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ABSTRACT

A brief summary of the evolution of economic policies and growth in Chile since 1973 is presented, distinguishing between four periods: 1973–89 with average growth of 2.9 percent, 1990–98 with 7.1 percent (notably above the 3.2 percent Latin American average), 1999–2013 with 3.9 percent, and 2014–16 with 1.9 percent, explaining the main forces underlying these sharp differences. Analysis focuses on the fiscal and external disequilibrium associated with the fiscal treatment of the copper price and the adoption of a free exchange rate since 1999. Subsequently, the focus is on the macroeconomic situation in 2013 and five sources of accumulated disequilibria that suggested a high probability of significant deceleration of the economy. The article ends with a discussion of the actual deceleration in more recent years, converging with the negative average outcome of the region, and concludes that worsening economic performance has been associated mainly with the shift from the coherent countercyclical policies of the 1990s to the procyclical opening of the capital account, liberalization of the exchange rate, and adoption of sharp inflation targeting overcoming other relevant macroeconomic targets since then.

KEYWORDS

Macroeconomic real disequilibria; pro-cyclical policies; development; Chile

JEL CLASSIFICATIONS

E63; O11; O23; O24; F41

Since 1999, the performance of the Chilean economy has been dominated by terms-of-trade and capital-account shocks. These were negative in the early 2000s and, except for the peak of contagion from the 2008–9 global crisis, highly positive in 2004–13. Since 2013, there have been intense negative shocks.

Chile's gross domestic product (GDP) growth averaged 3.9 percent in the fifteen years from 1999 to 2013. This represented a sharp drop from the sustained 7 percent annual growth in 1990–98 after the country's return to democracy in 1990 (see [Table 1](#)), when an active countercyclical macroeconomic policy was implemented. It included regulation of financial inflows, management of the exchange rate, and use of potential GDP and current account targeting, all of which were rejected around 1999 (see [Ffrench-Davis, 2015](#)).

Ricardo Ffrench-Davis is a professor of economics at the University of Chile, former chief economist of the Central Bank of Chile, principal regional adviser of ECLAC, and cofounder of CIEPLAN, a Chilean think tank. The author appreciates the research support of Simón Ballesteros.

Color versions of one or more figures in the article can be found online at www.tandfonline.com/mpke.

Table 1. Exports and the rest of GDP in economic growth, 1974–2016 (annual average rates of growth, %).

	GDP	Exports	Nonexported GDP
1974–89	2.9	10.7 (1.6)	1.6 (1.3)
1990–98	7.1	9.9 (2.0)	6.5 (5.1)
1999–2007	3.9	6.4 (1.6)	3.1 (2.3)
2008–2013	3.9	0.9 (0.3)	5.1 (3.6)
2013	4.0	3.3 (0.9)	4.2 (3.1)
2014	1.9	1.1 (0.3)	2.2 (1.6)
2015	2.3	−1.9 (−0.5)	3.7 (2.8)
2016	1.7	1.2 (0.3)	1.9 (1.4)

Sources: Based on Ffrench-Davis (2014) for estimates of nonexported GDP, updated to 2015 with Central Bank figures for GDP and exports, reference 2008 series. For 2016, estimations based on IPOM (2016).

Notes: The numbers in parentheses indicate the contribution of exports and the rest of GDP to the rate of change of total GDP in each period.

The adoption of inflation as the dominant target, combined with full opening of the capital account and exchange rate liberalization, successfully kept inflation low and avoided balance-of-payments crises, but implied that the economy usually operated below potential output while the real exchange rate and the current account exhibited extreme midterm instability and outlieriness.

Procyclical financial flows and the price of copper performed as active channels of transmission of midterm external instability to domestic markets. On the other hand, fiscal policy moved from being rather neutral in the 2000s to being effectively countercyclical in 2009–10 but became procyclical in 2011–13. As a consequence, when the external shocks of falling commodity prices started in 2013, the external and fiscal sectors of the Chilean economy had accommodated to notably high copper prices, and the exchange rate appreciated.

Overall economic performance in 1999–2013

During the late 1990s, macroeconomic policies in Chile underwent a deep change with respect to the approach adopted immediately after the return to democracy in 1990.¹ In September 1999, amid contagion from the Asian crisis, the Central Bank renounced the managed flexibility of the exchange rate (ER) and adopted a fully free floating rate with full liberalization of the capital account. These, together with dependence on copper exports with a highly unstable price, were determining factors of a persistent exchange rate misalignment and recessive gaps since 1999.

Between 1999 and 2013, the Chilean economy experienced a strong economic cycle, with a long recession in 1999–2003 and a sharp recovery led by the significant boom in commodities prices that started in 2003, briefly broken between 2008 and 2009 by the contagion of the global crisis. The

¹Economic reforms, policies, and outcomes in Chile from the military coup of 1973 up to 2012 are covered in Ffrench-Davis (2014). More recent analysis and data are found in Ffrench-Davis (2015).

combined effect of recessive and recovery years provided 3.9 percent average GDP growth in 1999–2007, while inflation targeting was fully achieved with an actual average rate below the 3 percent goal,² fiscal discipline was strong and accumulated large sovereign funds but avoided executing significant countercyclical policies, the real exchange rate appreciated sharply, and, consequently, the volume of imports rose much faster than that of exports.

In 2008 contagion from the global crisis had an abrupt direct impact on economic activity. The government addressed it by implementing a sharp fiscal policy shift. In 2008–9, the effects of the strong negative external shock were reduced by the positive fiscal pull that moved from a large surplus balance to an actual deficit (4.4 percent of GDP in 2009, financed by the sovereign fund built up in previous years). Solid GDP recovery prevailed by the last quarter of 2009; the copper price boom, which had restarted by mid-2009, also contributed to recovery.

The recovery of economic activity was interrupted by an earthquake/tsunami on February 27, 2010. The already higher domestic demand that resulted from the countercyclical policies of 2009 increased further with fiscal spending on post-earthquake reconstruction. Given that there was still significant underutilized capacity, accelerated public spending—pulling up domestic demand—was consistent with a movement toward real macroeconomic balance, eliminating the gap between actual and potential GDP, without creating inflationary pressures; however, again, a sharp appreciation of the exchange rate took place which contributed to anchoring the consumer price index (CPI).

As the recessive gap narrowed, the pace of actual GDP growth decreased to 4.0 percent in 2013. If the 2007 peak is taken as a base, actual GDP growth between 2007 and 2013 averages 3.9 percent (adjusting for the destruction caused by the earthquake, the rate becomes 4.1 percent). Consequently, actual GDP growth was rather similar in both stages of this cycle and reached the end of the cycle with fiscal and trade imbalances, as documented in the following section.

The commodities boom and recovery with two procyclical biases, 1999–2013

The exchange rate became a frequent outlier during both stages of the 1999–2013 cycle; as a consequence, both the real exchange rate (RER) and the current account behaved procyclically, with evident allocative and destabilizing implications. In the case of fiscal accounts, a sharp difference emerged between the two stages; in fact, fiscal policy evolved from an initially rather neutral approach to a countercyclical one in 2008–10, and returned to procyclicality in 2011–13.

²The average was 2.5 percent in 2004–6; then, an international boom in food prices began and lasted until the global crisis exploded in 2008, generating significant imported inflation. The annual CPI change rose to 7.5 percent in 2007–8 and fell to –1.4 percent in 2009.

The structural fiscal balance and procyclical bias³

In the first stage of this economic cycle (1999–2007), fiscal discipline was strong and accumulated large sovereign funds provided by the profits of the public copper company (CODELCO) and tax proceeds from private producers, while avoid in the execution of significant countercyclical policies. But in the second stage, the path experienced deep contrasts. Initially, the government adopted a set of strong countercyclical policies, in order to respond to the negative external shocks of the global crisis in 2008–9, taking advantage of the sovereign fund and credibility that the Chilean economy had accumulated, including its sovereign stabilization funds and net creditor position (see [Table 3](#) later in the article). An actual deficit of 4.4 percent of GDP was generated in 2009, contrasting with the 5.4 percent surplus in 2004–7. This countercyclical behavior of the Treasury was partially compensated for by spectacular outflows on the part of private social security firms (AFPs, which withdrew the equivalent of 9.6 percent of GDP).

By the last quarter of 2009 domestic economic activity was exhibiting a significant recovery (Ffrench-Davis, 2014, [Table 4](#)). Due to the earthquake, GDP declined for some weeks, but recovery soon restarted supported by a further increase in the price of copper as well as by the fiscal expenditure on post-earthquake reconstruction, pulling up domestic demand in a movement toward macroeconomic balance with potential GDP. By early 2013, the recessive gap had disappeared and fiscal expenditure remained excessive vis-à-vis permanent tax revenue. In 2013 fiscal expenditure exceeded the 2007 level by 52 percent, while noncopper revenue had increased merely 36 percent ([Table 2](#)). Consequently, the budget policy had moved from countercyclical to procyclical in 2012 and 2013.

The net effect was that the SFB exhibited a 0.5 percent deficit, despite benefiting from a fast-rising overestimate of the trend copper price (from US\$1.00 in 2004–7 to US\$3.06 in 2013; see [Table 3](#)).

The fact is that two persistent biases gave way to a significant fiscal imbalance by 2013. The SFB approach required estimating two key structural variables: (1) the *trend* GDP growth rate and (2) the *trend* price of copper. The estimation of both parameters used inputs provided by two independent committees of experts each year.

The structural rule implied maintaining a level of expenditure consistent with the estimated medium-term trend of GDP. Definition of the concept is essential for estimating the structural tax revenue. The Ministry of Finance made an explicit option in favor of the trend GDP (GDP_t) concept instead of the potential GDP (GDP^*).

³The experience with the structural fiscal balance (SFB) started in 2001 is analyzed in Frankel (2013) and Ffrench-Davis (2016a).

Table 2. Fiscal expenditure and income, 2008–2015 (indexes 2007 = 100; and average annual % changes).

	2013	Average annual growth (%) 2008–2013	2014	2015	Average annual growth (%) 2014–2015
1. GDP	125.9	3.9	128.3	131.2	2.1
2. Real fiscal expenditure	152.4	7.3	161.7	173.7	6.8
3. Real fiscal income	103.0	0.5	104.2	109.6	3.2*
4. Real fiscal noncopper income	136.1	5.3	139.2	150.4	5.1*
5. Domestic demand	140.2	5.8	139.7	142.6	0.8

Sources: Taken from Ffrench-Davis (2014, Table 5), updated to 2015. Based on Central Bank figures for GDP and domestic demand from the chained base, reference 2008 series. Nominal fiscal figures from DIPRES (2016), deflated by an index of the annual average CPI.

*Includes revenue from the gradual tax reform of 2014.

Given that option, structural tax proceeds were estimated using the annual rate of change of GDP_t for the budget year (t) provided by the new estimate for (t) over ($t - 1$), disregarding any “error” in the previous year estimate for ($t - 1$), or unexpected events such as a recession that depresses investment or an earthquake that destroys capacity. This feature implied that between the output *peaks* of 2007 and 2013, the sum of the growth rates of actual GDP was 6.8 points lower than the sum of the growth rates of GDP_t used for estimating changes in structural tax proceeds for each budget year (see Table 3, rows 1 and 2). In addition, as detailed below, the underestimation of the trend price of copper in 2001–10 was replaced by an overestimation.

Table 3. Trend GDP and Copper Price and Structural Fiscal Balance, 2001–2015 (annual averages).

	2001–2003	2004–2007	2008	2009	2010–12	2013	2014	2015
1. GDP actual (% annual real change)	3.2	5.6	3.3	−1.0	5.7	4.0	1.9	2.3
2. GDP trend (% annual real change)*	4.2	4.6	5.0	4.9	4.7	5.0	4.8	4.3
3. Copper price actual (nominal US\$/lb)	0.74	2.31	3.16	2.34	3.68	3.32	3.11	2.49
4. Copper price midterm trend (nom. US\$/lb)	0.90	1.00	1.37	1.99	2.58	3.06	3.04	3.07
5. Fiscal balance actual (% of current GDP)	−0.7	5.4	3.9	−4.4	0.5	−0.6	−1.6	−3.3
6. Structural fiscal balance (% of current GDP)	0.9	1.2	0.0°	−1.2°	−1.2	−0.5	−0.6	−1.6

Sources: Ffrench-Davis (2014), updated with data from the Central Bank and DIPRES (2016).

Notes: Values correspond to a simple annual average for each period. Real GDP growth figures are from the National Accounts in 2003 prices; as from 2006, the rates of change of the new chained base, reference 2008, are used.

*Trend GDP corresponds to calculations of the Finance Ministry, based on inputs provided by the Advisory Committee on Trend GDP. The figures in row 2 correspond to estimates from each annual consultation.

°SFB deficit according to methodology used up to 2009.

The trend price of copper and the exchange rate

Volatility in international financial and trade markets tends to generate large fluctuations of the free exchange rate so as to equilibrate the balance of payments. It is a significant fact that since a free exchange rate was adopted in 1999, the Chilean economy has suffered three sharp RER cycles, each with processes of midterm appreciation followed by midterm depreciation (see Ffrench-Davis, 2015, Figure 6).

Cyclical RER fluctuations were first related to the contagion of the Asian crisis that brought generalized financial outflows, which led to a sharp depreciation process. In 2003 a long boom of commodities prices began, including prices of copper, which led to a strong appreciation until early 2008; in parallel, capital inflows were returning, thus reinforcing the excess supply of foreign currency and their appreciating pressures. Subsequently, a significant abrupt depreciation took place due to the brief but acute drop in copper prices during the peak of the global crisis (from more than US\$4.00 to US\$1.35), and was reinforced by capital outflows. Soon appreciation resumed, until mid-2013, when sharp depreciation took place.

A series of jumps in the nominal price of copper (up from US\$0.60 at a point in 2002, to US\$4.00 in 2008 and to US\$3.70 by early 2013) generated a persistent foreign exchange bubble fostering an artificial outlier, *strong peso*.⁴ Three reasons contribute to explaining the instability of the real exchange rate linked to the price of copper despite the stabilization mechanism at work.

First, Table 3 shows that when the price boom started in 2003, the estimate by the independent the Copper Trend Price Committee provided figures that, year after year, followed the rise in the actual nominal price but from far below: by 2008 the actual price was US\$3.16 and the trend estimate was US\$1.37. Subsequently, however, since the actual price remained high, the trend estimate continued rising, in 2011 projecting a high plateau of US\$3.02 for 2012. Evidently, this price implied a huge rate of return on investment. Consequently, since 2011 Chile—both the public and private sectors—has tended to act on the overoptimistic side of expectations.

Second, the fund mechanism only covers fiscal income, which is associated with the taxes paid by both public and private miners, but covers only the profits of CODELCO; that is, one-third of copper output.

Third, the fact is that the foreign exchange market is notably cyclical, being strongly influenced by the short run. The market, with a fully free rate, tends to equilibrate the balance of payments instead of the current account. As a consequence, the procyclical behavior of the price of copper transmitted directly into the exchange rate (see Figure 1, illustrating the sharp daily correlation). The long stage of persistent appreciation strengthened the

⁴The relevant copper price is that in real terms, deflated by the international inflation relevant for Chile. In addition, climbing copper production costs, related to falling ore grades, must be considered.

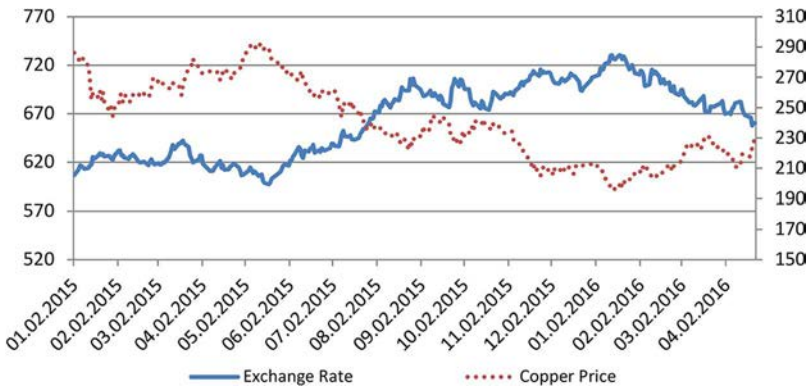


Figure 1. Exchange rate and copper price, daily prices January 2015–April 2016 (correlation = -0.95). Source: Nominal exchange rate in Chilean pesos per US\$1 from Central Bank (left side); copper price in cents of US\$ per pound from COCHILCO (right side).

expectations of a sustainable cheap dollar and discouraged new nontraditional exports, value added to exports, and the competitiveness of small and medium-size enterprises (SMEs) competing with artificially cheap imports. It became particularly detrimental to a growth strategy based on a leading role for tradables.

The Central Bank, which was responsible for freeing the price of the dollar, repeatedly indicated that the market exchange rate was consistent with *fundamentals* at prices of the dollar that were, for example, as diverse as \$450 and \$700. It was apparent that imports were growing notably faster than exports. It is clear that the higher price was closer to *fundamentals* than a price as depressed as \$450.

The new economic cycle that began during 2013

The inherited situation

By 2013, the Chilean economy faced a mix of significant pros and cons. On the positive side, the government had considerable liquid assets (equivalent to 11 percent of GDP) on which it could draw if it were to implement a countercyclical fiscal policy. Its spread on lending markets was also quite low (an EMBI [Emerging Market Bond Index] of 154 basis points). The Central Bank had net international reserves amounting to 16 percent of GDP. The banking system, in spite of the fast rise in the stock of loans over the preceding few years, appeared to be in a solid situation. The gross investment ratio had recovered from the shock of 2008–9 and was comparatively high in 2013.

However, the vulnerabilities that existed by 2013 were apparent in the trends seen in several of those features. Here, we look at five variables indicating that, without early implementation of a vigorous countercyclical program, a spontaneous recessive adjustment after 2013 was probable.

First, fiscal responsibility had worsened (Tables 2 and 3). If the target of a structurally balanced budget was to be achieved, the trend price of copper would have to remain notably high or expenditure growth would have to slow and/or a tax reform be implemented to boost revenues. It is telling that the fiscal sector had lost its exceptional feature of being a net creditor, again becoming a net debtor in 2012 (see the bold line in Table 4), despite still benefiting from a very high copper price of US\$3.61. It is also important to note that, even in 2013, deposits continued to be made to the sovereign Economic and Social Stabilization Fund, despite an actual fiscal deficit of 0.6 percent of GDP. This apparent contradiction was explained by the fact that the counterpart of the replenishment of the sovereign funds in 2010–13 was a significant increase in government borrowing (Table 4).

Second, in 2013, Chile ceased to lead growth in Latin America, falling below several countries in the region (CEPAL, 2015). By 2013, after its significant recovery from the contagion of the global crisis, the Chilean economy was working at the top of its capacity and it was, therefore, unavoidable that actual GDP growth would converge toward trend GDP, as properly measured (close to the 3.9 percent recorded between the peaks of 1999 and 2013, rather than the actual 5.3 percent of the 2010–13 recovery). In 2013, as the economy reached its production frontier, growth actually declined to 4.0 percent, and to 3 percent in the last quarter.

Third, the gross investment (GFKF) ratio appeared to be rather high in 2013. However, a 26.2 percent of GDP ratio (1) is a gross figure, and, because depreciation has risen by close to four percentage points of GDP, net investment has decreased with respect to the 1990s; (2) the ratio included a significant cycle of mining investment, which began in 2006 and was coming to an end by 2015, and the share of mining in total gross capital formation rose from 17 percent in 2007 to 34 percent in 2013; most mining investment was directed to compensate for a sharp decline in the quality of mines; (3)

Table 4. Fiscal assets and liabilities, 2007–2015 (current US\$ millions).

	FEES (1)	FRP (2)	Other assets (3)	Liabilities (4)	Net balance (5)	% of GDP (6)
2007	14,033	1,466	5,411	7,094	13,816	8.0
2008	20,211	2,507	2,806	7,335	18,188	10.1
2009	11,285	3,421	1,654	11,096	5,264	3.1
2010	12,720	3,837	3,893	20,358	92	0.0
2011	13,157	4,406	10,588	25,928	2,224	0.9
2012	14,998	5,883	10,419	32,423	-1,123	-0.4
2013	15,419	7,335	7,364	33,515	-3,397	-1.2
2014	14,689	7,944	8,527	36,587	-5,427	-2.1
2015	13,966	8,112	5,500	38,963	-11,385	-4.7

Sources: DIPRES and Central Bank.

Notes: Consolidated assets and liabilities of the National Treasury, at the end of each period. Col. (1) Economic and Social Stabilization Fund (FEES); col. (2) the Pensions Reserve Fund (FRP). Col. (5) shows the net balance of assets and liabilities (5) = (1 + 2 + 3 - 4); col. (6) is col. (5) as a percentage of GDP of the respective year in current prices.

the 26.2 ratio is measured in 2008 chained prices; in current 2013 prices the ratio falls to 23.8 percent, which reflects the financing effort made by investors, whereas the former figure measures purchasing power or real terms. The ratios are so different because the National Accounts estimate that the price of capital goods fell nearly 10 percent between 2008 and 2013; and (4) in the second semester of 2013, gross investment fell 9 percent, contributing to the deceleration beginning in that year. In all, GFKF has weakened, which is more consistent with the sharp drop of GDP growth from 7.1 percent in 1990–98 to 3.9 percent in 1999–2013.

Fourth, the fiscal stabilization mechanism—clearly a valuable asset—understabilized. In early 2016, the nominal copper price fell temporarily below US\$2.00/lb, prompting the government to call an extraordinary meeting of the Copper Trend Price Committee, which reduced its earlier estimate of US\$2.98/lb for 2016 to US\$2.57/lb, whereas during the first semester of 2016, the actual price hovered around US\$2.15/lb.

Fifth, during most of the decade-long price boom, the real exchange rate was overappreciated as was reflected in the trade disequilibrium. In the decade ending in 2013, the volume of imports (as measured by the Central Bank) jumped 117 percent while that of exports rose just 25 percent and their diversification stagnated, particularly since 2008. The current account ran a deficit of 3.8 percent of GDP in 2013 even though the actual copper price averaged a high US\$3.32/lb. By 2013, there was an evident need for a significant sustained devaluation.

Overall performance since 2013

The set of vulnerabilities that existed by 2013 was combined with a progressive program of structural reforms imposed by the new government taking office in March 2014 and the ongoing uncertainty on international markets. When the new government started, GDP growth had already dropped below the 3 percent threshold and fluctuated at around 2 percent through to the first semester of 2016 (IPOM, September 2016).

Chile was far from alone in Latin America in experiencing significant deceleration. [Figure 2](#) shows that it was still growing ahead of the regional average. However, if Brazil and its marked deterioration are excluded, Chile's 2.1 percent growth in 2014–15 is closer to the average for Spanish-speaking Latin America (1.4 percent), whereas in the 1990s its growth had surpassed the regional average by nearly four percentage points (7.1 percent vs. 3.2 percent); in 1999–2013, it had exceeded this average by only 0.7 points. The change in the macroeconomic approach, abandoning the earlier countercyclical strategy, had contributed to the convergence of Chile's performance with that of the rest of the region.

Two variables that played a key role in Chile's economic deceleration were exports and productive investment. After increasing 6.4 percent in 1999–2007,

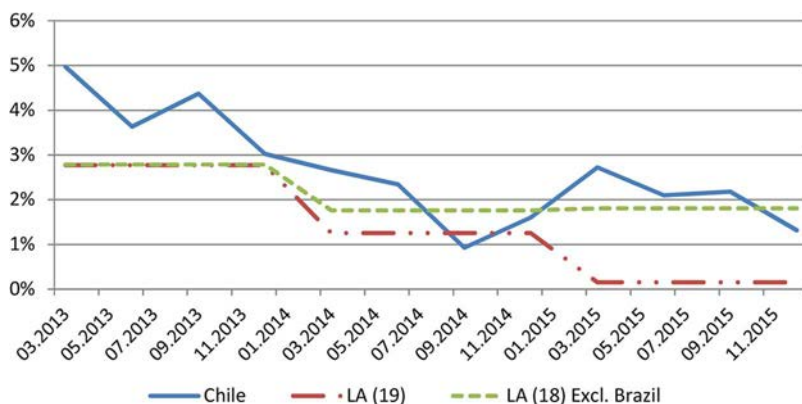


Figure 2. Rates of GDP growth in Chile and Latin America, 2013–2015. *Sources:* For Chile, data from Banco Central in chained prices, reference 2008; quarterly GDP percentage changes in twelve months. For Latin America, CEPAL, annual averages in constant prices of 2010.

exports had collapsed to 0.9 percent in 2008–13 (see [Table 1](#)). Moreover, by 2013, fewer products were being exported and fewer firms were exporting than in 2008 (Ffrench-Davis, 2016b, [Table 4](#)), notwithstanding the numerous free trade agreements signed by Chile. In 2014–16, exports stagnated, which is already too long to remain below the depressed performance of world trade (averaging 2.5 percent annually since 2008).

It is interesting to compare the evolution of capital formation by nationals and foreigners. During the 1990s, GFKF increased by eight percentage points of GDP over its average during the dictatorship. Greenfield foreign direct investment (FDI) then accounted for only one-sixth of gross capital formation. Subsequently, FDI expanded rapidly. In 2009–15, FDI represented nearly 30 percent of GFKF; only the equivalent of 16 percent of GDP corresponded to capital formation by nationals, down from 20.5 percent in 1991–95. At the same time, overseas investors acquired part of the stock of existing capital, equivalent to 2 percent of GDP in 2009–15 (Ffrench-Davis, 2016b, [Table 7](#)).

The deceleration affected not only exports but also the rest of GDP in 2014: the contribution of nonexports to the GDP growth rate was cut by half, from 3.1 percent to 1.6 percent (see [Table 1](#)). In 2015, on the other hand, the output for domestic markets accounted for more than all the 2.3 percent expansion of GDP while export volume had a negative impact. The resilience of the domestic economy was explained largely by fiscal spending. The impact was the result of the official decision to implement a reactivating, albeit very moderate, countercyclical fiscal adjustment.

The composition of the deceleration helps to explain why the unemployment rate did not increase up to 2015, but started to rise thereafter with a climbing share of informal employment.

The worsened political and social mood

In general, surely not an exception in the present world, expectations and the mood of citizens became markedly negative, with a majority taking a critical stance toward not only the president and the government but also the political parties, businesspeople, churches, and the judiciary. The contributory factors are seen in different sectors, and include a lack of transparency, corruption, fraud, indolence, inconsistency, personal agendas at odds with the common good, permissiveness, and unethical conduct, which have resulted in generalized distrust and a tendency to believe any accusation that is bandied about. All these phenomena are part of a very gradual deterioration of life in society that began in the late 1990s and had cumulative effects. However, the reelection of Michelle Bachelet as president by a large margin (62 percent of valid votes) and her high approval rating in opinion polls at the beginning of her government (polls that also include those who abstained in the election) appeared to indicate the start of a new cycle of progressive advances and a reunified society. Within a few months, though, her approval had dropped to below a third, and two-thirds were critical of her performance. However, despite their very important impact on the economy, these issues far exceed the scope of this article and we therefore return to the economy.

Many analysts, the most influential media (in which a neoliberal bias predominates), and business leaders blame the depth of the deceleration and the pessimism of economic expectations on the structural reforms that have or are being implemented, principally the government's tax, labor, and educational reforms. In what follows the tax reform is examined.

The 2014 tax reform and its modifications

In 1990, just after the restoration of democracy, Chile implemented an important tax reform. The main change introduced by this reform approved by Congress was the reinstatement of a tax on profits that had been abolished in 1988. The *integrated* system introduced by the dictatorship in its 1984 tax reform was maintained. This required the profit tax paid by a company to the National Tax Service (SII) to be subsequently reintegrated to personal taxpayers when they declare their Global Personal Tax (IGC) where only the income effectively received is taxed. The 1990 reform also permitted the ongoing existence of *investment companies* in which the profits distributed can be held as reinvestment, thereby deferring their declaration until they are formally withdrawn. On the register of profits not distributed by companies and these investment companies (the so-called FUT), almost half corresponds to the latter companies, which are *paper* societies that allow tax delay or avoidance, of which 78 percent corresponded to taxpayers in the highest income decile (Agostini, 2014).

The new government sought to raise tax collection by 3 percent of GDP and to do so in a markedly distributive way. A third of the additional revenue would be used to cover the deterioration in fiscal accounts inherited from the previous government. The bill included a number of taxes of different natures but referred principally to that on profits: the rate of 20 percent would rise to 25 percent, maintaining the integrated system and allowing the personal taxpayer to receive the 25 percent credit from the SII, but the IGC would now be paid on all individuals' share of the company's profits whether distributed or not (*taxing accrued profits*).

The matter of accrued profits was the focus of intense opposition to the bill from large business organizations and the political right. One point on which the media, mostly controlled by them, insisted was that the reform would have a negative impact on SMEs and nonrich segments of the population. However, the proposed reform was clearly progressive in focusing on high-income earners. Nonetheless, by raising taxation of reinvested profits by five percentage points, it would be reducing companies' cash holdings, and, through the IGC, would return this to individuals who would be taxed on accrued profits. In other words, the net effect would be negative for reinvestment.

After difficult negotiations and a fierce campaign against the reform, a modified bill was passed. It maintained the option of being taxed on accrued profits (attractive for companies intensive in profit distribution) but also established as the main system (referred to as a semi-integrated system) a higher rate of 27 percent on profits and the IGC levied only on effective income but with the tax credit reduced to 65 percent of the taxes paid by the company. In this way, part of the burden of the original bill was redistributed from reinvested profits to distributed profits, which was a positive change for capital formation.

The tax reform discussion has had deep and contradictory effects on expectations. It increases tax collection and is clearly progressive, despite faults such as defining the SMEs eligible for preferential treatment in such a way as to include a segment of mid-sized companies whose owners belong to the richest decile of the population (Agostini, 2014). What stands out, in my opinion, is the increasingly negative view of the reform taken by a large segment of the public during the course of the debate, which still persists. This is not surprising in the case of high-income segments that will contribute most of the higher tax revenue. However, a critical view is also found among segments of the population for whom the reform will have net benefits because they pay little tax and the additional revenues will be allocated principally to them. This represented a major communicational defeat for the government.

Closing remarks

The Chilean economy's current failures have been incubating since the late 1990s, although they have undoubtedly been accentuated by the evolution

of the international economy: both have entailed a deterioration (in Chile and elsewhere) in the trust between citizens and have generated severe uncertainties that both entail. I have written several times about proposed lines of economic action (e.g., Ffrench-Davis, 2014, ch. 11; 2015, sect. 4). Here, we revisit some macroeconomic and economic development issues.

In the current external and domestic context, it is evident that Chile needs to embark on a new development cycle, with crucial challenges.

The gap in economic development with respect to more advanced economies (which more than double Chile's per capita income) does not lie in the large, most modern companies and large-scale exporters. The productivity gap is found in (1) the country's hundreds of thousands of SMEs, (2) low-skilled workers in the formal sector, and (3) workers in the informal sector. This is where the gaps in productivity between Chile's 40 percent average GDP per capita in purchasing power parity terms (and 27 percent at market prices) and the 100 percent of U.S. citizens. In order to grow and combat inequality, it is therefore essential to raise productivity and employability in these three sectors, reducing the distance that separates them from high-income sectors and, in this way, raising productivity and average incomes—growing by including.

For inclusive development, it is crucial to recover real macroeconomic equilibrium and to implement long-postponed productive development policies that boost capital formation and innovation, particularly in SMEs. These include:

1. Recovering real macroeconomic equilibrium: The lesson as regards macroeconomics is that it is necessary to apply a comprehensive set of countercyclical policies (monetary, credit, fiscal, and exchange rate policies and regulation of the capital account) in order to offset the intensity of the volatility of financial and export markets (see Ocampo, 2011). The effective implementation of these policies calls for full coordination between the Central Bank and the Finance Ministry. Given the recessive international and domestic environment, a shared countercyclical shock appears as a crucial need to raise the rate of use of potential GDP, improve employment, and encourage capital formation.
2. Productive development policies benefiting SMEs calls not only for correction of the procyclical macroeconomic approach but also for a capital market reform in order to facilitate access to long-term local financing, the transfer of technology and labor training. With international commercial markets likely to expand more slowly than in previous decades, the vacuum this creates can be offset by increasing the value-added component of current exports and developing domestic markets where over 80 percent of the labor force and the vast majority of firms are located.

Chile's indiscriminating integration into financial markets is a great barrier, in the face of the strong *financieristic* ideology and such powerful lobbying to maintain procyclical macroeconomic policies. Economic agents

who specialize in short-term and volatile financial flows may be very efficient in their field, but *by training and because of the compensation they receive* have been decisive in the evolution of the regressive and recessive macroeconomic situation and have had a key influence in the design of Latin American policies. Chile has been a clear part of this trend since 1999. This implies the predominance of a *financieristic* approach over a *productivistic* approach and is at odds with the twofold objective of growing with equity, which calls for improved incentives to increase productivity, with innovation and labor training and financing for development, rather than giving priority to rent seeking. The above proposals are ingredients for a renewed *productivistic* approach.

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