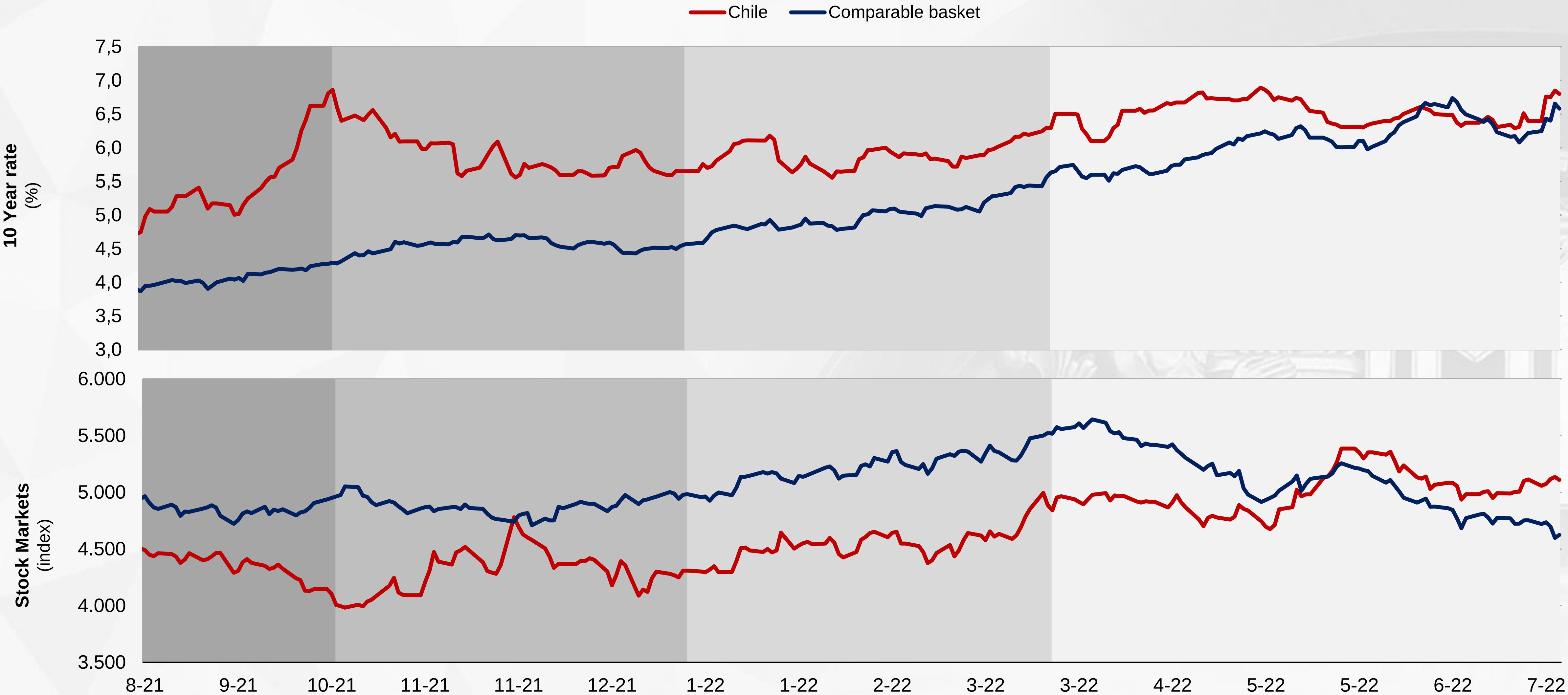


Q2 2022 Public Finance Report forecasts

	2022	2023	2024
GDP (YoY % change)	1.6	-0.1	3.1
Non-mining GDP (YoY % change)	2.3	-1.4	3.0
Domestic demand (YoY % change)	1.3	-4.0	3.2
CPI (YoY % change, average)	11.1	5.4	3.0
Exchange rate ($/US$, average, nominal)	854	836	810
Copper price (USc$/lb, average, BML)	419	392	387
Oil price, WTI (US$/bbl)	102	87	75

Source: Central Bank of Chile and Ministry of Finance.

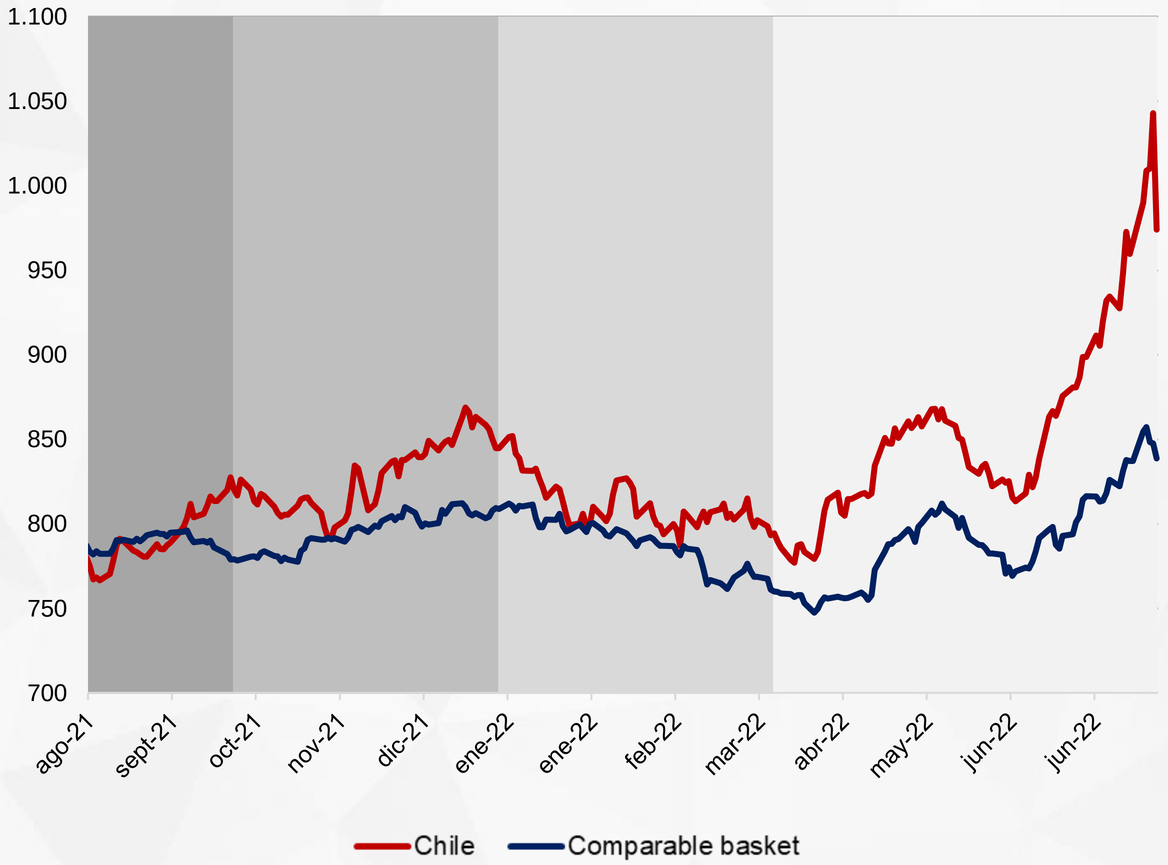
The stock market and interest rates seem less affected by the global risk aversion mood



Note: The basket of comparable economies considers Latin American and commodity exporters countries (Brazil, Colombia, Mexico, New Zealand, and Peru). Weights are the coefficients of a cointegrating relationship with Chile's variables. Data up to July 15th. **Source:** Bloomberg, Central Bank of Chile, and Ministry of Finance.

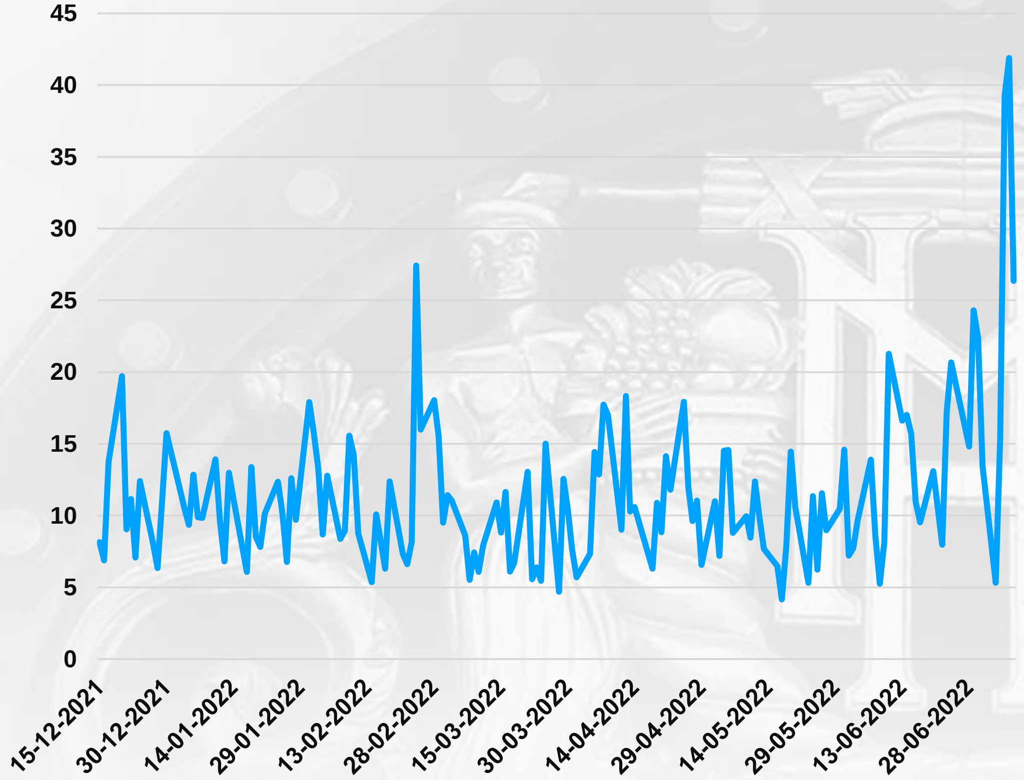
However, the exchange rate depreciated more than its peers and showed high volatility

Exchange rate
(pesos per dollar)



Note: The basket of comparable economies considers Latin American and commodity exporters countries (Brazil, Colombia, Mexico, New Zealand, and Peru). Weights are the coefficients of a cointegrating relationship with Chile's variables. Data up to July 15th. **Source:** Bloomberg, Central Bank of Chile, and Ministry of Finance.

Daily volatility of the exchange rate
(Chilean pesos)



Note: Calculated as the difference between the maximum and minimum daily rate.
Source: Bloomberg

The Central Bank announced an exchange rate intervention program up to US$25bn

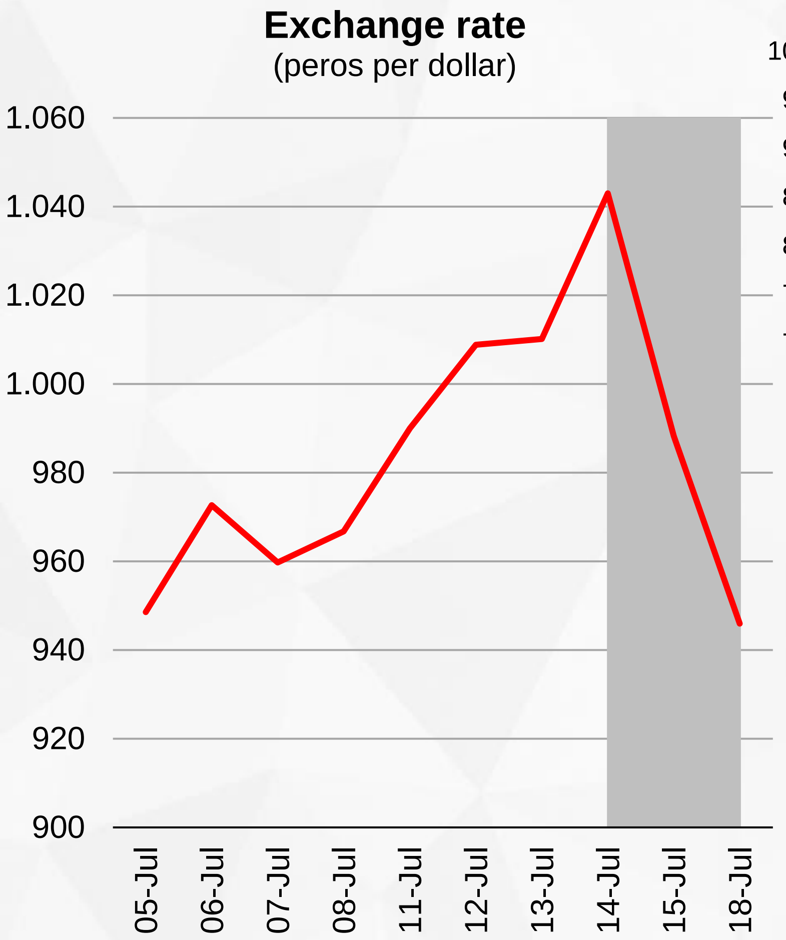
The exchange rate intervention program started Monday July 18 and will end on September 30, 2022.

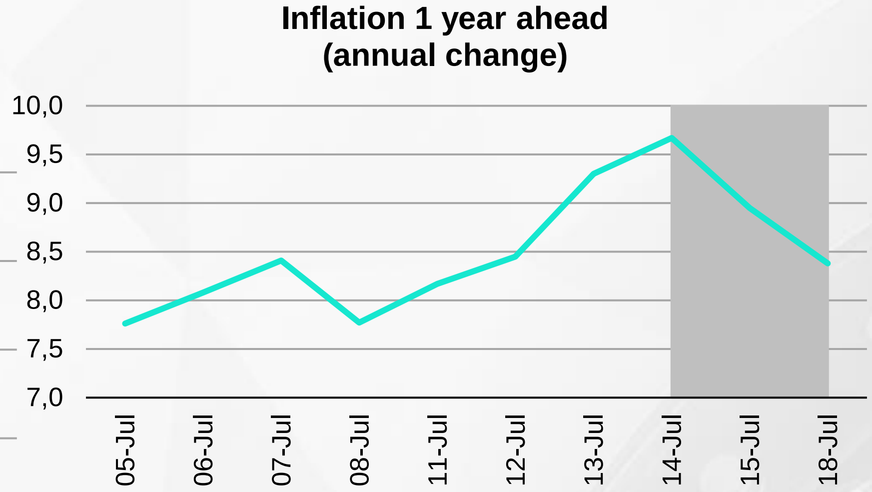
It considers:

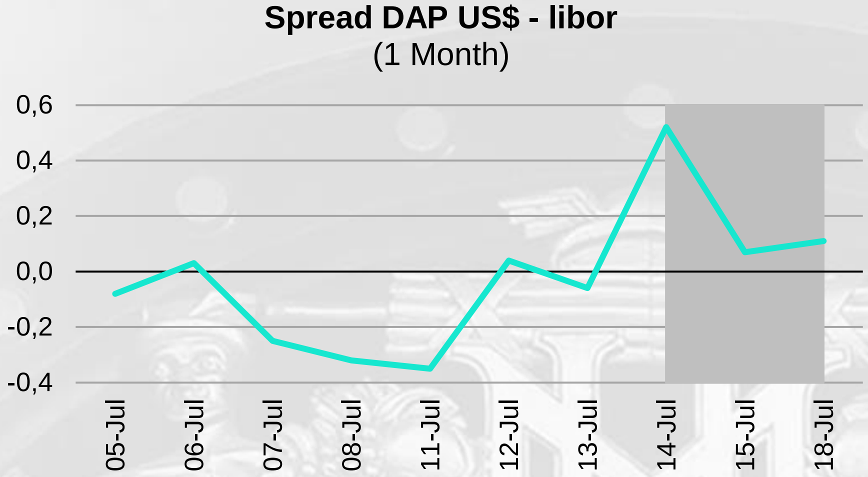
1. Spot sales of USD up to US$10bn (via auctions)
2. Sales of hedge instruments (USD non-deliverable forwards) for up to US$10bn

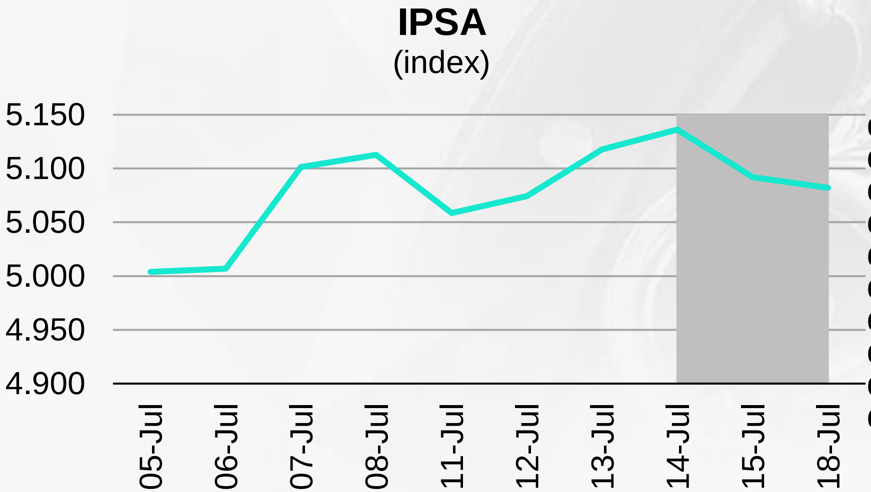
In addition, regarding liquidity in USD, even though the monetary market is USD is working in a proper way, a preventive program for up to US$5bn in currency swaps will begin. This program will be complemented with a liquidity program in CLP through REPO operations.

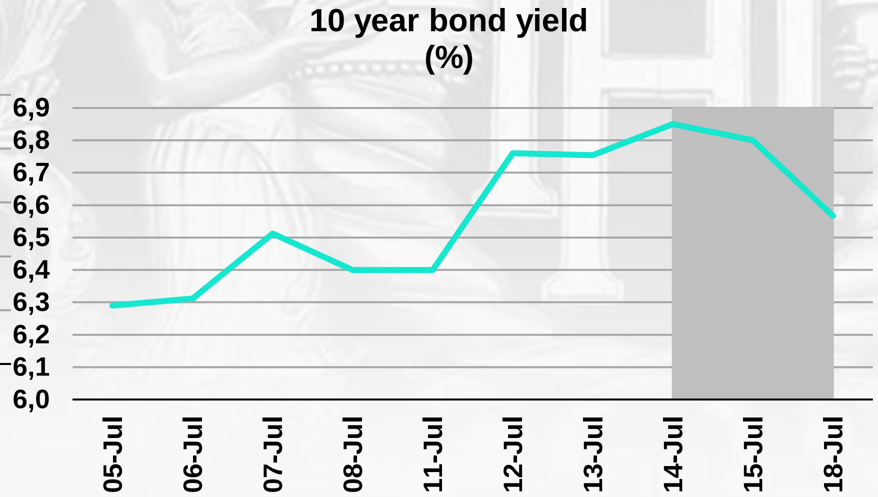
The exchange rate dropped significantly after the Central Bank announcement











Note: The gray area represents the day of the announcement of the intervention of the Central Bank of Chile.
Source: Central Bank of Chile and Bloomberg:

The currency risk exposure of the Chilean economy is low

Banks

- Banks maintain an active management of their foreign exchange position, generally staying hedge, which mitigates currency risks

Insurance companies

- Insurers have sources of liquidity (via debt or sale/collateralization of liquid assets) to meet the additional demands generated by potential increases in the exchange rate.

Corporate

- The level of corporate exchange mismatch has remained negative —net asset position in dollars.
- Higher external bond issuance comes from companies whose functional currency is the dollar

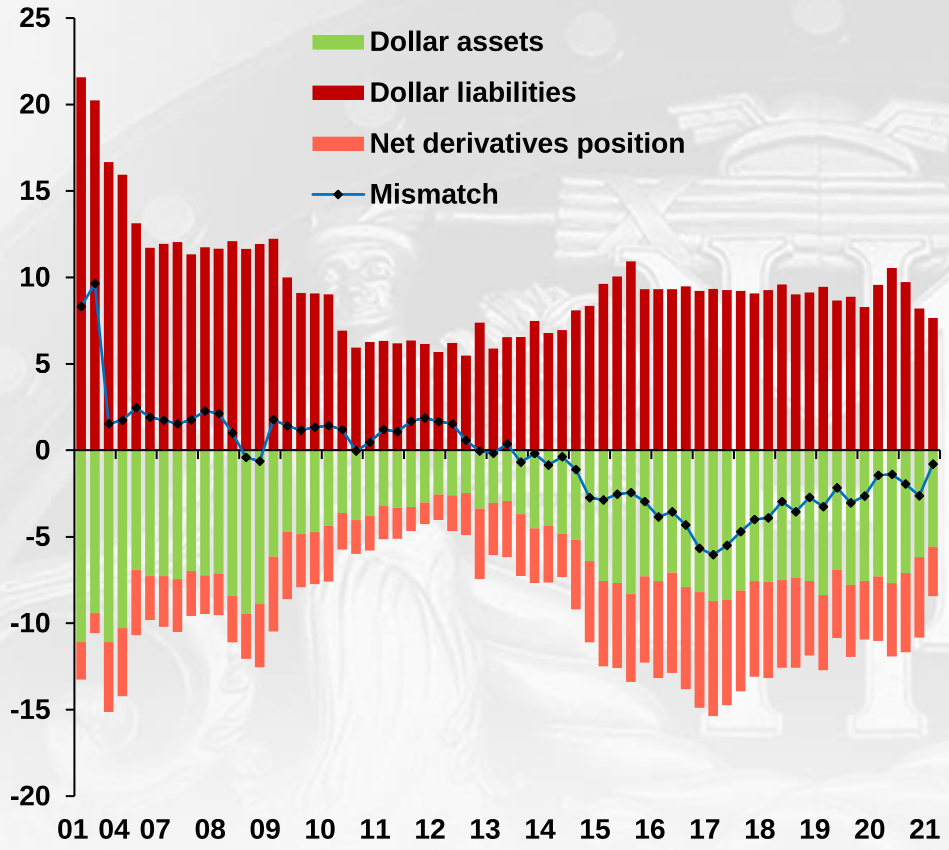
Households

- Households do not hold USD liabilities

Government

- Government is regularly in FX surplus due to the importance of copper revenues

CORPORATE CURRENCY MISMATCH (*)
(percent of total assets, pesos)



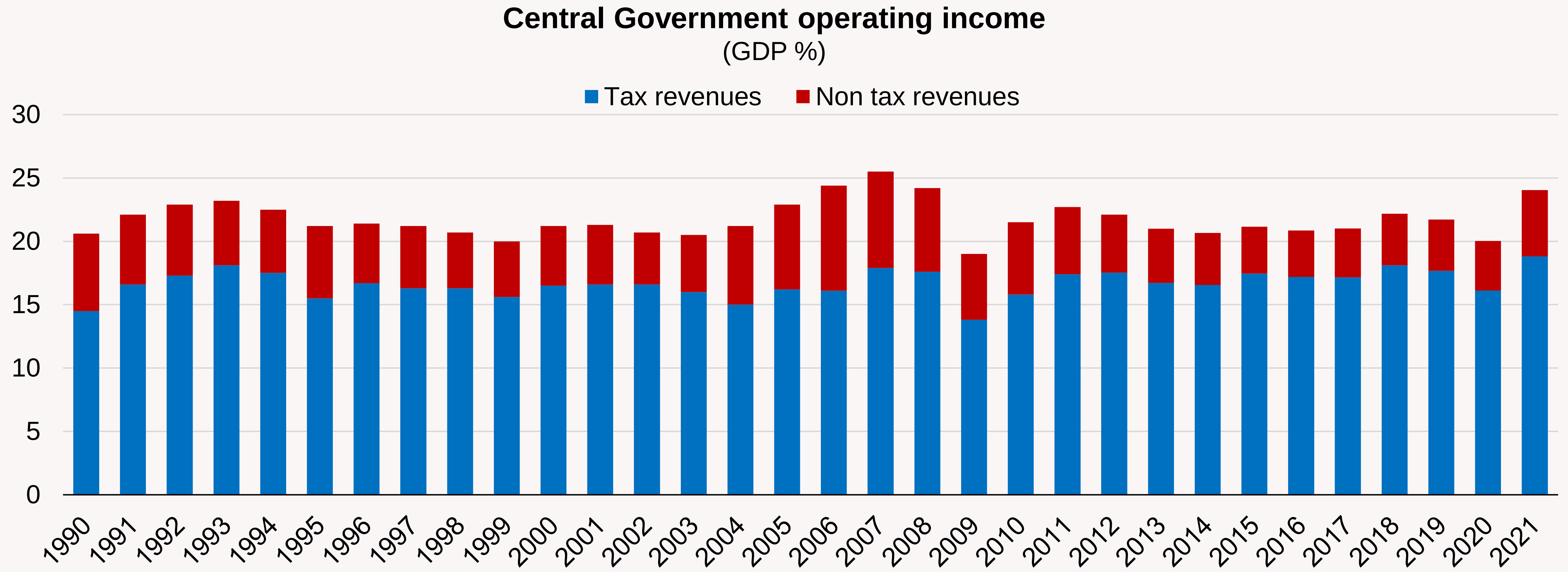
Mismatch refers to dollar liabilities minus dollar assets, minus net derivatives position, as percent of total assets.

Source: Central Bank of Chile and CMF

Tax Reform:
A New Fiscal Pact

Reforma
Tributaria
Justicia y futuro

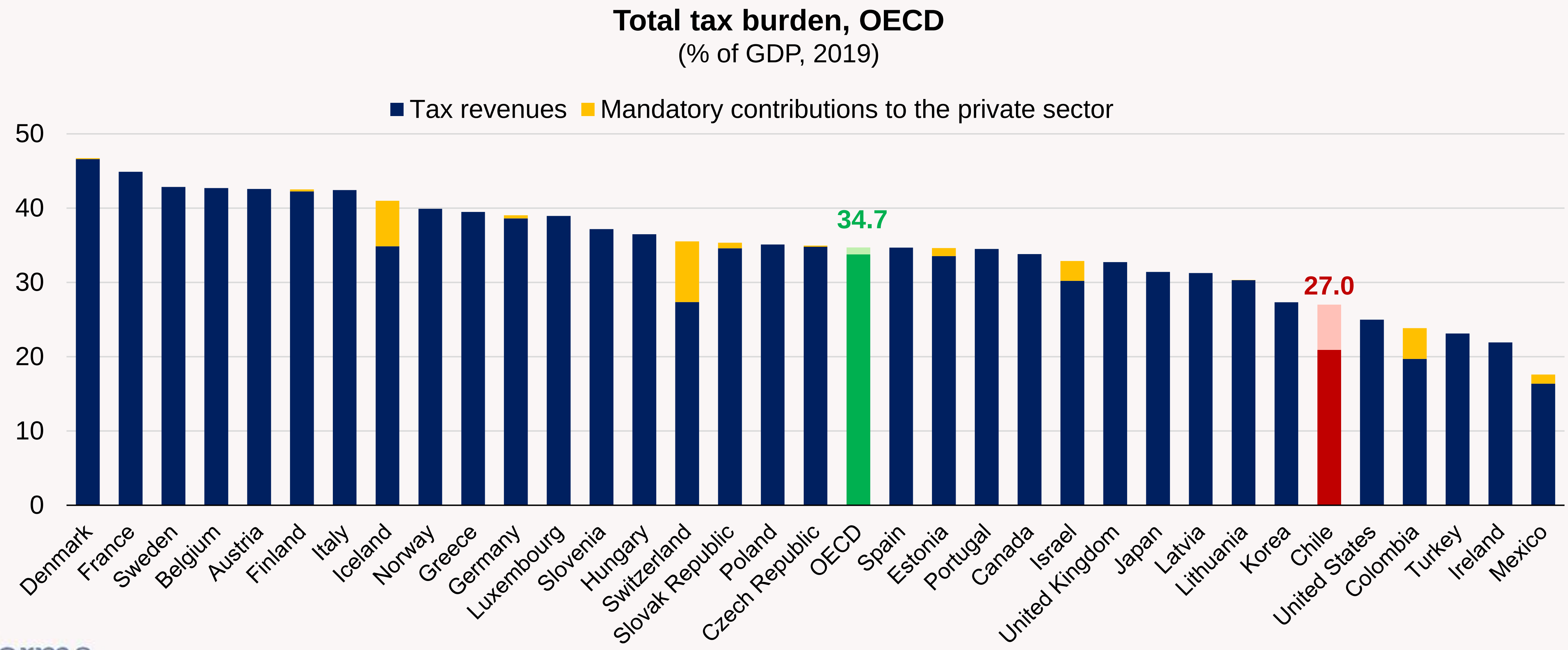
Tax burden in Chile is comparatively low and has changed very little over the last 30 years



Reforma Tributaria
Justicia y futuro

Source: Budget Office (Dipres).

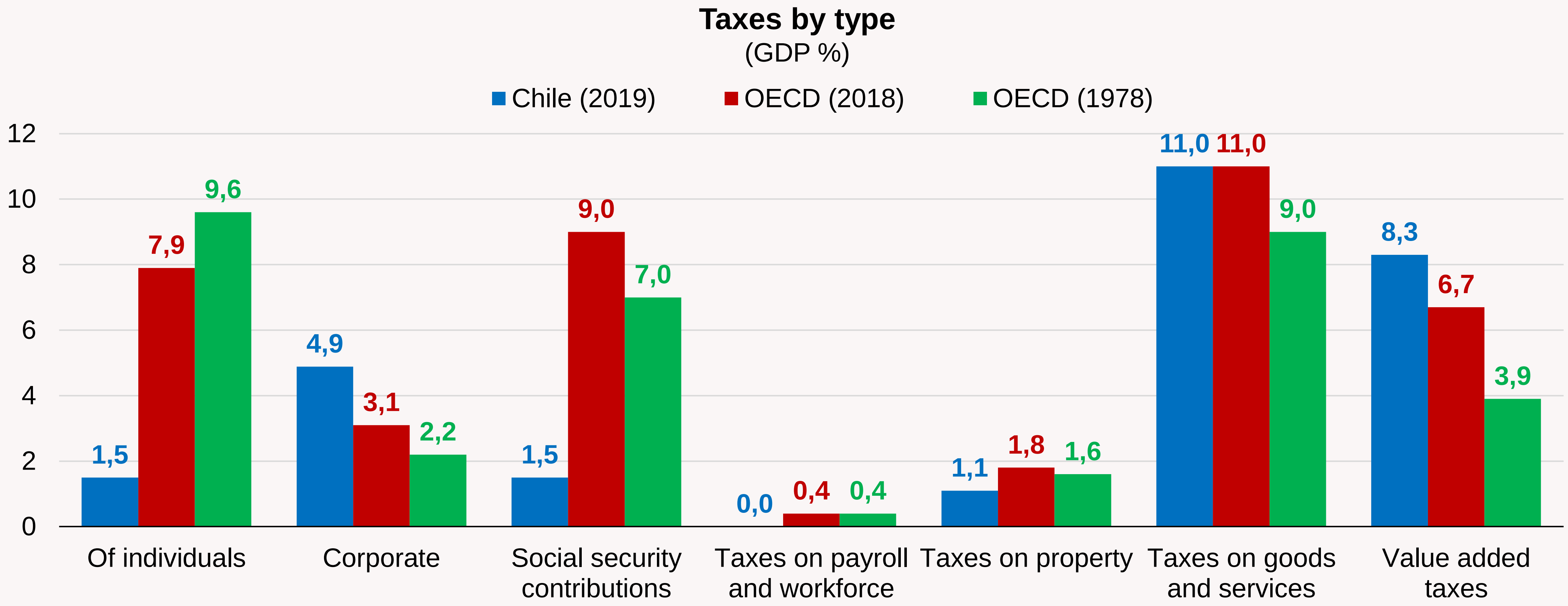
The normalized gap with OECD countries is almost 8 points of GDP



Reforma Tributaria
Justicia y futuro

Source: OECD.

Chile´s tax structure is atypical in comparison with OECD countries. There are large gaps on personal income taxes, property tax, and social security contributions.



Reforma Tributaria
Justicia y futuro

Source: OECD (2022), OECD Tax Policy Reviews: Chile 2022.

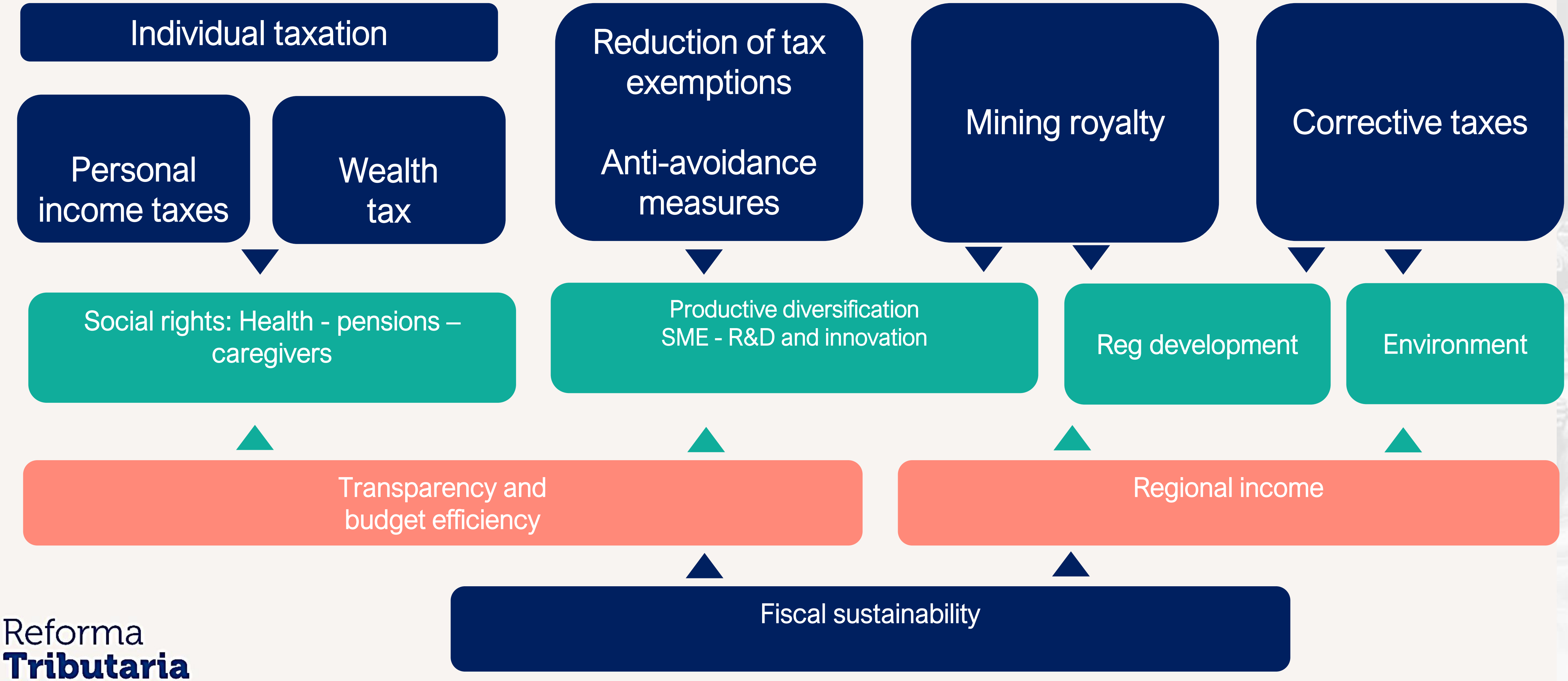
A new fiscal pact: Tax Reform objectives

Tax revenue	• Increase tax-to-GDP ratio by 4.1 percentage points
Fair Distribution	• Raise the progressivity of the tax system • Reducing tax loopholes and opportunities for aggressive tax planning
Tax revenue legitimacy	• Good use of resources • Transparency in the use of resources
Tax Modernization	• Incorporate global trends in taxation • Taking into account the globalization of taxpayers • Financial development
Efficiency	• Simplify and reduce compliance costs • Reduce incentives for aggressive tax planning with avoidance purpose

Reforma Tributaria
Justicia y futuro

Source: Ministry of Finance.

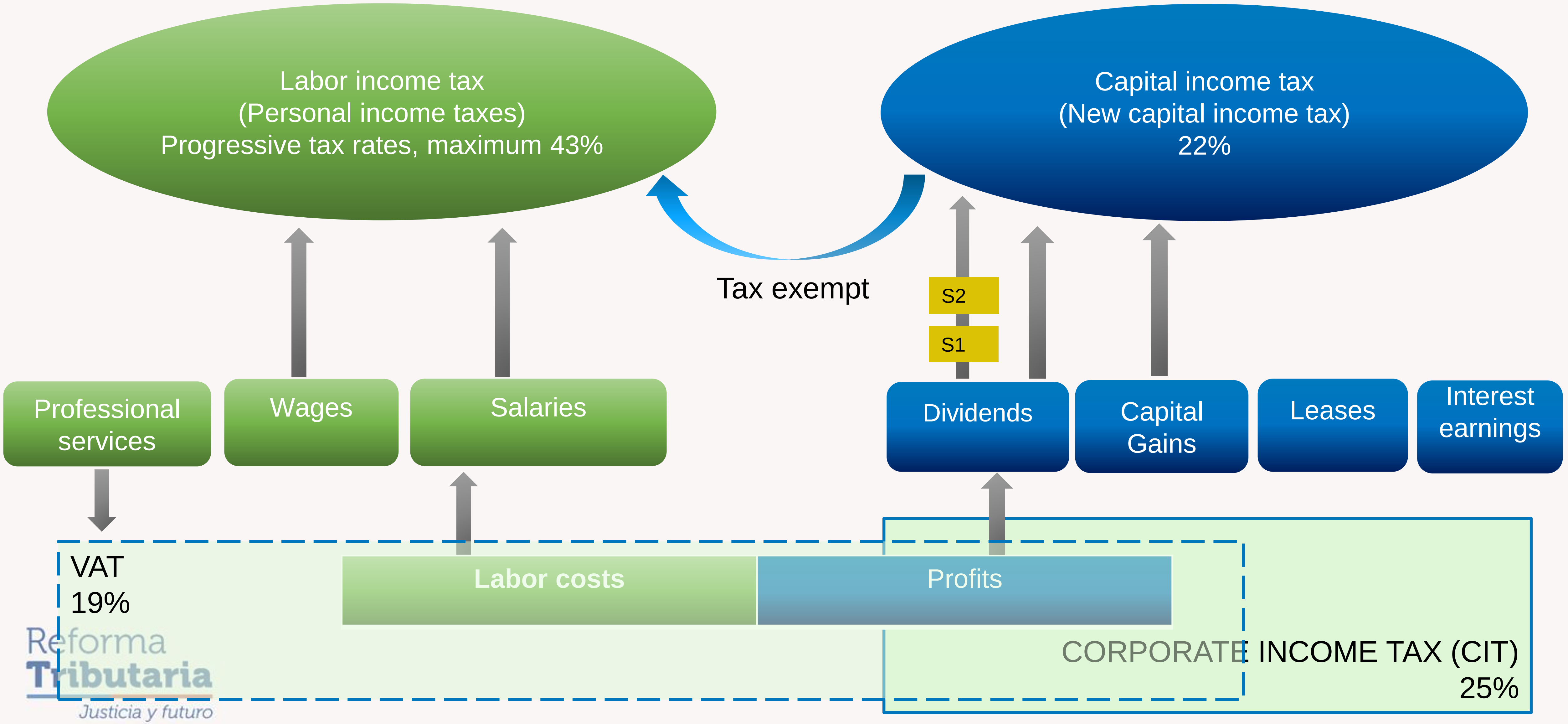
Tax Reform Structure



Reforma Tributaria
Justicia y futuro

Source: Ministry of Finance.

Restructuring Income Tax



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Income Tax

- The current semi-integrated tax system becomes a dual tax system
- Corporate income tax (CIT) is reduced from 27% to 25%
- New 2% development rate (DR)
- 22% tax on distributed dividends and capital gains on stock instruments
- Labor income: marginal rates from 0% to 43%
- Deferral of personal taxes subject to a 1.8% tax rate only in companies receiving more than 50% of their income from passive sources

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Wealth Tax

1. Applied to less than 0.1% of taxpayers, facilitating audits by the tax authorities
2. Avoids exemptions to prevent taxable base erosion
3. Simple rules for the valuation of assets and liabilities

Brackets and tax rates

Bracket (US$)	Marginal tax rate
0 - 4,9 millions	0%
4,9 – 14,7 millions	1%
More than 14,7 millions	1,8%

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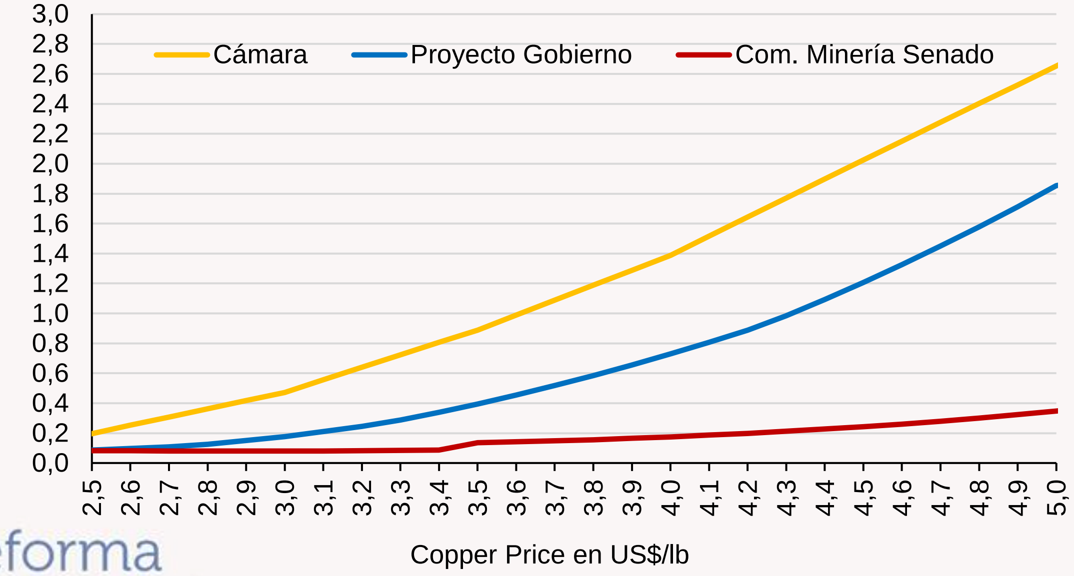
Source: Ministry of Finance.

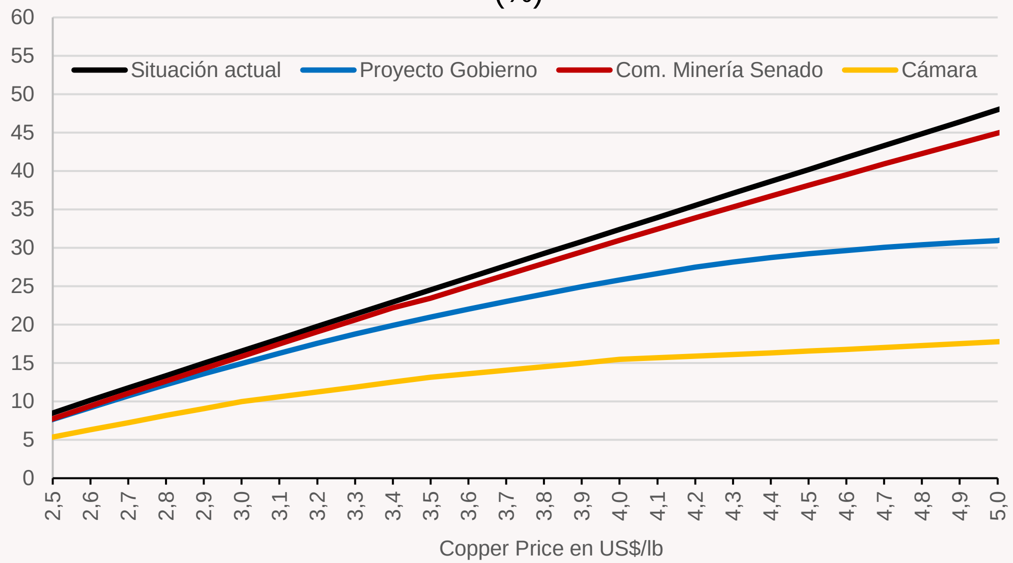
Royalty on mining

1. Taxation of large private copper mining is increased to generate a fairer distribution of economic rent
2. Price risks shared between the private sector and the State
3. Incentives to invest remain
   - Yields greater than 15% per year
   - Similar tax burden than competitors at long-term prices

Increase in tax income, according to different copper Price proposals (% GDP)



Return over equity (ROE) industry average according to different proposals of copper price
(%)



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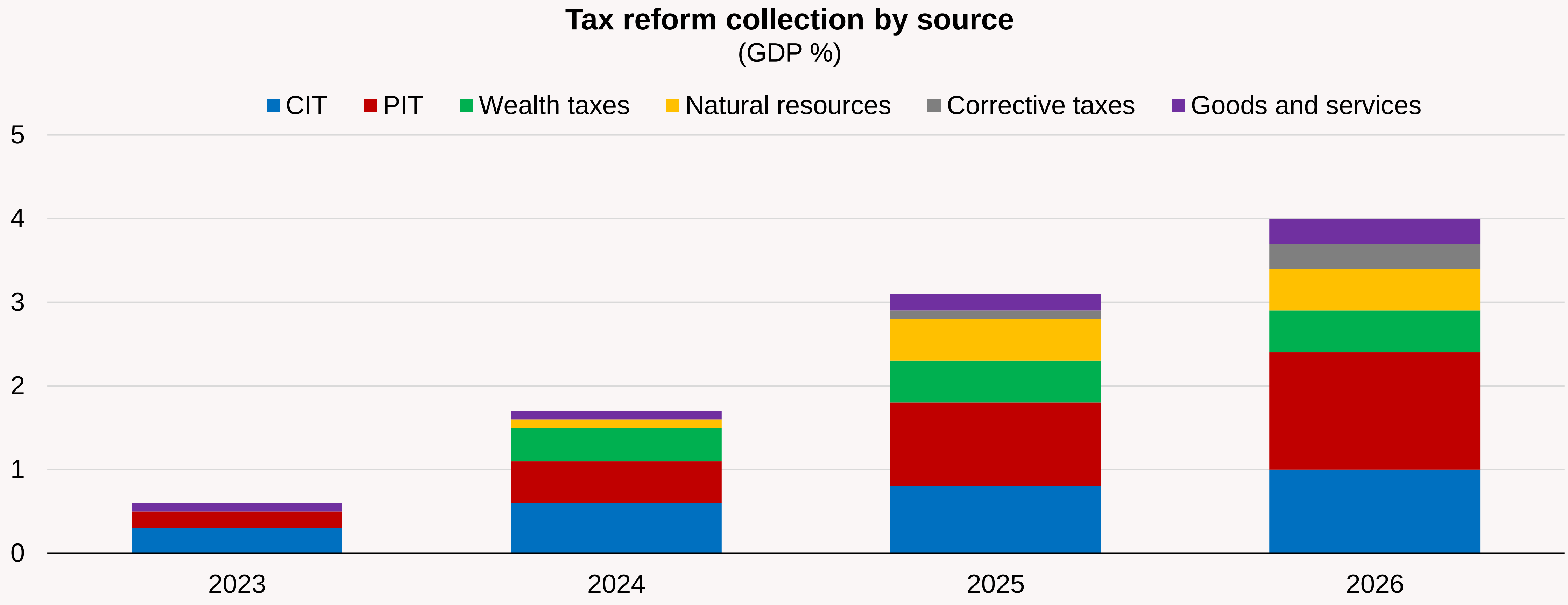
Expected revenue from Tax Reform



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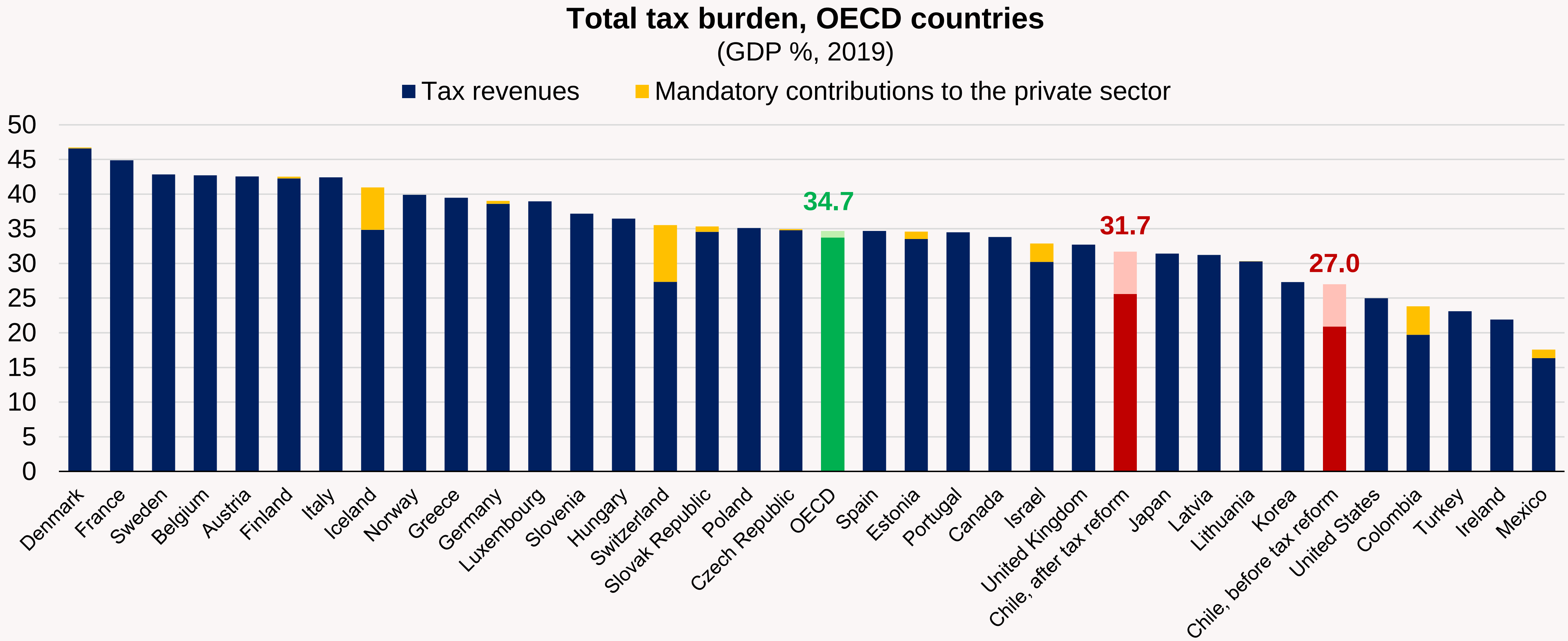
Source: Ministry of Finance.

Adjusted tax gap, before and after the tax reform



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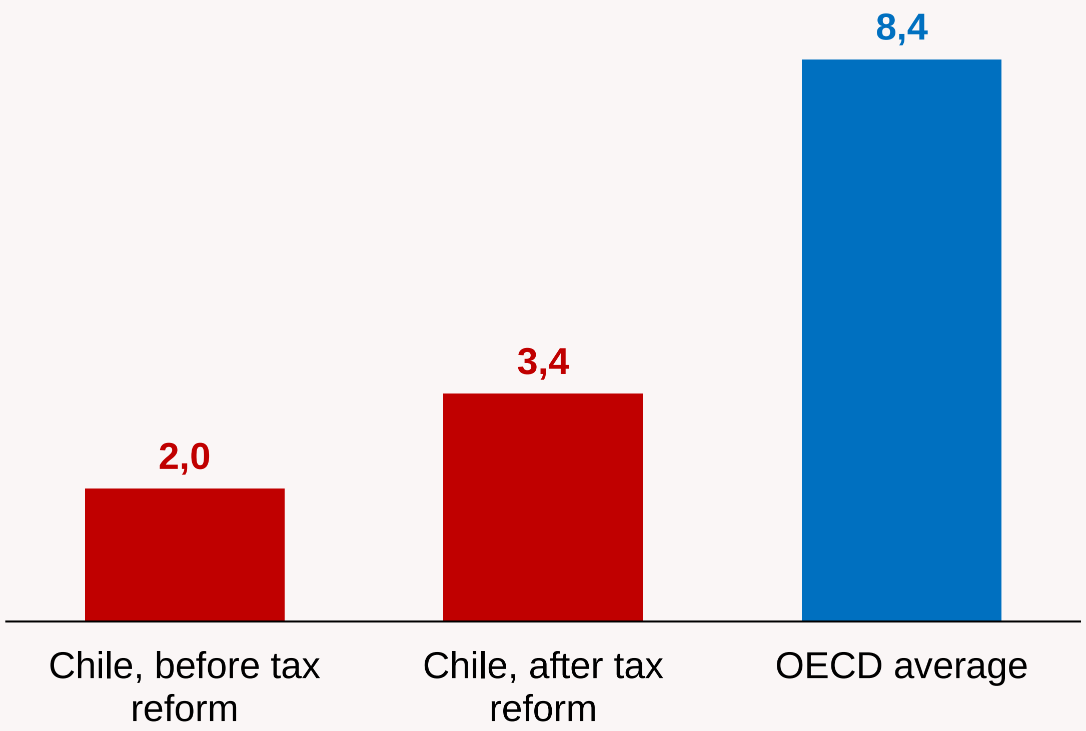
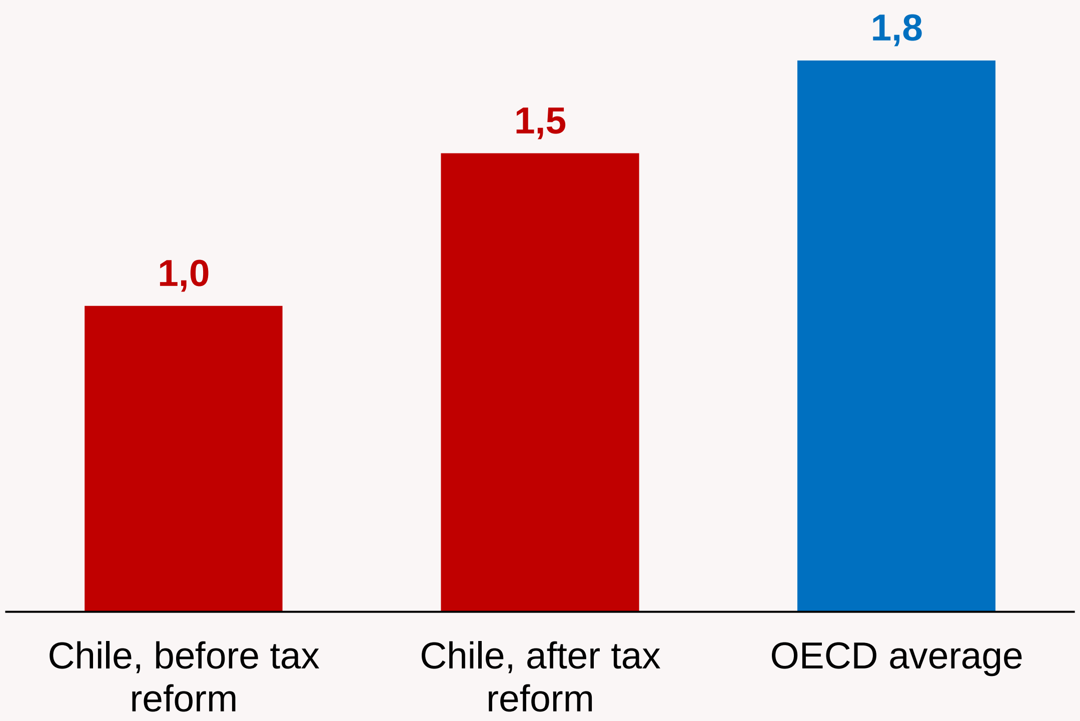
Note: The after-tax reform situation considers the changes entered into force in January 2022 and the tax reform proposed by the Government
Source: Ministry of Finance based on OECD Revenue Statistics

Gap in personal income taxes and property taxes, before and after the tax reform

Personal income taxes, OECD countries
(GDP %, 2020)



Property taxes, OECD countries
(GDP %, 2020)



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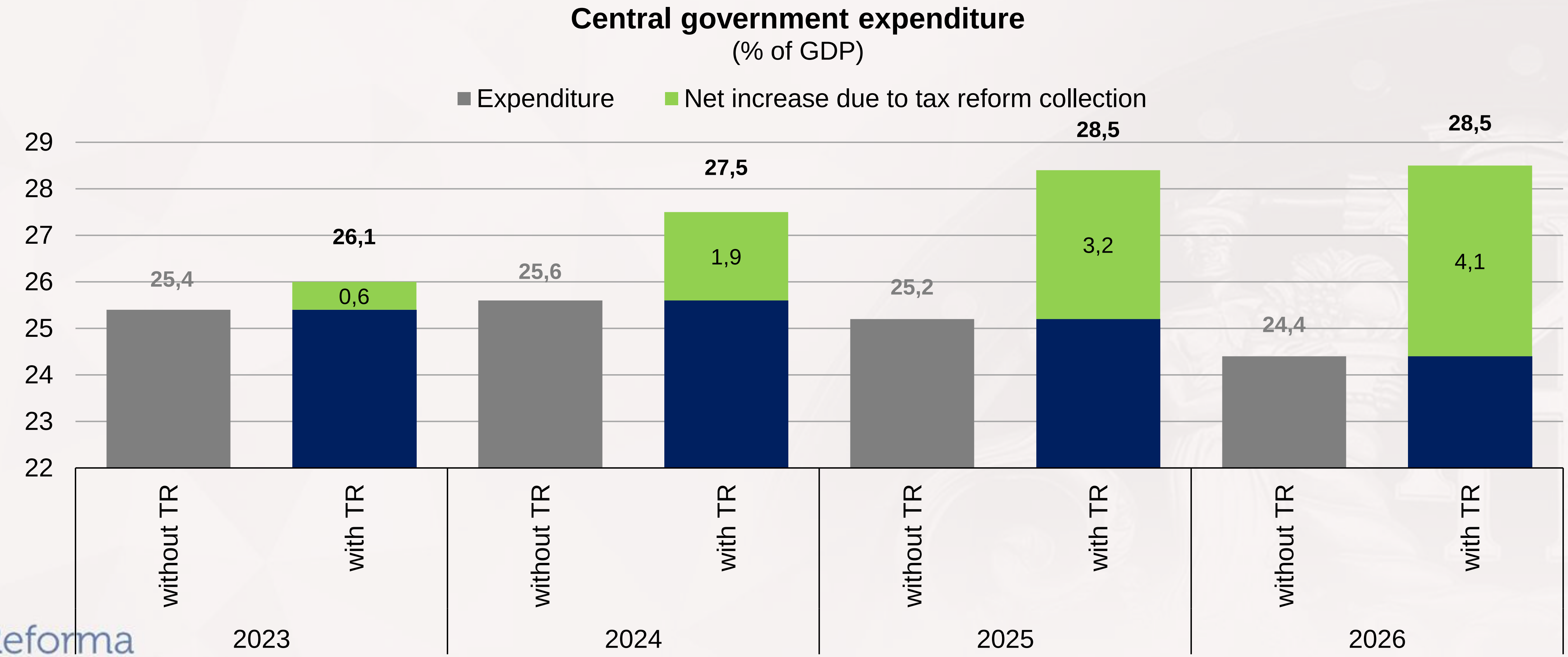
Source: Ministry of Finance based on OECD Revenue Statistics

Revenues from tax reform will fund approximately 50% of the Government´s program. They will be especially important in 2024 and 2025



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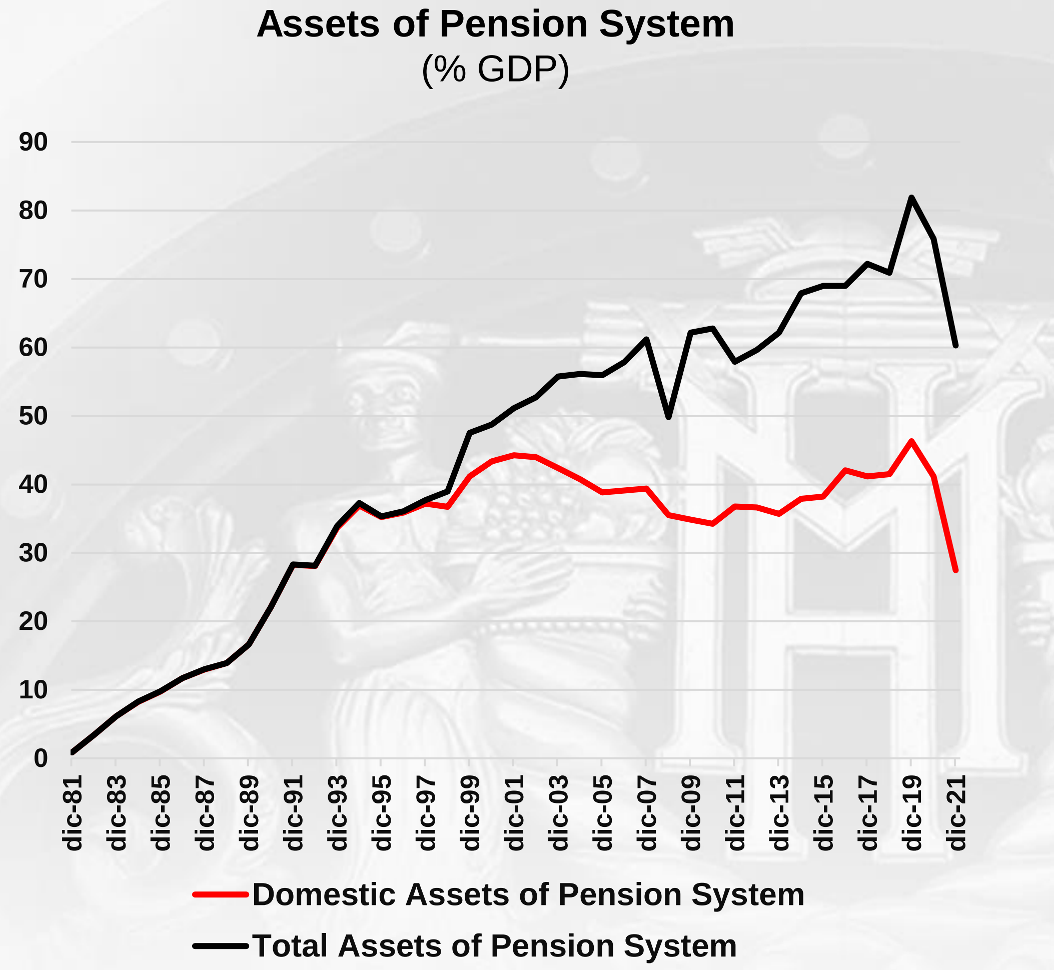
Source: Budget Office (Dipres).

Recovering Chilean capital markets

The Chilean capitals market lost more than 20% of GDP as a result of pension fund withdrawals. Several ongoing initiatives will contribute to rebuild it

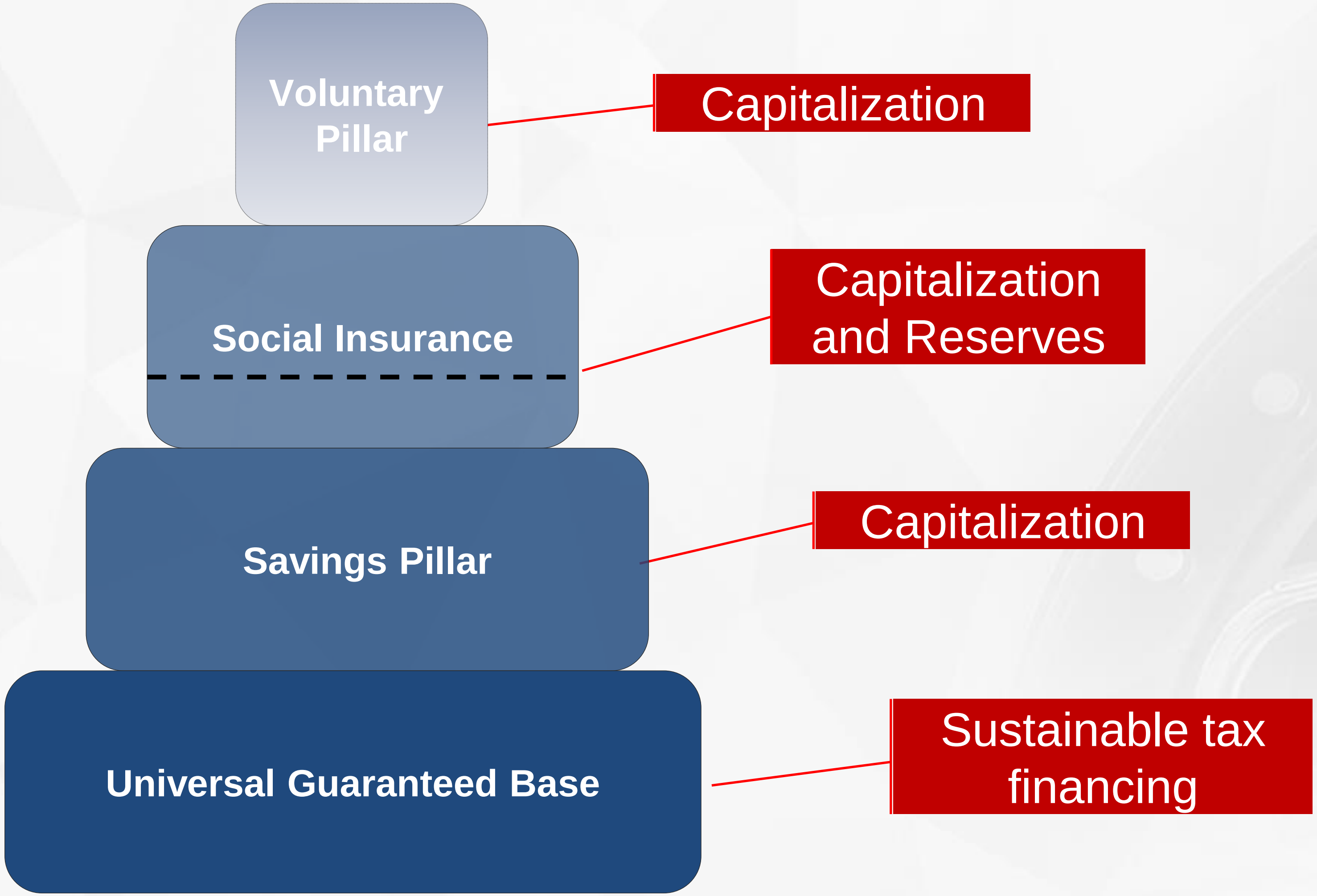
Initiatives that will promote further progress towards deeper, more stable, and inclusive capital markets

- Financial Innovation Bill. (Fintech)
- Internationalization of the CLP (simplified RUT).
- Resilience of the financial system and its infrastructure. (allow the Central Bank to grant liquidity to non-bank financial players)
- Risk-based supervision on insurance companies.
- Consolidated debt registry.
- Legal protection and treatment of personal data, creation of Agency for the Protection of Personal Data.
- Market makers program for government bond issuances



Note: Red dots show the PF withdrawal dates (10%). The red line shows the pension system's assets average between January 2010 and September 2019.
Source: Chile's Pensions Supervisor (SAFP) and Financial Market Commission (CMF).

Pension Reform bill will include a number of mechanisms to rebuild long-term domestic capital markets



Pension reform is intended to change the architecture of the current system.

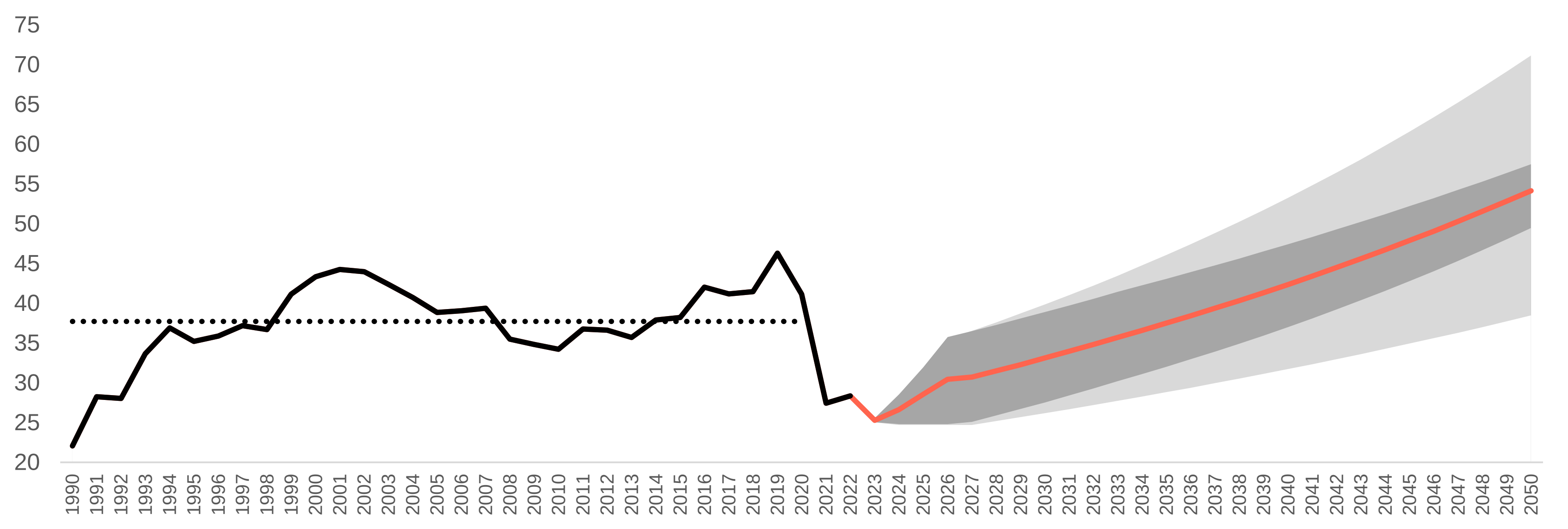
It will be supported by

- (i) a universal guaranteed base;
- (ii) a savings pillar via capitalization, with a quotation increase of 6%;
- (iii) social security; and
- (iv) voluntary savings via capitalization.

Source: Ministry of Finance.

Recovering the long-term private savings' base in the economy

Domestic assets of Pension System
(% GDP)



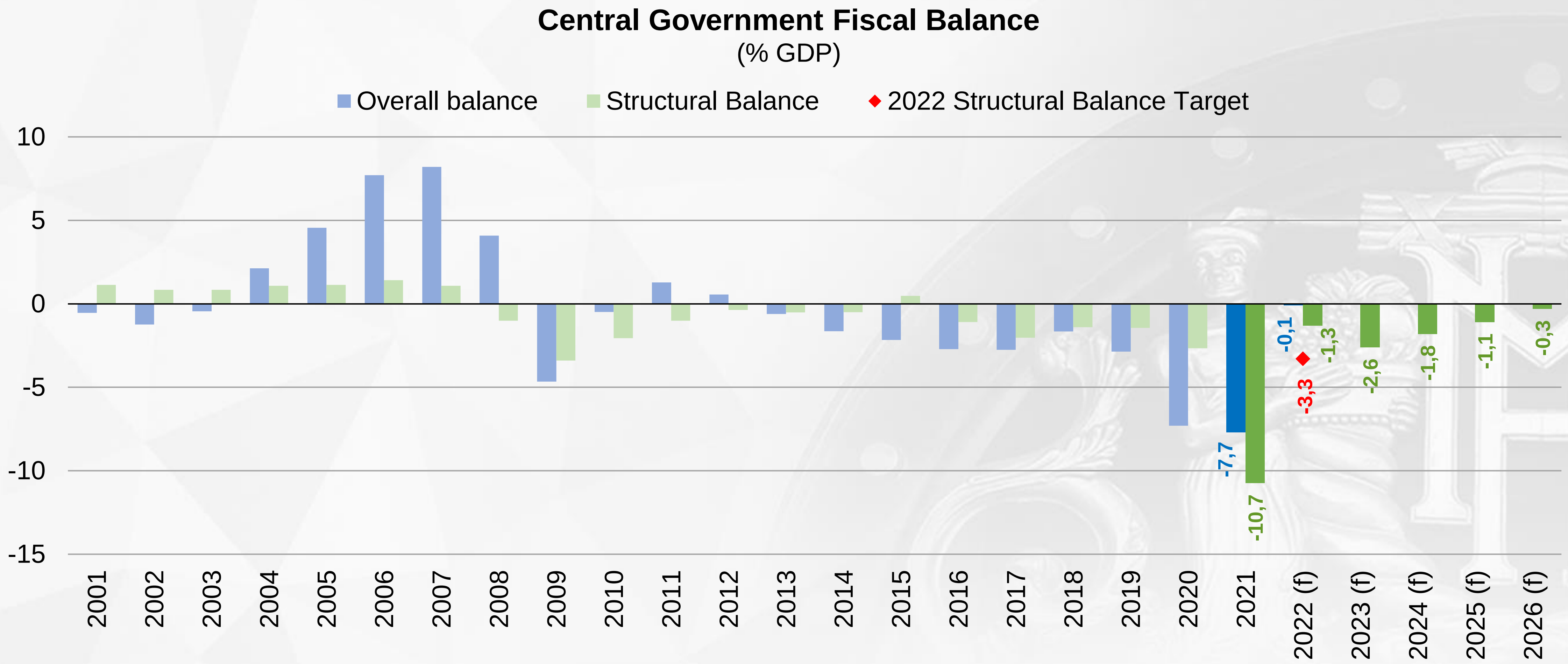
Note: Simulations assuming different scenarios of increases in pension contributions, growth, domestic investment, decrease in contribution gaps, etc
Source: Ministry of Finance.

The pension system may contribute by:

- Capitalizing workers´ contributions
- Reserve accumulation in the social security of defined benefit pillar, from employers´contributions
- Increasing density of contributions
- Reducing under-declaration and raising wage top

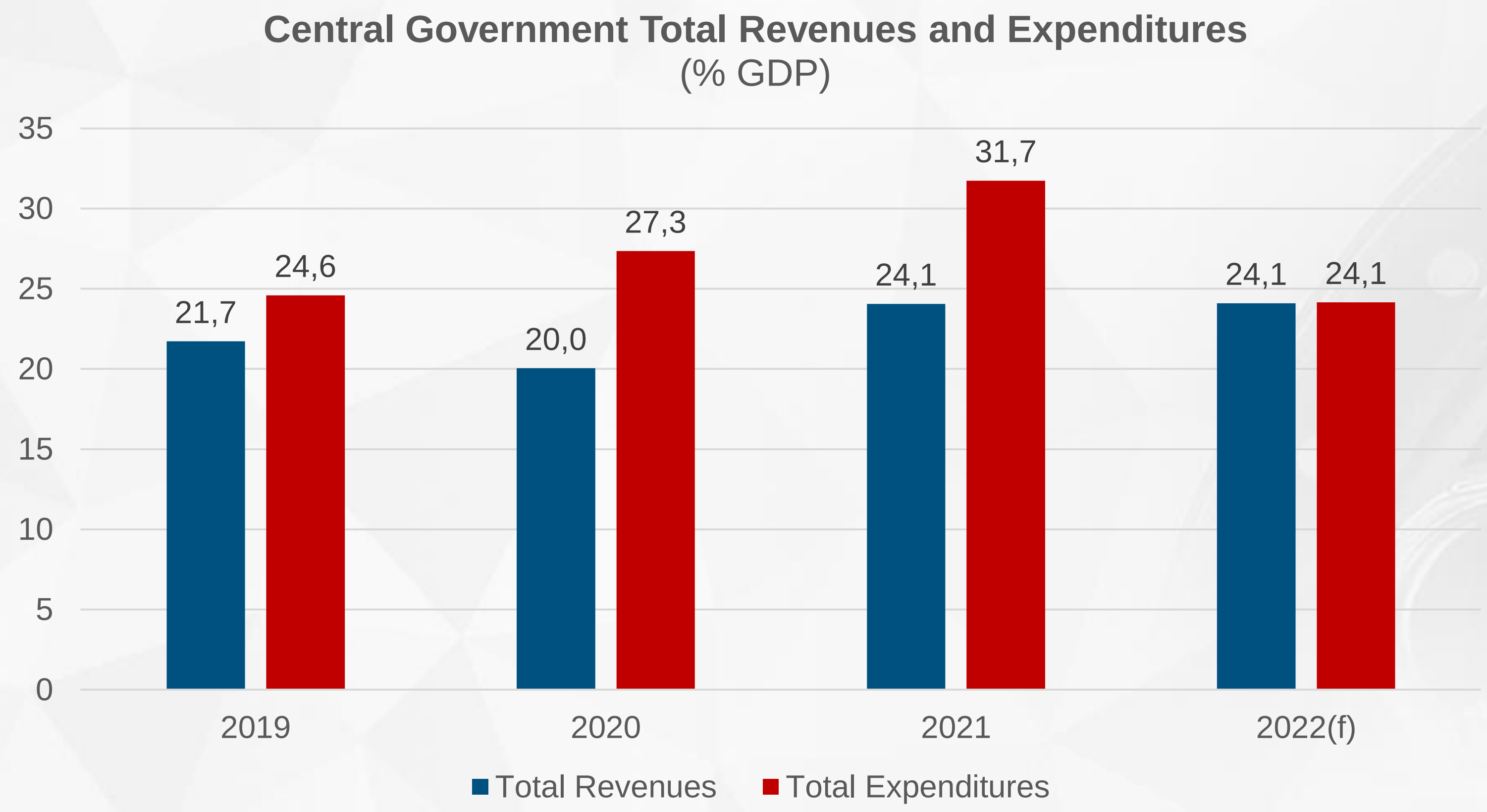
Fiscal Policy

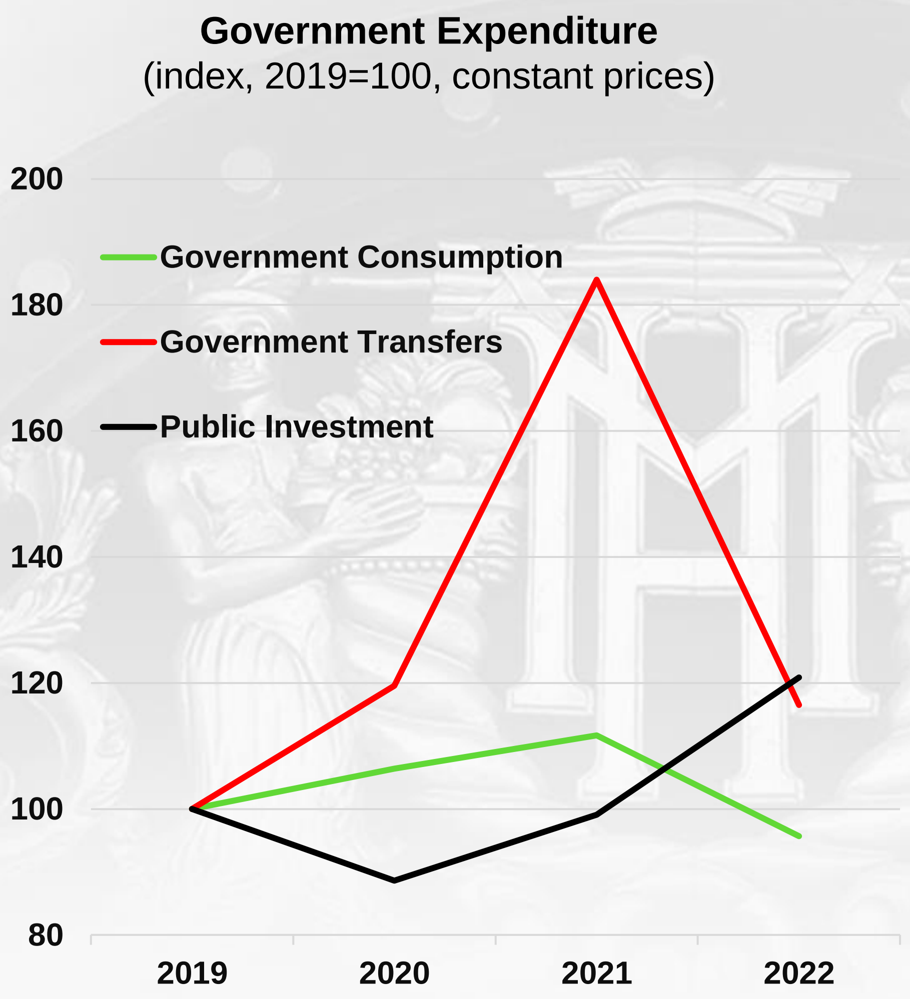
After a historically high deficit caused by the Covid-19 crisis, fiscal accounts have undergone substantial consolidation in 2022, which should continue until 2026



Note: (f): forecasts. Between 2022 and 2026, green bars show the 2Q22 Public Finance Report projections. The fiscal policy decree establishes a structural balance target of –3.3% of GDP for 2022 and -0,3% of GDP for 2026.
Source: Budget Office (Dipres).

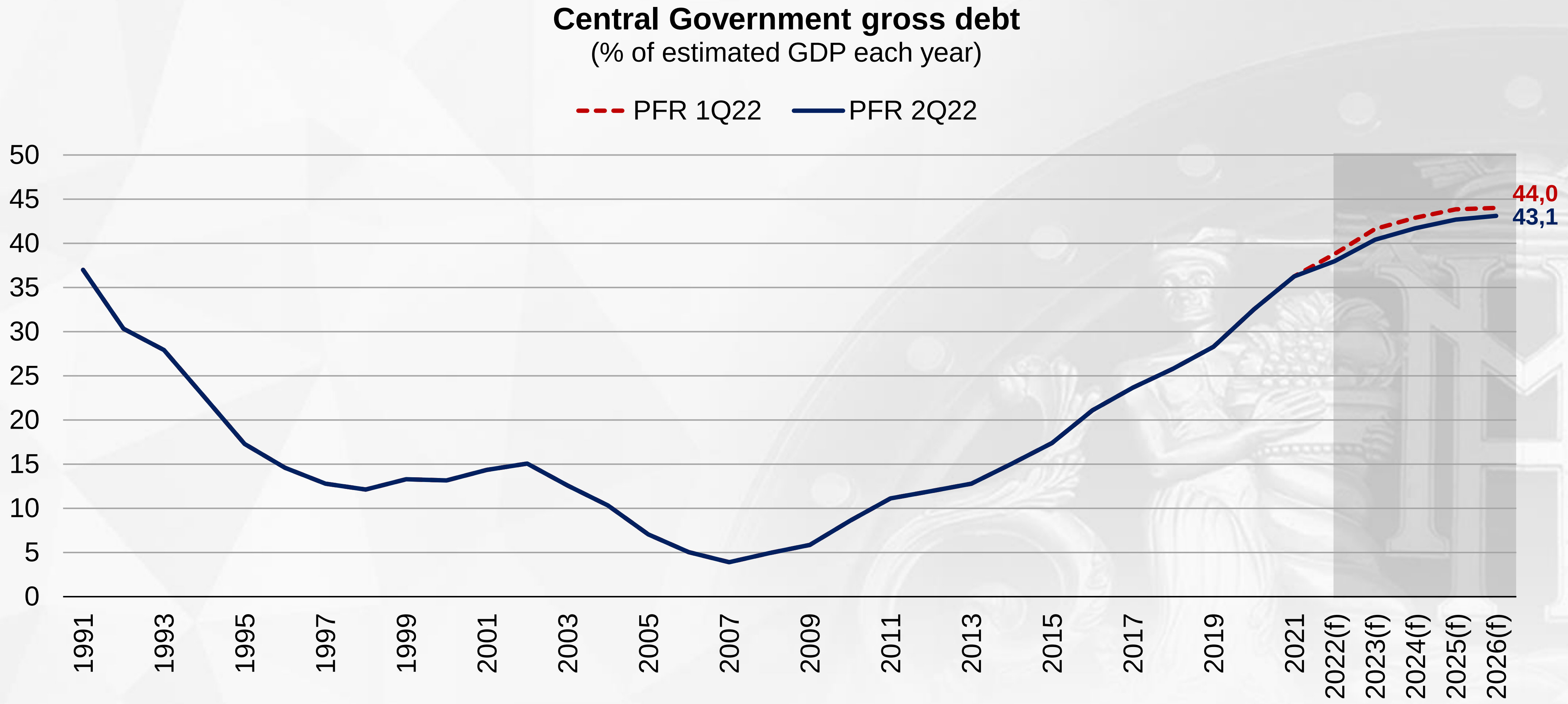
Fiscal consolidation in 2022 is based on a 24% cut in real expenditures and better performance of revenues from anual tax submissions. The process will extend to 2026, with annual structural targets





Source: Budget Office (Dipres) and SII

The fiscal policy framework includes an anchor for the prudent level of debt over the medium term of 45% of GDP.



Note: (f): forecasts. PFR: Public Finance Report.
Source: Budget Office (Dipres).

Constitutional Process

Constitutional Process Calendar

July 4th, 2022:

Constitutional Convention delivered the Proposal for a New Constitution.

CHAPTERS

I. PRINCIPLES
II. FUNDAMENTAL RIGHTS
III. NATURE AND ENVIRONMENT
IV. DEMOCRATIC PARTICIPATION
V. GOOD GOVERNANCE
VI. REGIONAL STATE
VII. LEGISLATIVE POWER
VIII. EXECUTIVE POWER
IX. JUDICIAL SYSTEMS
X. AUTONOMOUS INSTITUTIONS
XI. REFORM OF THE CONSTITUTION

September 4th, 2022:

Referendum to approve or reject the proposal.

- ✓ Mandatory participation
- ✓ Simple majority

Plebiscite

Do you approve the text of the New Constitution proposed by the Convention?
Approve or **Reject**

Approve	**Reject**
President ratifies New Constitution	**Current Constitution remains**

Source: New Constitution Proposal https://s3.amazonaws.com/gobcl-prod/public_files/Campa%C3%B1as/Chile-Vota-Informado/Propuesta_de_la_Nueva_Constituci%C3%B3n.pdf

Economic issues in the Proposed New Constitution

- New Constitution guarantees robust social rights and a larger role of the State to secure them.
- Many key issues (social rights, regionalist structure, attributions of the different branches of the State) will depend on the implementation of future legislation.
- Government has called for a gradual implementation of changes that imply higher fiscal costs.
- Fiscal Budget almost identical to the current Constitution.
- Freedom of entrepreneurship, property rights properly acknowledged.
- Central Bank remains autonomous with price stability and normal operation of internal and external payments as mandate.
- Fiscal sustainability and responsibility principles are now recognized at a constitutional level.

V. GOOD GOVERNANCE AND PUBLIC FUNCTION

183h art.:

i.“Public finances will be conducted through ***fiscal sustainability and responsibility principles****, which will guide the State action in all its institutions and levels.”*

ii. “The State will use its resources in a reasonable, optimal, effective and efficient way in benefit of the people and in accordance with what the Constitution and the laws impose” (*)

Note: (*) Original version (in Spanish) prevails.

Source: New Constitution Proposal https://s3.amazonaws.com/gobcl-prod/public_files/Campa%C3%B1as/Chile-Vota-Informado/Propuesta_de_la_Nueva_Constituci%C3%B3n.pdf

Summing up

- Chile is addressing both the aftershocks of the Covid-19 crisis and longer term challenges in a decisive way
- Macroeconomic policy is doing its job, and its impact on spending and demand is evident already
- The financial sector remains solid while economic agents are exposed to limited to none FX risk
- Government is laying down plans to further strengthen the financial sector and to deepen capital markets
- Productivity and green-growth agenda is developing fast
- Fiscal consolidation is moving ahead faster than expected and D/Y trend revised downward
- Tax reform will provide the resources to address long-term social needs that emerged in the social crisis of 2019. Government is prepared to pragmatically engage with Congress and economic actors during the legislative process
- Political and social transition is keeping to its institutionalized track
- Many challenges lay ahead; common purpose, dialogue and trust will be essential to face them

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