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Chile Economics | Latin America

The Times, They Are a-Changin'

The elections yielded a bearish outcome for markets, with unorthodoxy gaining ground. Disruptive outcomes are not the base case, but we see a larger public sector in the coming years, with growth bearing the burden.

The result of this weekend's elections were negative for market participants, with unorthodox platforms gaining ground. Chileans went to the polls to vote for local governments and the upcoming Constitutional Convention, which will be tasked with writing the new constitution in the coming year. A strong showing by party lists with unorthodox platforms and independent candidate lists in the Convention weakened the two main blocs of the current political establishment and yielded a fairly fragmented outcome. Still, candidates with unorthodox policy platforms did not attain the 66% threshold that would be required to push forward disruptive outcomes. The municipal elections also cast additional uncertainty around the outcome of the November presidential elections.

Based on the election results, we see several potential points of change in the new Constitution. These include: 1) an expansion in the role of the public sector through new social rights' protections in the Constitution; 2) a more decentralized government structure, with additional autonomy for regional governments and a more even split of powers between the President and Congress (such as a shift to a semi-presidential regime; and 3) reform of the Constitutional Court, likely reducing its powers. We think the orthodox macro framework (i.e., central bank independence and fiscal prudence) is likely to be maintained, but there could be more pressure on the business environment in coming years.

We think economic growth, and possibly fiscal metrics, will likely bear the burden of a bigger public sector. The election results further skew incentives toward a larger state role in Chile. Starting out with a relatively small public sector and taking into account a solid institutional framework, we continue to think Chile has room to expand its public sector without derailing its macro prudence, but the growth outlook could pay the price. The ongoing debate around proposals to fund an expanded social safety net is not focused on deficit-widening, but rather on increasing taxation on corporations and financial wealth to cover additional expenditure commitments. Various wealth tax proposals, the mining royalty bill, and a temporary surcharge on large corporations having somewhat advanced in Congress are examples that underscore the potential for a more challenging backdrop for private investment, and thus growth prospects, in the coming years. With candidates who support various policies that could increase financial scrutiny on corporations winning seats in the recent election, we think this route is the more likely one to fund Chile's bigger government ahead. Past episodes of gradual fiscal deterioration in the region (such as Brazil post the 1988 Constitution) somewhat resemble Chile's current environment and thus warrant caution around the buildup of structural spending pressures.

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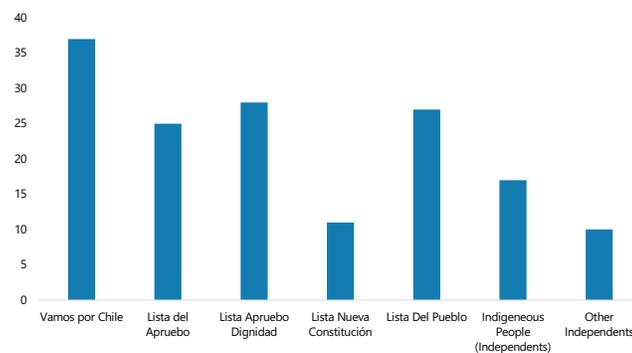
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The Times, They Are a-Changin'

This past weekend, Chileans went to polls to vote for the Constitutional Convention (a body composed of 155 delegates who will be in charge of rewriting the Constitution over the coming year) as well as local governments, namely municipal mayors and councillors. Below, we outline the results for both elections, as well as our take on what they mean for Chile's future.

The main lists and their proposals

Exhibit 1: Chile: Constitutional Convention Composition (# of seats per list)



Source: Servel, DecideChile, Unholster

We briefly describe the broad views of the main lists, which won seats in the Convention, per the preliminary results of the elections (see [Exhibit 1](#)).

Vamos por Chile (~24% of seats): Represents the current Executive and the center-right ruling coalition. Closest to maintaining the current, more liberal Constitution. Agrees on some social demands and the need to reform the Constitutional Court, but not eliminate it. Favors a small reduction of presidential powers, but maintenance of the presidential regime.

Lista del Apruebo (~16%): Represents the center-left political establishment. Wants a Constitution that broadens social rights and widens the social safety net. Favors a move towards a more decentralized government regime, such as semi-presidentialism. Overall in favor of preserving the current orthodox macro framework (i.e., central bank independence and fiscal prudence), but proposes to change the role of the Chilean state away from a subsidiary state to one focused on social rights.

Lista Apruebo Dignidad (~18%): Party coalition list that represents the unorthodox camp, according to political observers. Want a deep Constitutional overhaul that places social and human rights at the center of the institutional framework. List proposes to advance a new economic model "to overcome neo-liberalism." Favors a move towards a more decentralized government regime. Some elected delegates are in favor of a revision to the central bank's role in the economy.

Lista Nueva Constitución (~7%): Independent candidate list with a centrist stance; favors a wider role for the state and more scrutiny on use of environmental resources, but is in favor of fiscal discipline and central bank independence. In favor of broader decentralization of presidential powers, but there are diverging views within the list around the ideal magnitude of decentralization.

Lista del Pueblo (~16%): Independent list with broadly unorthodox proposals. Are in favor of rethinking the central bank's role in the economy, focusing against "neo-liberal practices", according to their platform statement, and against a pure market economy.

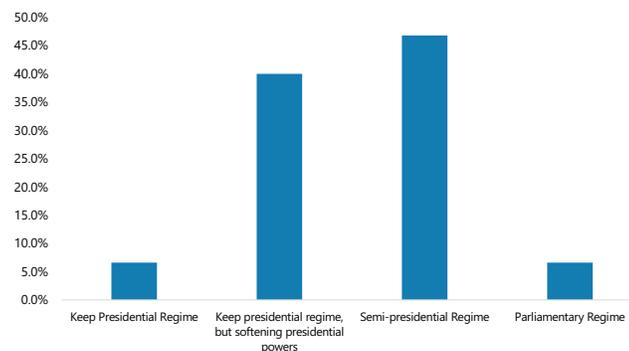
Other independent lists (~19%): Entails many different political movements, but it is worth mentioning that within this group some 17 seats (~11% of total) were reserved for indigenous people (native Chilean populations), a political group that historically has been more aligned with more unorthodox policies.

Our take and most likely changes

We think results were bearish for markets, with uncertainty to remain high over the coming year. Votes were fairly spread across different political movements, with none of the main party or bigger independent lists having obtained more than 25% of seats. Moreover, in line with our latest preview, full independent candidate lists and those seats reserved for indigenous people are poised to occupy around 40% of seats, thus casting an additional layer of uncertainty given that most of these two groups' lists carry at least some degree of unorthodox or deficit-widening proposals (see: "[Chile Economics: What to Expect of the Constitutional Convention](#)," in Chile and Peru Strategy & Economics, March 31, 2021). With the ruling coalition attaining less than 33% of seats, uncertainty is poised to remain high amid the risk of unorthodox proposals gaining traction in the Constitutional Convention. Still, we think that more unorthodox proposals – such as limits on property rights, eliminating central bank independence, or a more permanent change to the fiscal framework – remain unlikely, as the lists that could potentially push for those policy changes did not attain the 66% majority. Indeed, based on their track record for policymaking, we think the two main camps of the political establishment would stand together against more extreme proposals, which in turn would represent a safeguard against more profound changes to Chile's macroeconomic model.

We continue to think potential revisions to the Constitution could include changes regarding the government regime, the Constitutional Court, and the role of the Chilean state as guarantor of social rights. Consensus-building is necessary for Constitutional changes to materialize, and we think topics in which there is a broader degree of agreement across the political spectrum are the more likely ones to be approved. Based on lists' proposals and the splitting of seats, we think those topics are:

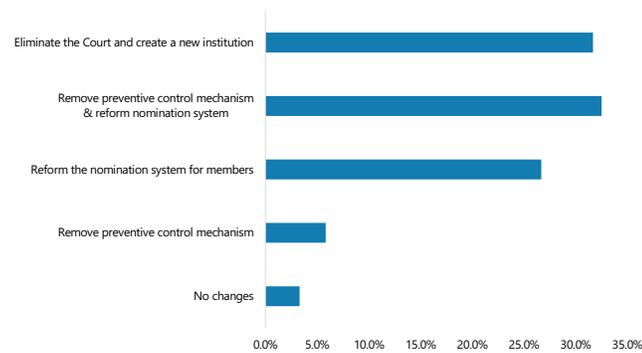
Exhibit 2: Chile: Constitutional Convention Delegates – Views on Government Regime (% of answers)



Source: La Tercera

Government Regime (see Exhibit 2): There seems to be some degree of consensus across the political spectrum about a more even distribution of powers between the Executive and Congress, such as a possible move towards a semi-presidential regime. In practice, this could mean that the balance of powers between Congress and the President would tilt toward the former. Indeed, party lists and independent candidates across the political spectrum have proposed a semi-presidential framework, whereby the role of Head of State would be delegated to the President, and the Chief of Government role assigned to Congress, via a Prime Minister. There is also an ongoing debate about whether the President holds excessive powers around certain structural matters, such as the Executive's exclusive power to propose legislation that touches on budgetary or social security matters. That debate has heated up amid the recent use of this Constitutional authority to allow the Executive to block initiatives proposed by the opposition in Congress via the Constitutional Court.

Exhibit 3: Chile: Constitutional Convention Delegates – Views on the Constitutional Court (% of answers)



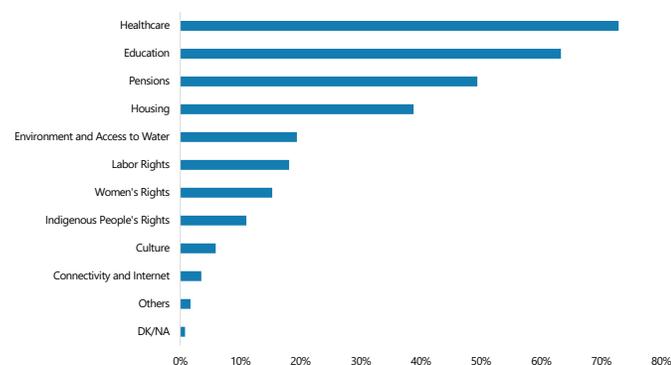
Source: La Tercera

Constitutional Court (see Exhibit 3): Most candidate lists agree on the need to reform the Constitutional Court. Several parties across the political spectrum have proposed tweaks to the “preventive control” mechanism, which allows the Constitutional Court to block legislative bills that the Court deems unconstitutional. Indeed, experts argue that this authority renders the Constitutional Court the same powers as legislators, effectively functioning as a “third chamber” in the legislative framework. In two recent well-known examples to Chile watchers, the Court effectively blocked the second round of AFP withdrawals, and the recent legislative proposal to levy a new royalty tax on mining companies is still open-ended, but the mechanism to block the legislative processing of the initiative via the Court has been activated. Another reform proposal is to include a new minister in the Constitutional Court. There are currently 10; an odd number would

reduce the power of the Court’s president, who casts the tie-breaking vote. Some parties are going as far as proposing the elimination of the Court, but we don’t think this version of the proposal will have sufficient traction to be included in the new Constitution. We think elimination of the Court would hurt Chile’s institutional framework, but its reform would not necessarily be a negative development, especially if accompanied by a more even distribution of powers in the government regime (see above).

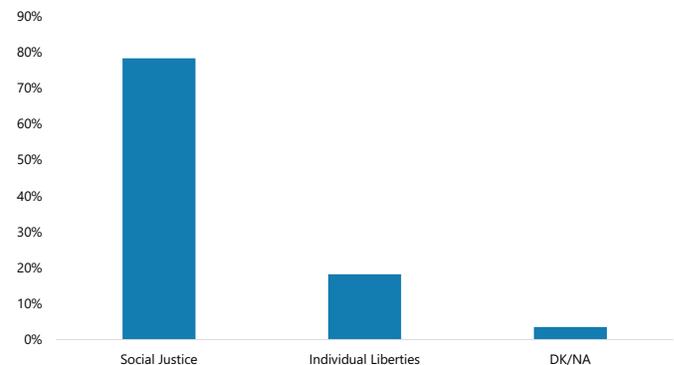
Fundamental and Property Rights: Based on the election’s results, this could be an area where more pronounced changes will take place, as it directly relates to the provision of public goods and services, one of the key reasons behind Chileans’ demands for a new Constitution (see Exhibit 4). The topic is also important for markets, given the possible associated implications for fiscal dynamics and the business environment. The current Chilean Constitution includes the right to basic goods and services such as education, healthcare, and social security, but critics argue that the role of the state falls more as a regulator than as a provider. With the election’s results validating public opinion polls, we expect the Chilean government model to steer more towards a social/welfare state, one in which the Constitution emphasizes the public sector as a provider of public goods and services (see Exhibit 5). This would mark a break from the current subsidiary state, or one in which the role of the state focuses on ensuring individual freedoms and controlling and regulating public services.

Exhibit 4: Chile: Public Opinion Polls - Top Three Priorities in Constitutional Reform (% of answers, cumulative)

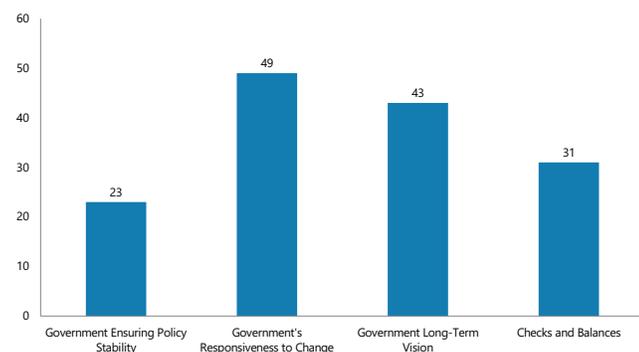


Source: CELAG Survey (March 2021)

Exhibit 5: Chile: Public Opinion Polls - Preferred Constitutional Principle in Concept of State (% of answers)



Source: CELAG Survey (March 2021)

Exhibit 6: Chile: Global Competitiveness Index (Ranking out of 141 countries, 1 = best)

Source: GCI

Beyond the Constitutional Convention, the election's results suggest an incipient shift away from orthodoxy. We think this weekend's elections further confirm Chileans' discontent with the current political establishment. One worrisome aspect of this trend, in our view, is that unorthodox platforms seem to be partly capitalizing on this discontent, a view that is confirmed by the progress of short-term-focused legislative proposals advancing in recent months. While we think that Chile's solid institutional framework and positive starting point in terms of macro fundamentals represent an important safeguard to the deterioration of the country's macro narrative, it is clear by now that the risks of the country's policy mix gradually moving away from the orthodoxy of the past decades have increased (see [Exhibit 6](#)).

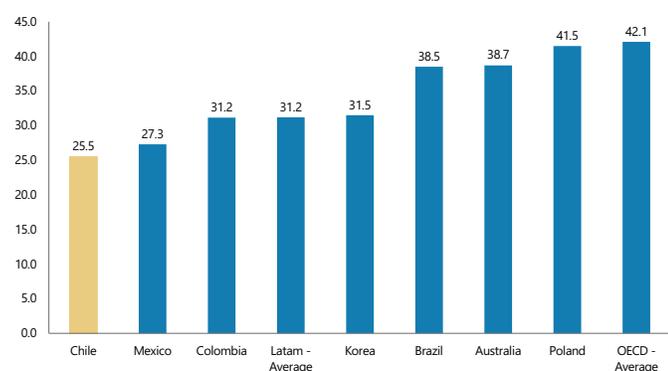
The results of the elections further skew incentives towards a larger public sector in Chile, heightening risks to the growth outlook. We think a gradual shift towards a bigger role for the state was already in place even before the onset of 4Q19 social unrest, the catalyst behind the Constitutional Reform process (see: "[Chile Economics: A Larger Role for the State](#)", in *Political Gauntlet Ahead*, October 22, 2020). The results of the elections confirm this trend and likely set the stage for expanded responsibilities for the public sector in coming decades, but we think Chile has room to afford those without seriously affecting its orthodox macro framework (see: "[Chile Economics: What to Expect of the Constitutional Convention](#)", in *Chile and Peru Strategy & Economics: Short-Term Uncertainty for Longer-Term Clarity*, March 31, 2021). Indeed, amid the current environment we see meaningful risks not just to the fiscal outlook, but mainly to the growth outlook.

Specifically, lawmakers and the broader public opinion are focusing on increasing taxation on corporations and on financial wealth to fund proposals such as an expanded social safety net and more permanent cash transfers (such as an universal basic income), rather than discussing deficit-widening. Recent political developments suggest that could be one common ground between the center-left and more unorthodox policymakers. The various wealth tax proposals, the mining royalty bill, and the temporary surcharge tax on large corporations seeing support in Congress – even if some of these proposals ended up not materializing– are all examples that underscore the potential for a more challenging backdrop for the private sector in the coming years. In turn, this potentially could dim investment prospects and, with it, long-term growth potential (see "[Lower House of Chile's Congress Approves New Progressive Copper Royalty; Bill Moves to Senate](#)", May 6, 2021).

Past episodes within the region warrant caution around the structural buildup of spending pressures. Chile's public sector is one of the smallest in the OECD, thus implying broad room for the buildup of additional public spending (see [Exhibit 7](#)). Still, past episodes within the region suggest that incremental spending commitments are politically easy to implement, but difficult to revert. A case in point is the link between Brazil's ongoing fiscal woes and the 1988 Constitution. Following its re-democratization and amid winds of political change, Brazil engaged in a constitutional reform that introduced a large number of social welfare initiatives, ensuring broad social rights in the Constitution. Over the following two decades, economic growth improved (helped by the global backdrop), allowing for sustained increases in spending commitments to

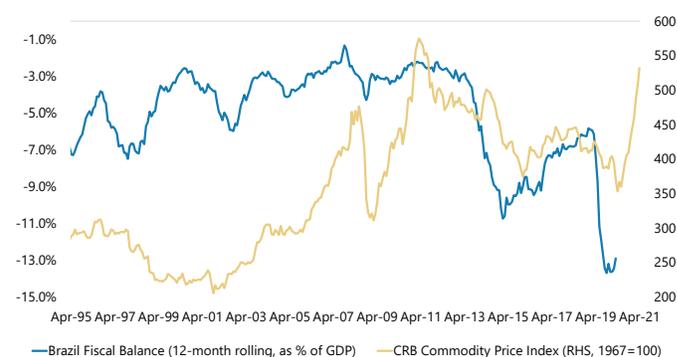
cover the rights ensured in the Constitution. Following the unwinding of commodity prices in the 2010s, and the associated hit to growth, the country faced a combination of falling revenues and sticky expenditures, as those proved politically difficult to cut in part thanks to the generous rights outlined in the Constitution. Consequently, the fiscal backdrop has worsened rapidly since 2014, and its ongoing efforts to correct this became an uphill battle that is well known to Brazil watchers (see: "[Brazil: Fiscal Noise Remains, But Turned Down One Notch](#)", April 27, 2021 and [Exhibit 8](#)). For now, Chile remains far from this scenario, but the election's results and the progress of legislative proposals that imply additional spending commitments in the long run warrant some caution, as they share similarities with the acceleration of Brazil's significant spending starting in the early 2000s.

Exhibit 7: Chile: General Government Expenditure (2019, as % of GDP)



Source: OECD

Exhibit 8: Brazil: Fiscal Balance and Commodity Price Index

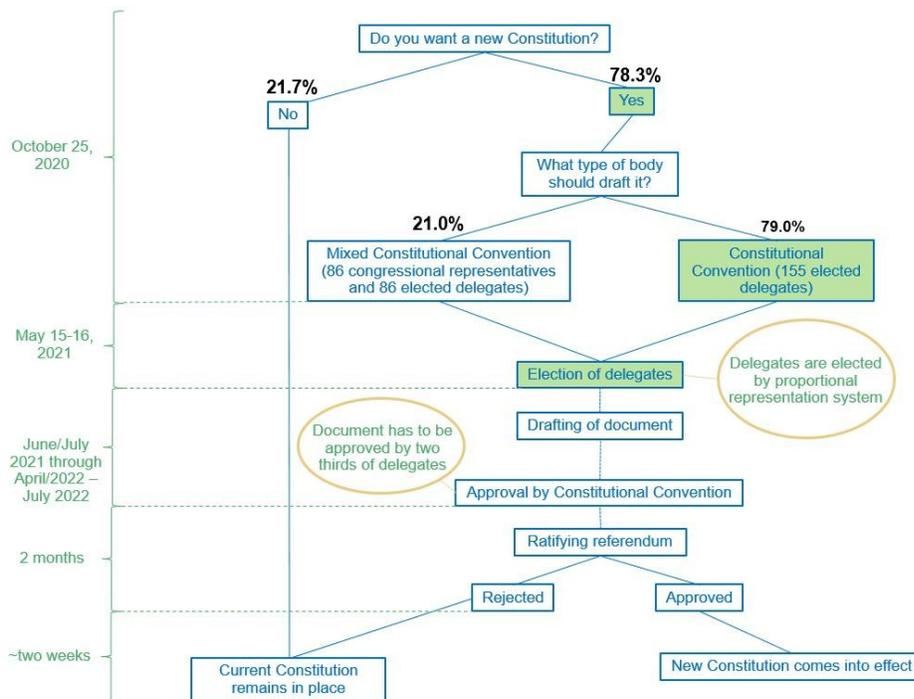


Source: National Treasury, CRB

What's next?

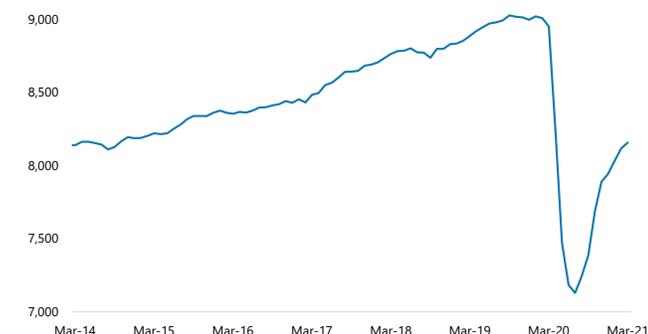
The full Constitutional process could extend as far as late 2022. The next step of the process is the drafting of the new Constitution by the Convention, which should start at some point in June or early July at the latest. From the establishing of the Constitutional Convention, delegates have nine months to work on the document, with the possibility to request (by at least one-third of delegates) a single three-month extension to this deadline. Once the Constitutional Convention approves the final text by a two-thirds majority, there will be a 60-day period until a ratifying referendum takes place, where Chileans will have to accept or reject the document. If accepted, the old Constitution would be replaced and the new one would come into effect in about ten days later. If rejected, the current Constitution would remain. See the flow chart below for a more detailed explanation of the process.

Exhibit 9: Chile: Constitutional Reform Process



Source: Servel, Morgan Stanley Latam Economics

Exhibit 10: Chile: Employed Population (thousands of people, seasonally adjusted)



Source: INE

Improving social and employment dynamics could act as backstops to a deteriorating narrative.

The deteriorating social backdrop marked by rising poverty and unemployment prompted by the pandemic has likely made unorthodox policy ideas more attractive to some voters, in our view. In that regard, we think that tracking currently lagging employment metrics (see Exhibit 10) and the progressing of renewed fiscal stimulus via cash transfers – currently being studied by the government and the opposition alike – could act as backstops to Chile's ongoing deterioration of the governance and macro frameworks. To be clear, we are not arguing cash transfers should drive a shift in outcomes, but we think that a better economic situation for households could help stabilize the social backdrop and thus ease some of the traction that unorthodox platforms have gained of late.

Given our constructive take on the Chilean economy for the next year or so, we think these factors could also help to slightly mitigate the risk of disruptive outcomes emerging from the Constitutional Convention and the legislative front (see: "[Chile: Ready for Liftoff](#)", in Latin America Macro Mid-Year Outlook, May 16, 2021).

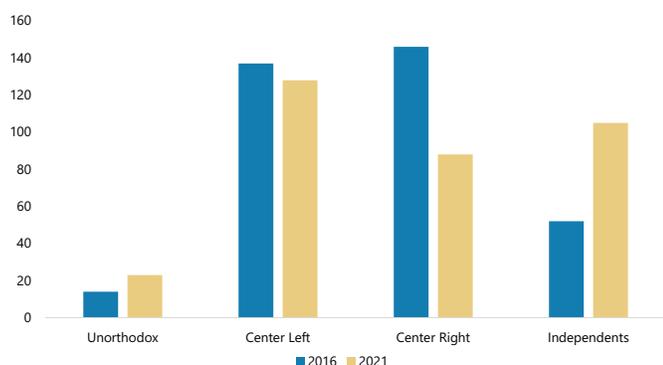
What about the regional elections?

We think the results of regional elections cast additional uncertainty around November's presidential contest.

Market participants seem to be more focused on the Constitutional Convention elections than the regional elections, but we think there are important takeaways from those as well. Specifically, the results from the mayoral elections underscore the country's dissatisfaction with the political establishment. While this phenomenon was already expected to some extent, both of the country's primary political blocs lost a meaningful share of municipalities to either independent candidates

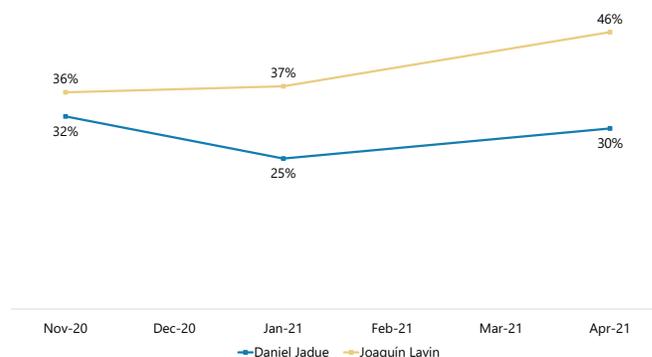
or candidates with unorthodox platforms (see [Exhibit 11](#)). We think this means 1) the chances of the unorthodox front-runner winning the presidency have increased, albeit not yet the base case given his relatively high rejection rates, and 2) uncertainty around election outcomes should remain high in coming months, as it is not yet clear where the rising preferences for independent candidates seen in local elections will flock to in the presidential contest, especially in the ballotage. For now, the more likely contender from the ruling coalition – still to be confirmed in the primaries – seems to have the upper hand in an eventual ballotage against the front-runner from the unorthodox camp, but the situation is very fluid and we should not take any outcome for granted (see [Exhibit 12](#)). Similar to discussions around the Constitutional Convention, we think that tracking the social backdrop and employment prospects will be key in coming months to gauge chances of a policy continuity outcome post-November.

Exhibit 11: Chile: Mayors Elected per Bloc



Source: Unholster, SERVEL, Morgan Stanley Latam Economics

Exhibit 12: Chile Presidential Poll: Daniel Jadue vs Joaquín Lavín Ballotage Simulations



Source: Cadem

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