

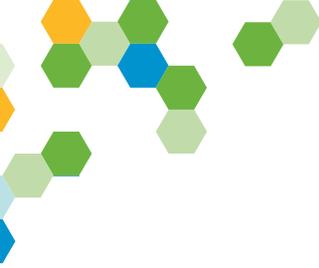


SPECIAL REPORT

“Realism without Quitting” Second Term of Bachelet’s Government

Chile, July 2015

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I. INTRODUCTION

"We need to address our second term taking into account the consequences that these difficulties (economic, managerial, social and political) will entail, but without forgetting our commitment with citizenship... If I could summarize it, I would call it "**Realism without Quitting**", said Bachelet.

The prologue of the Second Term of the Government of Bachelet started with the appointment of the new Cabinet, the drafting of various anti-corruption measures suggested by the Engel Commission¹, a lukewarm Public Account in which the President briefly touched the main domestic issues (growth, corruption, reforms, constitutional process) and a heartfelt request by the President to "restore confidence".

This stage was defined by the President herself as "Realism without Quitting", a clear idea in which the Government recognizes a **context** marked by low growth and public support for reforms and yet the conviction of not **giving up** on the reforms.

Although the Government does not clearly recognize its fault in the weak state of the national economy and management, the fact that it does acknowledge that the country is going through a difficult economic period illustrates the new approach of the Ministers for the Interior and Finance. This new philosophy defines the second term of the Government. Nevertheless, surveys assessing the performance of the President still show negative results.

¹ Presidential Advisory Council against conflicts of interest, influence peddling and corruption.

“Whether it was because of naivety or honesty is unclear, but Minister Valdés spoke about it openly and recognized the need to “prioritize” the legislative agenda”

2. ABSOLUTE HONESTY

“We have to be realistic and honest as regards the country. Without growth there will be no sustainable reforms”
Michelle Bachelet.

The arrival of Rodrigo Valdés, new Minister for Finance, and his will to enhance the economic context is an empirical example of how technocratic leaderships may face problems if they are not combined with a sound political management. An example of the aforementioned phenomenon were several public appearances where the Minister said what people wanted to hear and yet had to correct his statements due to political coexistence issues. This is how Christian Democrat Jorge Burgos, right hand of the Minister for the Interior, was announced as the ideal complement to the Minister for Finance.

Rodrigo Valdés, a widely respected politician throughout all political sectors thanks to his brilliant career in private and state banking, the Central Bank and the IMF, was the first member of Government to voice some doubts implying that things (reforms) could have been done better. Whether it was because of naivety or honesty is unclear, but Minister Valdés spoke about it openly and recognized the need to “prioritize” the legislative agenda.

The honest analysis of the meager economic figures was carried out by the Minister a few weeks ago during the Joint Finance Committee in Congress. In his speech, the Minister mentioned the low expectations of growth of the Chilean economy, with an estimation that dropped almost 2 percent points, far from the 3.6% used to draft the National Budget. According to the estimations, tax revenues were expected to generate USD 52,947 million, which was reduced to USD 51,416 million (USD 1,531 less millions). These figures reflect, among other factors, the low revenues generated by copper due to the sharp drop in the price of the aforementioned commodity, commonly called “Chile’s salary”.

For its part, the Central Bank has maintained the Monetary Policy Rate at 3% for nine months. It is aligned with the Government as regards honesty and recognizes the weak state of the economy. This

Figure 1: Gross Domestic Product Development (GDP)

Variance between the same period during the current and previous year, %



Source: Central Bank of Chile

is supported by an inflation of 4.4% during the past 12 months in which energy, transport and housing recorded the largest price increases. The hopes of the Central Bank are being placed on potential improvements starting in September, since July and August are expected to be negative months. (See Figure 1)

The Chilean economy continues declining, May's IMACEC (0.8%) was a severe blow to the expectations of the market, which hoped for a growth near 1.5%. This result was due to the higher added value of the services and the contraction in manufacturing, mining and large-retail activities. (See Figure 2)

Figure 2: Development of the Monthly Indicator of Economic Activity (IMACEC)/SOFOFA

Variance between the same period during the current and previous year, %

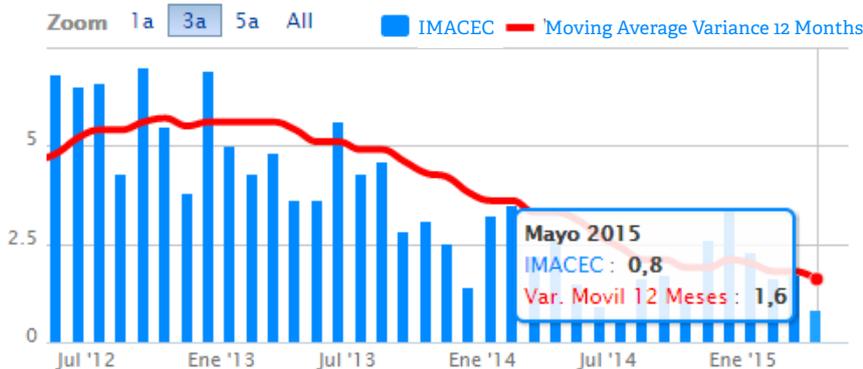
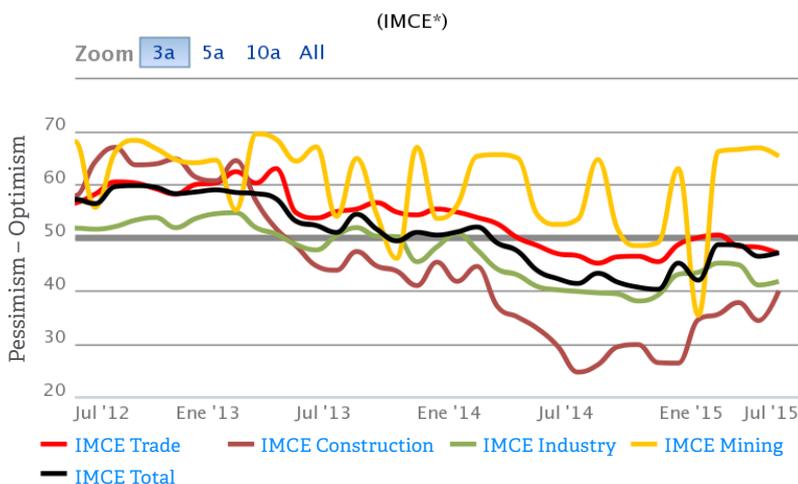


Figure 3: Development of Business Confidence / ICARE-UAI



*A value above (under) 50 points shows optimism (pessimism).

Additionally, the Monthly Business Confidence Index shows a steady decline. In May, it reached 47.14 points, 20.69 points under the score recorded in the previous month. Thus, the overall business expectations fell to the **pessimistic** level, since 50 is the minimum optimism level. Trade, Construction and Industry show some signs of pessimism. The confidence levels in the Mining and Trade sectors were weakened over the previous month. (See Figure 3)

From an investment point of view, after a decade of extremely positive external conditions in copper prices and favorable financing conditions (interest rates), now Chile needs to face unexpected conditions, reflected in 8 consecutive quarters with negative figures as regards investment (with the exception of the fourth quarter of 2014). In 2014, Total Investment dropped by 6%, a fall that can be mainly explained through the decline of mining investment. According to financial analysts, despite the increase of near 30% in public investment, total investment will suffer a mild contraction in 2015, which will entail a drop of 5% in

“The conditions of uncertainty and mistrust which entail ambiguous scenarios do not contribute to the creation of a favorable climate for the economic recovery”

private investment. The latter can also be explained by the drop of mining investment and the **persistent lack of confidence within the business sphere.**

The aforementioned points, added to an unemployment rate of 6.6% and an expected fiscal deficit of USD 73 billion for the current year (USD 12 billion combined with the figure recorded in 2014), make us think that the current context that Chile is facing calls for clear and defined guidelines for investment, saving and spending decisions. Market players can take measures and evaluate them, even when policies and laws can be unfavorable, i.e., risk can be assessed. However, the conditions of **uncertainty and mistrust** which entail ambiguous scenarios (or at least, not clearly defined), as occurs with reforms, do not contribute to the creation

of a favorable climate for the economic recovery.

3. “RESTORING CONFIDENCE”

Although this concept is widely used by the Government and was repeated several times during the speech of “Realism without renouncing our objectives”, it now has a very different meaning than that of previous months. During Bachelet’s first year in office, the opposition and the entrepreneur sphere were severely “wounded” as they had to face a very tough political style, imposed by a parliamentary majority able to appease any type of discrepancies. The “5th Study on Business-Government Relations in Latin America, Spain and Portugal”, already showed low confidence levels in the Chilean political sphere, to the extent that 68% of the respondents had no confidence whatsoever in politicians. (See Figure 4)

Figure 4: 5th Study on Business-Government Relations in Latin America, Spain and Portugal, LLORENTE & CUENCA

Entrepreneurs’ Confidence Level in Politicians/Political Parties



ENTREPRENEURS/POLITICIANS CONFIDENCE INDEX (1-5)		
Entrepreneurs	Politicians	Total
1.71	2.78	1.8
1.78	2.36	1.9
1.76	2.4	1.88

In this context, the Government passed the Tax Reform, which took its toll on the political class, entrepreneurs, Government, and let us say it, the whole citizenship. This was the first structural change promoted by the Government of Bachelet and agreed by a political elite in what was known as the “Kitchen” a term that described the negotiations of the reform between Government, Nueva Mayoría and Alianza por Chile, outside the walls of the Congress.

The country was concerned about the upcoming reforms:

education and labor, since the Tax Reform had entailed a drop in confidence levels. This year, after a series of scandals of

corruption, influence peddling, campaign and pre-campaign illegal financing affecting people close to the President and the political class as a whole, confidence is more related to political honesty rather than the fear to laws lacking wide consensus.

4. REFORMS: A CAR WITH LOW FUEL AND A LONG WAY AHEAD

Given the low growth and tax revenue scenario, currently there are few resources to maintain the rapid pace at which the Government wanted to implement the reforms. We should not forget that the Government’s plan sought to implement a Tax Reform (ongoing) to sustain the Educational, Labor and Pensions Law Reforms as well as a Constituent process, a clear sign of a new potential Constitution.

After a widely-covered Council of Ministers aimed at reorganizing the legislative agenda, Bachelet summarized three factors that prevented the proper management of the aforementioned amendments:

- **The State** was not ready for the reforms.
- **The economic slowdown** has been deeper and longer than expected, thus limiting fiscal resources.
- **The State administration** was not fully prepared to address structural changes simultaneously.

		ENTREPRENEURS’ DATA		
		Little or no confidence (1-2)	Some or much confidence (3-4)	Absolute confidence (5)
IBERIA	SPAIN	85.2%	14.8%	0.0%
	PORTUGAL	75.7%	24.3%	0.0%
LATAM	ARGENTINA	85.2%	14.8%	0.0%
	BRAZIL	82.0%	18.0%	0.0%
	COLOMBIA	68.1%	31.9%	0.0%
	CHILE	68.0%	30.7%	1.3%
	ECUADOR	63.0%	37.0%	0.0%
	MEXICO	88.5%	10.6%	0.9%
	PANAMA	88.0%	12.0%	0.0%
	PERU	90.9%	9.1%	0.0%
	DOMINICAN REPUBLIC	88.0%	11.2%	0.8%

ENTREPRENEURS/POLITICIANS CONFIDENCE INDEX		
Entrepreneurs	Politicians	Total
1.68	3.29	1.74
1.96	1.95	2.13
1.75	2.50	2.53
1.67	2.38	1.76
2.09	3.00	2.12
2.18	-	2.19
2.16	2.88	2.26
1.73	1.81	1.73
1.82	-	1.97
1.57	2.51	1.63
1.56	-	1.59

Confidence Index: weighted average of the assessments made on a 1-5 scale by politicians and entrepreneurs who responded to the question. Results range from 1 (no confidence) to 5 (complete trust).

“The reform which sought to provide universal, free upper education (technical-college) cannot be fully carried out”

Although the Government’s responsibility in this faulty implementation is implicit, the aforementioned factors involve third parties and not the Government itself. The information hereunder analyzes each of the initiatives.

One of the sectors which has suffered the most in this difficult situation is education. The reform which sought to provide universal, free upper education (technical-college) cannot be fully carried out. However, the Government is still committed to provide upper education to 60% of the students from the most vulnerable sectors in areas part of the Council of Rectors.

Although the Tax Reform is already in force, the Minister for Finance (Rodrigo Valdés) is working on a series of areas and could eventually provide “specific indications” to modify the Tax Act, showing the goodwill of Valdés and the willingness by the Administration to implement the changes that several political and business sectors had requested.

The Labor Reform, currently in its second stage, provides the opportunity of achieving a greater participation and dialogue among the people involved in the project, said Bachelet herself, particularly because the project seeks to foster domestic growth and productivity, in addition to generating jobs.

Members of Nueva Mayoría (President of Christian Democrats) are now discussing certain points regarding the end of replacements in strikes, one of the main points of the Labor Reform.

The Constituent Process announced some months ago by the President will start in September of the current year. However, no information has been released in relation to its contents and the feasibility of completing it during Bachelet’s second term.

The possibility of amending the Pensions Act and creating a state-owned AFP (pension funds administrator) are not prioritized in the reforming plans of the Government. In fact, it was not mentioned in the last presidential speech.

However, following the type of dialogue proposed by the Government, Nueva Mayoría is preparing a **Meeting** so that the Government’s coalition reaches a common position on these national issues. It will not be a simple mission, as Democracia Cristiana (DC) has increased its power and now can greatly influence the Government’s agenda, particularly through the Minister for Interior, with a wave of new mayors from their ranks and a postponed discussion on the Abortion Act. On the other hand, the weakened Communist Party considers the Labor Reform to be the cornerstone of its

“Organizing the Copa America was still insufficient to improve the poor Presidential performance indexes”

portfolio and is slowly losing more and more prominence.

Reaching agreements among the members of the Government's coalition and reorganizing the latter are two of the tasks that Bachelet must carry out to achieve a sound management during her mandate and pave the way for the next electoral battle.

5. OBSESSION WITH POLLS

"It is true that the changes that we have implemented during this first stage have been complex, mainly due to their institutional and long-term nature. The negative effects they have had in terms of citizen support are clear and anyone can see what polls are showing" Michelle Bachelet.

For some time, the Chilean society has been busy analyzing all surveys and studies. It is no longer sufficient to check monthly studies which analyze all activities, the Chilean public opinion now has weekly reports at its disposal.

There are currently little news for the Government as regards the results of these surveys, the steady decline of the assessment on the Presidential management has become a trend. Organizing the Copa America was still insufficient to improve the poor Presidential performance indexes (25% approval). (See Figure 5)

Despite the positive perception of the changes in the Cabinet of Ministers and a lukewarm Public Account which obtained a 33% approval according to the Plaza Pública Cadem survey carried out on the following day (May 22), presidential support has continued declining towards disapproval. The calm that brought the new cabinet was only a short break in a storm in which the Government has been sailing for months. There have been new cases of corruption involving their presidential campaign advisers. An alleged irregular presidential pre-campaign supported by contributions and lively discussions in universities, as a result of the announcement of gratuitousness, are the reasons behind this complex scenario of disapproval.

Figure 5: Plaza Pública Survey, Cadem. July 10, 2015



“Bachelet has made efforts to create an agenda of transparency and probity”

6. CORRUPTION: A DIFFICULT PROBLEM TO TACKLE

“The time to act has come. Chile will not tolerate any delays in relation to this problem and, as the President of the country, I will push institutional measures to control in a strict and efficient manner the relations between money and politics, both in the public and private spheres”
Michelle Bachelet.

Corruption has undoubtedly been the greatest concern of the President, mainly because it involved politicians who were close to her: her son Sebastián Dávalos and her political heir, Socialist Rodrigo Peñailillo, along with several politicians of the Government’s coalition.

Despite the poor management of the CAVAL case, which involved the President’s son and daughter in law in the purchase of land using privileged information, Bachelet has made efforts to create an agenda of transparency and probity, whose cornerstone is the Engel Commission’s report. The Commission is named after its director, renowned economist Peter Engel, who developed

“accessible and effective” mechanisms to prevent conflicts of interest, influence peddling and corruption.

The President has prioritized this (probity) agenda and established three main points for its development:

- New rules for political parties and their systems of internal elections.
- New standards that shall govern the appointment of public authorities.
- Focus on “bad practices in the private sector”.

These points are already being handled in Congress through the Political Parties Law and initiatives to regulate political campaign contributions, illustrating the real efforts made by the authorities to put an end to a series of bad practices that were being developed in all spheres of Chilean politics and from which entrepreneurship profited. However, all these initiatives will be pointless unless the political and business classes recognize their mistakes and build a future based on **transparency without quitting.**

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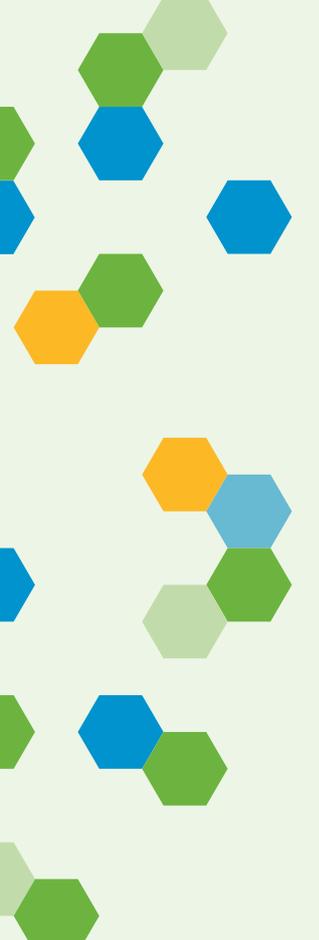
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