

LatAm Watch

Chile trip notes: Patience & Moderation

Policy uncertainty: large decline

We met economists, political analysts, and policy makers in Chile. Policy uncertainty has declined markedly post rejection of the constitutional draft and continues to decline amid structural reform negotiations. Inflation convergence not there yet to cut rates.

Monetary policy: better late than wrong?

On monetary policy, local economists we met perceive the BCCh has a hawkish reaction function, more concerned on inflation persistence than on activity weakness or global banking tensions.

BCCh is seen as cautious and may need to be very confident about inflation convergence before starting the cuts, according to economists we met. Inflation likely also harder to predict coming from high levels.

Most locals we met think BCCh can cut as soon as in June's meeting, but with substantial risks of a delay to 3Q. Once they start, cuts could be substantial if needed, as real interest rates are at historically high levels.

Upside inflation and activity surprises since last monetary report should lead to higher inflation and activity forecasts and perhaps a higher rate corridor, according to economists we met.

Hawkish activity & inflation surprises. FX supportive

Consumption seems to be adjusting more slowly than anticipated, likely on the heels of resilient activity. Deleveraging of families using stimulus money opened room to larger than anticipated retail lending. This could explain resilient inflation in goods, despite CLP appreciation.

Locals are not concerned about the fiscal deficit given Mario Marcel's commitment with fiscal discipline. Interestingly, locals are not focusing on the impact of expansionary fiscal policy on inflation.

Chileans are not too concerned about domestic banks despite the global backdrop. However, some local investors are eyeing the impact of quantitative tightening (unwind of cheap BCCh loans to banks, to be done through 2Q24).

FX uncertainty seen as declining substantially amid lower policy risk (reforms moderation) and high metal prices. Local investors are wondering when BCCh could start unwinding FX forwards and rebuilding FX reserves, but this may not be a priority now. The government is seen pursuing a de-dollarization strategy.

Structural reforms: moderating moderation

Policy uncertainty has declined markedly post rejection of the constitution draft and continued to decline amid structural reforms negotiations (continues inside).

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We saw locals more optimistic regarding structural reforms despite the tax reform setback in Congress. The government is perceived to show flexibility to introduce the changes needed to advance with tax and pension reforms, seeking a broader agreement.

Tax Reform: moderate optimism on a watered-down reform

Regarding the tax reform, the government is expected to move in parallel with three initiatives: 1) the mining royalty, 2) corrective green taxes and 3) the broader tax reform. Locals we met were optimistic the royalty could pass congress this year, possibly with some further reduction in the tax burden (expected to collect around 0.4-0.5% of GDP). Corrective taxes would be presented in 2Q and could collect about 0.3% of GDP according to a legislator from the center left.

The broader tax reform would be presented in the Senate where it requires 2/3 support (due to the rejection in the Lower House). This would be focused on income taxes as analysts we met expect they will scrap taxes rejected by the opposition (wealth, retained earnings and corporate taxes).

Pension reform: big changes needed

We came back a bit more constructive about the chances of passing some kind of pension reform, though still not our base case. The current pension reform is seen as unlikely to pass the congress as it is too complex, and some proposals generate strong opposition (notional accounts, strong role of the government).

A couple of political analysts we met see the government as willing to negotiate some important changes to make the reform more palatable. For example, to replace the proposed notional accounts for a scheme where the additional 6% contributions go partly to individual capitalization accounts, partly to finance a new pay-as-you-go system. Also, the opposition would require measures to ensure competition both for the administration of the system (back-office) and the management of savings.

Risks: if the government fails to pass any tax changes there will be pressures on the fiscal deficit amid promised social spending. Some analysts we met believe if none of the reforms or changes pass Congress, another round of pension fund withdrawals is a real risk.

Constitution: is another referendum rejection the main risk?

All analysts we met expect a moderate and reasonable constitutional draft amid the important role of experts committee and Senate checks on basic principles (e.g. property rights). Still, the new constitution it is expected to enhance social rights and put some pressure on government spending, but with the counterbalance of fiscal discipline.

Political analysts we met believe there is a real risk that the new constitution is rejected in the exit referendum (December), given the government's low popularity and the lack of interest of the population in the process. This would perpetuate the uncertainty about the new constitution, a drag for investment. Note a recent Cadem poll showed a majority of Chileans would reject the new constitution in December despite the majority believing Chile needs a new constitution.

Mining framework

The government is expected to present a new framework for Lithium investment and production (it represents about \$8bn of exports and 1.5% of GDP in government revenues) open to partnerships between the private and public sectors. Environmental related frictions and risks are also perceived as a factor delaying investments.

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