Chapter 1

The macroeconomic context in Chile

This chapter sets out the macroeconomic context for the review, including recent macroeconomic trends, the contribution of regulatory reform to economic performance, and the remaining challenges of the Chilean economy. Over the past 25 years the Chilean economy has become stronger, and social progress and poverty reduction have seen significant improvements. However, the economy is in a transition as prospect for copper prices have weakened and growth and investment have decelerated sharply. To sustain progress in well-being, Chile needs faster productivity growth which has stagnated. The government has introduced important steps to strengthen redistribution, improve equality of opportunities and boost productivity, including ambitious tax, labour and education reforms and a productivity agenda. These reforms go in the right direction, but there is still room to improve policies to make the regulatory framework more growth friendly and boost productivity.

The quality of life in Chile has improved significantly over the last two decades. Thanks to robust growth, poverty has decreased significantly while increases in average disposable income and life expectancy have been among the highest in the OECD. This high level of growth was a consequence of many economic reforms carried out in the 1980s and 1990s that helped the country catch up with the most advanced economies in the world. Trade liberalisation led to productive opportunities, and macroeconomic policies helped to control inflation and smooth economic cycles, reducing uncertainties and encouraging investment. These developments have helped Chile become the country with the highest GDP per capita in Latin American and the first South-American member of the OECD.

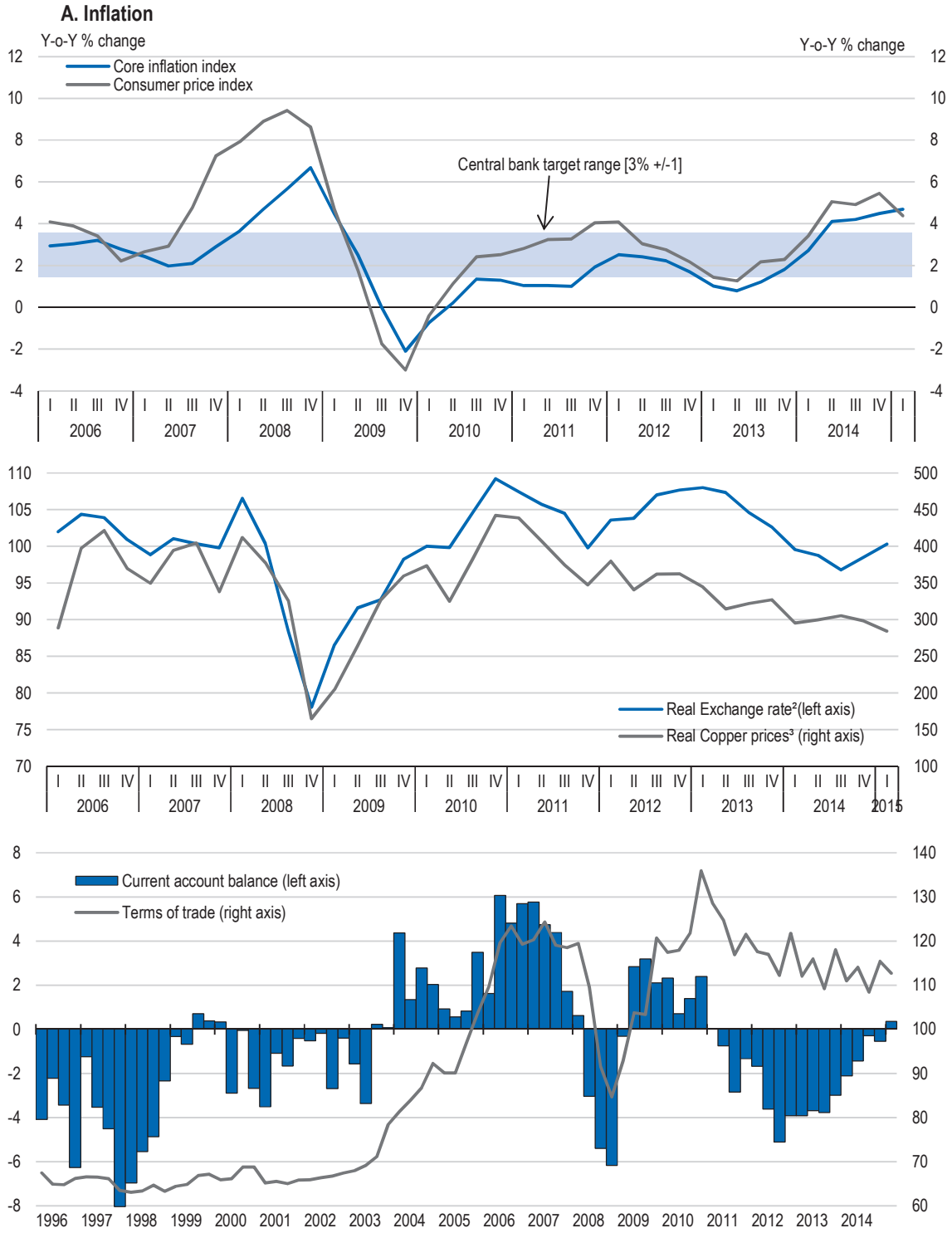
A sound macroeconomic framework that helps dampen the impact of external shocks

One of Chile's biggest strengths is a very sound macroeconomic framework that reinforces the resilience of the economy in the face of shocks, notably terms of trade volatility. This framework is based on a responsible and predictable fiscal policy rule that isolates expenditures from the business cycle and seeks to build up a large financial buffer, an inflation-targeting regime (with a flexible exchange rate) administered by an autonomous Central Bank, and a prudent regulatory and supervisory framework governing the financial system.

The fiscal rule, for example, helped Chile in the early part of the commodity boom to run current account surpluses by forcing the country to save a substantial part of the windfall. The fiscal surplus grew from 2% in 2004 to over 7% of GDP in 2007, allowing the country to save more than 10% of GDP in sovereign wealth funds. In the second half of the period, the counter-cyclical response to the financial crisis, reconstruction spending related to the 2010 earthquake and tsunami, the increase in production costs in mining and the internalisation of what then seemed to be permanently higher commodity prices, significantly reduced fiscal surpluses, which then turned into deficits. However, since the fiscal situation remains robust – notably by the near absence of net debt – the government has room to act counter-cyclically and sustain aggregate demand if conditions warranted.

Similarly, the inflation-targeting framework allows for counter-cyclical monetary policies, enabling the exchange rate to absorb adverse external shocks. For instance, during the period 2013-2015, allowing the exchange rate to depreciate has been an effective mechanism to dampen the recessionary effects of lower terms of trade on activity and employment. Currency depreciation has also led to a notable reduction in the current account deficit which, in 2014, was almost 2 percentage points of GDP lower than in 2013. However, the weaker exchange rate influenced the dynamics of inflation, and has put upward pressure on prices. Consumer prices rose by 4.7% in 2014, which is above the Central Bank's target range of 2 to 4%. Nonetheless, inflation expectations remain well-anchored at 3%, the centre of the Central Bank's tolerance range.

Figure 1.1. **Chile absorbs external shocks thanks to exchange-rate flexibility**



1. Exchange rates are index relative to the average value of 2007 which is defined as 100 for each currency.
2. Based on constant trade weights; deflated by import prices of goods and services. Average 2007 = 100.
3. For the real copper price, deflator: US Producer Price Index (PPI, all commodities). Average 2012 = 100.

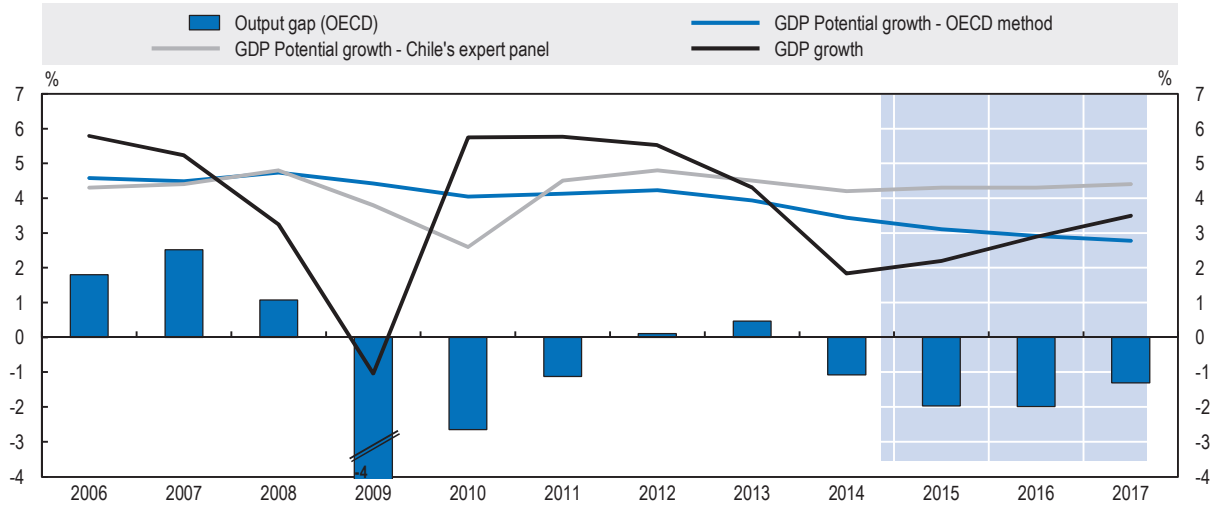
Source: OECD, Analytical and Economic Outlook database, and Comision Chilena del Cobre.

An economy in transition

As the largest producer of copper in the world, Chile benefited immensely from the upswing in commodity prices that started around the year 2000, and which, together with low international interest rates, had important macroeconomic implications. First, they provided a strong impulse to GDP growth which, during the last decade and with the exception of the 2009 financial crisis, was higher than in most OECD countries. Second, it attracted large capital inflows as investment rates, especially in mining, rose significantly. Mining investment grew from approximately 2% of GDP in 2002 to almost 7% of GDP in 2012, generating large spill-over effects on other sectors.

However, the long phase of strong economic growth driven by the booming mining sector has come to an end. Commodity prices have declined sharply and tighter external financial conditions are expected once the United States starts to normalise monetary policy. Although commodity prices are still high by historical standards, their significant drop in the last few years has put an end to the so-called commodity super cycle. The widespread view that the decrease in copper prices will persist for some time to come has affected expectations and investment. Following the fall in commodity prices there has been a significant deterioration in business confidence and a sharp decline in investment. The recent prolonged period of weak investment has been one of the most notable trends in the last cycle: investment growth has been negative for six quarters, one of the worst records of the last three decades. Business confidence is around the lowest levels of the last ten years. The high correlation between expectations and investment has given rise to the idea that, in the absence of a substantial improvement in confidence, it will be difficult to sustain a recovery of investment in the medium term; and lower investment affects potential growth which is also trending downwards.

Figure 1.2. **Slowing economic growth in Chile (2006-2017)**



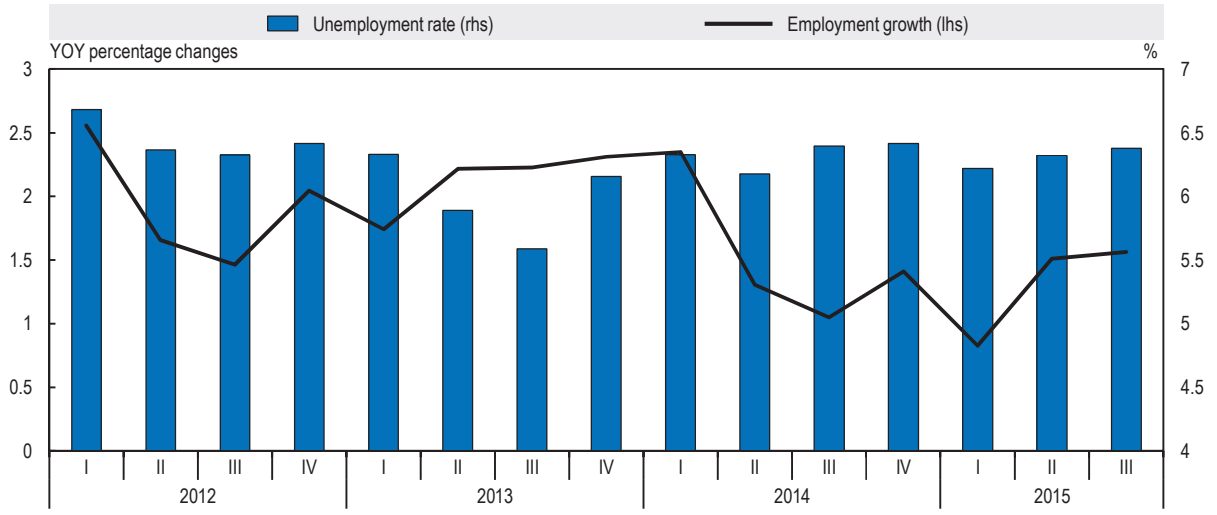
Source: OECD, Analytical and Economic Outlook database, and DIPRES, Directorate of Budget of the Ministry of Finance of Chile.

Lower terms of trade have also cut household incomes and private consumption. The growth of private consumption is limited and is currently below the aggregate growth rate of the economy. This includes somewhat higher nondurable goods consumption. The

other components of private consumption are weak, especially durable goods. In the first quarter of 2015, durable goods contracted, with an annual growth rate of -5.1%. In terms of output, the private consumption trend was reflected in the heightened fragility of the trade sector, where the annual growth rate dropped to 0.1% in the first quarter of 2015. In particular, retail sales of durable goods fell more than in the previous quarter (-5.1% annual versus -4.0% in the previous quarter).

On the employment side, despite the substantial slowdown of output and domestic demand, the unemployment rate has stayed low, and annual wage growth has accelerated, reaching high levels that have been sustained over time. This apparent contradiction between the labour market data and the output dynamics has generated a degree of concern, to the extent that it could be an indication that the economy's output gap is smaller than estimated (OECD, 2015c) and, therefore, could have a negative effect on inflation.

Figure 1.3. **Chile's employment has remained stable (2012-15)**



Source: OECD, Analytical and Economic Outlook database.

Sound financial indicators

Evidence suggests that the recent slowdown in activity and currency depreciation have not had a significant impact on the balance sheets of corporations, thanks in part to limited currency mismatch (Banco Central de Chile, 2015). Financial indicators of the companies reporting to the Superintendency of Stocks and Insurance (*Superintendencia de Valores y Seguros,* SVS) are sound, although levels have deteriorated with respect to historical averages. This reflects a loss in the sector's resilience to the possibility of a less favourable macroeconomic environment. Similarly, some bank payment indicators have deteriorated, with varying effects across banks, but especially affecting medium-sized ones.

The activity in the residential housing market remains strong, with prices still on the rise. This could be a consequence of the moderation of construction costs and anticipated purchases facing the forthcoming enactment of tax reform. Meanwhile the price indicators continue to grow, although some moderation is observed in specific areas and

sectors. In the office space sector, new square metres built were not offset by an equivalent increase in demand, generating a significant increase in the vacancy rate. These levels could be maintained for a prolonged period due to the inertia of the market and the incorporation of new projects.

Aggregate household indicators remain relatively stable, but with some of them showing a marginal deterioration. The debt over disposable income rose in 2014, while the financial burden remained around 14% of income, due to low interest rate levels. No changes in indicators of bank payment are seen, whereas in non-bank lenders a new increase is observed.

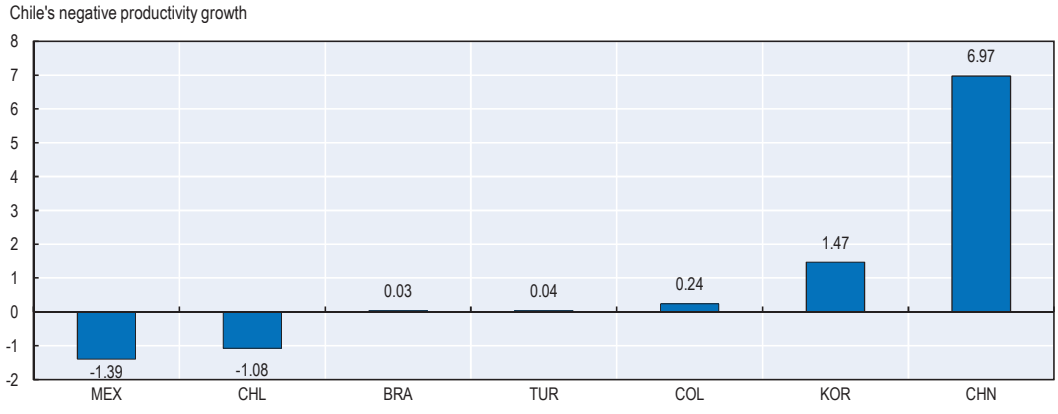
Bank financial indicators are stable and stress tests yield that capital levels are sufficient to confront a severe stress scenario. Operating income continues to be the primary contributor to the profitability of banks, which fell to 16% of capital during the first quarter of 2015. This was due to the reversal of the temporary impact of inflation on the indexation margin and a reduction in the interest margin. Bond issues by the banks contribute to the diversification of funding sources, but medium-sized banks are highly dependent on wholesale funding. Finally, the levels of capitalisation enable the materialisation of a severe stress scenario to be absorbed. [1]

Stronger productivity growth for long-term prospects

While during the 1990s, 4.7 percentage points of growth were attributed to increased productivity per year, in the past decade it reached 1.4 percentage points and last year -0.5% (Bergoeing, 2015). Economic growth in the past decade was mainly driven by investment in commodity-related sectors. Total factor productivity (TFP) growth, by contrast, was stagnant until recently. This contrasts with other large emerging economies, some of which had exceptionally rapid TFP growth. Chile's economy relies heavily on natural resources, with copper representing more than half of Chile's exports.

Figure 1.4. **Productivity growth has been negative**

2007-2014

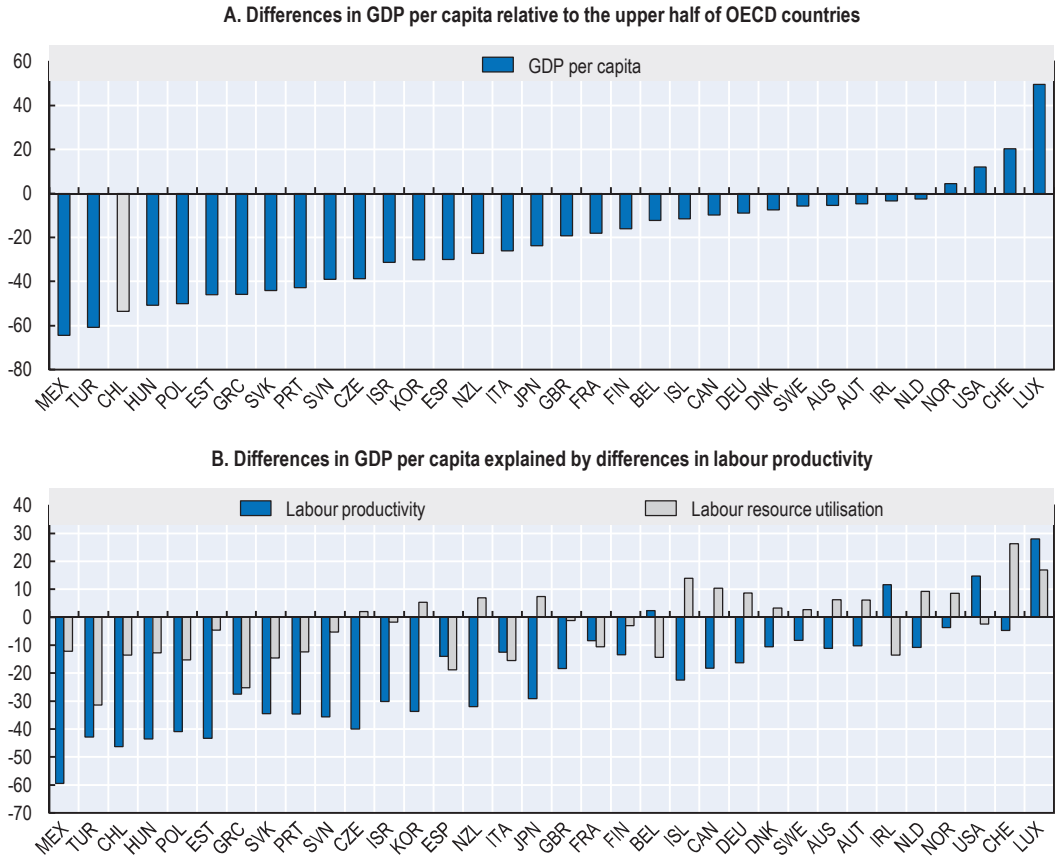


Source: Author's own calculations.

1. The severe stress scenario considers a drop in GDP in the short term (activity shrinks by 2.5% in 2015) and low growth in the medium term (1.5% growth in 2016).

Despite the large improvements of the last three decades, large productivity gaps remain, and further reforms are needed to reduce them. About 50% of the income gap between Chile and countries at the top of OECD countries can be explained by differences in labour productivity. To close economic development gap Chile needs to significantly improve productivity. Boosting productivity is very important to create quality jobs and improve well-being. In the most productive economies new technologies are developed and adopted more easily, workers have access to better wages and access to better employment opportunities, costs and prices are lower and goods are of a higher quality and greater variety, benefiting consumers.

Figure 1.5. **Chile has room to increase productivity and catch up with best performer OECD countries**



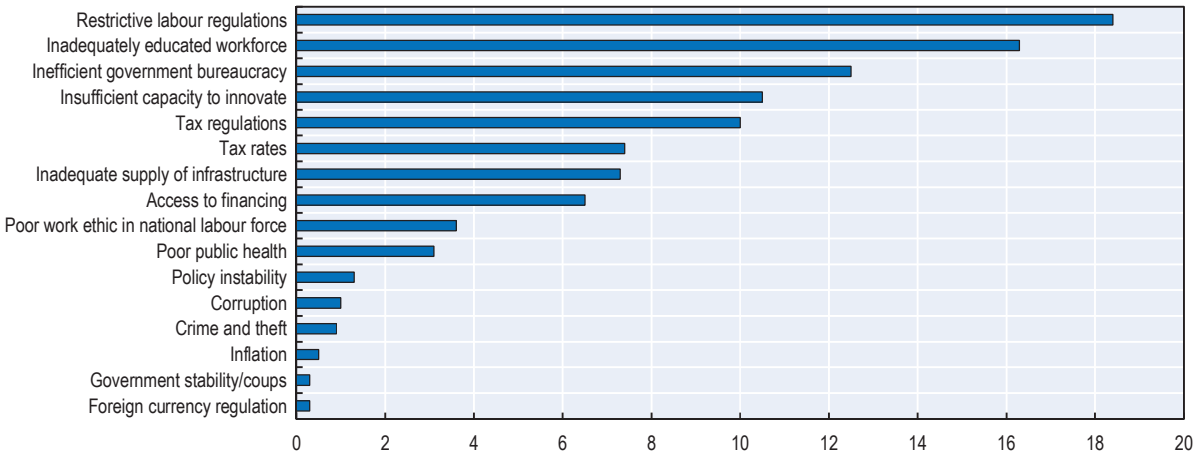
Source: OECD (2015b), *Economic Policy Reforms 2015: Going for Growth*, OECD Publishing, Paris, http://dx.doi.org/10.1787/growth-2015-en.

Improving the business environment for increased productivity growth

According to surveys, the four main problems for doing business in Chile are: i) restrictive labour regulations, ii) inadequately educated labour force, iii) inefficient government bureaucracy, and iv) insufficient capacity to innovate. Therefore, to boost productivity, Chile should make further improvements in these areas that are affecting the business environment. First, it should continue improving economic certainty, as this allows long-term investments. Second, Chile's economy needs to be adaptable to global

competition and changing global economic circumstances to weather both short-term shocks and longer-term trend changes. For example, there are questions regarding the flexibility of the labour market; hiring and firing costs are high by international standards, and labour participation relatively low, especially among women. Third, raise the quality of human capital as it appears to lag behind countries at a similar level of development, complicating skills-matching. Finally, refine the regulatory framework and improve the quality of production factors through innovative technologies and advanced production processes that can generate greater value added per hour worked.

Figure 1.6. **Restrictive labour regulations, low human capital and insufficient capacity to innovate are the most problematic factors for doing business**



Note: From the list of factors above, respondents were asked to select the five most problematic for doing business in their country and to rank them between 1 (most problematic) and 5. The bars in the figure show the responses weighted according to their rankings.

Source: Schwab, K. (2014), *The Global Competitiveness Report 2014-2015*, World Economic Forum, http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2014-15.pdf.

More inclusive and flexible labour markets

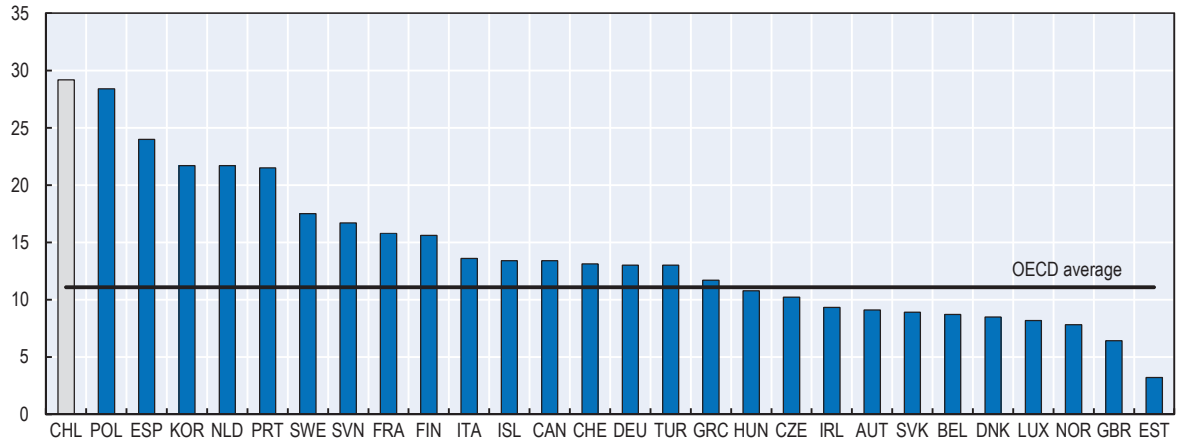
The Chilean labour market is characterised by strong inequalities and rigidities. Women's participation in the labour market is among the lowest in the OECD. Youth face particular difficulties in gaining employment. The market is segmented with far too many workers in non-regular work arrangements: many are either in a cycle of temporary work contracts, in the informal sector or work through commercial arrangements. Workers' basic skill levels remain low, activation programmes are weak, the training system does not provide adequate training for those that need it most and there are no tools to ensure that skills development is aligned to the skills the market needs.

Labour market regulations in Chile are not neutral and affect the allocation of labour across industries and corporations. Evidence shows that these regulations and institutions decrease the adjustment speed of firms that hire intensively labour that is relatively more protected, contributing to labour misallocation and affecting productivity growth (Micco and Repetto, 2014). These results imply that there may be space for efficiency enhancing labour market reforms. One aspect that should be considered is the rigidity of hours, possibly by defining the length of the workday not at the weekly level, but at the monthly or even annual level. It is necessary to modernise the organisation of working hours.

Today the law requires that they be equal in all companies, in all sectors and at any time of year. This is not only inconsistent with the reality of heterogeneous productive enterprises, so it is with the diversity of needs among workers. Also, transforming the current severance pay system into a compensation scheme that finances job loss independently of the reason for separation, possibly financed through the individual accounts of Chile's unemployment insurance system could also help improve labour allocation.

Figure 1.7. **High incidence of temporary work**

Temporary work arrangements as a percentage of dependent employment, 2013



Source: OECD Labour Force Statistics, http://stats.oecd.org/Index.aspx?datasetcode=temp_i (accessed 1 March 2016).

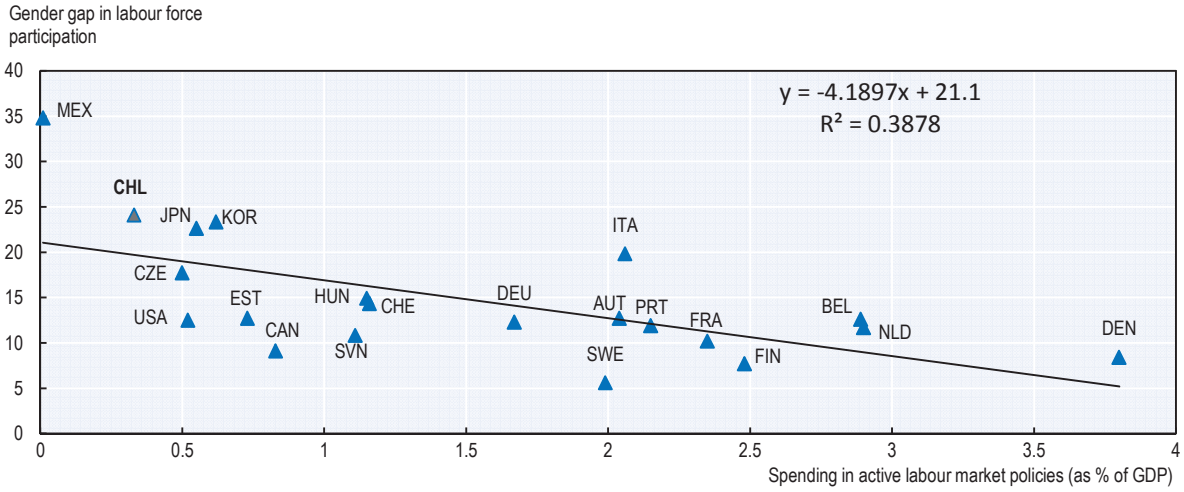
Chile is one of the OECD countries with the widest gender gap in labour participation rates. Empirical evidence suggests that reducing the gender gap can have a significant impact on growth (Thévenon et al., 2012). Bringing more women into the labour force should also reduce child poverty.

To reduce the gender gap, policies should seek to increase job market options for women, while reducing the opportunity costs of joining the labour force. Female labour supply is much more responsive to wage changes than male labour supply, affecting the hours they work but even more their decision to participate in the labour market. This is because the decision faced by women takes into account that there is a high opportunity cost (an outside option) of joining the labour force: choosing to bear children and/or become a housewife, while a partner may provide household income. In Chile, to promote female participation, part-time jobs are being encouraged (they are seen as a way to balance paid work, care and household activities). However, there are adverse consequences of part-time jobs in terms of gender equality and labour market incentives. Beyond the lack of perspectives, low probability of receiving training, high job turnover, low probability of accessing public social welfare benefits and low future pensions, women are penalised when they work part-time in formal employment.

Chile is one of the OECD countries with the lowest level of public spending devoted to active labour-market policies. Evidence suggests that active labour market policies are potentially very important to bring women into employment as the average effects of these programmes are larger for women than for men (Bergemann and Van den Berg, 2008). This is because women's labour supply is more elastic than men's, and therefore

participation in a programme that increases labour market opportunities, such as a successful skill-enhancing training programme, may subsequently lead to job offers that are acceptable. Therefore, expanding spending in labour-market programmes could contribute to increasing women's labour participation and reducing the gender gap.

Figure 1.8. **Chile spends little on active labour market policies and has a relatively high gender gap in labour force participation**



Source: OECD/Eurostat Labour Market Programmes database. http://stats.oecd.org/index.aspx?datasetcode=TEMP_I (accessed 1 March 2016).

Raising the quality of human capital

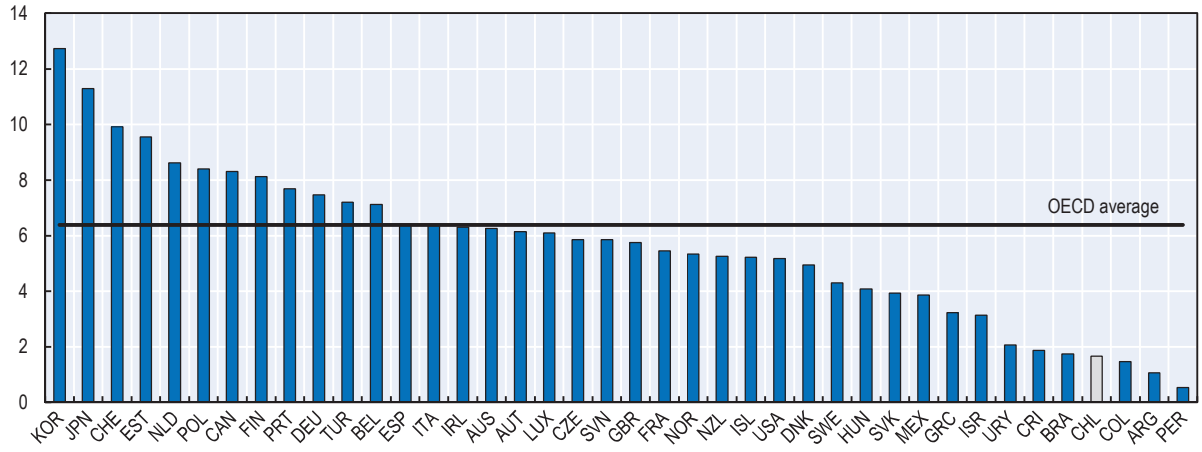
Chilean firms report that human capital is an important obstacle to productivity improvements. High-value added industries are heavily dependent on well-trained workers, especially those with postgraduate qualifications. Despite important advances in increasing the number of university graduates, Chile still lacks sufficient quantities of advanced human capital in the fields of science, technology and engineering management. Furthermore, the quality of Chile's educational system lags behind the OECD average (OECD, 2015a).

Chile performs better than the other seven Latin American countries that participated in PISA 2012, but still ranks below the OECD average. The performance gap with respect to the OECD average PISA 2012 score in mathematics is the equivalent of 1.7 years of secondary schooling. And while Chile made significant improvements in mathematics and reading between the PISA 2000 and 2009 cycles, the improvement in equity and quality decelerated in PISA 2012. Slightly more than half of 15-year-olds in Chile (51.5%) perform below level 2 in mathematics (OECD average 23.0%), meaning that they can only use basic algorithms to solve problems with whole numbers. This share has remained stable across most PISA cycles. Only about 1.6% of Chilean 15-year-olds are top-performers, and this percentage has even decreased from previous PISA cycles (Avendaño et al., 2015). The impact of socio-economic status on student mathematics performance in Chile is one of the highest among OECD and other participating countries. Moreover, Chile shows one of the highest correlations in the region between the quality of educational resources of schools and the socioeconomic status of the school's pupils.

A largely unregulated market for schools has contributed to inequitable schooling outcomes, and also to poor overall educational performance. Chile is one of the countries with the highest level of school competition, yet performance differences between public and private schools become statistically non-significant once the socioeconomic status of pupils and schools is taken into account. The government recently passed a law ending profits, tuition fees, and selective admission practices in any primary and secondary schools receiving state subsidies. New bills sent to Congress will reform early childhood and pre-primary education and the career path of teachers. These reforms will bring Chile closer to OECD best practice, ensuring that the implementation of the reforms meets the expected social, political and pedagogical objectives will be a challenge.

Figure1.9. **Raising the quality of education is key to increasing long-term growth**

Share of pupils that perform in the top quarter of pupils in PISA 2012 after accounting for socioeconomic status



Source: OECD (2015a), *Education Policy Outlook 2015: Making Reforms Happen*, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789264225442-en.

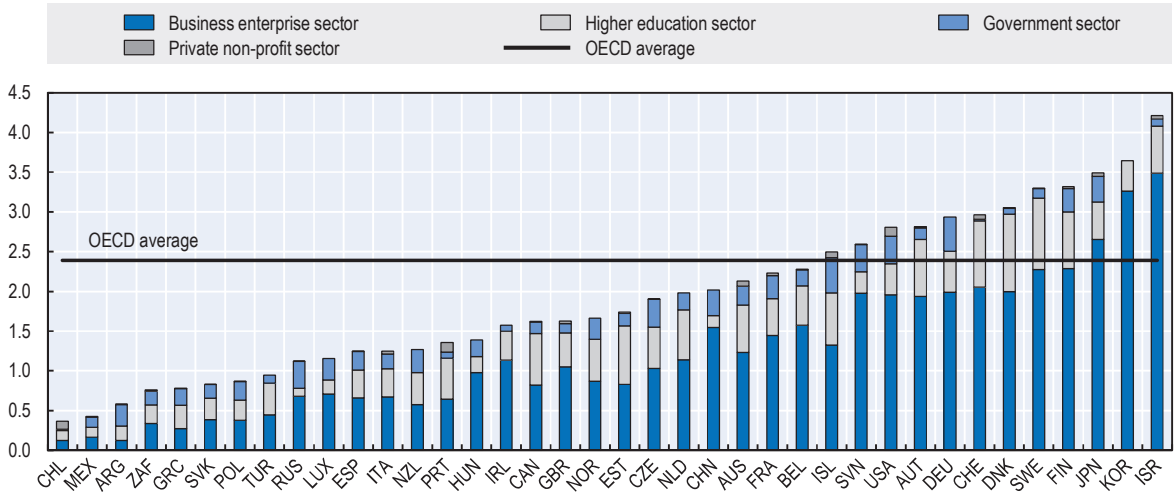
Investing in R&D and fostering the capacity to innovate

R&D intensity in Chile remains low. Although Chile's stable macroeconomic policies and trade openness provide useful preconditions for long-term investments in R&D, R&D expenditure has increased only slightly in recent years, from 0.3% in 2007 to 0.4% in 2013 (OECD, 2012). Furthermore, R&D expenditure is heavily concentrated in the publicly-funded university sector. As a result, the country scores poorly on measures of innovation outputs such as patents and top scientific publications.

To promote private participation in R&D investment, an initial tax benefit for R&D expenditures was implemented in 2008. A modification to this tax benefit in 2012 made in-house R&D activities eligible for the tax credit. Other important changes to the law include a threefold increase in the annual tax ceiling for the benefit, to USD 1.2 million, and raising the 15% cap as a share of gross income. After this modification, the flow of new patent applications increased five-fold. The existing programme is still most relevant for large firms, since the credit is only redeemable against profits. Evidence from the OECD's work on new sources of growth suggests that refundable credits can help dynamic smaller firms, including start-ups that do not yet have profits, to immediately benefit from non-refundable credits (Andrews and Criscuolo, 2013).

Figure 1.10. **Chile invests very little in R&D**

Expenditure on R&D by sector of performance, % of GDP, 2013 or latest available year



Source: OECD, Main Science and Technology Indicators database, https://stats.oecd.org/index.aspx?datasetcode=gerd_funds (accessed 1 March 2016).

The creation of the Start-Up Chile entrepreneurship programme in 2010, an initiative of the Ministry of Economy, Development and Tourism and CORFO, aims to make Chile the leading innovation hub in Latin America, along with a number of complementary programmes that help to facilitate international technology transfer, whose funding was recently boosted. The government recently announced plans to expand the Start-Up Chile programme, increasing funds by 47% and facilitating SME's access to credit through the *Banco Estado*.

Chile has several well-designed innovation promotion programmes, which seek to address a long-standing divide between businesses and universities in Chile's innovation system. But programme scale and take-up have not been large enough to make a substantial impact. In fact, less than 1% of companies in the formal sector have applied and received support from these. To boost take-up and ensure the cost-effectiveness of programmes, the authorities should design them so that they can be adequately evaluated. Based on a regular review of the programmes, those that have been positively evaluated should be enlarged and given an enhanced degree of policy stability, while those that are found to be inefficient should be closed down or revised.

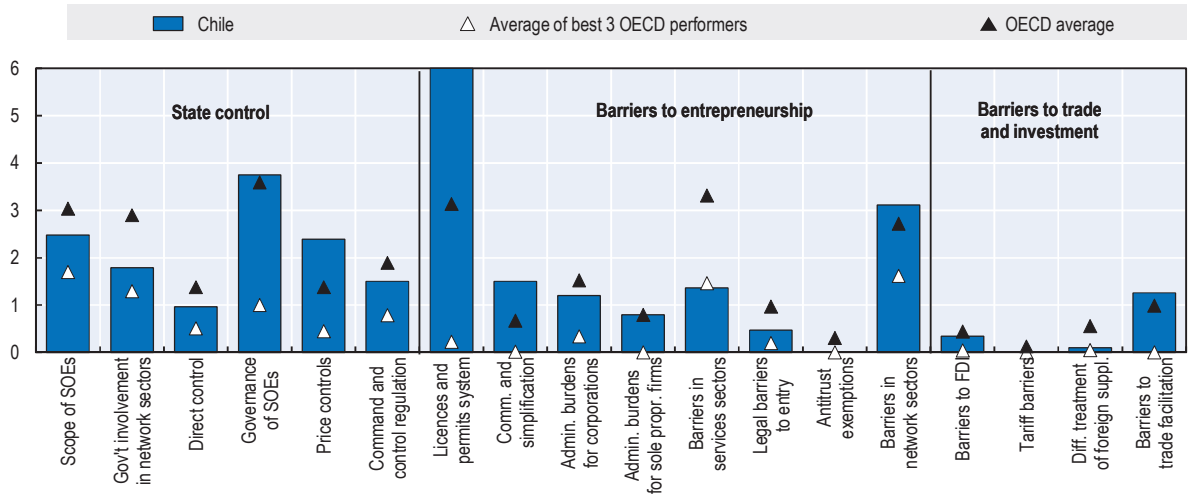
The government's Agenda for Productivity, Innovation and Growth goes a long way to addressing the fragmented institutional set-up for innovation. It includes 47 different measures, focused around promoting the diversification of production, boosting sectors with high growth potential, the expansion of programmes and resources available for early-stage start-ups, increasing productivity and competitiveness of businesses and generating a new impetus to exporting. Among the most notable of these endeavours is the creation of a Productivity Commission that will help to ensure that productivity is the focus of policymaking across the government, and help to identify policy reforms.

Refining the regulatory framework

Regulatory reform is an important part of a government's toolkit for improving economic growth. Cross-country evidence suggests that the bulk of job creation and gains in aggregate productivity come from the rapid growth of young dynamic firms (Haltiwanger, 2012). Despite improvements over recent decades, regulatory policy barriers for young firms still remain in Chile (OECD, 2012). Existing regulatory restraints, both in international trade and the domestic market, limit the possibility for adopting new technologies and hamper the re-allocative process that can help to take full advantage of new innovations. The regulatory policymaking framework lacks essential features, such as regulatory impact assessment, that could ensure that regulations are designed in the best way.

Product market restrictiveness for Chile remains above the OECD member average. The governance of state-owned enterprises can be improved and the state's involvement in business operations further aligned with best practice. For example, the government still provides pricing guidelines for road transport companies and the costs of water purification and wastewater treatment is not taken into account when setting the prices for users other than households. Regulatory procedures are very complex, involving extensive licensing requirements, and competition in some network sectors such as rail and gas is hampered by still high entry barriers.

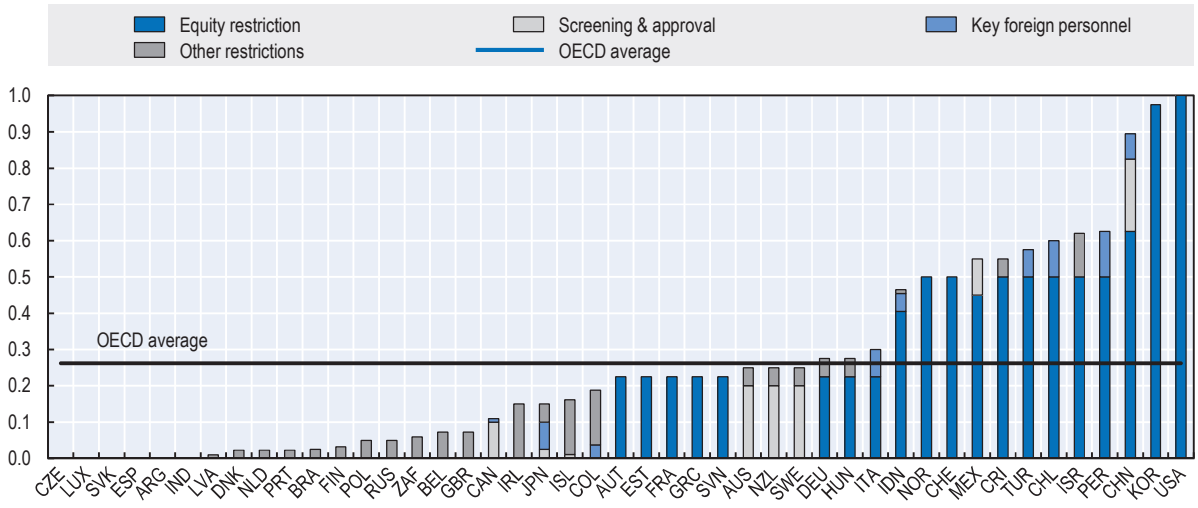
Figure 1.11. **Product market regulation remains restrictive in some areas**



Source: OECD Product Market Regulation database, https://stats.oecd.org/index.aspx?datasetcode=gerd_funds (accessed 1 March 2016).

Chile can improve the regulatory stance towards maritime transport services, and the situation for the underlying port infrastructure. Chile maintains a foreign equity limit of 49% to register vessels, along with a requirement that the majority of the Board of Directors of a shipping company must be Chilean nationals. Foreign participation in the cabotage market is restricted. These restrictions imply a high cost and affect Chile's low participation in global value chains.

Figure1.12. **Restrictions on FDI inflows into the maritime transport sector are high**



Source: OECD FDI Regulatory Restrictiveness database, https://stats.oecd.org/index.aspx?datasetcode=gerd_funds (accessed 1 March 2016).

While national regulations provide the general framework for administrative procedures and an efficient state administration, the lack of a comprehensive regulatory reform programme has reduced the possibilities to achieve even better economic outcomes and unleash resources to boost productivity. Many laws are likely to be out of date, particularly as the country has never undergone a review of existing regulations. Furthermore, most regulators prepare regulations without clear evidence of the best way to intervene, and good practices in rule-making procedures are limited.

Chile has made progress in making regulations more accessible and communicating administrative requirements. There are registries that gather all regulatory inventories and make information on the legal framework available for users. However, Chile lags behind most OECD countries in ensuring that the public can systematically participate in the rule-making process. Even though a recent law (Law No. 20.500) made public participation standard practice, specified general criteria for it, and established permanent bodies within the administration to ensure compliance, there is still no standardised practice for the whole of the state administration on how to conduct regulatory consultation, including its length, scope, timing, and underlying procedures. Apart from consultation, Chile does not have guidelines and standards for the implementation of better regulation practices. Importantly, the country does not make systematic use of Regulatory Impact Assessment (RIA), which is now standard practice in most OECD countries, which might reduce the effectiveness and efficiency of regulations. Efforts have been made to introduce some types of *ex ante* impact assessments like *Estatuto PyME*, but with limited success. The development of new regulations is therefore not compelled by the need to explain the rationale of the regulatory intervention and ensuring that benefits outweigh the costs.

Also, although Chile has made important improvements to its competition policy framework, some crucial features are still missing (OECD, 2014). Tackling these issues would be an important step towards fostering competition and, hence, encouraging firms to invest and become more innovative and efficient. Chile's 2009 competition law

supports effective policy and enforcement against anticompetitive behaviour. However, amendments to the law are needed in order to establish an effective, efficient and transparent merger control regime. Merger control constitutes an essential component of an effective competition policy, which allows assessing the impact of mergers on consumer welfare and economic efficiency. Chile's current system for reviewing mergers lacks clear merger control jurisdictional and substantive criteria, relies on general antitrust procedures which were not designed for merger control purposes, and lacks streamlined merger review powers between the Competition Authority (*Fiscalía Nacional Económica*) and the Competition Tribunal (*Tribunal de la Competencia*). Tackling these problems would allow mergers to be selected, notified and reviewed in a timely, effective and predictable fashion, to the benefit of economic efficiency and consumer welfare.

Chile should also improve the legal framework to carry out market studies. Market studies provide competition authorities with an in-depth understanding of how sectors and markets work. They are conducted whenever concerns on the functioning of a market arise, that can be caused by factors such as firm behaviour, market structure or consumer conduct amongst others. Market studies can lead to recommendations to private firms or public bodies aimed at removing any unnecessary obstacles to the working of markets, and if anti-competitive behaviours are detected they can lead to the opening of antitrust investigations. Many OECD jurisdictions are increasingly relying on this tool to promote competition.

The current government is committed to reforming the competition law framework to ensure effective competition enforcement. A draft competition bill was submitted to Congress in March 2015, covering a new set of sanctions for cartels, a reformed system for merger control and market studies. The proposed reform is ambitious and in line with OECD best practices and OECD recommendations to Chile. The core of the reform includes a proposal to increase the effectiveness of sanctions against illegal cartels: it promotes the introduction of criminal sanctions for executives and a higher ceiling for monetary fines. The OECD has consistently promoted a strong and effective system of sanctions to stamp out hard-core cartel behaviour, which is considered the most egregious violation of competition. The new bill would also address the above mentioned concerns by introducing a more effective and transparent merger control regime and granting the *Fiscalía Nacional Económica* formal powers to perform market studies.

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