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FEATURED Q&A

What Does a Ratings Downgrade Mean for Chile?

Chilean President Michelle Bachelet's government has faced low prices for copper, the country's top export. // File Photo: Chilean Government.

Q Standard & Poor's on July 13 downgraded Chile's long-term foreign currency rating to A+ from AA-, marking the country's first ratings downgrade since the 1990s. The ratings agency cited weak business confidence and low prices for copper, Chile's chief export, for the decision. What does the ratings downgrade say about the current state of Chile's economy? What will the ratings action mean for the economy going forward and for external financing? How well is President Michelle Bachelet managing Chile's economy in her final year in office, and what top priorities will her successor face?

A Manuel Agosin, dean of the School of Economics and Business at the Universidad de Chile: "The ratings downgrade will have few immediate impacts. Chilean debt issues are still selling at good prices, and sovereign spreads continue to be low. However, the downgrade is a warning light for Chilean policymakers. The Minister of Finance has been doing a Herculean job in trying to keep down the fiscal deficit in the face of weak growth and low copper prices. Government social plans, particularly in education, will also probably continue to put upward pressures on the fiscal deficit, which this year will be between 3 and 4 percent of GDP. The Bachelet government is ending, so the correction of the fiscal stance will fall to the next administration, which will not have an easy job. If private investment and growth pick up, this downgrade will come to be seen as a glitch. If not, further downgrades will be in store, which would eventually translate into higher international borrowing costs for the government and private firms."

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U.S. Sanctions 13 Top Venezuelan Gov't Officials

Officials sanctioned include Tibisay Lucena, the head of Venezuela's elections commission. The sanctions come ahead of a planned vote on Sunday to elect a "constituent assembly" to rewrite Venezuela's Constitution.

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Policymakers lowered the Selic rate by one percentage point to 9.25 percent.

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Panama Opens Embassy in Beijing Following Break With Taiwan

The embassy's opening followed Panamanian President Juan Carlos Varela's announcement last month that his country was establishing diplomatic relations with China and severing relations with longtime ally Taiwan.

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Varela // File Photo: Panamanian Government.

POLITICAL NEWS

U.S. Sanctions 13 Top Venezuelan Officials

The U.S. Treasury on Wednesday slapped sanctions against 13 top Venezuelan officials, ahead of Sunday's vote in the South American country to elect a "constituent assembly" to rewrite the Constitution, The Wall Street Journal reported. Among the Venezuelan officials targeted are Tibisay Lucena, the head of the country's elections agency, and the heads of Venezuela's army, national guard and national police. Elías Jaua, a top politician close to President Nicolás Maduro; Erick Malpica Flores, a nephew of Venezuela's first lady; and Simon Zerpa, the finance chief of state oil company PDVSA, are also named in the sanctions. "The United States will not ignore the Maduro regime's ongoing efforts to undermine democracy, freedom and the rule of law," said U.S. Treasury Secretary Steven Mnuchin, the newspaper reported. The sanctions freeze the officials' assets in the United States and revoke their U.S. visas. U.S. citizens and businesses are also now barred from conducting business with them. Maduro on Wednesday night responded defiantly, awarding ceremonial swords to officials targeted by the sanctions. "We will never kneel, and our vengeance will be our victory on Sunday, July 30," Maduro said in a nationally televised broadcast. "Congratulations for these imperialist sanctions," he said, Reuters reported. U.S. President Donald Trump has called Maduro a "bad leader who dreams of becoming a dictator." Trump also threatened to take "strong and swift economic action" if Maduro proceeds with Sunday's vote. Maduro has said Venezuela needs a new Constitution in order to resolve the country's political and economic crises, while the opposition sees his effort to rewrite the Constitution as an effort to increase his own power. The newly elected body would become Venezuela's top political institution and would have the power not only to rewrite the Constitution but also dissolve the opposition-controlled National Assembly. In May, the United States sanctioned eight Venezuelan Supreme Court justices under similar sanctions after the court issued a ruling, which it later reversed, to effectively dissolve the country's National Assembly. More than 80 percent of Venezuelans oppose Maduro's plan to elect the constituent assembly, according to polls, the newspaper reported. Additionally, more than 7.5 million Venezuelans voted in an unofficial referendum asking whether they support the plan to rewrite the Constitution. The overwhelming majority of those who cast ballots voted against the plan. Venezuela's opposition on Wednesday morning began a two-day strike as part of a last-ditch effort to stop Maduro from holding the election for the constituent assembly. Government opponents estimated that some 92 percent of businesses and workers observed the strike, though it did not present evidence for the figure, Reuters reported. Protests tuned violent in some areas, including Caracas, where youths clashed with soldiers firing tear gas. In Mérida State, a man was fatally shot when troops and armed civilians clashed with protesters, according to a local opposition lawmaker. More than 100 people have been killed in the nearly four months of violent protests in Venezuela. Also on Wednesday, Colombia's Avianca became the latest airline to announce a suspension of service to Venezuela. The carrier said it would suspend its twice-daily flights to Caracas, citing Venezuela's need to improve infrastructure at airports and also adhere to international security standards, Bloomberg News reported. Carriers including United Airlines, Latam Airlines, Aeroméxico and Lufthansa have also cut back on service to Venezuela.

ECONOMIC NEWS

Brazil's Central Bank Cuts Key Rate

Brazil's central bank cut is key borrowing rate by one percentage point to 9.25 percent, The Wall Street Journal reported. The central bank has now cut the benchmark Selic rate by one percentage point for three consecutive months. The bank said further cuts to the rate would be likely. "The pace of easing will continue to

NEWS BRIEFS

U.S. Warns About Possibly Tainted Alcohol at Mexican Resorts

The U.S. State Department on Wednesday warned Americans about possibly tainted or substandard alcohol at resorts in Mexico, the Associated Press reported. The warning followed a report in the Milwaukee Journal-Sentinel about dozens of Americans becoming sick after drinking moderate amounts alcohol at all-inclusive resorts in the country. A 20-year-old woman from Wisconsin died in January after being pulled from a pool at the Paraiso del Mar resort near Playa del Carmen. Spain-based Iberostar, which owns the resort, said the resort only purchases sealed bottles of alcohol that adhere to regulatory standards.

Panama Opens Embassy in Beijing Following Break With Taiwan

Panama on Tuesday announced it opened its embassy in China after breaking diplomatic ties with long-time ally Taiwan, Reuters reported. The Central American country established diplomatic ties with the world's second-largest economy in June, delivering a blow to Taiwan, which now only has 20 formal diplomatic partners. The embassy is already functioning, though an ambassador has not yet been installed at the Panamanian embassy.

Airline Startup JetSMART Launches Service in Chile

Chilean air carrier start-up JetSMART has launched commercial service in Chile, and plans to have routes to eight domestic locations in the coming months, Flight Dashboard reported Wednesday. The airline operated its first revenue flight from Santiago to Calma in northern Chile on July 25, and is now operating the route nine times a week. JetSMART plans to open 10 more routes in the next few months, including flights from Santiago to Antofagasta.

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A **Alfredo Coutiño, director for Latin America at Moody's Analytics:** "Chile has certainly created its own vulnerabilities, which are the result of prolonged expansionary policies and a lack of structural changes. The fiscal and monetary expansion was prolonged far beyond what was necessary after the 2009 recession, which, combined with the absence of reforms, generated the acceleration of macroeconomic imbalances.

> **"Chile will have to face a more severe fiscal adjustment in order to stop the fiscal deterioration."**
> **— Alfredo Coutiño**

Thus, the fiscal deficit increased, the public debt accelerated and the external account deteriorated to some extent. The lack of structural changes and the prolonged policy expansion created a negative environment that undermined private-sector confidence, ultimately expressed in low investment. All this was reflected in an economy with chronic structural anemia, since the production capacity declined and remained limited. The fiscal and monetary expansions were ineffective to lift the economy from prostration, precisely because the weakness was structural rather than cyclical. Chile's economy turned more vulnerable to external shocks in an environment of low commodity prices. This was reflected in the country's rating. Despite the downgrade, Chile still holds an investment grade, but sends the alert that the country has generated some vulnerabilities that need to be addressed. The cost of financing might be marginally affected. However, the main consequence is on domestic fiscal policy, because the government will have to make an extra effort to correct the increasing fiscal vulnerability. Chile will have to face a more severe fiscal adjustment in order to stop the fiscal deterioration, which will impose limitations to the already weak economic growth. Bachelet will end her term with an economy in its fourth year of deceleration and low growth. The challenges for the new government will be to recover business confidence, deepen structural changes and restore macroeconomic discipline."

A **Luis E. Gonzales-Carrasco, senior economist at Clapes UC in Santiago:** "The downgrade is very bad news for Chile, and it worsens the conditions under which the government and Chilean companies, public and private, can obtain credit in the international markets. But it also has an impact on individuals. Just as local interest rates dropped significantly since the 1990s as Chile's risk rating improved, a sustained deterioration of the latter would inevitably lead to an increase in interest rates at which Chileans can borrow. In 2010, S&P raised Chile's rating to AA-, a level previously unheard of for an emerging country. In addition, between 2010 and 2013, Chile improved its risk rating every year by one of the world's leading classifiers (Moody's, Fitch and DBRS, as well as S&P). And in 2012, Chile issued a sovereign bond with the lowest rate and lowest spread ever obtained by an emerging issuer, a record that still stands. Some economists explain this performance because of the fall of copper prices. In contrast, the other major copper-exporting countries, Peru, Australia, Indonesia and Canada, also saw a fall in mining investments, but they have not seen their sovereign debt risk ratings reduced since 2013. Therefore, the downgrade cannot be explained only by the fall in mining investment. The main reasons are explained by deficient decisions in local policy, and in the short term, there is not a clear sign of change in this tendency. Moreover, in the last monetary report of the central bank, the expectations of GDP were corrected

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depend on the evolution of economic activity, the balance of risks, possible reassessments of the extension of the cycle, and on inflation forecasts and expectations," the bank said in a post-meeting statement. Some analysts believe the statement indicates that the bank will cut the Selic rate by another full percentage point next month. Brazil's annual inflation dropped to 2.78 percent last month, down from 8.93 percent year over year. The bank's target inflation rate is 4.5 percent, plus or minus 1.5 percentage points.

Peru's La Oroya Smelter Receives No Bids at Auctions

Peru's nearly 100-year-old La Oroya polymetallic smelter did not receive any offers on Wednesday in the last of six auctions in which it tendered, stymieing President Pedro Pablo Kuczynski's plans to expand the country's metals refining capacity, Reuters reported. Kuczynski last year extended the liquidation deadline for the smelter, but no one has tried to purchase it, even after the government raised the sulfur dioxide emission limits, which would have lowered the cost of upgrades to the facility. La Oroya will have to be liquidated unless the president further extends the deadline, said Pablo Peschiera, the director of consulting firm Dirige, which has been hired to finding a new operator of the facility. The consulting firm is asking Kuczynski to give it another year to find another buyer, saying that potential bidders are concerned about the possible liability for pollution in surrounding soils.

Kuczynski // File Photo: Peruvian Government.

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downward for the end of 2017. The next administration will receive an unprecedented negative fiscal gap for future years. In this way, it is observed that for the next three years the committed expenditure is more than the amount that is compatible with the objective of reducing the structural deficit, which the ministry itself established. This negative clearance amounts to $1.79 billion (0.6 percent of GDP) a heavy weight to start any new administration."

A **Sergio Urzua, associate professor in the Department of Economics at the University of Maryland:** "Standard & Poor's decision to downgrade Chile's rating came as no surprise. Yes, low copper prices wounded the economy, but a sequence of harmful economic policies, jointly with political pressures to maintain public expenditure at imprudent levels, are self-inflicted injuries explaining at least part of Chile's unprecedented downgrade. The country's economic performance under the Nueva Mayoría administration has been disappointing. The average annual growth rate will not exceed 1.9 percent over the current four-year term, the lowest since the Unidad Popular (1970-73). The opportunity to adjust Chile's archaic labor code was lost and replaced by a labor reform to strengthen unions, which will most likely foster informal employment. And under a poorly designed tax reform, coupled with a reduction in business investment incentives, gross capital formation plummeted. Unfortunately, and despite the blind faith of the authorities, the 'emblematic reforms' did not allow the government to sustainably finance its ambitious and controversial social initiatives, including the regressive promise of tuition-free higher education. In fact, the fiscal deficit has grown, translating into a snowballing debt-to-GDP ratio. Expectations for President Bachelet's last year in office are low. GDP does not seem to be recovering, unemployment rates are increasing, informal employment remains high and stable, and real salaries are stagnant. Even worse, there are only minor indications that authorities took note of the jab-cross-hook-uppercut combination inflicted by foreign and local shocks. In this context, regardless of the party of the successor, top objectives for the next administration should be threefold. First, the country must resume its fiscal responsibility approach to public finance, a building block of Chile's economic success. Second, Chile must implement long-overdue pro-productivity reforms in key sectors, including labor, education and social protection, hopefully promoting public-private partnerships. And last but not least, the country must continue eliciting efforts to secure and promote competition across and between industries. The strategy will most likely imply revising, adjusting and even reversing some of the economic policies implemented under the Nueva Mayoría administration. It is the cost of Chile's hangover, but the country's social and economic progress can't wait four more years."

> **"The country's economic performance under the Nueva Mayoría administration has been disappointing."**
> **— Sergio Urzua**

The Advisor welcomes comments on its Q&A section. Readers can write editor Gene Kuleta at gkuleta@thedialogue.org.

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