# CHILEAN ECONOMIC REPORT

THIRD QUARTER 2019

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It is with regret that as we go to press, we must report on a weekend of violent protests that have taken place in Santiago and other major cities across Chile. We have included the key facts of what happened during and leading up to the weekend of the 18th to 20th October in an information box in section 4 of this report. However, it is too early to comment on the underlying causes of the disturbances, and equally premature to fully understand and comment on the continuing risk of further problems and their consequences.

It is of concern that the seriousness of these protests and the extent of the damage done will impact the major events due to take place in Santiago in the coming weeks, including the APEC summit and the COP25, when Chile will be highly visible on the world stage. Despite picking up speed in the third quarter, the economy is still being pegged back by the ongoing trade war between its two major global export markets, China and the US, and in particular the effect on the price and demand for copper, and there is no clarity about when this will change., Consumers have grown more concerned about the outlook for the economy over the next twelve months and their ability to buy household items, as well as big-ticket items like cars. Of great concern to all is the severe shortage of water caused by the driest winter for 70 years, with many livestock already dead and states of emergency declared in a third of the districts across central Chile. All aspects of the water system are being analysed, from the legal framework which controls ownership rights to consideration of how massive investment can be best placed to ensure resilience in the future. Unfortunately, none of this work will result in anything to alleviate the situation for this coming summer. See the insight article in section 3. So not a lot of positive news in this our last report during 2019, but important to remember that Chile is still the most successful economy in the region, and has shown great resilience in the past when confronted with difficult situations. We here at Britcham will continue to keep you up to date with what's happening.

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## CHAMBER SPONSORS 2019

# INDEX

# KEY POINTS

• The Chilean economy picked up speed in the third quarter after a difficult first half of the year, but the US-China trade war and a slowing global economy threaten future growth.

• Analysts now expect the economy to grow by just 2.5% this year as rising investment is offset by weakening consumption and shrinking global trade.

• Chile is facing one of its worst droughts on record, which could impact agricultural exports and seasonal employment and push up food prices, lifting inflation.
* Exports fell 5.0% in the third quarter, reflecting lower commodity prices (especially copper and pulp), while imports declined 5.9% on lower imports of consumer goods and a fall in energy prices.

• International copper prices have fallen to their lowest level in two years on fears that continued US-China tensions will hit demand for the metal.

• Inflation stabilized in the third quarter at the bottom of the Central Bank's tolerance range but is not expected to return to its medium-term target of 3.0% until 2021.

• In September, the Central Bank cut its benchmark interest rate to 2.00%, its second 50 basis-point cut this year. Another cut (to 1.75%) is predicted by the end of the year to bolster the flagging economy.

• The government has launched a US$3.0 billion stimulus program, including infrastructure projects and housing subsidies, to encourage investment and create jobs. Under its budget for 2020, public spending will rise by 3.0% next year, the smallest expansion in more than a decade.

• Unemployment rose to 7.2% in August as the steady expansion of the workforce (due to recent immigration) outpaces job creation. Public spending, rather than private activity, continues to lead the creation of new jobs.

• Consumer confidence remains very weak, with optimism for the economy's long-term outlook falling to its lowest level on record. However, business confidence has stabilized after declining during the first half of the year.

• The government has been able to advance its legislative agenda with its flagship tax reform progressing to the Senate while deputies are due to vote on its pensions bill in the coming weeks. However, political debate has been dominated by an opposition proposal to cut working hours.

# 1

# DOMESTIC ECONOMIC PERFORMANCE

## 1.1 GDP Growth

Economic activity recovered in the third quarter after a disappointing first half of the year. The Chilean economy expanded by 3.1% and 3.7% in July and August, respectively, according to preliminary data from the Central Bank, up from growth of just 1.9% in the second quarter.

In July, robust activity in business services, manufacturing and construction, aided by two additional working days, led the expansion, offsetting weak growth in the mining industry as well as the impact of the public teachers' strike. In August, a surge in copper production (see 2.2 Mineral Exports) as well as strong services and construction activity caused the economy to grow at its fastest rate since October last year.

Analysts now expect the third quarter to be the strongest in the year for growth.

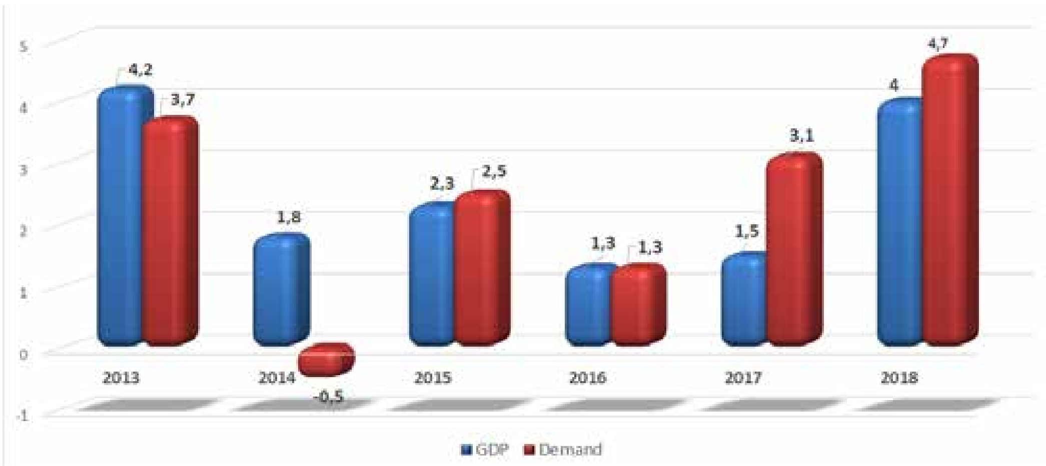
A low base of comparison means growth in September could exceed 4.0% which would lift quarterly growth to around 3.5%. Growth data for September will be published in early November.

However, this would not be enough to improve annual growth forecasts which analysts have pared back to reflect the economy's weak performance in the early part of the year as well as deteriorating conditions in the global economy. Analysts surveyed by the Central Bank in October predicted that the economy would grow by just 2.5% this year, down from 3.6% predicted at the end of 2018 and matching the Bank's latest forecast of 2.25-2.75%. With the global trade war now expected to drag into next year, the average forecast for 2020 fell to 3.2% (down from 3.5% previously).

As well as a drop in mining production and slowing global trade, internal demand has emerged as a key factor behind the economy's disappointing performance in 2019. Demand grew by just 1.8% in the second quarter, down from 2.8% in the first quarter and 4.7% in 2018, as slowing private consumption undermined rising investment.

Private consumption grew by 2.3% in the second quarter, suggesting households have slowed spending in the face of a poor jobs market and low consumer confidence. Hardest hit has been sales of consumer durables, especially cars (See 2.2 Key Sectors). Investment grew by 4.8% in the second quarter, up from

GDP & Domestic Demand, 20103-2018
(Base = 2013; variation over same period of previous year) (%))



3.7% in the first three months of the year, driven by construction work, especially at major mining projects such as Codelco's US$5.5 billion Chuquicamata underground project which was officially inaugurated in August. However, spending on machinery and equipment rose by just 2% (after growing by 8.2% in 2018).

Looking to 2020, the Central Bank expects the economy to grow by 2.75-3.75%, driven by a recovery in private consumption.

This is expected to grow by 3.1%, up from 2.7%, while investment would grow by 4.0%, similar to the forecast for 2019.

After declining through the first part of the year, business confidence has stabilized but only just inside positive territory. The Monthly Business Confidence Indicator produced by the Adolfo Ibáñez University and the ICARE business organization reached 50.74 points in September, little changed since May. However, while other sectors have remained relatively stable, confidence in the construction sector fell to 42.65 points, its lowest point since the current government was elected in 2017.

Consumer confidence remains deeply pessimistic with GfK's Economic Perceptions Index falling to 38.6 points in September, its second lowest reading this year and almost its lowest in more than two years. Consumers have grown more concerned about the outlook for the economy over the next twelve months and their ability to buy household items. Long-term optimism for the economy (five years) fell to 20.9%, its lowest-ever level, while optimism about the labour market fell to 30.3%, a three-year low.

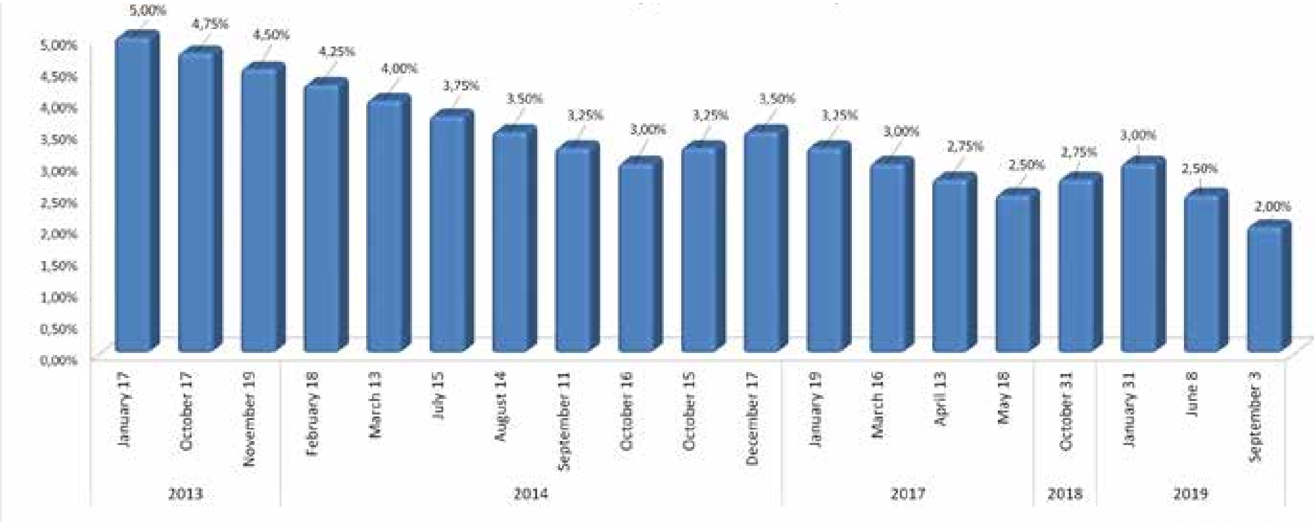
## 1.2 Key Sectors

Services. Business services grew by 3.2% in the second quarter, similar to the previous quarter, driven by professions related to investment, such as architecture, engineering and consulting. Personal services slowed slightly to 3.1% as an expansion in private healthcare was offset by a decline in public education, related to the teachers' strike which began in June. Retail. Retail sales in the Metropolitan Region rose by 4.4% in the twelve months to August, the first increase in more than 12 months, reflecting discounted sales of clothing and footwear and electrical goods as well as a low base of comparison. The National Retail Chamber attributed the sector's poor performance to declining consumer confidence and the weak state of the labour market, which have hit purchase of big-ticket items, especially vehicles.

Car sales during the first nine months of the year reached 289,478 units, down 7.0% from last year's record figure for the period, although September (the month when new vehicle models are released) was the best month for sales so far this year.

Manufacturing. Manufacturing shrank by 1.5% in the twelve months to August. The fall was driven by a 3.3% drop in food production, especially vegetable juices, and a 4.4% fall in potash production. In addition, production of leather goods fell 49.9%, following the closure of the Guante Gacel shoe factory. These were offset by increased production of pharmaceutical goods.

Central Bank Interest Rate, 2013-2019
(%, annual nominal rate)




*Source: Central Bank of Chile*

Construction. Construction activity has slowed, growing by just 1.4% in the twelve months to June, down from 7.5% in June 2018, according to the Chilean Chamber of Construction's IMACON index. Employment in the sector grew by just 1.0%, down from 2.5% twelve months earlier, while sales of building materials shrank by 0.5%, down from an 11.5% expansion in 2018.

## 1.3 Monetary Policy

On September 4th, the board of the Central Bank decided unanimously to cut its benchmark interest rate by 50 basis points to 2.00%, citing the downturn in conditions in the global economy which threaten economic growth and convergence with its inflation target (See 1.5 Domestic Prices). Unlike the 50-basis point implemented in June, the latest reduction was widely anticipated especially after one board member voted in favour of a 25bp cut in July. Less expected was the Bank's warning that further cuts could be required to achieve convergence within its two-year horizon.

Analysts and traders surveyed following the decision predicted that the Central Bank will now implement a further 25-bp cut (to 1.75%) at its penultimate meeting of the year on October 23rd.

## 1.4 Fiscal Policy

Government revenue growth has slowed in line with weaker economic growth and lower copper prices. Income during the first eight months of the year rose by 1.2% to CLP28.3 trillion (US$39.6 billion). Income from privately-owned mines rose by 34.4% to CLP1.4 trillion (US$2.0 billion) while revenue from other taxpayers rose by 0.4% to 23.4 trillion (US$32.7 billion).

State-owned mining company Codelco's contribution to the treasury fell by 49.9% to CLP447 billion (US$625 million).

Public spending during the same period reached CLP29.5 trillion (US$41.2 billion), up 3.5% from the same period of last year, on increased spending on education and health. Government investment has risen sharply since the middle of the year, rising by 11.2% in August, compared to a 12.8% decline in June.

The government now expects to end the year with a deficit equivalent to 2.2% of GDP,

up from 2.1% forecast in June. However, on a cyclically adjusted basis (using long-term forecasts for GDP growth and the copper price), the deficit will reach 1.4% of GDP this year, down from 1.6% in June. As a result, government debt will reach CLP56 trillion (US$76.1 billion) by next December, equivalent to 27.2% of GDP, up from 25.6% at the end of last year. Following the sharp fall in revenue this year, Codelco issued bonds worth US$2.6 billion and sold a U$200 million stake in an LNG terminal in order to finance its massive investment program and delay repayment of debts until after the new mines are in operation. Without additional support from the government, management has warned that the company's debt could exceed US$20 billion within a few years, up from around US$14 billion currently.

To support the Chilean economy through the headwinds of the trade war, the government unveiled an economic acceleration program bringing forward almost US$3.0 billion worth of public investment to this year and next, designed to boost economic activity and job creation. The largest item is almost US$1.4 billion for infrastructure projects, including US$300 million on hospital building.

Another US$1.2 billion will be used to subsidize the construction of 20,000 new homes for low-income families (creating around 45,000 jobs in the construction industry). The program will also almost double the subsidies available for irrigation projects (to help farmers deal with the ongoing drought) and provide funds to purchase new equipment for the public health system. The government plans to increase public spending by 3.0% next year to US$74.1 billion under the 2020 budget sent to Congress in late September. Although the rise represents the smallest annual increase in public spending in over a decade, President Sebastián Piñera said that the plan seeks a balance between responsible management of government finances and providing a boost to Chile's flagging economy. More than a third of the spending increase will go towards public healthcare with education and public works also seeing major increases.

The increase in spending will be funded by a forecast 4.5% rise in tax revenues to CLP46.1 trillion (US$63.8 billion) driven by a 5.3% rise in non-mining tax revenue (to US$50.4 billion) and a 25.2% increase in income from state copper company Codelco (to US$1.4 billion).

However, a reduction in the long-term forecast copper price to US$2.86/lb (down from US$2.97/lb used in the 2019 budget) cut by approximately US$800 million the amount the government could spend to meet its target of reducing the structural deficit to 1.0% by 2022.

Finance Minister Felipe Larraín took the unprecedented step of including in the budget almost US$400 million of additional revenue to be raised through measures included in tax legislation which is still being debated in Congress. Senator Ricardo Lagos Weber, chairman of the Congressional Budget Committee, requested that the General Comptroller of the Republic rule on whether the newly created Autonomous Fiscal Council can advise on this issue. Chile's sovereign credit ratings were unchanged.

| | |
|---|---|
| Fitch Ratings | A (stable) |
| S&P Global Ratings | AA- (stable) |
| Moody's | A1 (stable) |
| JCR | AA- (stable) |

At the end of August, Chile's two sovereign wealth funds held assets worth US$24.8 billion, up 4.3% from the end of last year.

The gains were driven by the Pensions Reserve Fund which has grown by 8.7% this year to US$10.5 billion. However, the funds remain below highs reached last February.

## 1.5 Domestic Prices

Inflation stabilized in the third quarter after climbing gradually during the first half of the year.

The government's Consumer Price Index recorded no change in prices in September, implying an increase of 2.1% over the previous twelve months, compared to rises of 0.2% in both July and August (or 2.2% and 2.3% respectively on an annualized basis). While inflation in the second quarter was driven largely by higher electricity and fuel prices, other items have led the rise in the third quarter, with core inflation (which excludes often volatile energy and food prices) rising by 2.3% in the year to September, up from 2.0% in the year to June.

The figure reflects higher prices for non-tradable goods and services (which rose by 2.3% in the year to September) while the prices of tradable goods rose by just 1.7% over the same period.

The slight weakening in inflation in September largely reflected falls in the prices of just two items. Airfares fell by 20.7% on an annualized basis following the reduction in boarding fees announced by the government last year, while beef prices fell by 3.7% as supermarkets temporarily cut prices ahead of the September national holidays to boost sales.
Analysts expect inflation to recover in October and continue rising through the rest of the year as the impact of the stronger US dollar spreads through the economy.
Analysts surveyed by the Central Bank in early October predicted the government index to reach 2.7% by December, matching the Bank's own forecast.

However, convergence with the Bank's medium-term target of 3.0% is expected to take longer than previously anticipated. This will now occur in 2021 rather than sometime next year, the Bank said.

## 1.6 Employment and Wages

Unemployment has continued to climb, reaching 7.2% in the June-to-August quarter, up from 6.7% last December, but down from 7.3% twelve months earlier. The rise reflects the steady expansion of the workforce (up 1.4% over the last year) which the government has linked to high rates of immigration over the last three years.

Fortunately, job creation has accelerated. The number of people in work rose 1.5% in the twelve months to August to 8.461 million, compared to a 0.7% increase during 2018.

The rise was driven by new jobs in retail, mining and water management. However, the increase appears to reflect higher public spending rather than a recovery in private economic activity. The government's jobs survey showed that while the number of

### AFP Assets Under Management
(September 2019)

| Type of fund | Amount (billions of pesos) | Change October 2018 - September 2019 (%, real in pesos) | Return October 2018 September 2019 (%, adjusted for inflation) | Limits on Equity Investments (% of fund assets) | |
|---|---|---|---|---|---|
| | | | | Maximum | Minimum |
| A Funds | 18,933 | -9.2 | 5.83 | 80 | 40 |
| B Funds | 23,329 | 4.3 | 7.77 | 60 | 25 |
| C Funds | 53,859 | 10.4 | 12.52 | 40 | 15 |
| D Funds | 29,191 | 29.2 | 15.27 | 20 | 5 |
| E Funds | 32,043 | 57.4 | 13.40 | 5 | 0 |
| TOTAL | 157,358 | 16.6 | | - | - |

*Source: Pensions Supervisor (Superintendencia de Pensiones)*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public sector employees rose by 11.2% over the previous twelve months and the number of self-employed by 2.2%, the number of people employed in the private sector fell by 0.5% over the same period. Wages have continued to rise steadily, rising by 5.1% in the twelve months to August, compared to the 3.8% increase achieved in 2018. The increase was driven by higher pay in the education, manufacturing and retail sectors. Adjusted for inflation, wages rose by 2.5% in the year to August, up from a 1.2% increase in 2018.

## 1.7 Financial Markets

Share prices on the Santiago Stock Exchange rallied strongly in September after declining through most of 2019, on news that the US and China will resume talks to end their dispute over trade. After falling below 4,700 points in August (its lowest level since early 2017), the IPSA index of Chile's most-widely traded shares rose above 5,000 points on September 13th for the first time since July. It ended the quarter down 4.2% from twelve months earlier and little changed from the second quarter. The largest gains were among transport and natural resource companies.

Trading volumes reached CLP 6.6 billion (US$9.2 billion) in the quarter, down 20.1% from the second quarter of the year. Volumes in July were boosted by the acquisition of salmon producer Australis Seafoods by China's Joyvio Agriculture for over US$900 million.

Low interest rates have led Chilean companies to issue a record volume of corporate bonds. Seventy-four companies issued bonds worth CLP 5,900 billion (US$8.2 billion) during the first six months of the year, compared to CLP 8,000 billion in the whole of 2018. They included a US$548 million issue by highways operator Vías Chile and a US$400 million issue by newly-listed shopping centre operator Cencosud Shopping.

**Banking**

After slowing during the first half of the year, bank lending has begun to recover, expanding by 7.5% in the twelve months to August to CLP182.4 trillion (US$250.8 billion), compared to a 6.2% expansion in the twelve months to July.

Corporate lending has softened the most this year, expanding by just 5.6% to CLP106.9 trillion (US$146.9 billion) in the year to August, down from 9.2% in 2018.

Meanwhile, consumer lending remains strong, expanding by 10.5% to CLP80.2 trillion (US$110 billion), driven by a 16.3% expansion in consumer loans to CLP26.7 trillion (US$37.1 billion) and a 7.8% expansion in mortgage lending to CLP53.5 trillion (US$74.4 billion).

Interest rates have continued to fall, with rates on UF-priced (inflation-indexed) mortgages averaging 2.14% in mid-September, down from 3.28% at the end of last year. However, medium-term (1 to 3 years) nominal lending rates have begun to rise, reaching 12.0% in September, up from 8.3% in June.

The banking industry recorded profits of CLP1.8 trillion (US$2.5 billion) during the first eight months of the year, up 5.1% from twelve months earlier.

**Pension Funds**

The value of assets managed by Chile's private pension fund administrators (AFPs) reached CLP157.4 trillion (US$218.7 billion) by the end of September, up 16.6% from twelve months earlier, driven by the appreciation of the US dollar against the Chilean peso.

The gains were led by the conservative D and E funds which recorded double-digit returns as they benefited from the depreciation of the local currency while avoiding the falls in asset prices which affected the riskier funds earlier in the year. Savers have continued to move away from riskier investments, with the most conservative E funds gaining a net 161,403 savers during the first seven months of the year, while the riskiest A and B funds lost a net 221,117 individuals. The AFPs have reduced their exposure to overseas assets in recent months which accounted for 40.4% of assets under management by the end of September, down from 42.2% three months earlier. Around a dozen pensioners have gone to court seeking the right to withdraw all of their pensions savings, rather than receive monthly payments. The government and the AFPs are challenging the suits, warning that allowing such withdrawals could undermine Chile's private pensions system. The government has also proposed modifications to its pensions reform bill in Congress to allow such withdrawals in exceptional cases.

## Automation

Advances in artificial intelligence and automation have the potential to boost Chile's productivity but could mean radical changes for its labour force.

Mining companies have long been exploring the potential of automation of its processes. Codelco launched the first driverless trucks at its Gabriela Mistral mine almost a decade ago and now runs much of the machinery at its underground mines remotely.

This not only allows its plants to operate more efficiently but also reduces the exposure of employees to unpleasant and dangerous conditions inside the mine.

The new highly automated underground mine at its Chuquicamata division will produce as much as copper as the open pit it replaces but with one-third fewer operators.

New technologies are also shaking up the services sector. Websites have already largely replaced the role of travel agents and airline booking offices.

Bank branches could be next as more of us manage our finances on our computers and smartphones.

In August, Banco de Chile, the country's largest second bank, announced the closure of 33 of its almost 400 branches as it provides more services online.

Online shopping threatens traditional retail stores. In the United States, once thriving malls have become empty shells as consumers prefer to browse from home.

In Chile, the malls are still bustling but e-commerce is growing fast. According to the National Retail Chamber, online sales are set to reach US$7.0 billion this year, up 75% in two years. In fact, retail sales in Santiago would have fallen in the year to August were it not for sales over the internet.

Meanwhile, retailers are turning to automation to cut costs to remain competitive and improve shoppers' experience. Most Chilean supermarkets and home improvement stores now offer self-checkout machines where clients scan and pay for items themselves.

The machines are popular. Last year, Walmart opened a 100% self-checkout store in Providencia, the first not only in Chile but also anywhere in Latin America and the United States. Other chains look set to follow the trend.

But such technology could dramatically reduce retailers' need for staff, causing tensions.

When the 15,000 members of SIL, Chile's largest union, walked out on strike in July, they were protesting not just about pay and conditions but also how Walmart's automation plans would affect them.

Similarly, Codelco's plan to slim its workforce was a bone of contention during a two-week strike at Chuquicamata that same month.

As technology advances, its impact on the labour market will only deepen. Chile's relatively low productivity and low education levels make the country particularly vulnerable among OECD members.

A recent study by the Latin American Centre for Economic and Social Policy at the Catholic University (CLAPES UC) suggested that around 17% of jobs in Chile - approximately 1.1 million – are at high risk of being replaced by machines.

According to the study, transport workers will be the worst affected with almost half at risk of being replaced by a machine, followed by mining (27.6%), financial intermediation (23.2%) and fishing (22.4%).

Experience suggests that while technological change can cost jobs, as the economy develops, new roles appear to replace them. The challenge for Chile will be to ensure that the workers of today and tomorrow have the right skills to take on those new jobs.

# 2
# EXTERNAL SECTOR

## 2.1 Trade Balance

Chile's trade surplus reached US$95 million in the third quarter, compared to a deficit of US$70 million in the same period of 2018, as imports fell faster than exports. However, the quarterly surplus compares to a surplus of US$1.0 billion in the second quarter.

**Imports**

Imports reached US$16.8 billion in the quarter, down 5.9% from a year ago, driven by lower imports of fuels and consumer goods. Imports of fossil fuels declined 10.6% to US$2.6 billion, reflecting the fall in energy prices over the last year. Oil prices have continued to decline, with the West Texas Intermediate benchmark price reaching US$52/barrel by early October, down from US$70/barrel in the third quarter of last year, as global production outstripped demand.

The sharpest declines were in imports of diesel which fell 19.4% to US$700 million and imports of liquefied natural gas which fell 18.1% to US$241 million, as Chile imported more natural gas by pipeline from Argentina. Imports of non-energy intermediate goods fell 5.5% to US$6.2 billion, on lower imports of chemical and metallic goods and cardboard and paper.

Imports of consumer goods fell 10.1% to US$5.3 billion compared to twelve months earlier, in line with declining retail sales and low consumer confidence. Imports of consumer durables fell 15.2% to US$2.0 billion, especially of cars (down 28.5% to US$774 million).

However, there are signs of a recovery with imports of consumer goods rising 8.7% when compared to the second quarter.

Imports of capital goods fell 3.9% in the third quarter to US$3.8 billion in the quarter, compared to the 12.5% rise recorded in 2018.

A 26.5% decline in imports of lorries and other transport vehicles to US$479 million offset increased imports of construction and mining equipment (up 18.0% to US$283 million) and buses (up 79.8% to US$201 million).

**Exports**

Principal Exports

| | Jul-Sep 2018 (US$ mill.) | Jul-Sep 2019 (US$ mill.) | Variation (%) |
|---|---|---|---|
| Copper | 8,597 | 8,470 | -1.5% |
| Molybdenum | 443 | 399 | -9.9% |
| Fresh fruit | 883 | 852 | -3.6% |
| Salmon & trout | 1,047 | 1,126 | 7.5% |
| Wood pulp & cardboard | 1,171 | 837 | -28.5% |
| Timber products | 698 | 606 | -13.2% |
| Wine | 524 | 500 | -4.6% |

*Source: Central Bank of Chile*

The value of Chile's non-mineral exports reached US$7.8 billion in the third quarter, down 7.2% from twelve months earlier as agricultural and industrial exports both declined Agricultural exports reached US$986 million in the quarter, down 3.2% from twelve months earlier, on lower exports of fresh fruit, especially apples.

Industrial exports fell 7.7% to US$6.8 billion in the third quarter, reflecting a sharp fall in forestry exports.

Pulp and paper exports fell 28.5% to US$837 million, as exports of long-fibre pulp (Radiata pine) fell 34.3% to US$294 million. Pulp prices have continued to decline, as the slowdown in the global economy and the US-China trade war hit demand. Prices for Bleached Softwood Kraft Pulp averaged US$633/ton in the second quarter, down 17% from a year ago. Exports of timber products fell 13.2% to US$606 million as exports of sawn lumber and plywood fell.

Exports of salmon reached US$999 million in the third quarter, up 4.0% from the same period of last year, driven by increased production and higher prices.

The value of Chile's wine exports reached US$500 million in the third quarter, down 4.6% from twelve months earlier.

While exports of bottled wine fell 2.6% to US$421 million, exports of bulk wine fell 14.0% to US$79 million.

According to the Ministry of Agriculture, shipments of wine reached 656.8 million litres during the first eight months of the year, up 3.2% from twelve months earlier driven by a 16% rise in exports of bulk wine to 245.4 million litres. Exports of denomination of origin wines fell 1.8% to 297.5 million litres. Average prices fell 4.9% to US$2.06/litre on lower bulk prices.

Exports of fine wines to all major markets fell except to China which rose 3.3% to US$177 million, accounting for 18% of the total.

## 2.2 Mineral Exports

Mining production recovered strongly in the third quarter, after the torrential rains, maintenance shutdowns and labour disruptions which hit output during the first half of the year.

Production in the first eight months of the year reached 3.817 million tons, down 0.6% from the same period of 2018, although production in August surged 11.1% to 517,902 tons, its highest level so far this year. The Chilean Copper Commission expects production this year to match last year's record of 5.83 million tons.

International copper prices declined in the third quarter to their lowest level in more than two years, reflecting fears that growing US-Chinese tensions over trade could tip the global economy into recession. Prices averaged US$2.63/lb during the quarter, down from US$2.80/lb in the first six months of the year, but in early October slipped to US$2.53/lb, a level not seen since May 2017.

Predicting that the trade war would extend into 2020, the Central Bank said that it expects copper prices to average US$2.60/lb next year, down from US$2.70/lb in 2019. The government is slightly more optimistic predicting US$2.75/lb and US$2.85/lb for this year and next respectively in its 2020 budget report.

Chile's mineral exports reached US$9.2 billion in the third quarter, steady from the second quarter but down 3.2% from the same quarter of last year. Exports of copper fell 1.5% to US$8.5 billion as lower copper prices offset the rise in production. However, equally important were declines in exports of other minerals.

Exports of iron ore reached US$199 million, down 10% from the same quarter of 2018, reflecting the closure of CAP Minería's Guacolda II port facility since late last year. The company now expects to restart a new ship-loader at the port in November.

Exports of molybdenum products reached US$399 million in the quarter, down 9.9% from twelve months earlier, on lower exports of ferromolybdenum and molybdenum oxide. Production of molybdenum during the first eight months of the year fell 9.2% to 36,283 tons, reflecting lower ore grades and production disruptions at many of Chile's large copper mines where molybdenum is a by-product.

Molybdenum oxide prices declined slightly in the third quarter, averaging US$11.76/lb in July and August, down from US$12.13/lb in the second quarter. Exports of lithium carbonate declined 22.4% to US$185 million, reflecting lower prices for the mineral. These averaged US$10,375 a ton in September, down 31% from twelve months earlier.

## 2.3 UK Trade and Investment

Bilateral trade in goods between Chile and the UK reached US$334.5 million during the second quarter of the year, up 1.1% from the same period of 2018. The increase was largely due to a 2.2% increase in exports from the UK to Chile, reflecting increased deliveries of trucks and mining vehicles, offsetting a fall in shipments of cars compared to twelve months earlier.

Chilean exports to UK were little changed in the quarter at US$189.4 million. Chile's principal exports to the UK included wine, avocados, blueberries and frozen chicken.

In September, the Chilean Congress completed approval of the new Association Agreement with the United Kingdom. Once enacted by President Piñera, the treaty would allow trade between the two countries to continue under existing conditions in the event that the UK leaves the European Union without a withdrawal agreement.

During the annual Chile Day event in London on September 10th-11th, Finance Minister Felipe Larraín signed agreements with the UK government to cooperate on cybersecurity and the development of financial markets.

## 2.4 Current and Capital Accounts

Chile's current account deficit grew to US$2.9 billion in the second quarter of the year, equivalent to 4.1% of GDP, up from US$1.0 billion (or 1.4% of GDP) in the first quarter of the year. The higher deficit was the result of an increase in profits earned from Foreign Direct Investment into the country, especially mining and banking, and the reduced trade surplus. In addition to the decline in exports, the smaller surplus reflected a rise in the import of services, especially IT services.

The Central Bank now expects Chile's current account deficit to reach US$9.6 billion by the end of this year, equivalent to 3.3%

of GDP, up from 2.9% forecast in June, largely due to a fall in forecast exports. The deficit will shrink to US$9.2 billion next year as exports recover and foreign-owned companies send less profits abroad.

**Capital flows**

Chile recorded a financial account deficit of US$4.0 billion in the second quarter, compared to almost nothing in the first quarter of the year, reflecting an increase in foreign debt issued by Chilean companies and the government.

Foreign Direct Investment into Chile rose to US$4.0 billion in the quarter, up from US$2.4 billion in the first three months of the year, driven by capital contributions to companies in the manufacturing and retail sectors.

According to Chile's investment office, Foreign Direct Investment into Chile reached US$9.1 billion during the first eight months of the year, up 70% from the same period of 2018.

In October, China's State Grid Corporation announced a deal to buy Chilean distribution firm Chilquinta Energía and other assets from US-based Sempra Energy for US$2.2 billion.

Foreign Direct Investment by Chileans fell to US$887 million, down from US$2.1 billion in the previous quarter.

Financial investment into Chile reached US$1.3 billion in the second quarter, up from US$385 million three months earlier, as foreign investors bought more government debt.

Chileans invested US$1.6 billion in foreign financial assets, down from US$3.8 billion in the first quarter, reflecting a decline in share purchases.

Chile's net international debt position declined to US$65.3 billion (or 22.7% of GDP), down from US$70.3 billion at the end of last year, reflecting the increased value of assets held abroad, especially by the AFPs, thanks to the strong performance of international stock markets.

Foreign debt and international reserves

Chile's foreign debt rose to US$194.0 billion by the end of June, equivalent to 67.5% of GDP, up from US$186.7 billion three months earlier, reflecting a 10.5% increase in government foreign debt to US$26.8 billion while non-financial corporate debt grew 3.3% to US$76.7 billion.

Chile's international reserves reached US$40.0 billion in September, little changed from the end of last year. The reserves were the equivalent to 6.8 months of forecast imports. Investor confidence in Chile's finances remains firm. Five-year Credit Default Swaps fell in early September to below 30 points, their lowest level in at least five years and down from 59 points at the end of last year. Meanwhile, JP Morgan Chase's Emerging Market Bond Index (EMBI) for Chile averaged 136 basis points in August, down from 159 points in December.

## 2.5 Exchange Rate

The Chilean Peso depreciated sharply against the US dollar as investors feared US-China tensions could tip the world into recession, concerns which in turn pushed down copper prices.

The peso/dollar exchange rate averaged 705 pesos/dollar during the quarter, up from 684 pesos/dollar in the previous quarter and its highest level in more than sixteen years.


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After climbing above 700 pesos/dollar in early August, the US dollar has appreciated gradually, reaching 728 pesos/dollar, almost its highest ever level, in early October.

Analysts surveyed by the Central Bank in early October predicted that the US dollar would move towards 710 pesos/dollar in the final quarter of the year and 700 pesos/dollar over the next year, compared to 675 pesos/dollar three months earlier.

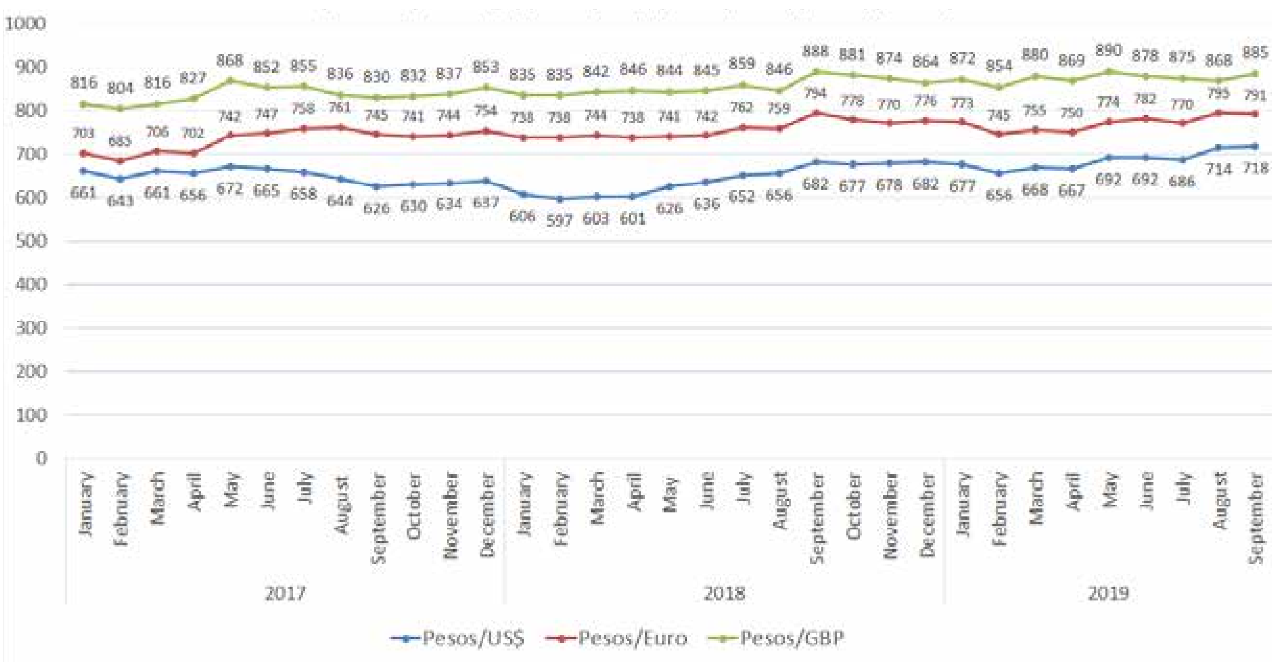
The Chilean Peso also depreciated against the Euro during the quarter, averaging 785 pesos/euro, against 768 pesos/euro in the previous quarter and 770 pesos/euro twelve months earlier.

On the other hand, the peso traded at an average of 869 pesos/pound against Sterling during the quarter, compared to 878 pesos/pound in the second quarter and 844 pesos/pound in the third quarter of 2018.

The real exchange rate – calculated by the Central Bank based against a trade-weighted basket of currencies – rose to a two-year high of 94.96 points by the end of August, up from an average of 90.74 points in 2018. In September, the Central Bank said that the rate is now above its historic averages and is expected to remain above these levels during the next two years.

Peso/Dollar Exchange Rate 2013-2019

(Monthly average, pesos/US$, pesos/Euro, pesos/pound)



# 3

# QUARTERLY INSIGHT: CHILE'S DROUGHT

# 3.0 QUARTERLY INSIGHT: CHILE'S DROUGHT

Thousands of farmers in central and northern Chile are facing severe difficulties after the country suffered its driest winter in almost seventy years.

An estimated thirty thousand cattle, sheep and goats have already died due to lack of water and pasture. Rural communities have seen their wells run dry.

In response, the Ministry of Agriculture has declared agricultural emergencies in a third of districts across central Chile, allowing the distribution of animal feed and drinking water.

So far water supplies to Chile's cities are not at risk.

But the situation could grow much worse. If Spring rains do not materialize, this year's harvest will be at risk and the effects on the economy could be multi-fold.

Lower agricultural output could slow economic activity and hit employment in the sector.

Some food prices could rise, driving up inflation more than expected. The drought could also restrict exports of some agricultural products, such as fresh fruit and wine.

But the Central Bank has reassured markets that the macroeconomic impact is likely to be limited compared to previous droughts.

That is because Chile is a much richer country that it was half a century ago when the 1968 drought forced the government to request food aid from the United States.

In addition, agriculture accounts for a much smaller proportion of the economy and labour force today and Chile is less reliant on hydropower for its electricity supplies. Its open economy means it can easily import food if needed.

But this year's record-breaking drought is being taken as a sign of things to come as climate change leads to hotter, drier weather through much of central Chile.

Adapting to change will be expensive.

Earlier this year, the government launched a national plan to build 26 reservoirs (to be financed through private concessions) which will double the amount of land under irrigation. But it will take at least a decade for all of these to be built.

The problem is not just the lack of water but that many farmers do not use it efficiently. Traditional irrigation methods, such as using unlined canals to flood fields, waste more than half the water.

As part of its Economic Acceleration Program, the government has agreed to almost double the subsidies available for irrigation projects, helping farmers to implement efficient irrigation technologies, such as drip irrigation, sprinklers, and micro-aspersion.

To ensure drinking supplies to major population areas, Chile's water companies have drawn up plans to invest US$5.0 billion by 2030 in additional treatment and storage capacity and, in some cases, desalination plants.

Ideas once thought hare-brained – such as irrigating fields with desalinated water or water pumped north from southern rivers via canals or undersea pipelines - are now being studied seriously.

They will make water much more expensive. Many farmers in dry areas will have to switch to less water-intensive crops or move to greener pastures. That could lead to significant movements of population from north to south over the coming decades, President Piñera has warned. There are also legal questions to be resolved.

Lawmakers are still debating a proposed reform of Chile's Water Code which would prioritize water for human consumption, but that farmers fear will affect their water rights.

Meanwhile, the mining industry is concerned by legislation in Congress to protect the country's glaciers, a key source of water in many valleys, but which could force the closure of four of the world's largest copper mines.

In October, President Piñera announced the creation of a National Water Council, with representatives from government, Congress, and private business, that will meet over the next two months to design a long-term plan to deal with Chile's water crisis.

Its recommendations will include a national water policy, new water infrastructure as well as necessary legal changes.

# 4
# POLITICAL CONTEXT

# 4.0 POLITICAL CONTEXT

After months of negotiations and debate, the government is beginning to advance its legislative agenda through the opposition-dominated Congress.

In August, the government's flagship tax reform advanced to the Senate after the Chamber of Deputies voted narrowly in favour of the legislation. The bill only passed after the members of the centrist Christian Democrat party broke with opposition colleagues to support the bill, following government concessions on issues such as anti-avoidance rules, more support for the regions and taxation of digital services.

Finance Minister Felipe Larraín has said that the government will likely have to make further concessions in the Senate in order to approve the legislation by the end of the year. The government achieved another legislative victory when the Chamber's Finance Committee approved its reform of the pensions system, which would increase total contributions from 10% to 14% of wages with employers paying for the increase. The legislation, which also increases benefits for the elderly poor, will be voted on in the Chamber during October.

Despite these advances, politics has been dominated by a debate over working hours.

After the government presented legislation to introduce more flexible working hours (based on a maximum of 180 hours/month), opposition lawmakers unveiled their own bill to reduce maximum working hours to forty hours a week, down from forty-five currently. Ministers and business leaders have warned that the proposal would disrupt the economy, reduce productivity and increase unemployment. However, opposition members on the Chamber of Deputies' Labour Commission passed the bill in September and it is due to be debated by the Chamber in full during October.  In response, President Piñera announced the creation of a working group of economists, former ministers and labour experts to recommend a series of measures designed to improve workers' quality of life.

In September, opposition lawmakers sought but failed to impeach Education Minister Marcela Cubillos over the implementation of the new school admissions law, her handling of a lengthy teachers' strike and management of the state school system. Although the government has a minority in the Chamber of Deputies, the motion was stopped from advancing to the Senate after a handful of centrist deputies voted with government supporters or abstained, highlighting continued divisions within the opposition.

Support for the government has improved in recent weeks but remains low. According to the weekly Cadem poll, approval of President Piñera reached 34% in early October, up from a low of 29% in August but down from 44% in February this year.

Disapproval has declined slightly, reaching 53%, down from a mid-year peak of 59% in June. While supporters highlighted the improved performance of the economy since he came to office, critics focused on his failure to fulfil campaign promises. President Piñera was invited to attend the G7 summit of the world's richest economies in August in Biarritz, France to discuss the upcoming APEC and COP meetings in Chile.

Following a clash between the presidents of Brazil and France, Piñera was asked to coordinate global support for fighting forest fires in the Amazon rainforest. In September, he attended the United Nations Climate Action Summit in New York where he helped to launch a new Coalition for Ambition for states, regions, companies and other organizations to set their own emission reduction targets and a global alliance to protect the world's rainforests.

Former president Michelle Bachelet denied any knowledge of contributions made to her 2013 election campaign by the Brazilian construction company Odebrecht as alleged by one of the suspects in the massive Lava Jato corruption scandal.

## A weekend of unrest

Over the weekend of October 18th-20th, Chile was hit by the worst outbreak of civil unrest in a generation, leading the government to declare a state of emergency and impose curfews in Santiago and other major cities.

The incidents began with protests against a CLP30 (US$0.04) increase in the price of a peak-hour metro ticket to CLP830 (US$1.14) with hundreds of students and schoolchildren jumping the turnstiles at metro stations to avoid paying fares.

However, following clashes with police, the protests turned violent with protesters vandalizing metro stations and setting them on fire.

As the situation escalated with protesters throwing stones at police who responded with tear gas and water cannon, the government was forced to shut most of the metro system causing chaos at the height of the Friday rush-hour.

Protesters set up barricades at major road junctions while mobs looted supermarkets, petrol stations and other businesses, leading President Sebastian Piñera to call the army onto the capital's streets, the first time this has happened since the return to democracy in 1990.

Peaceful demonstrations, together with looting and unrest continued even after the government announced that it would reverse the increase in transport fares with protesters citing a long list of grievances, from rising electricity bills and meagre pensions to the poor state of public schools and hospitals.

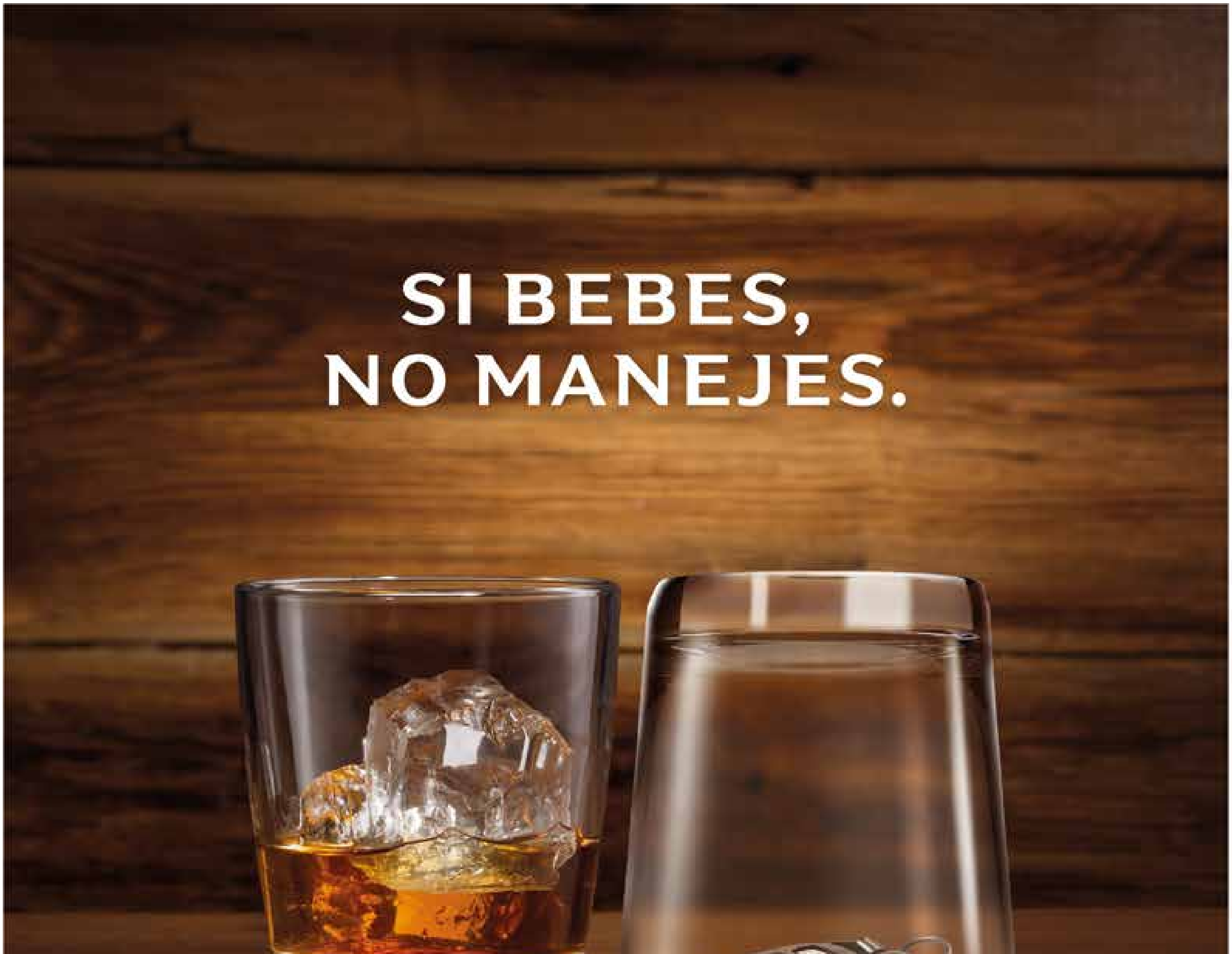
Thousands of Chileans took to the streets to bang pots and pans against the government and its heavy-handed security measures, though a Cadem poll over the weekend indicated that 53% supported the state of emergency.

By the end of the weekend, hundreds of people had been arrested while ten had died as the result of fires in looted supermarkets and factories. Damage to the metro system alone has been estimated at US$300 million.

With soldiers and protesters still on the streets of most major cities, thousands of businesses and schools shut and curfews still in force, it was not clear as this report went to print when the situation will return to normal.

The government is under pressure to halt the rioting not least because Santiago is due to host both the APEC Leaders' Summit and COP25 Climate Change Conference in the coming weeks.

While some members of the opposition, which has majorities in both houses of Congress, have condemned the violence, they have also demanded changes to the government's legislative agenda to tackle the inequities raised by the protesters.




JOHNNIE WALKER
*Keep Walking*

# 5
# ECONOMIC OUTLOOK

# 5. ECONOMIC OUTLOOK

US-China relations and their impact on global trade flows are set to dominate the development of the Chilean economy over the coming months.

After Beijing and Washington failed to resolve differences in Tokyo earlier this year, many analysts, including Chile's Central Bank, expect the trade war to drag into 2020. The situation could grow more volatile as the conflict's instigator US President Donald Trump faces not only elections next year but also possible impeachment by Democrats in Congress.

This is likely to further slow growth among Chile's trade partners – the Bank estimates that the Chinese economy will grow by 5.5% next year, its slowest rate in a decade.

This will hit copper prices which the Bank now expects to average just US$2.60/lb in 2020, down from US$2.70/lb this year, causing Chile's exports to stagnate.

If copper prices stay low for longer, mining companies may reduce spending and delay major investment projects, seen as central to a sustained recovery in economic growth.

Some of these impacts will be mitigated by the sharp reduction in interest rates and the impact of a stronger US dollar on the competitiveness of Chilean exports. The government has promised public spending to bolster the economy but is constrained by its commitment to reduce the deficit. Approval of the government's tax reform and other initiatives could boost confidence as long as they are not too diluted during their progress through the opposition-controlled Congress.

## Economic Forecasts, 2019

| | Central Bank [1/] | Finance Ministry[2/] | Private analysts[3/] |
|---|---|---|---|
| GDP (% annual variation) | 2.25-2.75 | 2.4-2.9 | 2.50 |
| Inflation (% annual variation) | 2.7 | 2.2 | 2.7 |
| Monetary-policy interest rate (% annual, nominal, end-year) | 2.00 | NA | 1.75 |
| Exchange rate (pesos/US$) | NA | 690 | 710 |
| Copper price (annual average, US$/lb) | 2.70 | 2.75 | NA |

*Source: Central Bank of Chile*

# 6. LATIN AMERICA REGIONAL NEWS

Voters in Argentina and Uruguay were all due to vote in presidential elections as this report went to print.

**Argentina**: Peronist Alberto Fernandez looks set to win presidential elections on October 27th, after trouncing President Mauricio Macri in August's primary vote. The result sparked panic in financial markets, with the Buenos Aires Stock Exchange's MERVAL index losing almost 40% of its value in one day, forcing the government to reintroduce capital controls to halt a run on the peso.

**Bolivia**: President Evo Morales won the first round of voting in the presidential election on October 20th with 45% of the vote, according to preliminary results. However, he now faces his first run-off since taking office 14 years ago against centrist candidate Carlos Mesa, a former president. The government's tardy response to massive wildfires in the east of the country sparked huge protects in Santa Cruz and other cities ahead of the poll.

Brazil: The Central Bank said that the economy will grow by 0.85% this year, its slowest expansion since emerging from recession in 2016. President Jair Bolsonaro has begun to open up the economy to more international competition by cutting tariffs on hundreds of manufactured goods.

**Colombia**: Unemployment reached 10.8% in September, its highest rate in almost decade, as the workforce is swelled by immigrants from neighbouring Venezuela while the trade war has cost jobs in agriculture and manufacturing.

**Ecuador**: A plan to withdraw fuel subsidies triggered protests by lorry and taxi drivers which quickly escalated into a nationwide revolt against the government's austerity program which left seven dead and paralyzed the country. Peace was only restored after President Lenin Moreno sent troops on to the streets and agreed to maintain the subsidies.
**Mexico**: The Mexican economy grew by just 0.3% in the year to July as the country feels the effect of the trade war.

In September, the Bank cut interest rates by 25 basis points to 7.75%, citing slack in the economy and slowing inflation.

**Peru:** The country faced its worst political crisis in 30 years after lawmakers resisted President Martin Vizcarra's call to dissolve Congress and hold early elections in January 2020. Analysts fear that months of turmoil may now hit the economy which grew by 3.3% in twelve months to July.

**Uruguay**: The centre-left Broad Front coalition was expected to lose power for the first time in twelve years in elections on October 27th.

The centre-right National Party's candidate Luis Alberto Lacalle is likely to succeed President Tabaré Vásquez. The economy grew by just 0.1% in the second quarter, slowed by the recession in neighbouring Argentina.

**Venezuela**: Official negotiations between the government of President Nicolás Maduro and opposition leader Juan Guaidó, backed by Norway, ended without a deal in September.

However, talks have continued between the government and other opposition groups.

# UK ECONOMY Q2 - 2019

**1. Economic growth**

The Office of National Statistics (ONS) stated the UK economy contracted by 0.2% in Q2 (Apr – June), down from growth of 0.5% in Q1 (Jan – March). This is the first quarterly contraction since 2012, partly driven by the reversal of the build-up of stocks in Q1 ahead of 29th March. Both production and construction contracted by 1.4% and 1.3%, respectively. Manufacturing declined by 2.3%, the biggest rolling three-month contraction since April 2009. This was slightly offset by 0.1% growth in services, although this was the weakest quarterly growth seen in services since Q2 2016. Monthly GDP growth in June was flat at 0.0%, down from 0.2% growth in May 2019. Service growth was flat for the month, and construction and production sectors declined by 0.7% and 0.2%, respectively. The National Institute of Economic and Social Research now forecast GDP growth of 0.3% in Q3. The IMF revised down its UK growth forecast for 2019 by 0.1ppt, to 1.2%, reflecting a combination of downward pressures from weak global growth and ongoing Brexit uncertainties.

**2. Inflation**

Annual CPI and CPIH (includes owner-occupiers housing) both increased by 0.1 ppts in July to 2.1% and 2.0%, respectively. The increase in inflation was driven by increasing prices for games, accommodation services, clothing and financial services. The increase was moderated by a large downwards contribution from transport services. Estimates suggest growth in average weekly earnings increased to 3.9% in the year to June for regular pay (excluding bonuses). When adjusted for inflation, pay increased by 1.9% in the same period. Earnings growth can in part be attributed to increases in certain parts of the public sector and a 4.9% increase in the National Living Wage in April. The UK house price index indicates that house price inflation was 0.9% in the year to June 2019, unchanged from the year to May 2019. There has been a slowdown across the UK over the last three years, but the greatest slowdown has been in the south and east of England; London saw the biggest contraction, with prices falling by 2.7% over the year to June 2019.

**3. Monetary policy**

At the Monetary Policy Committee meeting on 18th September, the committee voted unanimously to maintain the official Bank rate at 0.75% - keeping the July meeting decision. In addition, the committee voted unanimously to maintain the stock of sterling non-financial investment-grade corporate bond purchases at £10bn and maintain the stock of UK government bond purchases at £435bn.The minutes of this meeting reemphasised the importance of EU exit related factors on the path of monetary policy, which "will not be automatic and could be in either direction". The latest quarterly inflation report forecasts that inflation will fall below the 2% target, to 1.6% by Q4. Across a three-year horizon, they expect that inflation will rise to 2.4%.

**4. Labour market**

In the three months to June 2019, the unemployment rate increased marginally, by 0.1ppt to 3.9%, the first increase in the unemployment rate since June-August 2018. The employment rate was unchanged at 76.1%, whilst the employment level increased by 115,000 on the quarter to 32.8m – a record level. The employment rate for women rose by 127,000, whilst for men it fell by 12,000. Economic inactivity for all people in the three months to June stood at 20.7%, which is a joint-record low. This was driven by a fall in the female inactivity rate, which has continued to fall to a record low of 25.1%. UK productivity fell by 0.6% in Q2 (Apr-June), which represents the fourth consecutive quarter of negative quarter-on-year growth rates. This was a result of weekly hours worked growing faster than production. There were significant net flows away from low-skilled jobs (-32,000), towards medium-skilled jobs (48,000) in Q1 2019.

**5. Trade**

In Q2 (Apr-June), the UK's headline total trade deficit (goods and services) narrowed by £16.0bn, to £4.3bn, due to a fall in imported goods. In June, there was a trade surplus of £1.8bn, the first monthly surplus since February 2011. The leading factor in narrowing the trade in goods deficit was falling imports of unspecified goods (including non-monetary gold), chemicals, machinery and transport equipment. Excluding these unspecific goods (including non-monetary gold), the trade deficit narrowed by £6.2bn, to £4.0bn in Q2. In the year to June 2019, the total trade deficit increased by £19.9bn, to £42.8bn. The goods deficit widened by £14.4bn, to £149.2bn, whilst the services surplus narrowed by £5.5bn, to £106.4bn.

**6. Government finances**

Public Sector Net Borrowing (PSNB) in August was £6.4bn, which is £0.5bn smaller than in August 2018, and £0.6bn smaller than market expectations. Borrowing in the current financial year (April 2019 to August 2019) was £31.2bn, £6.8 billion more than in the same period last year. Public Sector Net Debt excluding public sector banks (PSND ex) was equivalent to 80.9% of GDP (£1779.9bn), a decrease of 1.5 ppts compared with August last year. Public Sector Net Borrowing (PSNB) for the full year 2018/19 has also been revised up by £17.8bn to £41.4bn, largely due to changes in methodology[1].

**7. The IMF revised its growth outlook**

The IMF revised their 2019 forecast for UK GDP growth upwards, but its projections assume an "orderly Brexit followed by a gradual transition to the new regime". The Fund forecast growth of 1.3% in 2019 (revised up 0.1% from their April forecast) and maintained their forecast for 2020 at 1.4%. The slight increase reflects stronger than anticipated Q1 growth, largely due to stockpiling ahead of the original EU-exit date. However, much uncertainty remains around the UK's EU-exit outcome and, by extension, the UK's short-term economic performance.

*[1]The new approach includes student debt, which has increased borrowing by £12.4bn, after the ONS recognised that "a significant proportion of student loan debt would never be repaid." There have also been revisions to the treatment of pensions and corporate tax which have increased borrowing by £1.3bn and £2.6bn respectively. Whilst methodology changes to student loans and corporate tax has not affected Public Sector Net Debt (PSND), the changes to pensions has reduced PSND by £28.6bn.*

# Brexit Update

## The Irish question

The timing of the United Kingdom's withdrawal from the European Union is in doubt after the House of Commons withheld support from the latest deal struck between London and Brussels.

Once again, the sticking point is relations between Northern Ireland and the neighbouring Irish Republic, the UK's only land border with the EU.

Although hardly mentioned during the 2016 referendum on EU membership, the status of Northern Ireland has proved to be a key issue during the withdrawal negotiations. The reasons are historical.

After the Irish War of Independence ended in 1921, Ireland was divided in two. Most of the island broke away to become an independent country, the Irish Republic, while the northeast corner, Ulster, remained part of the UK as Northern Ireland.

From the late 1960s onwards, Northern Ireland erupted in violence between members of the Catholic community (who increasingly wanted to see Ireland united), Protestant groups (who wanted to remain part of the UK) and the British Army which was deployed to keep the peace.

More than 3,500 people were killed over the next three decades.

Peace was finally secured with the 1998 Good Friday Agreement between the UK and Irish governments and politicians from the Catholic and Protestant communities.

As well as the disarming of paramilitary organizations, the withdrawal of British troops from Northern Ireland and the creation of a devolved legislature and executive in Belfast, the agreement also recognized the right of people living in Northern Ireland to hold British or Irish citizenship or both as they wished.

Since the deal came into force, the border between Ireland and Northern Ireland has essentially disappeared, with people, goods and even animals moving between the two jurisdictions largely unimpeded.

However, this arrangement has been possible because both Ireland and the UK are EU members.

Fearing a return to the conflict of the past, the EU has made the avoidance of a hard border between Ireland and Northern Ireland a key demand during withdrawal negotiations with the UK government.

Under the first deal reached in 2018, Prime Minister Theresa May agreed that the whole of the UK would remain aligned with EU regulations until arrangements can be agreed that preclude the need for a physical border.

This proposal was rejected three times by the UK parliament, partly because of opposition from "hard-Brexit" Conservatives who fear it would tie the UK to the EU indefinitely.

The new deal reached in October by Mrs May's successor Mr Johnson avoids a border on the island of Ireland by replacing it with custom checks in the Irish Sea.

But this has proved just as controversial. It is strongly opposed by the government-supporting Democratic Unionist Party who fear it will weaken ties between Northern Ireland and the rest of the UK as well as opposition parties who want to maintain strong links to the EU.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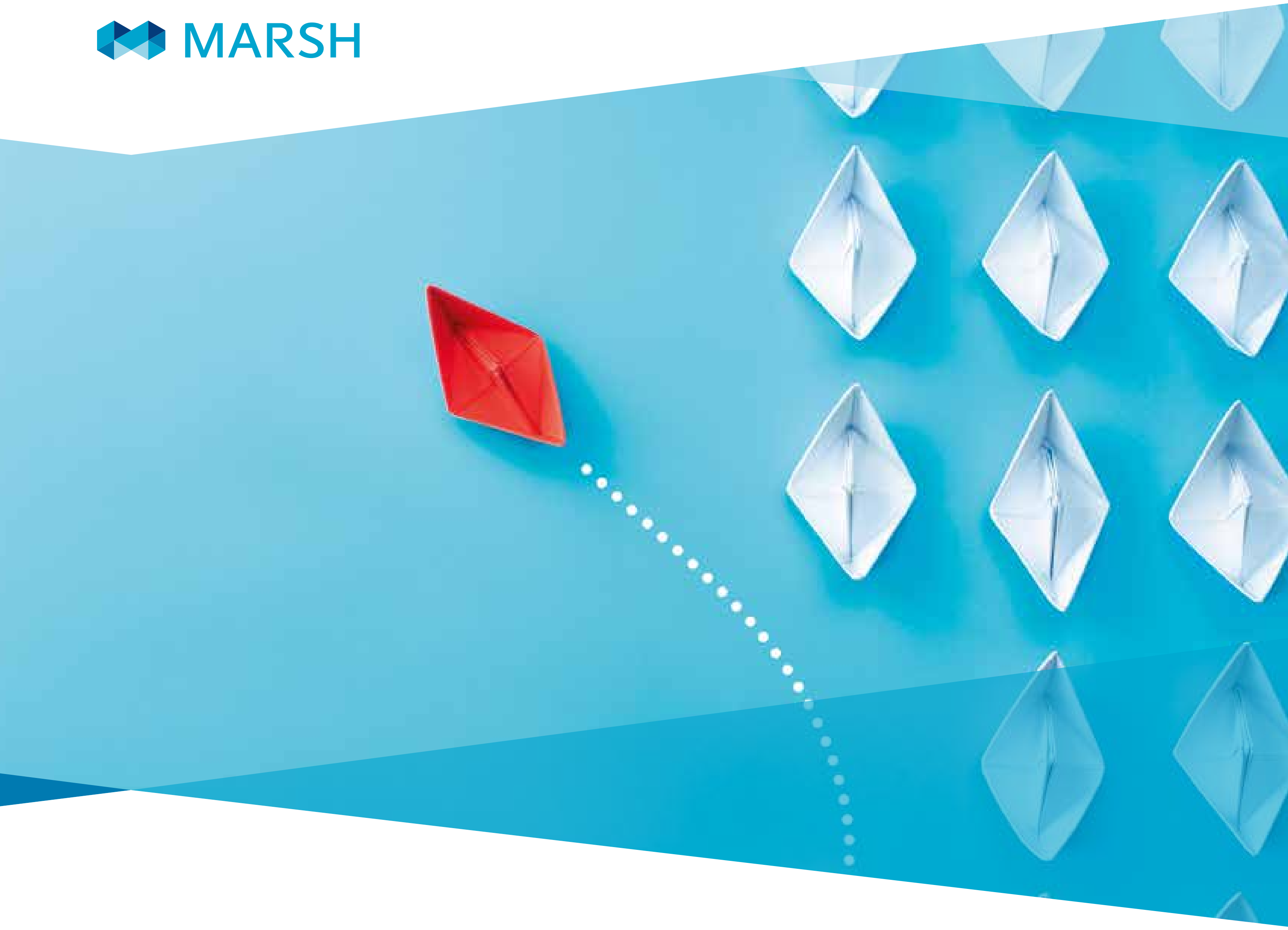

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