Statement by Luis Oscar Herrera, Alternate Executive Director
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On behalf of my Chilean authorities, I thank staff for the report on the Flexible Credit Line (FCL) arrangement and the assessment of Chile's qualification criteria for the FCL. An FCL arrangement would augment precautionary reserve buffers and provide a valuable backstop against tail risk scenarios, and, together with Chile's very strong policy and institutional framework, would contribute to bolster market confidence amid a gloomy and more uncertain global outlook.

Since Chile's acceptance of the Short-term Liquidity Line (SLL) *offer* last May, several negative risks for the world economy have materialized: the persistent rise in inflation, the pivot of monetary policy in advanced economies, the continuation of the war in Ukraine, and the slowdown of the Chinese economy. The balance of external risks remains tilted to the downside, including a global recession, further tightening of global financial conditions, new commodity price shocks, or an intensification of the spillovers from Russia's war on Ukraine.

These international developments have negatively affected the outlook for the Chilean economy. Export markets are expected to grow more slowly, terms of trade have fallen around 10 percent, external financing costs have increased moderately, net portfolio inflows have declined, and the Chilean peso has been subject to unusually high volatility. GDP is expected to slowdown in the second half of the year and next year, while short-term inflation projections have been revised downwards.

The immediate impact of global developments on Chile's inflation has been significant due to the high pass-through of international prices and the exchange rate, which have added to domestic pressures stemming from a positive output gap. Headline inflation reached 13.1 percent in the last 12 months (July 2022), while measures of core inflation stand around 10 percent in the same period. Inflation expectations for the next 12 and 24 months have increased above the 3 percent target.

The negative impact on activity, domestic demand, and the labor market is expected to be more gradual. Personal consumption has remained relatively strong, albeit on a moderating path, due to the lingering effects of income support programs during the pandemic and the early withdrawal of pension savings in 2020-21. Other drivers of personal consumption, such as labor income, consumer confidence, and household credit, point downward. Fixed investment and inventory changes are expected to weaken domestic demand in the coming quarters. The current account deficit remains high on the back of lower terms of trade but is expected to decline along with the contraction of domestic demand and a depreciated real exchange rate.

Chile's very strong institutions ensure preparedness to withstand adverse shocks and a commitment to maintaining very strong policies in the future. Chile has benefited from its long and excellent track record of very strong macroeconomic performance, based on prudent policies. Such policies include: (a) an inflation-targeting monetary policy framework with a free-floating exchange rate carried out by the accountable and autonomous Central Bank of Chile (BCCh) since 1989; (b) a responsible fiscal

policy, based on a structural budget target aimed at stabilizing debt in the medium term; and (c) a deep and solid financial system, further strengthened by the recent General Banking Law, which strengthens the financial sector regulatory and supervisory framework and adopts the Basel III standards. Chile's economy has remained resilient on the face of large external and domestic shocks, including the global financial crisis, the social upheaval in 2019, and more recently, the COVID-19 pandemic.

Amid the deterioration of the global outlook, the Chilean authorities have continued to rebalance their policies to mitigate risks, maintain macroeconomic stability, and support vulnerable groups.

In response to rising inflation, the BCCh has continued raising its benchmark interest rate (9.75 percent) to well above the neutral level and has communicated that it will continue to adjust monetary policy as needed to ensure that inflation returns to the 3 percent target. The benchmark yield curve has shifted upwards and credit conditions for firms and households have become more restrictive.

The exchange rate has flexibly adjusted to the fall in terms of trade and the tightening of global financial conditions. The peso-dollar exchange rate has depreciated close to 20 percent in the last 12 months (ending in July), while the real exchange rate stands more than 25 percent below its average from 2010 to 2019.

Since mid-2021, Chile's financial authority (CMF) has withdrawn the extraordinary prudential measures adopted during the pandemic and has resumed its agenda to implement Basel III standards and strengthen buffers in the financial system. In the wake of the pandemic crisis, Chile's banking sector has shown resilience and maintains an adequate solvency and liquidity position. Banks' capital adequacy ratio has risen above 15 percent, while loan delinquencies remain low, stable, and well provisioned.

The government is implementing a multi-year fiscal consolidation plan to achieve close to a balanced structural fiscal position by 2026 (-0.3 percent of GDP) and keep public debt below 45 percent of GDP. The extraordinary support programs implemented during the pandemic have been wound down while continuing to provide targeted support to the most vulnerable within the budget envelope. Non-mining tax revenues have significantly increased due to strong growth in 2021 and the tax mobilization plan which was implemented in the last two years. The overall headline fiscal position is expected to close almost in balance in 2022 (-0.1 percent of GDP), while the structural fiscal deficit is expected to decline to 1.3 percent of GDP, from over 11 percent of GDP last year. Gross public debt is projected to reach 38 percent of GDP by the end of 2022.

Despite the timely and adequate rebalancing of domestic policies, the peso exchange rate has recently been subject to unusual bouts of volatility triggered by international developments. From mid-June to mid-July, the peso experienced an unusually large depreciation over the course of a few weeks. During this period, the bid/ask spreads in the foreign exchange market widened while transaction volumes decreased, and FX market dynamics threatened to distort the transmission of monetary policy and the normal functioning of financial markets.

In response to these developments, in mid-July, the BCCh announced a temporary and transparent program of foreign exchange intervention and preemptive provision of liquidity in dollars (FXI program) to prevent disorderly market conditions and facilitate the adjustment of the Chilean economy to the uncertain and changing economic conditions. The FXI program commenced on July 18, 2022, and will run until September 30, 2022, and considers sales of foreign exchange in the spot market (up to US$10 billion), currency hedging operations (up to US$10 billion), and currency swaps (up to US$5 billion). Since the launch of the program, price formation conditions in the FX market have improved and exchange rate volatility have subsided, while the volume of weekly FX auctions has been reduced.

Chile is a small open economy, dependent on the export of commodities, with a sustainable external position. The current account deficit, temporarily high due to the lagged effect on personal consumption of the support programs implemented during the pandemic, is mainly financed by private creditors. By the end of July 2022, international reserves held by the BCCh stood at US$44.7 billion, supplemented by precautionary liquidity lines of US$9.25 billion. In addition, the government holds substantial international liquid buffers, including as part of their Sovereign Wealth Fund and Pension Reserve Fund (US$14.8 billion by the end of July 2022). The government maintains an investment grade rating in international capital markets with fluid access to external financing in favorable terms.

While the current level of international reserves and liquidity buffers is adequate, considering Chile's mature flexible exchange rate system and access to international financial markets, considering the heightened international uncertainty, the authorities wish to strengthen their access to precautionary reserve buffers in case of tail risk scenarios.

Chile has a very high degree of regional and global integration in financial markets, explaining large asset and liabilities’ international investment positions, 139 and 150 percent of GDP respectively. A protracted slowdown in the global economy combined with high uncertainty, a strong US dollar, and tight international financial conditions may lead to a sudden shift in investors’ confidence in emerging markets, also affecting Chile. A substantial decrease in capital inflows, together with higher portfolio outflows from institutional investors, would explain most of the financing needs in a severe adverse scenario. In addition, Chile's position as the world’s leading copper exporter exposes it to a deterioration in its current account because of the sensitivity of commodity prices to global growth, partially offset by lower energy costs and lower income to foreign direct investment. The widening on the current account deficit would be less than that of a financial account reversal. Overall, amid an environment of exceptionally high external risks, the external financing gap could amount to about US$18.5 billion.

The response to potential shocks would use multiple policy instruments, including exchange rate flexibility, additional tightening of monetary policy, FXI operations in case of disorderly market conditions, and a responsible budget policy implemented in accordance with the fiscal rule and targets and financed in a balanced way between external and internal sources.

Against this background, Chile has requested access to the FCL arrangement in the amount of SDR13.954 billion, equivalent to 800 percent of quota, covering a period of 24 months, and notified the cancellation of the current SLL arrangement with access equivalent to SDR 2.529 billion (145 percent of quota).

Chile meets the qualification criteria for access under the FCL and the authorities are committed to maintain very strong policies in the future. Such policies are embedded in the solid policy framework described earlier.

Chile intends to treat the arrangement as precautionary, underscoring the insurance component of the FCL. If approved, the BCCh will also be responsible for managing financial operations associated with the FCL arrangement. If FCL resources were to be drawn, they would not be used for budget financing, consistent with Chile's institutional framework.

The exceptional circumstances justifying this request are expected to be transitory, and hence Chile intends to maintain the FCL arrangement on a temporary basis. At the time of the mid-term review, the authorities will reassess the external conditions and the access level. Conditional on a reduction in external risks, they intend to exit the FCL arrangement once the 24-month period is completed, while starting the exit preparations well in advance, including through an adequate communication strategy.

The requested FCL is equivalent to bolstering the availability of upfront liquidity of the BCCh by more than 40 percent, and, as such will provide a strong signal to reinforce market confidence amid heightened uncertainty and volatility in global financial markets. The precautionary nature of the liquidity buffer will contribute to prevent a tail risk scenario, with negative social and economic costs to Chile, as well as contributing to the stability of the international monetary system amid heightened uncertainty.

The relationship of Chile with the Fund is longstanding, not only as a member, but also as a creditor, with a current position of SDR9.24 million in the NAB, the NAB credit arrangement with the Fund in the total amount of SDR1,381.94 million, and a commitment that amounts up to SDR269 million under the bilateral borrowing agreement, as well as its active participation in the Fund's voluntary trading agreements of SDR.