IMF
Chile: Staff Concluding Statement of the 2021 Article IV Mission

March 9, 2021

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Washington, DC: Following a good performance until late-2019, the pandemic hit the Chilean economy when it was recovering from the 2019 social unrest. The country has responded with wide-ranging and unprecedented policy responses, supported by the approval of an FCL arrangement in May 2020. While policy buffers have narrowed somewhat owing to the crisis response, Chile's macroeconomic policies and institutional frameworks remain very strong.

The Chilean economy is now recovering amid significant uncertainty,

Economic activity is recovering, supported by ample policy stimulus. The economy is projected to have contracted by 6 percent in 2020—with sharp declines in the second and third quarters. However, the recovery picked up in the fourth quarter, with annual growth estimated at close to zero. Similarly, after a large contraction in employment and a spike in the unemployment rate in mid-2020, both started improving in late-2020, albeit they remain worse than the pre-pandemic levels. Annual headline inflation moderated in mid-2020 and has then hovered close to 3 percent, the policy target. The current account balance improved considerably in 2020 amid plummeting imports and resilient exports. Credit is supported by the broad set of policies.

A strong economic growth rebound is expected in 2021, supported by acommodative policies, and then gradually receding fallout from the pandemic. Economic activity is expected to expand by 6 percent in 2021, as normalization is underpinned by the ongoing ambitious vaccination program. Over the medium term, as the output gap closes and the policy stimulus is progressively withdrawn, growth is projected to converge to its potential of 2.5 percent and the unemployment rate to gradually decline to about 7 percent. Notwithstanding an expected significant improvement in the terms of trade, the current account balance is expected to deteriorate in 2021-22 owing to strong import demand associated with the recovery, before narrowing somewhat over the medium term.

Risks remain amid high uncertainty, but the country exhibits strong resilience. External risks are largely related to the dynamics of the pandemic, though mitigated by the fast vaccination process. De-globalization demands may reappear, reducing trade and growth opportunities. Large movements in the price of copper would significantly affect exports, fiscal revenues, and prospects for investment and growth. Domestic risks stem primarily from the uncertain outcome of the New Constitution process as well as a possible resurgence of unrest. A delay in the recovery could increase delinquency rates, though bank capital appears adequate at present. Overall, the country presents significant resilience in the face of these risks, not only because of the large policy response and the remaining fiscal space, but also due to the country's very strong institutional policy settings, the demonstrated sound record of policy reaction, and the low level of public debt by international standards.

Macroeconomic policies remain appropriately accommodating

The authorities have implemented a wide-ranging set of fiscal, monetary, and financial policy actions in response to the pandemic. The government is implementing a multi-year package to safeguard health, protect incomes and jobs, facilitate refinancing and repayments, and buttress the recovery. The Central Bank of Chile has expanded the monetary stimulus and introduced a broad range of unconventional measures to support liquidity, including through funding-for-lending facilities, asset purchase programs, and an expanded collateral framework. Financial sector policies have been adjusted to facilitate the flow of credit, especially to households and SMEs, and the implementation of Basel III standards has been delayed.

Chile's fiscal position remains very strong notwithstanding some weakening over the past decade. The deterioration that began with the global financial crisis was heightened by the social unrest at end-2019 and the pandemic in 2020. Nonetheless, Chile still presents a low indebtedness by international standards (32 percent of GDP) and maintains steady and favorable access to international markets at low rates—with spreads returning to pre-pandemic levels, as evidenced by the recent Environmental Social and Governance issuances.

Staff views the fiscal policy stance in 2021 as broadly appropriate. The 2020 multi-year fiscal stimulus package has effectively helped to counteract the effects of the crisis. Going forward, fiscal policy will need to remain data driven and additional stimulus might be needed, if the pandemic is prolonged, to continue protecting health, incomes, and jobs, such as through targeted household transfers and an extension of tax deferrals. Staff cautions against additional pension withdrawals: although the ones in July and December 2020 are supporting the recovery, they were poorly targeted, regressive, and have weakened the pension system.

Fiscal policy should progressively shift from supporting an inclusive recovery in the near term to strengthening sustainability in the medium term. The authorities remain committed to their plan for a gradual consolidation, reducing the structural deficit towards a target of 0.9 percent of GDP by 2025. Once the health crisis is under control and the recovery strengthens, permanent revenue and spending adjustment measures would be needed to provide additional space to address social needs, absorb risks in revenue projections, and rebuild buffers, while preserving macroeconomic stability.

Going forward, enhancing the fiscal framework with a medium-term debt anchor, a formal escape clause, and an adjustment mechanism would further strengthen policy credibility. While the structural balance rule has enhanced fiscal discipline, its flexibility did not prevent a large increase in gross public debt since late 2000s. In this context, complementing the current rule with an explicit medium-term debt anchor—that encompasses a debt ceiling and a debt buffer zone—will boost the credibility of the fiscal policy framework. In line with international experience, it will also be valuable to introduce a formal escape clause that envisages temporary relaxation or suspension of the structural balance target, accompanied by an adjustment mechanism to offset temporary deviations from targets. The establishment of an autonomous fiscal council with own resources and a broader mandate has been an important step in strengthening the institutional framework for fiscal responsibility and transparency.

The monetary policy response has been well-conceived, adequate, and unprecedented in magnitude. The reduction of the monetary policy rate to its technical lower bound was complemented by a set of unconventional measures, which have helped contain the adverse impact of the pandemic. At the same time, inflation and inflation expectations have remained well-anchored.

The monetary stimulus appears appropriate, and should continue to be contingent on developments and risks. Underlying economic weaknesses—as reflected in a large negative output gap, high unemployment, and depressed labor participation—amid well-anchored inflation expectations provide space for maintaining the current monetary stimulus. Going forward, the monetary stance should continue to be guided by the inflation targeting framework, encompassing economic developments, the policy mix, and risks.

Monitoring financial sector vulnerabilities will remain critical. At present, temporary emergency measures to facilitate the flow of credit and support income are preventing a deterioration in credit quality. It is essential to continue monitoring developments closely, to identify early signs of stress in the system and to stand ready to intervene to avoid disorderly conditions. As normalcy returns, financial institutions should be encouraged to restructure loans prudently, as needed, on a commercial basis, while maintaining both prudential (lending) standards and adequate reporting. In addition, banks should continue to assess credit quality carefully.

Financial sector reforms have set the stage for boosting financial resilience and transforming the financial sector's regulatory and supervisory landscape . As the recovery continues, the implementation of regulations stemming from the new Banking Law in compliance with Basel III should proceed in line with the revised timeline. Passed legislation enhancing financial portability, improving financial market functioning regulating financial advisors, and strengthening CMF powers is welcome. In addition, it will be important to broaden the powers and tools for bank resolution, establish a national deposit-insurance scheme funded by member banks, and strengthen regulation of insurance companies and of financial conglomerates. Regulation needs to keep pace with the expansion in FinTech and looming cybersecurity threats, and the authorities' initiatives and recent advances in this area are welcome. The upcoming 2021 Financial Sector Assessment Program (FSAP) will conduct a detailed analysis of financial stability policies and risks.

Advancing the reform agenda

Quickly reaching a broad agreement over structural and social reforms while preserving macroeconomic stability would help to stimulate investment, productivity, and confidence as well as promote social convergence, thus supporting inclusive growth.

- **Finalizing the pension reform is an urgent step towards ensuring adequate pension coverage in the future.** The 2020 legislation change which increased the solidarity pillar and recent government proposals to increase the contribution rates and further strengthen the solidarity pillar are important steps in the right direction. Going forward, it will be essential to adjust contribution rates, retirement age (especially for women), and solidarity parameters on the basis of demographics, employability, economic developments, expected replacement rates, and expected returns on pension assets. Furthering efforts to reduce informality would increase the contribution density, which could improve coverage and the pension levels for a significant share of the population. Ensuring competition in the management of the pension system will be crucial to promoting efficiency and containing costs.

- **It is also pressing to reform the health system.** Key challenges on this front relate to creating a basic universal health plan (pooling risks from the public and private members), eliminating discrimination based on pre-existing conditions in the private system, improving efficiency in the public system, increasing competition, and reducing the out-of-pocket spending on medicines.

- **Addressing medium term fiscal needs, including for social spending, will require increasing revenues and rationalizing expenditure when the recovery is well-advanced.** Efforts should be directed towards: (i) increasing direct taxation (by revisiting exemptions, deductions, and special regimes, as well as strengthening tax administration); (ii) gradually rationalizing indirect taxes; and (iii) raising green taxes. Valuable recommendations for gradually reducing tax exemptions, deduction, and special regimes have been recently offered by a Commission of Experts. At the same time, authorities should sustain efforts towards increasing efficiency in spending.

- **In the medium term, broader structural reforms will be important to increase productivity and promote inclusiveness.** A broad agenda is needed, encompassing continued efforts to: enhance the quality of education, address labor market mismatches, promote labor market flexibility, reduce informality, strengthen competition, streamline bureaucracy, continue trade and financial integration, and support policy actions in response to climate change.

The mission is grateful to the authorities and other counterparts for excellent cooperation, and candid and open discussions.

Chile: Selected Economic Indicators

			Est.	Proj.	
	2018	2019	2020	2021	2022
Output					
Real GDP Growth (%)	4.0	1.1	-6.0	6.0	3.7
Consumer prices					
Inflation (End of period, %)	2.1	3.0	2.9	3.0	3.0
Central Government Operations					
Structural Fiscal Balance (% of GDP) 1/	-1.5	-1.7	-2.7	-4.2	-3.9
Overall Fiscal Balance (% of GDP) 1/	-1.6	-2.8	-7.3	-2.6	-3.1
Balance of payments					
Current Account (% of GDP)	-3.6	-3.8	0.3	-1.6	-1.3
Source: Chilean Authorities and IMF Staff Estimates					
1/ Structural adjustment based on IMF Staff estimate.					