Project Syndicate

Chile's Uncertain Future
October 28, 2015

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CAMBRIDGE – When I was in Chile earlier this month, I was impressed by the contrast between the palpable success of its long-standing free-market policies and the current agenda of its leftist president, Michelle Bachelet. How this contrast is resolved will be important not only to the country's more than 17 million people, but also to everyone who regards Chile as a model of what sound economic policies have been able to achieve.

Copper is Chile's major product and accounts for half of its exports. Although the government owns Codelco, the world's largest copper producer, it is Chile's only publicly owned company. The company's revenue varies with the global price of copper, yielding higher government revenues in some years and declines – for example, this year – when the global price is down. The government follows a wise fiscal strategy that involves budget surpluses in years when copper revenue is high, with the additional funds channeled to a national stabilization fund.

But even with the currently depressed copper price, Chile's budget deficit is only 2% of GDP. As a result of Chile's cautious fiscal strategy, the country has a national debt that amounts to only 16% of GDP – and a sovereign debt rating that is the highest in South America.

Taxes and other government revenues are less than 20% of GDP. Half of tax revenue is collected with a value-added tax, which is essentially a tax on consumption. Although there is a tax on corporate income, it is integrated with personal taxes in a way that reduces its adverse effect on investment and production.

Chile is well known for an investment-based pension system. Employees are required to contribute 10% of their wages to a private pension company of their choice and can then select one of the investment strategies offered by that company. The government mandates the range of investment strategies, which vary in terms of the share of equities and fixed income that companies may offer. For those who have worked and contributed during their entire adult life, this produces benefits that are more than 50% of pre-retirement income.

Meanwhile, sound monetary policy, guided by a series of talented central bankers (whose independence is enshrined in Chile's constitution), has prevented inflation and kept long-term rates relatively low. Chile's inflation target is 3% with an acceptable range of plus or minus 1%. Inflation this year is expected to be 3.9%, and the ten-year bond rate is just 4.4%. And, by protecting the floating exchange-rate regime, the central bank ensures that Chile does not confront the kind of foreign-debt crisis that has hit other Latin American countries.

Chile is also a devoted free trader. It has free-trade agreements with more than 20 countries and is a member of the nascent Trans-Pacific Partnership. The economy has also benefited from its openness to foreign investment, with the stock of foreign direct investment in Chile topping 80% of GDP.

There is also universal literacy, with 98% of the adult population able to read and write. On average, young people spend an average of 15 years in school from primary through tertiary education.

Chile's excellent economic performance has been the result of the free-market policies introduced during the military dictatorship of General Augusto Pinochet but confirmed and strengthened by democratically elected governments over the 25 years since he left office. So, given the success and popularity of these policies, it is surprising that Chile's voters have elected a president and a parliament that many Chileans now fear could put this approach at risk.

Bachelet's policy agenda emphasizes three major changes. A key element would be universal free university education, modeled on European systems. Paying for this educational reform would require higher tax rates. And labor laws would be revised to strengthen the role of unions.

Critics of Bachelet claim that this agenda is already depressing business investment and is responsible for relatively slow economic growth. And they worry that foreign and domestic investors will be discouraged by the new labor rules.

Fortunately, the Chilean public shows no inclination to follow the mistakes of several other South American countries,

especially Venezuela, Ecuador, Brazil, and Argentina.

Even Bachelet's critics agree that Chile's basic macroeconomic policies will not change: an independent central bank committed to price stability, a free-trade regime with a floating currency, and a fiscal policy that will keep deficits and public debt low.

Bachelet's term in office will end in 2017. Under Chile's constitution, she cannot serve another consecutive term. The election that year will therefore be an important one to watch.

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