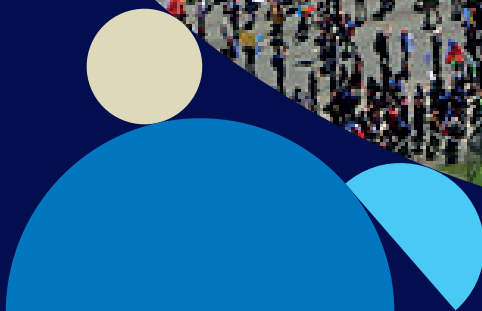



Chile's new constitution



The constitutional debate in Chile will continue, no matter the referendum result





The social unrest in Chile that began in October 2019 triggered the drafting of a new constitution. The objective was to write a new Magna Carta that would unify Chilean society by taking social demands into consideration. The process was carried out democratically with a constitutional convention elected by popular vote. After a year of work, on July 4, 2022, the convention delivered the final proposal for the new constitution.

Nevertheless, during the last year, institutional and political uncertainty has increased, impacting the outlook for economic growth and financial asset prices. Unfortunately, the process of drafting the new constitution against this backdrop has increased polarization, and the final referendum's outcome is now uncertain. On September 4, 2022, Chile will decide, with a mandatory popular vote, whether it will adopt the

new constitution or continue to be governed under the current one. Regardless of whether the newly drafted constitution is approved or rejected, the outcome of the vote will bring economic implications and lots of questions will likely still need to be addressed. Furthermore, we believe the discussion regarding the constitution will continue, especially if the vote is close, regardless of the referendum's outcome.

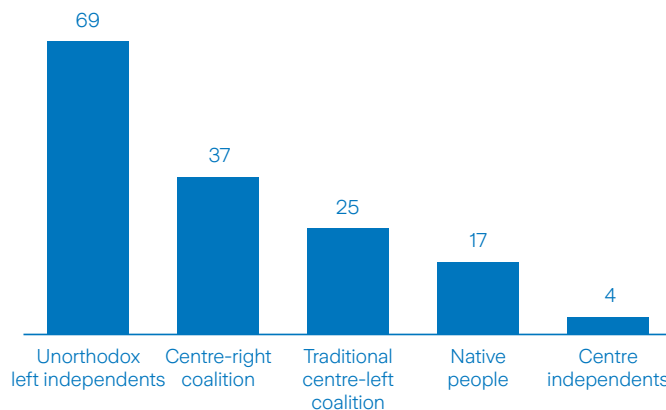


Source: Revista educación

Contextualising the constitutional process

In November 2019 the various political parties of Chile signed a national agreement for peace resolving to redraw the constitution taking into consideration the social demands promoted by the social unrest of October 2019. The process was ratified by a constitutional reform on December 24, 2019, paving the way for the redrafting process. In the constitutional referendum of October 2020, the option to write a new constitution succeeded with almost 80% of the votes. The constitutional convention, comprised of 155 democratically elected members, was chosen as the body responsible for drafting the new constitution. After being elected in May 2021, the constitutional convention convened on July 4, 2021, with one year to deliver the final new constitution proposal. The political composition of the constitutional convention was biased to the left, while the centre-right coalition did not have enough votes to veto any proposal.

Composition of the constitutional convention (number of seats)



Source: Servel, ZIG

Main economic concerns regarding the newly proposed constitution

While the constitutional convention had enough votes to make significant structural changes to the current economic and institutional model, and the new proposed constitution incorporates some transformations to the existing model, it leaves out the most radical ones, such as nationalising the mining industry, eliminating some property rights, and revoking the autonomy of the Central Bank, among others. The proposed constitution complies with all international standards regarding constitutional democracy and the rule of law and, notably, establishes the principle of sustainability and fiscal responsibility in conducting public finance. Furthermore, it incorporates innovative and relevant articles to recognise the right to protect the environment, introducing the concept of 'rights of nature'. It also includes an extensive set of social rights, such as education, health, housing, and gender equality in an effort to improve social welfare and reduce inequality but requires new fiscal spending and institutional regulation. However, many of the changes that have been included in the draft would increase fiscal spending without having a funding source, which will likely negatively impact the medium-term economic outlook and add uncertainty to fixed investments.

On the political front, the constitutional proposal maintains the current presidential system but reduces and attenuates the powers of the president. A fundamental principle of the current constitution in Chile is the president's ability to enact exclusive legislative initiatives on matters that affect public spending and social security, among others. In the constitutional proposal this principle is replaced by one that only requires presidential concurrence. Thus, Congress can present bills with economic consequences regarding public spending. Although the final approval requires the president's support, we believe this mechanism increases the risk of populist measures and complicates fiscal responsibility, which could lead to a deterioration in Chile's credit rating and increase interest rates.

The bicameral system is maintained in the new constitution, but the Senate as Upper House of Chile's National Congress will be replaced by the Chamber of the Regions. This new body will have significantly fewer attributes than the Lower House. Therefore, the political system will be asymmetrically bicameral, eliminating the counterweights that maintain balance within the legislative branch.

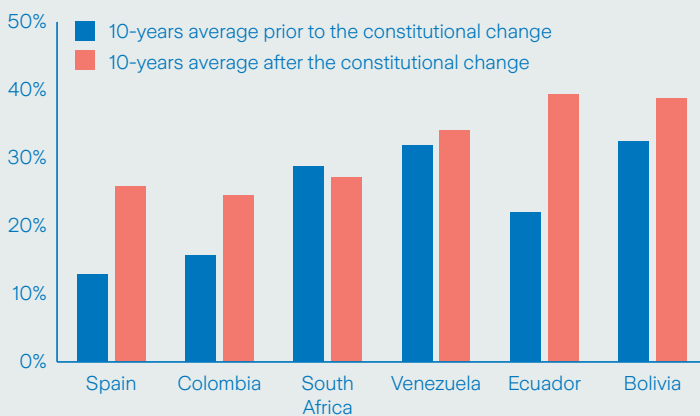
Chile has sixteen regions. The proposal grants autonomy to those regions, providing fiscal independence and allowing them to create public companies, impose contributions and fees in their territories, and issue debt. We anticipate that this new system will be hard to implement and will present a challenge to fiscal credibility and responsibility.

Also concerning are the changes to the legislative majorities. The proposal reduces the special quorums to simple majorities for some topics, which will likely lead to a higher frequency of change and less predictability. This will likely affect legislation regarding the pension system, which is a fundamental pillar of the capital market.

The mining sector is central to the economy in Chile and is currently economically protected by the constitution. The proposed changes reduce its protection and subject changes in the mining laws and concessions to a simple majority. Likewise, the proposal modifies the current legislation of water usage rights, changing the property rights for administrative permits, limiting their use. Therefore, the proposal will affect the agricultural sector since farmers will not be able to use water rights as collateral for their credit operations. We believe both changes weaken mining and water property rights, likely reducing business confidence and undermining fixed investment.

Although the new constitution guarantees economic freedom, the autonomy of the central bank, and property rights, it significantly increases the size of the government by including social rights and increasing fiscal spending. A recent study published by economists from various universities indicates that the total annual cost of the new constitution is between 8.9% and 14.2% of GDP, of which 80% represent an increase in health, education, and social protection spending. Despite the potential positive impact on social welfare, the fiscal revenues to finance the additional fiscal spending are a concern. Congress is discussing a tax reform to increase revenues, which we believe will not be enough to finance the additional social spending. Consequently, implementing new social rights will be challenging, leading to a higher fiscal deficit and public debt.

Country comparison of changes in fiscal spending as percentage of GDP after changing the constitution



Source: Betancor, A., Larrain, G., Martinez, C., Ugarte, G., Valdes, R., Vergara, R., 2022, "Estimates of the direct fiscal cost of the proposed new constitution"



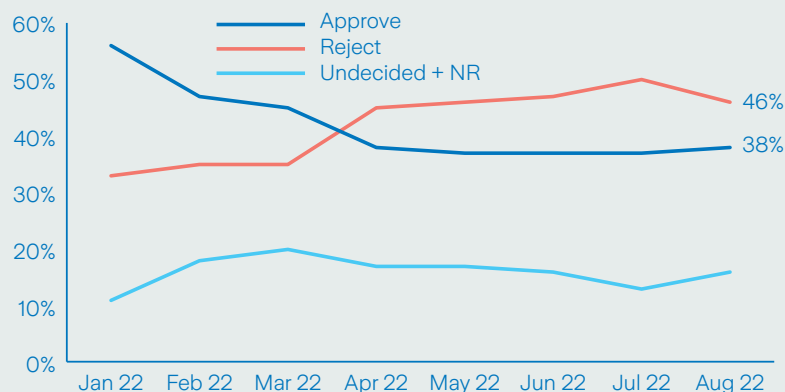
Expectations for the September 2022 referendum and next steps

The outcome of the referendum in October 2020 showed around 80% of the votes in favour of redrafting the constitution. The desire to improve social rights was the main driver. Initially, the expected outcome of the September 2022 referendum also appeared to be leaning towards approval of the new constitution. However, the latest polls have shown a change in sentiment, with the rejection option winning by a wide margin. The inability to reach consensual agreement on several key topics plus the increasing polarisation and disconnect with the civil society from the constitutional convention resulted in a dramatic change in the polling trend. In addition, new regulations that discriminate in favour of the indigenous population have further reduced support for the new constitution. However, despite the significant swing in voter preference, the nature of a mandatory vote and the current expectations of the outcome make it difficult to predict the referendum's results. What does seem clear is that whatever the outcome, debate about constitutional reform in Chile will continue to reverberate in the months and years to come.



What happens in the background politically after September 4, 2022, will depend on the margin with which the referendum is either supported or rejected. Broad approval could be seen as a sign of support for President Boric's government program and reform plan, while a wide rejection will plunge the government into a political crisis. In the case of either approval or rejection by a small margin, which we believe is the most likely outcome, we expect significant reforms to the proposal or even the start of a new constitutional process. Currently, both campaigns are promoting the idea that the constitutional debate will continue irrespective of the referendum's outcome. Therefore, we anticipate that the discussion regarding the constitution will continue regardless of the result. Political and institutional uncertainty will remain, which will likely challenge the investment and economic growth outlook and affect the prices of financial assets. Nevertheless, if the rejection wins, we believe it will be positive for the equity and FX markets in the short term.

Evolution of voter intention for the September referendum



Source: CADEM, ZIG

Conclusions

While the redrafting of the constitution was carried out in a democratic manner within an institutional environment, and the proposed new constitution complies with international standards and includes social and environmental rights, we believe that the constitutional convention failed to write a representative proposal based on consensual agreements. We think the new constitution will likely negatively impact economic growth and significantly increase the fiscal deficit and debt to GDP. We estimate that regardless of the referendum result, the constitutional discussion will continue, either to reform the new constitution if approved or to start a new constitutional redrafting process if rejected. Likewise, debate surrounding the redrafting process as well as political uncertainty will make it more difficult to predict the future path of monetary policy, increasing tension regarding fiscal policy and negatively affecting fixed investment. Finally, we think a new constitutional agreement that incorporates changes from the proposal that were well received while maintaining the current constitution's positive aspects will likely be positive for the economy in the medium term. Nevertheless, the timing for this agreement matters, while uncertainty will likely remain in the meantime.

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