



**Rabobank**

## Chile: A step to the right

*On 11 March 2010, Sebastián Piñera of the Coalition for Change was inaugurated as Chile's new president after winning the second-round run-off in the presidential elections against Eduardo Frei. Since the return to democracy in 1990, the center-left oriented coalition, the Concertación, had won every presidential election. In fact, Piñera is the first right-wing candidate to win a democratic presidential election since Jorge Allisandri Rodríguez won the presidency in 1958. Piñera's victory therefore represents a major change to Chile's political landscape. However, underlining the maturity of Chile's democracy, the outcome was accepted without incidents. In this Special Report we will take a closer look at Chile's economic policies, the elections results, and what the new political landscape will mean for Chile's economic future.*

### Successful macroeconomic framework

Chile's macroeconomic framework is well anchored by strong institutions and broad consensus. Under the regime of Dictator Augusto Pinochet (1973 -1990), major free-market reforms were pushed through. These reforms were largely based on policies designed by the 'Chicago Boys', a group of free-market oriented economists from the Chicago School of Economics. When the Concertación came to power in 1990, market-oriented economic policies were upheld. As a result, Chile's economy continues to be guided by free-market forces today. The government's role in the economy remains relatively small, with government expenditures amounting to only 20% of GDP. Also, Chile's economy is very open to international trade. However, Chile's economic success is not only based on left-over economic policies from the dictatorship era. In the past 20 years, the Concertación has managed the economy very prudently and has implemented valuable reforms of its own. The introduction of the fiscal surplus rule, which

was formalized in the Fiscal Responsibility Law in 2006, is one of the most important policies in this respect. Under the law, fiscal policy is designed on a structural long-term basis, which increases fiscal and economic stability. When the economy is performing strongly, fiscal expansion is subdued by mandatory saving of part of the windfall revenue. These savings contribute to the pension fund and the Economic and Social Stabilization Fund (FEES). During a cyclical downturn, the government can use these funds to provide a counter-cyclical fiscal stimulus to the economy. Due to its fiscal prudence, Chile's fiscal accounts remain strong. This has proven its worth during the recent global economic slowdown. Even after implementing a sizeable fiscal stimulus package in 2009, the fiscal accounts remain in good shape with public debt-to-GDP amounting to only 5% of GDP. Moreover, the government will be able to use the funds to pay for part of the rebuilding costs associated resulting from the February 27 earthquake (see also Special Report 2010/05).

**Table 1: Social indicators**

	1990	2000	2007
Gini index	55.5	55.4	52.0
Poverty rate at USD 2 a day (PPP) (% of population)	14	6	2
Life expectancy at birth (years)	74	77	78
Mortality rate, under-5 (per 1,000)	21	11	9
Labor force with tertiary education (% of total)	8	22	25

Source: World Bank

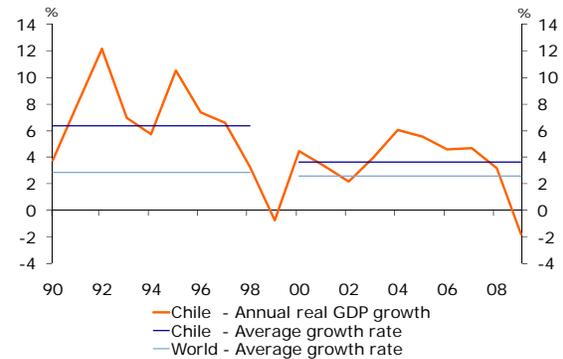
The Concertación social policies have also been successful. Poverty, as measured by the share of the population that survives on less than USD 2 a day, was reduced from 13.6% in 1990 to only 2.3% in 2007. The GINI-index, a measure of income inequality, is still high at 52% in 2007, but compares well to the 55.5% measured in 1990. Higher life expectancy and lower mortality rates demonstrate the improvement in healthcare since 1990. Similarly, more people have gained access to higher education and literacy rates have increased, which indicated the advance of

education in the past 20 years. Chile was officially invited to join the exclusive Organization for Economic Co-operation and Development (OECD) in December 2009. This invitation was based on more than just Chile's proven commitment to democracy and a free market economy. In order to qualify, legislation in areas such as corporate governance and corruption had to be overhauled. In addition, the steady improvement of social development indicators played an important role in the OECD's decision to invite Chile to the club. Currently, Chileans enjoy the highest standard of living in Latin America. In the most recent Human Development Index, which takes into account income, education and healthcare factors, Chile ranks 44<sup>th</sup> out of 183 countries. Looking at income alone, Chileans, on average, have seen their income triple in the past two decades to USD 14,000 in terms of purchasing power parity.

**How the Concertación lost the elections**

In spite of President Michelle Bachelet's record high approval ratings, the Concertación was unable to bank on her success. This was partly due to the Concertación's candidate's lack of appeal, but also due to a fatigue with the establishment among voters. In the past years, the Concertación had become more ideological and elitist, leaving little room for new leadership to advance within the coalition. In addition, the global economic crisis and its impact on the domestic economy put the country's economic performance to the forefront of voter's interests. This allowed Piñera to focus on the weaknesses in Chile's economic policy framework. One of these is a structural slowdown of real GDP growth during the past ten years of Concertación rule. While real GDP growth averaged 6.4% in the period 1990-1999, average growth nearly halved to 3.6% in the period 2000-2009 (see graph 1). This is surprising, as the global growth rate remained more or less constant during both periods.

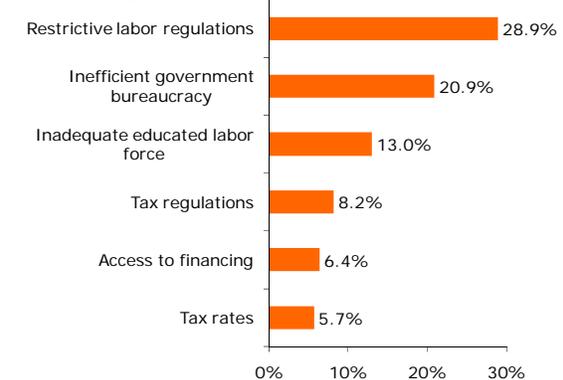
**Figure 1: GDP growth 1990-2009**



Source: EIU

As a result of high copper prices, which led to a vast amount of windfall revenues for the government, the urgency to follow through with politically sensitive reforms diminished. To prevent a potentially costly backlash from Chile's powerful unions, rigidities in the labor market were not dealt with. Enhancing bureaucratic efficiency was not a priority, which led to red tape impeding private sector growth. In addition, innovation and the availability of the type of education that is needed in the private sector were insufficiently stimulated. In short, complacency among the Concertación's policy makers increased. As a result, Chile lost some of its competitive edge.

**Figure 2: Most problematic factors named by the 2009 global competitiveness index**



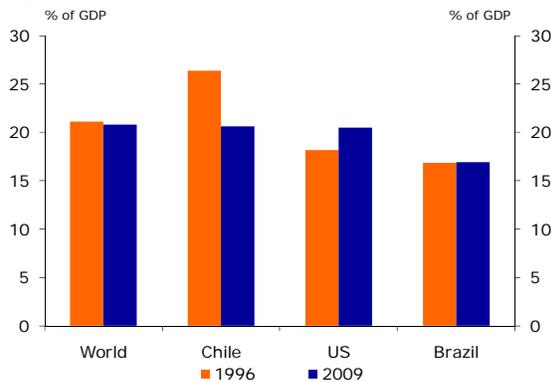
Source: World Economic Forum

This was best expressed by the World Economic Forum's global competitiveness index. Even though Chile has been steadily ranked as the best country in Latin America, it fell from the 22<sup>nd</sup> position in 2004 to spot number 30 in 2009. In fact, the most problematic factors for doing business in Chile that were named in 2009's competitiveness index have been an inspiration to Piñera's economic team (see graph 2). All of the issues identified by the World Economic Forum were placed at the forefront of Piñera's presidential campaign.

### Entrepreneurship takes center stage

In spite of the name of his coalition (for change) and the criticism on the Concertación's economic management, Piñera will not make any drastic changes to Chile's macroeconomic framework. He will also keep the Concertación's social policies in place. Entrepreneurship, however, will receive a boost under his leadership. One of the most important campaign promises of the new president is that he will increase trend growth to at least 5.5% a year. To achieve this, stimulating investment and productivity growth will receive renewed attention.

Figure 3: Gross fixed investments



Source: EIU

In 2009, gross fixed investments amounted to 20.6% of GDP in Chile, which is disappointing compared to the 26% of GDP measured in 1991 (see graph 3). Piñera's goal is to increase gross fixed investments to 28% of GDP during his term. Tax incentives, such as accelerated

depreciation of fixed assets and taxation based on distributed profits are among the policies that the government is likely to introduce in order to stimulate private sector investment.

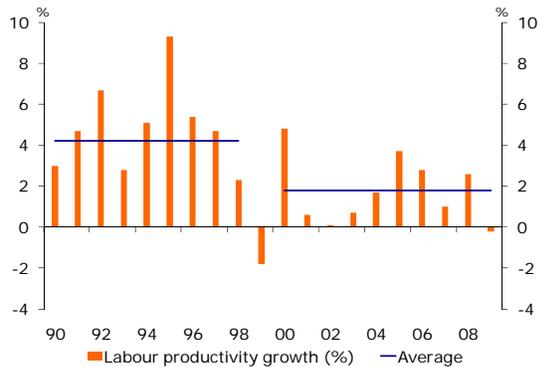
### Who is Sebastián Piñera?

Sebastián Piñera, aged 60, is one of Chile's richest businessmen, a politician and former senator (1990-1998). From 2001 to 2004 he was the president of the Renewal party before running for the presidency in the 2005 elections. In these elections he received 47% of the vote, but was defeated by Michelle Bachelet. Piñera holds a PhD in economics from Harvard University and is a strong believer in free markets. He is best known for bringing credit cards to Chile in the 1970's. Before taking office, his assets included a 27% stake in LAN, one of the major airlines in Latin America, full ownership of Chilevisión, a nationwide broadcaster and a stake in the country's most popular football team: Colo-Colo. A self-made tycoon, his personal wealth is estimated at one billion US dollars.

The government will also amplify its own investments in infrastructure by setting up public-private partnerships. A first example of was the 'lift Chile' plan, launched by Piñera shortly after the earthquake, which endorses private sector participation in the reconstruction effort. Planned investments by the government in education and healthcare, however, may be delayed because of the focus on reconstruction in the coming months, if not years. Piñera is also planning to further develop the country's capital markets by reducing entry barriers to the Chilean market for foreign financial firms and by improving control and supervision of the financial sector. Another important topic on his agenda is the publically owned Codelco. This state-owned copper mining company is the biggest source of revenue for the government, but has been plagued by underinvestment. In the case of Codelco, however, the introduction of private capital is politically sensitive. Shortly after the

victory of Piñera was announced, unions voiced their concerns loudly. As a result, Piñera will likely choose to recapitalize the company from public funds and make changes to the existing regime in which the armed forces receive 10% of Codelco's revenues. To stimulate productivity growth, the labor market will need to become more flexible. Piñera plans to reform the labor market and leave more freedom for individual labor arrangements. Labor reforms, however, will be one of the most difficult policies to implement, as they can count on fierce opposition from labor unions. Even though only 15% of Chilean workers are unionized, unions have a strong influence in Chilean politics. Another path through which Piñera will try to enhance productivity is by improving the quality of public education and stimulating technical training for workers. This should not only increase the quality of the workforce, but also make worker's skills match better with demand by the market.

Figure 4: Labor productivity growth



Source: EIU

Finally, Piñera will stimulate entrepreneurship in both the private and public sectors. To improve the quality of government expenditures, he will push for more 'entrepreneurial governance' within the public sector. Better measurement of the effectiveness of public expenditures will promote a stronger focus on results. Modernization of the public sector will streamline bureaucratic procedures and reduce red-tape. Strong growth, deeper capital

markets and an improved business climate should will Chile to achieve its long-lasting objective of reaching a developed country status by 2018.

**Conclusion**

*In all, Piñera is expected to leave the general policy framework intact. However, he will make some minor changes aimed at improving the business climate. Although Chile's business climate is already among the best in the region, the plans of the new president will further strengthen Chile's economy. The new government under his leadership will offer Chile a fresh breeze of political change. However, realizing the promises will be a challenge. Some of the planned reforms, such as the labor market reforms and the streamlining of the bureaucracy will face strong opposition. At the same time, he will need to gain the trust of the working class, while maintaining the support of the wealthy. In this regard, the quality and speed of the relief effort after the earthquake will be an important first determinant of his popularity. GDP growth is anticipated to speed up to in 2010 as a result of strong investment growth in the second half of the year, the global recovery and enhanced business confidence. However, due to the impact of the earthquake, it is unlikely that Piñera's growth target will be achieved. Therefore, the main challenge for Piñera will now be to propel growth to 5.5% or more in the years thereafter.*

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