

BUFF/ED/21/46

April 14, 2021

**Statement by Mr. Herrera on Chile
Executive Board Meeting
April 19, 2021**

On behalf of the Chilean authorities, I wish to thank staff for their open and constructive dialogue during the Article IV consultation, as well as the insightful report on the Chilean economy. The authorities attach great importance to staff's assessment and policy recommendations.

Chile entered the crisis with a healthy economy, a solid fiscal position, and a sound financial system. The policy response to the pandemic has been swift and comprehensive, anchored in a very strong policy and institutional framework. Using the buffers accumulated in previous years, buttressed by access to the Flexible Credit Line (FCL), the authorities have provided unprecedented support to households and firms. Initially, a broad range of measures were introduced to ensure an adequately resourced health care system, protect households' jobs and incomes, ease financial conditions, and provide a liquidity bridge to firms, especially small and medium enterprises (SMEs). In contrast to historical downturns, interest rates stayed at historical lows, corporate credit expanded, and the banking system remained solid. Activity and domestic demand are recovering, while jobs lag. More recently, new measures aim at stimulating investment and job creation, facilitating and extending refinancing terms, and limiting scarring effects, while remaining nimble to adapt to the unfolding health and economic situation. Vaccination is progressing rapidly, raising hopes of a broader upturn in the second half of the year. However, if necessary, the authorities are prepared to maintain policy support until the recovery takes hold.

Recent developments and economic outlook

The Chilean economy is recovering from the COVID-19 shock despite high uncertainty. After a sharp drop in activity in mid-2020, a gradual recovery started in the second half of last year bolstered by supportive monetary and fiscal policies. At the end of the first quarter, output was already back at the pre-pandemic level. The outlook for 2021 and 2022 has strengthened in recent months, buttressed by a stronger starting point, rapid vaccine deployment, a more favorable global environment, and the continuation of accommodative policies. Real GDP is projected to grow between 6 to 7 percent in 2021, and 3 to 4 percent in 2022, after contracting 5.8 percent in 2020. The recovery, however, remains uneven across sectors, with significant lags in contact-intensive activities, slowing down the

pick-up in employment. A temporary setback in output is likely in the coming weeks amid a new surge of infections and tightening of lockdown measures.

Vaccine deployment is making fast progress in Chile. As of April 12, 48 percent of the adult population in Chile has received at least one dose of a COVID-19 vaccine and 31 percent has received two. If vaccination continues unfolding as planned, most of the adult population is expected to be fully inoculated by mid-2021. Based on the limited international experience, such vaccine coverage should reduce the severity of new cases, relieve emergency services, decelerate contagion and, conditioned on these projections, allow a broader opening of the economy in the second half of the year.

As a small, open economy, Chile will receive a boost from improved global conditions. Besides favorable financial conditions and robust growth of trading partners, terms of trade are expected to be – on average – more than 10 percent higher than in 2020. Copper prices have peaked above USD4/lb, its highest since 2011. Since mid-2020, the sovereign has continued to place debt in the local and international markets at very favorable terms.

Domestic demand is expected to lead the recovery in 2021 and 2022. After a sharp contraction in mid-2020, consumption turned around in the second half of last year on the back of government emergency support and pension fund withdrawals. This impulse will last well into 2021, adding to the gradual reopening of the contact-intensive activities, for a real growth above 11 percent. Investment is expected to bounce back with support from public infrastructure investment and large mining and energy projects under way. However, non-mining private investment is proceeding at a slow pace due to high uncertainty and heavier financial burden of many companies. As domestic demand continues to pick up, the authorities expect the current account balance to turn into a moderate deficit in 2021 and beyond.

Although the economy has gained momentum, the recovery of employment is lagging, especially in contact-intensive activities. Only half of jobs lost since the outbreak of the pandemic have been recovered. Labor-intensive sectors, like commerce, services, and transportation activities, suffered the most in the early stages of the crisis and have not fully recovered due to continuing social distancing and the adoption of new, less labor-intensive, delivery modalities. Inactivity remains high for women. The government has implemented a temporary hiring subsidy, with special incentives for women and youth.

The authorities concur with staff that downside risks related to the pandemic are still high. The evolution of the pandemic, both locally and globally, remains highly uncertain. Exit policies in advanced economies could tighten global financial conditions and trigger negative spillovers into emerging market economies. And scarring effects, through reduced labor participation or weaker corporate balance sheets, could reduce potential output in the medium term. The authorities are prepared to respond to these emerging risks, as they have done in recent weeks, when, amid a new surge of cases and lockdown measures, they have allocated considerable resources to provide additional emergency relief to households.

Monetary policy, exchange rate, and external buffers

Low and stable inflation in the context of sound monetary and exchange rate policy. Chile has maintained inflation around 3 percent for the last two decades. Since 1999, the Central Bank of Chile (CBC), an autonomous and accountable institution, conducts monetary policy through a fully-fledged inflation targeting and free-floating regime. In addition, Chile can count on a deep domestic financial system, where households and firms can access short- and long-term credit in local currency, and exposure to FX risk is limited. The CBC continues enhancing its policy framework. In recent years, the CBC has voluntarily undergone an independent evaluation of the conduct of monetary and financial policy, which highlighted its par with high international standards. Currently, the CBC is undergoing a Fund review considering the new IMF Central Bank Transparency Code.

Headline and core inflation are expected to converge to the 3 percent target by the end of 2022.

Inflation has remained close to the policy target in recent months. In the coming months, headline inflation is expected to post a transitory increase to nearly 4 percent mainly due to higher prices of energy and other volatile items, to resume converging to the 3 percent target in the second half of the year. This is granted by the combination of currency appreciation and a still large output gap. Core inflation (excluding volatile items) is expected to fall to 2.6 percent by year-end, and then return to 3 percent. Inflation expectations remain well anchored to the target.

The CBC has implemented a broad set of measures aimed at boosting the monetary impulse, stimulate credit, ease the adjustment of financial markets and gain policy space. The monetary policy rate (MPR) completed a year at its technical lower bound (0.5 percent), while unconventional measures have mobilized resources equivalent to 13 ppt of GDP. Extraordinary measures include: (i) a new “funding-for-lending” facility (FCIC), which works in tandem with the public credit guarantee-scheme (FOGAPE); (ii) asset purchase programs to curb disorderly conditions in local bond markets; (iii) an expanded collateral framework to scale up liquidity operations; and (iv) temporary repo facilities to smoothen the financial impact of extraordinary pension funds withdrawals. These measures have allowed the economy to navigate this crisis with interest rates at historical lows and a countercyclical behavior of corporate credit.

The authorities concur that the monetary stance is appropriate. The CBC considers that, even as the economic outlook has improved, the convergence of inflation to the target in the policy horizon requires that monetary policy remains highly expansionary. The MPR will be held at its 0.5 percent minimum until the economic recovery takes hold and spreads to the more lagging components of expenditure, which will take several quarters. The unconventional measures will continue to operate under the stated conditions, complementing the low MPR. Future adjustments will depend on the macroeconomic outlook and its implications for inflation.

The peso is free floating, and the flexible exchange rate plays a useful role as shock absorber. The exposure of local agents to FX risk is limited, and the pass-through of currency fluctuations to inflation expectations, in contrast to headline inflation, is low. Over the past year, the nominal (and real) exchange rate has flexibly adjusted to dramatic changes in global financial conditions and commodity prices. Despite sharp fluctuations in the peso-dollar parity, medium-term inflation expectations remain stable, while the financial impact of exchange rate volatility has been limited due to currency hedging. FX interventions have been rare and limited to curb disorderly market conditions as those observed in late 2019 in the wake of the social unrest. CBC did not intervene in 2020.

The authorities intend to continue treating the FCL as a precautionary and temporary arrangement. Since May last year, the CBC has taken several steps to strengthen its external liquidity position and broaden its policy toolkit, including access to the FCL, participation in the FIMA Repo Facility of the NY Federal Reserve, and a Bilateral Swap Agreement with the People’s Bank of China for three years. Last January, the CBC announced a program of reserve accumulation – USD12 billion over fifteen months – to lift these to approximately 18 percent of GDP. The main goal of the program is to build an additional buffer to prepare for a smooth and timely exit of the FCL in May 2022, conditional on economic and financial developments. The program is proceeding through fixed daily purchases that do not interfere with the free-floating FX regime. The FCL arrangement, along with a comfortable reserve position and other precautionary arrangements, has provided confidence and additional policy space in a period of extraordinary uncertainty as the global pandemic.

Fiscal policy

Chile entered the pandemic crisis with a strong fiscal position that allowed to deliver an unprecedented multi-year fiscal package amounting to 13 ppt of GDP. Since the early 2000s, Chile’s fiscal policy has been guided by a structural rule and complemented by a sovereign stabilization fund, underpinned by the *Fiscal Responsibility Law* and the *Autonomous Fiscal Council* (CFA). The consistent implementation of this design over time has contributed to restrain public debt and accumulate important liquidity buffers, as well as favorable financial conditions in international capital markets, macroeconomic stability, and a more effective countercyclical fiscal policy.

Since the beginning of the pandemic, the government of Chile has taken swift and bold actions to protect lives and livelihoods. Initially, emergency measures included extraordinary transfers to vulnerable and middle-class households, tax deferrals to households and firms, adjusting the unemployment insurance scheme to support temporary suspended workers, and an expanded credit-guarantee scheme to protect loans to SMEs and mortgages. As the economy exits the crisis, policies have been targeted to support investment and job creation through temporary tax and subsidy measures, increase public investment, and enhance the credit-guarantee scheme to facilitate refinancing of SMEs over a long horizon. At each stage, the authorities have adjusted and recalibrated their policy programs as necessary to adapt to the economic and health situation. The most recent example is the emergency fiscal package exceeding 2 ppt of GDP approved in early April to support households in the second quarter.

Fiscal policy will remain supportive in 2021 and a gradual consolidation is anticipated thereafter to anchor public debt at a safe and sustainable level. Initially in the wake of social unrest and then later after the outbreak of the COVID-19 pandemic, the government loosened the target of the structural or cyclically adjusted deficit to allow for a stronger fiscal response. The headline deficit reached 7.4 ppt of GDP by the end of 2020, and gross debt increased to 32.5 ppt of GDP. The deficit is expected to decline in 2021, as revenues are bolstered by the growing economy, deferred taxes, and higher copper-related revenues. However, the structural deficit will increase this year reflecting the accommodative stance of fiscal policy and added impulse. Beyond 2021, the extraordinary measures will be phased out and the structural budget is planned to return to a gradual consolidation path to stabilize the gross debt below 45 ppt of GDP by 2025.

The authorities concur with staff on the need to enhance Chile’s fiscal rule and are considering the best way forward. In late 2020, the government asked the CFA to prepare a proposal to enhance the current fiscal framework. In early April, the CFA issued its recommendations including the adoption of a dual rule on net public debt and the structural balance, formal escape clauses, and correction mechanisms. The authorities are considering these suggestions and plan to work with the CFA on their implementation. In parallel, they have requested a Fund review considering the Fiscal Transparency Code.

The authorities concur that revenue and expenditure reforms could be considered in the medium term, but the immediate priority is to achieve a solid recovery. At the start of 2020, the administration passed a tax reform to increase revenues by 1 ppt of GDP and finance an increase in social benefits. More recently, the authorities requested a *Commission of Experts* to prepare a critical review of tax deductions and exemptions in Chile, based on a report prepared by a joint IMF-OECD team. The commission’s review and recommendations were issued last January, and the administration is considering their implementation. The authorities agree that more ambitious revenue and expenditure measures could be considered once the recovery is well entrenched to finance additional social spending, rebuild buffers, and strengthen public finances. In the near-term, the priority is to achieve a broad and solid economic and job recovery to limit the scope of scarring effects.

Financial sector

During the pandemic, the *Financial Market Commission (CMF)* and *CBC* provided regulatory flexibility to lenders. Measures included an easing of the liquidity coverage ratio; a transitory regime for provisions on deferred loans; improvements on the capital treatment of public credit-guarantees; and a delay in phasing in additional capital requirements under Basel III. The financial system has adequately transmitted the easing of monetary and financial conditions to the economy. Corporate credit accelerated strongly in mid-2020 as firms faced extraordinary liquidity demands but it has slowed down since then.

The financial sector in Chile remains liquid, solvent and well capitalized, supported by effective supervision and regulation. The authorities concur with staff that potential vulnerabilities, particularly in the corporate sector should continue to be closely monitored. The pandemic crisis has hurt banks’ profitability as interest margins have compressed and credit provisions increased even as non-performing loans remain low. Compared to other countries, however, Chile avoided compulsory across-the-board measures and relied on the banks’ knowledge of their customers for refinancing and the allocation of new credit, including the use of partial credit guarantees for SMEs and banks’ exposure to the first loss in the guaranteed loan portfolio. Larger companies have relied on their continued access to bank credit and capital markets and, when necessary, have undergone debt restructuring procedures. Therefore, the deterioration of bank portfolios is likely to be more limited and well absorbed by the public guarantee scheme and increased provisions. Stress tests carried out by the CBC show that banks remain adequately capitalized, but the buffers to cope with a severe stress scenario have been reduced. Liquidity in the banking sector remains high, and well above regulatory requirements.

Authorities have resumed the agenda of regulatory reforms to strengthen the financial system.

In December 2020, the CMF finalized the issuing of all new Basel III regulations, including systemic bank capital charges, the counter-cyclical capital buffer, the capital conservation buffer, new Tier-1 capital instruments, capital discounts, capital charges related to Pillar 2, and public disclosure standards related to Pillar 3. The phasing-in schedule for the new regulations was delayed by a year, giving banks more time to adjust to the new capital requirements. The process is planned to be completed in 2025. Going forward, the financial reform agenda of the authorities comprises many of the issues highlighted by staff, including strengthening the bank resolution framework and the regulation of financial conglomerates, expanding the scope of the public credit registry, implementing a risk based capital and enhanced supervision powers for the insurance sector, and submitting FinTech legislation to Congress. The authorities look forward to the conclusions and recommendations of the ongoing FSAP.

Social agenda and structural policies

We thank staff for valuable recommendations to continue advancing the social agenda and other reforms. Pensions and other social policies have remained at the top of the government's agenda but reaching a "quick and comprehensive" agreement has not been easy, particularly in a political environment as complex as the social unrest of late 2019, the pandemic in 2020, and a packed calendar of elections in 2021. An example of these difficulties is the approval by Congress of the massive withdrawals of pension savings, which will deepen the deficiencies of the contributory pillar in the pension system. Despite these difficulties, the government has already implemented an important enhancement of the solidarity pillar of the pension system (50 percent increase in the minimum pension and 34 percent increase in private pensions that receive a public supplement), and a new scheme that tops up wages to guarantee a minimum labor income above the minimum wage. In the near term, the administration's priority is to pass a reform on the pension system, which among other changes, increases gradually the contribution rate from 10 to 16 percent (funded by the employer), and further extends the coverage of the solidarity pillar.

Chile is strongly committed to climate action and has pioneered the issuance of sovereign green bonds in the Americas since 2019. Proceeds of these issuances primarily finance clean transportation projects, contributing to the decarbonization of the energy matrix, and advancing the country's Paris Agreement commitments.

Chile has embarked on a deep reform to write a New Constitution. Over the past three decades, Chile has been able to combine rapid growth and social development, reduce poverty and income inequality, and expand opportunities for all. In turn, these changes have altered the fabric and aspirations of society creating new demands on the political system that need to be addressed. In November 2019, an agreement was reached in Congress to initiate a profound constitutional reform. This is a historic opportunity to strengthen democracy and achieve a broad agreement that fosters social development and shared prosperity in Chile. Despite some delays related to the pandemic, the institutional process towards the New Constitution is moving steadily and is expected to culminate with a ratification plebiscite in mid-2022. Although uncertainty about the content of the New Constitution is inevitable, the authorities trust that the process will continue to evolve in accordance with the procedures and safeguards envisaged in the constitutional amendment of November 2019.