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IMF Executive Board Concludes 2011 Article IV Consultation with Chile

On August 23, 2011 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Chile[1], on a lapse-of-time basis[2].

Background

Chile's economy has recovered rapidly from the global financial crisis and the February 2010 earthquake. Its resilience was underpinned by solid policy frameworks (including a fiscal rule, inflation targeting and exchange rate flexibility), a sound banking system and a strong policy response, supported by the large fiscal buffers. Growth rebounded to 5.2 percent in 2010, and is expected to pick up further to 6.5 percent in 2011 on the back of strong domestic demand.

The slack in the economy has diminished and some constraints are emerging. The unemployment rate has reached a historically low level and wage growth is picking up. The rapid growth of domestic demand has fueled import growth, leading to a narrowing of the current account surplus despite favorable terms of trade. While the nominal appreciation of the peso has helped moderate the rise in consumer prices, headline inflation moved above the 3 percent target in the first half of 2011, although core inflation remained contained. Inflation is projected to increase in the second half of the

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

year as spare capacity diminishes further, before declining during 2012 as the effect of interest rate increases passes through.

Credit conditions have eased significantly over the last twelve months, and commercial and consumer loan growth has accelerated. External borrowing by non-financial corporations has also increased significantly. Nonetheless, the ratios of corporate debt-to-Gross Domestic Product (GDP) and household debt-to-disposable income remain broadly stable.

The authorities are withdrawing policy stimulus. Against a backdrop of rising inflation, the central bank raised the policy rate from 0.5 percent in mid-2010 to 5.25 percent in June 2011. The rapid increases in the policy rate in the first half of 2011 helped bring down inflation expectations close to the official target. In January 2011, the central bank announced a daily schedule of foreign exchange purchases to increase its gross reserve by US$12 billion by year-end.

In early 2011, the government announced a reduction of public expenditure of about 0.3 percent of GDP, which would lower the 2011 structural fiscal deficit to 1.6 percent of GDP (0.5 percentage point lower than in 2010). The headline fiscal balance is expected to move from a deficit of 0.4 percent of GDP in 2010 to a surplus of 1.3 percent in 2011 on the back of high copper prices.

Despite a pickup in gross capital inflows, net capital inflows remain moderate. Rising gross portfolio inflows have been largely offset by higher portfolio investments abroad by domestic pension funds. In early 2011, however, large foreign borrowing by banks and corporates resulted in a sizable surplus in the financial account. The peso appreciated 14 percent vis-à-vis the US dollar (although only 4 percent in real effective terms) in the year to May. The strengthening of the peso is consistent with improvement in the terms of trade and other fundamentals.

The financial soundness indicators are favorable. Banks are well capitalized, liquid, and highly profitable. Stress tests suggest that banks' capital ratios will remain above minimum requirements even if economic conditions deteriorate and the cost of funding increases. Non-performing loans declined in 2010 and banks have increased their provision coverage. Despite the recent rise in external borrowing, banks' foreign funding remains moderate and there are no significant currency mismatches in the banking and corporate sectors.

Executive Board Assessment

In concluding the 2011 Article IV consultation with Chile, Executive Directors endorsed staff's appraisal, as follows:

Chile has recovered rapidly from the global financial crisis and strong growth is expected to continue. Real GDP is expected to grow by 6.5 percent in 2011 on the back of buoyant domestic demand. Consumption will benefit from strong employment growth and firming wages, while large reconstruction spending will support investment. Domestic risks to the outlook are mostly to the upside. The main downside risks are related to the possibility of a sharp slowdown of economic activity in Asia, or an intensification of global financial stress.

The key task of macroeconomic policies at the current juncture is to ensure a smooth transition to a sustainable path for domestic demand. The output gap has closed and some capacity constraints are emerging. The current account balance has narrowed, despite favorable terms of trade, and is expected to deteriorate further as rapid import growth continues to outpace export growth. Upward pressures on headline Consumer Price Inflation (CPI) have eased in line with commodity price developments, but core inflation is likely to continue to rise as spare capacity diminishes further.

The authorities have appropriately started to withdraw policy stimulus. Fiscal expenditure growth moderated in 2010 (from very high levels during the crisis), and is expected to be somewhat lower than GDP growth in 2011. The rapid pace of policy rate increases in the first half of 2011 reinforced market confidence that inflation pressures will be contained, bringing inflation expectations closer to the target. Staff agrees with the authorities that the magnitude and timing of any future policy rate moves would depend on domestic and global economic developments.

Staff urges the authorities to accelerate the pace of fiscal tightening and set more ambitious medium-term fiscal targets. Rebuilding fiscal buffers at a faster pace than currently envisaged would optimize the contribution of fiscal policy to macroeconomic stability. In the near term, greater fiscal restraint would help guard against upside inflation risks and improve the policy mix, reducing the risk of a surge in capital inflows and easing pressures on the exchange rate. In the long term, larger fiscal buffers will help preserve the government’s ability to respond to adverse shocks and prepare it to deal better with challenges related to population aging. Staff recommends aiming for a structural surplus in the medium term, and frontloading the adjustment.

Ongoing efforts to improve Chile’s fiscal policy framework are welcome. Staff supports the thrust of the recommendations of the commission for improving the functioning of Chile’s fiscal rule and its institutional framework. In particular, it supports the recommendations to improve the calculation of the structural balance, reduce unintended policy procyclicality caused by assumptions about long-term copper prices, and add an explicit escape clause to the rule. Introducing an explicit link between medium- and long-term budget targets would help improve the policymaking process. Staff believes that the establishment of an independent fiscal council would strengthen the framework and enhance the assessment of fiscal policy.

The flexible exchange rate system continues to serve Chile well. It has helped limit speculative capital inflows and mitigate inflationary pressures. Staff analysis suggests that the current level of the exchange rate is broadly in line with fundamentals. Foreign exchange reserves at end-2011 would be fully adequate based on various reserve measures and staff sees no case for extending the intervention program beyond the end of the year.

Although financial soundness indicators remain strong, continued vigilance is necessary to contain vulnerabilities. In the context of heightened risks of a rise in global financial stress, it would be prudent to continue to maintain high levels of liquidity in the financial system. In addition, continued monitoring is needed to prevent an excessive buildup of leverage in the corporate and household sectors. In case concerns arise about the speed of credit or asset price growth, prudential measures could be considered to help maintain stability.

Staff supports the planned enhancements to the regulatory and supervisory framework for the financial system discussed during the Financial Sector Assessment Program update. Staff commends the authorities for advancing measures aimed at modernizing Chile's regulatory framework, including the establishment of a financial stability committee, the strengthening of consumer protection in financial services, the adoption of a commission structure for the supervisory agencies, and planned changes in the Banking Law. As the Financial System Stability Assessment points out, it would also be advisable to strengthen the legal basis for oversight of financial conglomerates, the framework for anti-money laundering and combating the financing of terrorism, and the procedures for resolution of failed financial institutions.

Boosting productivity remains the key long-term challenge. Government initiatives to reduce the cost of doing business, increase competition, support research and development, and reform the corporate bankruptcy code are welcome. Another important goal is increasing labor market efficiency and raising labor force participation.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2011 Article IV Consultation with Chile is also available.

Chile: Selected Social and Economic Indicators

I. Social and Demographic Indicators

GDP (2009)	103,742	**Poverty rate (2009)**	15.1
U.S. dollars (billions)	203.3	Indigent	3.7
Per capita (U.S. dollars)	11,981	Poor, not indigent	11.4
Population characteristics (2008)		**Income distribution (2009)**	
Total (in millions)		Richest 10% of households	
Urban population (percent of total)	17.0	Poorest 20% of households	40.2
Life expectancy at birth (years)	88.7	Gini coefficient	3.6

II. Economic Indicators

						Projections	
	2006	2007	2008	2009	2010	2011	2012
	(Annual percentage change, unless otherwise specified)						
National accounts and employment							
Real GDP	4.6	4.6	3.7	-1.7	5.2	6.5	5.0
Total domestic demand	7.0	7.3	6.5	-5.1	16.5	7.8	6.0
Consumption	7.0	7.0	3.9	1.8	9.3	6.6	5.9
Private	7.1	7.0	4.6	0.8	10.4	8.2	5.4
Public	6.4	7.2	0.5	7.5	3.2	-1.9	9.0
Investment	7.1	8.3	14.3	-23.7	42.9	11.0	6.4
Private	1.4	9.5	21.7	-21.9	25.3	11.0	8.8
Public	12.0	24.7	3.1	36.4	-14.7	16.5	2.4
Fixed	2.5	11.2	19.5	-15.8	18.6	11.7	8.0
Inventories 1/	1.2	-0.5	-1.1	-2.3	5.1	0.1	-0.3
Net exports 1/	-2.6	-3.1	-3.3	3.9	-12.3	-2.6	-2.2
Exports	5.0	7.5	3.3	-6.4	2.0	5.4	3.4
Imports	11.2	13.9	9.9	-13.0	29.9	8.5	6.2
Consumer prices							
End of period	2.6	7.8	7.1	-1.4	3.0	4.0	3.2
Average	3.4	4.4	8.7	1.7	1.5	3.3	3.2
Unemployment rate (annual average) 2/	8.0	7.0	7.4	9.6	8.3	7.2	7.2
Money and credit							
Broad money	17.5	20.5	18.6	-5.3	9.3	...	...
Credit to the private sector (end of period)	16.8	21.0	18.7	-10.6	8.1	...	...
External Debt and Balance of Payments	(In percent of GDP, unless otherwise specified)						
Current account	4.9	4.5	-1.9	1.6	1.9	0.3	-1.3
Trade Balance (in billions of U.S. dollars)	15.1	14.0	4.4	7.9	7.3	6.2	5.0
Exports of goods (in billions of U.S. dollars)	45.3	46.8	45.2	38.9	40.2	40.4	41.3
Imports of goods (in billions of U.S. dollars)	-30.2	-32.9	-40.7	-31.0	-33.0	-34.2	-36.3
Gross external debt	33.7	33.9	37.4	45.3	42.7	39.0	37.4
Public	7.8	7.8	7.2	8.4	8.6	7.7	7.2
Private	25.9	26.2	30.2	36.9	34.1	31.3	30.2
Gross International Reserves (in billions of U.S. dollars)	19.4	16.9	23.2	25.4	27.9	39.9	39.9
	(Annual percentage change)						
Terms of Trade	31.1	4.3	-16.5	4.8	23.5	-1.7	-0.3
Real Effective Exchange Rate 3/	3.6	-2.9	1.0	-1.4	5.4	...	...
Savings and investment	(In percent of GDP)						
Gross domestic investment	20.0	20.4	25.2	18.9	22.4	23.8	24.1
Public	2.0	2.4	2.6	3.0	2.5	2.8	2.7
Private	17.9	18.1	22.6	15.9	19.9	21.0	21.4
National saving	24.9	25.0	23.3	20.5	24.3	24.1	22.8
Public 4/	9.2	9.0	8.4	-3.3	0.7	2.4	2.9
Private	15.7	16.0	14.9	23.8	23.6	21.7	19.9
Public sector finance							
Net Debt	-1.8	-10.0	-17.7	-6.9	-2.4	-2.5	-7.5
Excluding public enterprises	-6.1	-13.5	-23.8	-12.9	-8.3	-8.5	-13.5
Public sector gross debt 5/	26.9	19.9	26.0	29.3	27.7	32.8	30.3
Central government gross debt	5.3	4.1	5.2	6.2	9.2	10.4	10.5
Public sector balance	7.7	8.2	4.3	-4.5	-0.4	1.3	1.8

Sources: Central Bank of Chile, Ministry of Finance, Haver Analytics, and IMF staff estimates.

1/ Contribution to growth.

2/ Gross saving of the general government sector, including the deficit of the central bank.

3/ Gross consolidated debt of the public sector (central bank, non-financial public enterprises, and general government).

4/ Gross saving of the general government sector, including the deficit of the central bank.

5/ Gross consolidated debt of the public sector (central bank, non-financial public enterprises, and general government).