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CHILENO BRITÁNICA
DE COMERCIO

Monthly Economic Update

July 27th, 2022

Campaigning has now begun ahead of the September 4th referendum on whether Chile should adopt the proposed constitution drawn up by the Constitutional Convention. Calling for radical changes to the country's system of government, the legislature, judicial system, social and property rights, the finished document does not enjoy wide support. While the government and its coalition largely back the text, other political parties and a majority of voters want either to approve it only to make significant changes to the text or to reject it and reform the existing constitution.

Faced with polls suggesting that voters will reject the new constitution at the referendum, President Gabriel Boric has now acceded to the idea of making improvements to the text once it has been approved. If Chileans vote to reject the proposed document, he has said Chile should elect a new constitutional convention to draw up a new text, a process which could take at least another 18 months. Opposition lawmakers have instead proposed reforming Chile's current constitution, advancing legislation to reduce the qualified majority required for constitutional reforms from 2/3 or 3/5 to 4/7.

Following meetings with civil society and business leaders, the government unveiled its flagship tax reform which aims to boost public revenues by around 4.2% of GDP by 2026 by increasing taxes on shareholders, the wealthy and mining companies. While corporate income tax will be cut from 27% to 25%, a new 22% tax on dividends would be introduced. Individuals earning more than CLP 4.0 million (US$4,280) a month would see their margin tax rate rise by 3-5 percentage points to a maximum of 43%, while those with fortunes worth more than US$5.0 million would have to pay the equivalent of 1% in an annual wealth tax, rising to 1.8% for those worth more than US$15.0 million.

The government will also clamp down on tax avoidance evasion, eliminate some tax breaks and impose a new 1-2% royalty on mineral exports (rising to 1-4% for the largest mines), plus a 5-32% levy on mines' operating margins. Given its lack of a majority in the Senate, the government will likely have to water down these proposals to obtain approval, reducing its impact on public finances.

To mitigate the impact of high energy prices, rising inflation and worsening economic conditions, the government announced a one-off payment of CLP 120,000 (US$130) to 7.5 million vulnerable individuals as well as the extension of job subsidies and benefits for working parents. These measures are expected to cost an additional US$1.2 billion or around 0.2% of GDP. Despite the additional spending, the government remains on target to reduce public spending by around 20% this year while the public deficit is expected to fall to 0.1% of GDP thanks to higher-than-expected tax revenues.

Economic Statistics

The Chilean Peso has depreciated by around a fifth against the US dollar, moving from below CLP 800/dollar in early April to record levels above CLP 1,000/dollar by mid-July. Mirroring the dollar's appreciation against most currencies as investors anticipate a sharp rise in US interest rates, the fall in the peso has been attenuated by the slump in copper prices, which has deepened the country's current account deficit, as well as uncertainty over the new constitution. An attempt by the Finance Ministry to reverse the fall by promising to sell US$5.0 billion in excess liquidity proved fruitless.

After initially resisting government calls to intervene on the grounds that financial markets were operating normally, the Central Bank finally announced on July 14th an unprecedented intervention to support the peso. Between July 18th and September 30th, the Bank will sell up to US$10 billion of US dollars and US$10 billion in currency hedges and offer currency swaps for up to US$5.0 billion. The announcement caused the Chilean Peso to fall from CLP 1060/dollar to CLP 920/dollar before recovering to around CLP 950/dollar by July 25th. Analysts predicted that the local currency will trade around CLP930/dollar over the next two months, declining to CLP878/dollar by June 2023.

Inflation has continued to accelerate with the government's Consumer Price Index rising by 0.9% in June to reach an annualized rate of 12.5%, its highest level in almost 25 years. Volatile food and energy prices explain much of the increase (each rising by around 20% over the last 12 months) although underlying inflation reached a record 9.9%. Reflecting the sharp fall in the peso since April, inflation expectations have continued to rise with traders surveyed by the Bank in early July predicting prices to rise by 7.85% over the next year and by 4.60% over the following year, far above the Central Bank's medium-term target range.

In response, the Central Bank has intensified efforts to tame inflation. On July 13th, the board unanimously agreed to increase its benchmark interest rate to 9.75%, its highest rate in two decades. Although the Bank had predicted in June that future rate hikes would be smaller, the 75 basis-point increase matches that made in June. Analysts surveyed by the Bank now expect the rate to reach to 10.00% by the end of the year (up from 8.00% predicted three months earlier) before falling to 6.50% by end-2023.

The slowdown in economic activity is continuing after record growth in 2021. Preliminary data showed that the economy contracted by a seasonally adjusted 0.3% in April and by 0.1% in May (or up 6.4% from twelve months earlier). After exceeding expectations in the first quarter, retail activity has begun to slow, declining by 2.3% in May while services fell 0.1%. In July, the government predicted that the economy would grow by 1.6% this year, in line with Central Bank and private forecasts.

Mining production has begun to recover after weak start to the year. Copper production hit 480,275 tonnes in May, the highest monthly figure since December and up 13.9% from April. However, production in the first five months of the year totalled 2.2 million tonnes, down 6.5% from a year ago as producers struggled with water shortages, lower ore grades and other problems.

Copper prices have slumped over the last two months on fears that the world economy is heading into recession as central banks tighten monetary policy. Prices on the London Metal Exchange fell from around US$4.60/lb in April to US$3.30/lb by late July. As a result, Chilean exports fell to US$8.5 billion in June, down 8.6% from May, triggering the country's first monthly trade deficit so far this year.

After rallying during the first five months of the year, shares prices in Chile have declined amid growing concern over the state of the global economy and rising inflation. After reaching a record 5,387 points in late May, the IPSA index of the largest companies listed on the Santiago Stock Exchange fell briefly below 5,000 in June before recovering to 5,230 points by late July.

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