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Country ESG Ranking – Chile Special Report

Turmoil in Chile: A "role model" under strain

- Despite strong growth, income inequality remains high in Chile
- Deteriorating ESG indicators highlight social and governance concerns
- Socio-political stability needs inclusive economic and fiscal policies

Chile is often cited as Latin America's economic role model. However, recent economic growth has not benefited all and as it slows inequality has remained entrenched. The end of the commodities boom and perceived social and governmental deficiencies have created conditions ripe for societal discontent. ESG indicators point towards the need for both inclusive economic growth and tax reform to bring back stability and social cohesion to Chile.

Article
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Turbulent times in South America

Much of Latin America has been ravaged by sudden and unexpected anti-government protests in recent months. The popular uprisings, the worst and most widespread to hit the region in decades, are already being compared with the pro-democracy rebellions across the Arab world in 2010-11. However, whereas in the "Arab Spring" oppressed and impoverished populations revolted against their autocratic regimes, in the current uprising in South America the actors and causes vary from country to country, and voters are protesting against leaders from both the left and the right.

While these protests across the region were triggered by country-specific issues, they occur against a common backdrop of extreme inequality, fragile state institutions, poor government provisions, corruption fatigue, and weakening growth. Thanks to the strong income flow from rising commodity prices and governments' pro-poor policies, the region has experienced a sharp reduction in poverty. From 2002 to 2014, the regional average poverty rate fell significantly from 45.4% to 27.8%, i.e. 66 million Latin Americans have escaped poverty and ascended to the middle class, according to ECLAC[1]. They have become part of a middle class with growing aspirations, but also one that has become increasingly vulnerable to renewed economic and social relegation. Indeed, with the end of the commodity export boom and the following economic slowdown this positive trend has been reversed, from 2015 onward new fiscal constraints have sharply limited governments' ability to maintain their generous social spending policies, which had enabled them to reduce poverty and redistribute wealth. As a result, the levels of poverty and especially extreme poverty have increased once more. In 2018 30.1% of the regional population was below the poverty line again, while 10.7% was even below the extreme poverty line (up from 7.8% in 2014).

This, of course, has been fueling discontent and frustration causing the intense and partly violent riots observed in most countries in the region during recent months. This has been compounded by economic inequality remaining very pronounced all over the continent, which comprises seven out of the ten most unequal countries in the world. So Latin America is now faced with the huge challenge of disappointing growth prospects and the unequally distributed gains from that growth.

Even "role model" Chile engulfed by widespread protests

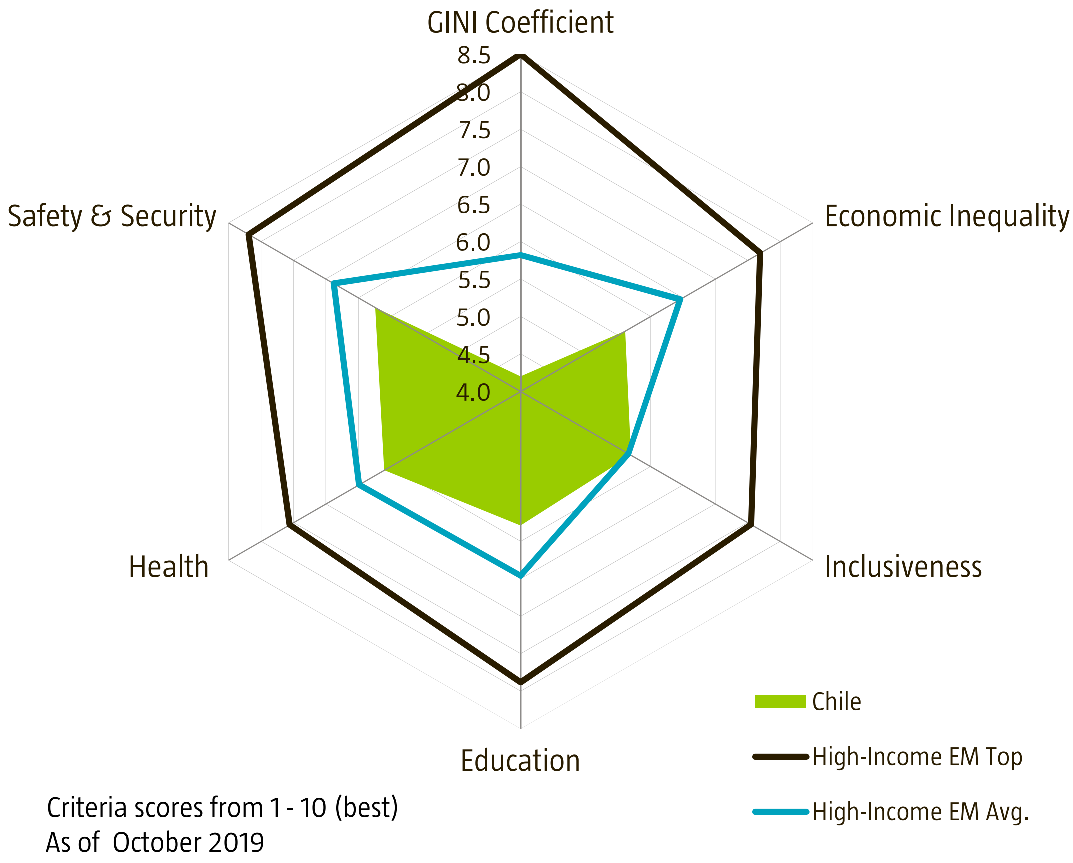
It is telling that even Chile, one of Latin America's most prosperous and politically stable countries has suddenly been affected by turmoil not seen since the end of Augusto Pinochet's dictatorship three decades ago. What began as a peaceful student-led demonstration on October 18 last year against a hike in metro fares quickly snowballed into a much deeper and violent movement against the right-leaning government and ruling elites. Chile has had remarkable success since its return to democracy in 1990 and is still better off economically than the rest of Latin America as shown by various macroeconomic indicators. The country has experienced an average growth rate of some 4% p.a. over the past 30 years, has achieved the highest per-capita income of the region with a GDP per capita of USD 25,222[2], and has seen a marked reduction in the poverty rate from 14.0% in 2007 to 5.7% in 2017[3], making it a role model for development in the region.

... as inequality remains deeply entrenched

However, this prosperity has not been shared equally among the Chileans as large parts of the population did not benefit to a sufficient extent. Looking at OECD data, the country has the highest rate of income inequality among the group of 36 member states with a GINI coefficient of 0.460 in 2017 as compared to an OECD average of 0.317[4]. A similar imbalance is the distribution in wealth with the top 1% of Chileans holding 26.5% of the country's wealth (net wealth based on 2015 data from ECLAC, the Economic Commission for Latin America and the Caribbean)[5]. But also, regarding several other social indicators Chile is lagging behind its high-income emerging markets peers as visible from **Figure 1**. Against the backdrop of a weakening economy, many Chileans fear a decline in living standards and increasingly perceive that income, wealth, and opportunities are not evenly distributed. The growth of the middle class in recent years has come with rising social aspirations and a perception that state institutions are failing to respond to these demands. This leaves a middle class that is, moreover, faced with low-quality jobs, poor social protection and low and volatile income, at risk of falling back into poverty, especially at times of economic downturn.

[1] Economic Commission for Latin America and the Caribbean (ECLAC): "Social Panorama of Latin America 2019"; December 2019.
[2] World Bank 2018: estimate in current USD PPP.
[3] The poverty rate threshold is set at 50% of median disposable income in the respective country and is "anchored" in 2005.
[4] OECD: "Income Distribution Database: Gini, poverty, income, Methods and Concepts"; 10 September 2019.
[5] Economic Commission for Latin America and the Caribbean (ECLAC): "Social Panorama of Latin America 2019"; December 2019.

Figure 1 | Chile's social & income inequality profile versus peers



Source: RobecoSAM

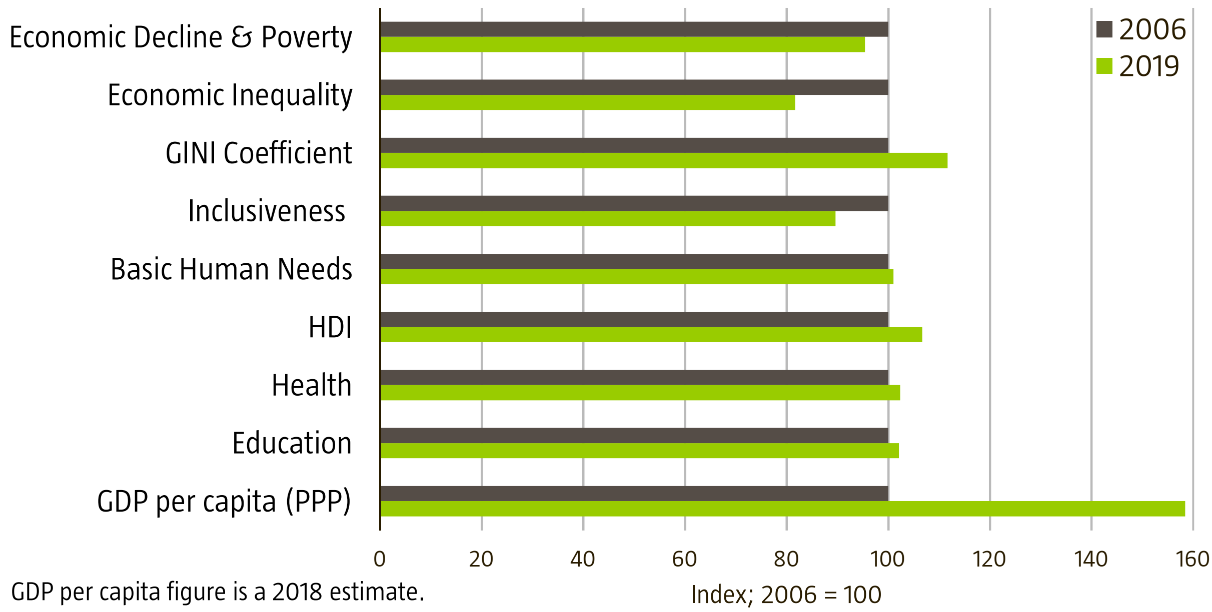
... and frustration over poor public services is widespread

Although Chile has consistently outperformed its Latin American neighbors, there are legitimate concerns regarding various deficiencies in the social and governance areas. Apart from the persistent inequality, these mainly relate to increasing costs of living, low wages and pensions, high utility costs, poor quality health care, a lack of education rights and sustained corruption. Indeed, during the past period of relative economic prosperity policy efforts have not proven enough to markedly improve government provisions, raise living standards and reduce inequality. **Figure 2** reveals that progress in the social sphere has been lagging far behind the growth in GDP per capita since 2006 (the first year for which we have determined a country ESG score); some indicators of inequality have even shown a deterioration. Hence, frustration over these issues is not new, as Chileans have repeatedly protested over the education and pension systems in the past, including in 2006, 2011, 2013 and 2016, although with less intensity than in the most recent wave of riots.

All this points to a deeper malaise and a slumbering potential for upheaval. While the series of student-led protests across Chile in 2011 & 2013 is clearly reflected in the fall of the scores for political risk, stability, and state legitimacy during that period, the development of these indicators in the latter half of the last decade did not necessarily provide indications of an imminent outbreak of such unrest (see **Figure 3**). Still, the events during the last three months of 2019 have taken their toll on the political risk assessments as the latest available scores for December 2019 from both Euromoney Country Risk (76.5, i.e. down by 2.6 points from September) and PRS Group (72.5, i.e. down by 3.0 points) show.

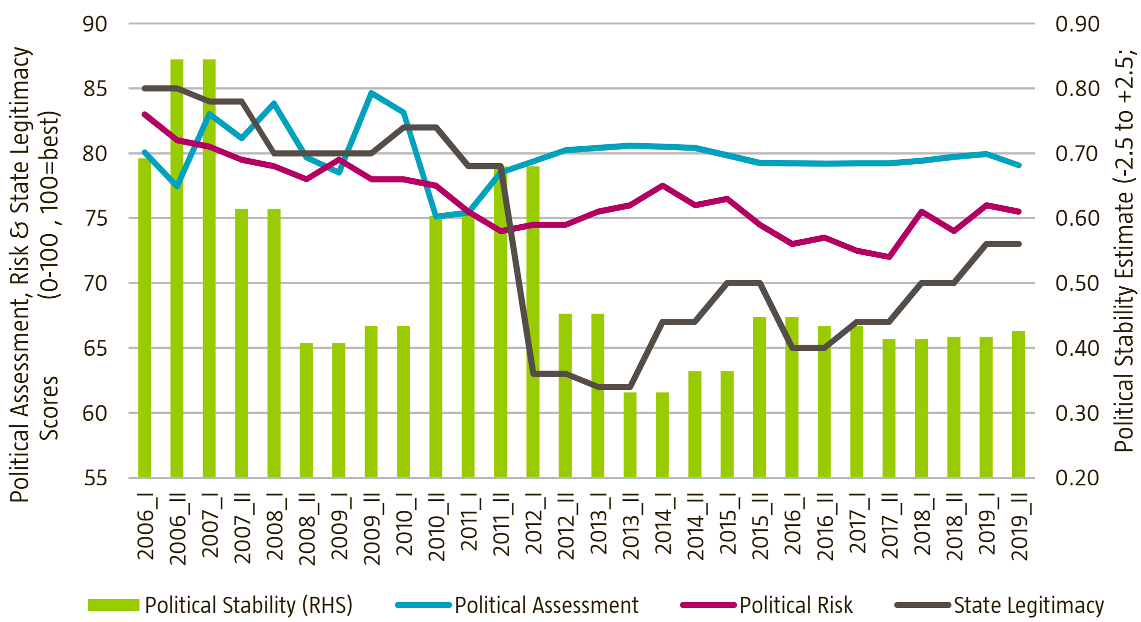
After a moderate recovery in the ESG score after the 2011-13 protests, Chile's overall sustainability performance has started to weaken again in the run up to the renewed protests in 2016. This came along with the economic slowdown and an increasingly harsher social and political climate, reflected in a gradual decline in the ESG score after the end of2015. Since then, Chile has slipped six positions to 36th place in October 2019. In July and August 2017, Chile suffered sovereign rating downgrades from both Standard & Poor's and Fitch by one notch each to A+ and A, respectively whereas sovereign CDS spreads continued their downward trend, with the exception of two temporary hikes in 2018. Only during October and November 2019, investors apparently began to worry again with CDS spreads trending upwards, before decreasing again in December (see **Figure 4**). It is true, the current global financial market environment has certainly contributed to this reasonably low risk premium, but with 41bps for the five-year sovereign CDS spread at the end of 2019 Chile still benefits from a considerable gap between its risk level compared with that of other Latin American countries such as Brazil, Colombia, and Mexico. Sure, the spread trend could be reversed again depending on the Government's final response to the crisis and once the potential changes in the new constitution are known.

Figure 2 | Social progress lagging behind economic growth



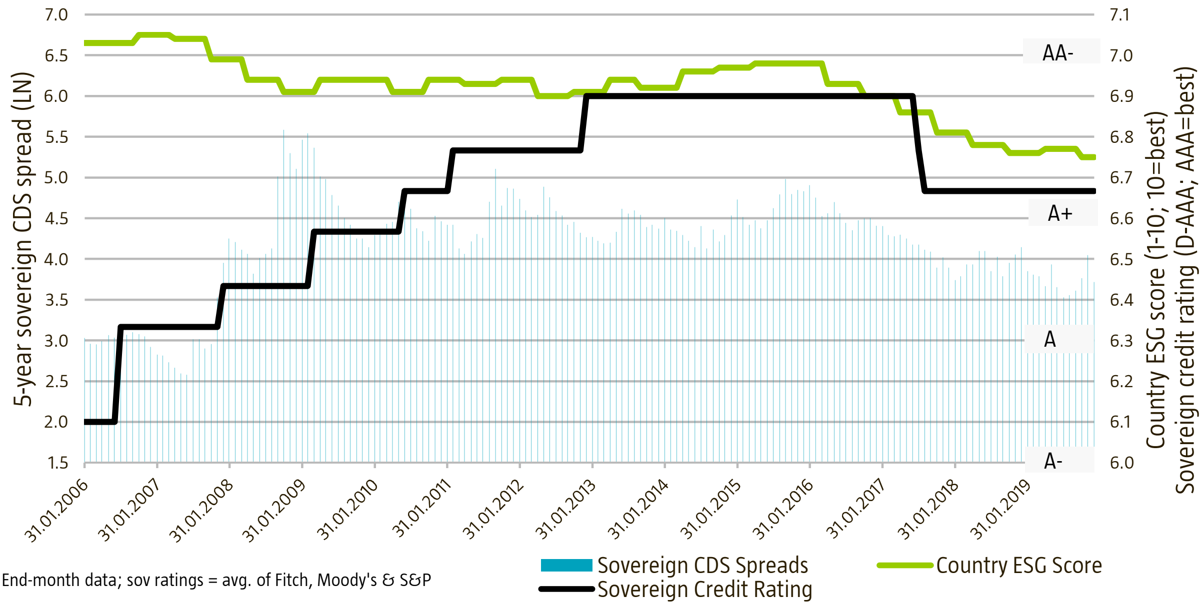
Source: Fund for Peace, Legatum Institute, OECD, Social Progress Imperative, UNDP, World Bank, RobecoSAM

Figure 3 | Political risk, stability & state legitimacy trends



Source: Euromoney Country Risk, Fund for Peace, PRS Group, RobecoSAM

Figure 4 | A renewed weakening of sustainability performance since 2016



Source: Bloomberg, Fitch, Moody's, S&P, RobecoSAM

The need for a more inclusive growth model

Responding to the protests, President Sebastián Piñera initially declared a state of emergency before lifting it again on October 27, in combination with the dismissal of his cabinet in order to form a new Government and the announcement to introduce social reforms, which included increasing the basic pension as well as the minimum wage. On November 15, 2019, Chilean lawmakers agreed to call a referendum in April 2020 to amend the current constitution – a key demand of protesters. And in early December last year, the government announced a plan to roll out a USD 5.5bn economic recovery program.

Even though these reforms were certainly a step in the right direction and have helped to ease the situation somewhat, the current superficial calm could prove deceptive as the underlying causes of the unrest will not be resolved overnight. A durable improvement rather requires a more inclusive growth model if Chile and all other countries in the region are to restore and preserve socio-political stability and ensure sustainable economic development. This is a demand that has also been affirmed at the occasion of the presentation of ECLAC's Social Panorama 2019 report on 28 November last year: "A decrease in income inequality is key to resuming the path of poverty reduction and achieving the targets established in the 2030 Agenda's Sustainable Development Goal 1. It is necessary to grow to equalize, and equalize to grow. Overcoming poverty in the region not only requires economic growth; it must be accompanied by redistributive policies and active fiscal policies"[6].

A sole focus on redistribution cannot be the answer, however, as has become visible in some neighboring countries (Venezuela). To achieve more inclusive growth and bring about more social cohesion in the longer term, a sound balance needs to be found between redistributive, fiscal and economic growth policies. From that point of view Chile should not delay the necessary policy adjustments nor the process of drawing up a new constitution in order to avoid a prolonged and harmful period of uncertainty.

Contact
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[6] ECLAC: "The Region Has Underestimated Inequality"; Press Release, 28 November 2019.