Statement by Mr. Herrera and Ms. Mostajo Soto on Chile
January 12, 2023

On behalf of the Chilean authorities, we would like to thank staff for the open and constructive discussions during the Article IV consultation, as well as for its insightful report on the Chilean economy. The Staff Report presents a fair assessment of the challenges facing the economy and our authorities welcome staff's analysis and policy advice.

The Chilean economy continues moving towards sustainable growth in a challenging external scenario. Amid a swift recovery from the COVID-19 crisis, buttressed by high vaccination rates and supportive monetary and fiscal policies, the extraordinary pension fund withdrawals boosted private consumption and created several imbalances in the economy, including a sizable positive output gap, inflationary pressures, and an elevated current account deficit.

Chile's monetary and fiscal policies have been recalibrated to ensure macroeconomic resilience and sustainability. Monetary policy maintains a tight stance to anchor inflation expectations and curb excess demand. The financial authority has resumed the implementation of Basel III to strengthen the financial buffers in the banking system. The government is implementing a multi-year fiscal consolidation path to restore buffers and anchor public debt below a prudent ceiling, while providing targeted support to the most vulnerable. The authorities are confident that this coordinated policy response will put the Chilean economy on a sustainable growth path, but they remain alert to implement any necessary adjustments. Meanwhile, the government continues advancing structural reforms to achieve a more inclusive, dynamic, and greener economy, while maintaining macroeconomic stability and fiscal responsibility.

Economic Outlook

The Chilean economy is currently adjusting to the deterioration of the external scenario and the tightening of domestic policies. After a strong post-pandemic recovery that continued through the end of 2021, quarterly economic growth turned negative at the beginning of last year. Output growth is expected to remain negative in the near term but to become positive again sometime in the first half of 2023. Overall, the Central Bank of Chile (CBC) projects real output to grow around 2.5 percent in 2022, contract between -1.75 and -0.75 percent in 2023 reflecting a negative carryover, and return to positive growth in 2024, between 2 and 3 percent.

Since its peak at the end of 2021, domestic demand has weakened, and further corrections are expected in the near-term amid soft labor markets, muted household and business expectations, higher interest rates, and the weak global economy. Private consumption has been slowing down for almost a year in a context of normalization of household liquidity, withdrawal of extraordinary fiscal support, rising cost of credit, low job creation, and moderation in real

wages. The correction has been concentrated in household spending on goods, while spending on services has continued to recover in response to the gradual lifting of health protection measures. Fixed investment has remained resilient buoyed by the completion of large projects in renewable energy and other specific sectors; however, it is expected to weaken amid unfavorable dynamics, especially in the housing construction sector. New home sales saw a sharp decline throughout 2022 amid tighter credit conditions. Domestic demand is expected to contract in 2023. In this context, the current account deficit is expected to decline in the near term in line with further adjustments in consumption and investment, the reduction in transport costs, and the weak real exchange rate.

The authorities concur with staff that external risks remain elevated and tilted to the downside, but they assess the balance of risks on the domestic front to be broadly balanced. Recent indicators show a reduction in domestic risks. The domestic economic uncertainty index (DEPUC) has been declining markedly, and, according to CBC analysis, the breakdown of movements in long-term domestic interest rates shows a growing preponderance of external factors, while the incidence of domestic factors has decreased. The Chilean stock market gained about 20 percent in 2022, while the world's main stock markets experienced heavy losses.

Monetary Policy, Exchange Rate, and External Buffers

The authorities agree with staff on the need to maintain a tight monetary stance until inflationary pressures have firmly abated and inflation expectations are well-anchored. Since mid-2021, the CBC has increased its monetary policy rate (MPR) from 0.5 to 11.25 percent, well above its neutral rate. The benchmark yield curve has shifted upward and credit conditions for firms and households have become more restrictive.

The monetary authority considers that the current stance is tight enough to ensure the convergence of inflation to its target in the next two years. Last December, the CBC stated its intention to maintain the MPR at 11.25 percent until it ensured that the convergence process was consolidated. The monetary authority concurs with staff that there are upside risks to inflation in the short run but stressed that downside risks over the medium run should not be disregarded, as domestic demand is expected to contract rapidly. The CBC remains vigilant to risks to the macroeconomic scenario and stands ready to adjust the policy stance if the balance of risks deteriorates or shocks materialize.

Inflation remains high and above the 3 percent target; however, it has moderated more recently and is expected to continue a downward path and converge to the target by 2024. Supply-side factors, such as the price of gasoline and the nominal exchange rate, have moderated in recent months. Demand-side factors have been receding through 2022 and further adjustment is expected to take the output gap into negative territory in 2023. In this context, the monetary

authority expects headline inflation to continue to decline in the coming quarters, converging to 3 percent in the second half of 2024, and for core inflation to decline somewhat more slowly, reaching 3 percent at the end of 2024.

After the exceptional foreign exchange intervention (FXI) carried out last year, the peso has remained broadly stable. In response to the excessive volatility observed in mid-year, the CBC conducted a temporary, transparent, and fully sterilized FXI program through the third quarter, including a preemptive provision of dollar swaps. The FXI program ended last September, as planned. The authorities concur with staff on the positive evaluation of the FXI program. It successfully stabilized the currency market, reducing frictions in the price formation process, and preventing broader financial and real sector spillovers. The authorities remain firmly committed to a flexible exchange rate, as it is a key shock absorber for the Chilean economy. The CBC will assess the convenience and opportunity of replenishing external buffers when conditions become appropriate.

A complementary measure was to expand access to precautionary international liquidity through a new FCL arrangement. The authorities will continue to treat this arrangement as precautionary and temporary amid heightened volatility in global financial markets. The FCL arrangement, together with very strong financial and macroeconomic policy frameworks, reinforce market confidence and provide tools to cushion the negative social and economic costs of extreme risk scenarios.

Fiscal Policy

Within the framework of the Fiscal Responsibility Law, the government is implementing a multi-year consolidation plan to achieve a structural equilibrium position by 2026 (-0.3 percent of GDP) and keep public debt below 45 percent of GDP.

The fiscal position was sharply strengthened in 2022. The new administration implemented one of the largest post-COVID-19 fiscal consolidations. The extraordinary support programs carried out during the pandemic were wound down, maintaining some targeted transfers to encourage formal employment and protect the most vulnerable population from the increase in the cost of living. On the revenue front, tax collections increased significantly due to the high level of activity and demand, as well as higher property revenues related to lithium exploitation contracts. Against this backdrop, the overall fiscal position in 2022 is projected by the government to have improved to a surplus of 1.6 percent of GDP from a deficit of 7.7 percent in 2021, while the structural fiscal balance recovers to a surplus of 0.9 percent of GDP from a deficit above 11 percent of GDP. Both the headline and structural balance were significantly stronger than the path established in the Fiscal Responsibility Law.

The 2023 budget establishes a structural fiscal deficit of 2.1 percent of GDP, with expenditures increasing 4.2 percent from 2022 in real terms. Expenditure increases will be focused on public investment, social spending, and productivity. Gross public debt is expected to rise to 36 percent of GDP by the end of 2022, below previous estimates, and to stabilize around 41 percent of GDP by 2026.

The authorities agree with staff that the ongoing improvements in the fiscal rule will continue to strengthen Chile's longstanding fiscal framework. Methodological changes have been introduced to improve the estimates of the output gap and government's structural revenues. In addition, the government sent to Congress reforms to the Fiscal Responsibility Law, which include the introduction of an explicit escape clause, a pre-established convergence route for public debt, and a special fund to deal with natural disasters, among others.

Financial Policies

The banking sector in Chile remains liquid, solvent, and well capitalized, supported by effective supervision and regulation. The authorities agree with staff that the emerging vulnerabilities for the financial sector should be closely monitored. The latest CBC assessment of the financial soundness of households, companies, and banks did not reveal systemic vulnerabilities, but it did show some areas of concern regarding the high indebtedness of low-income households and the financial weakness of certain companies in the real estate sector and construction.

Considerable progress was made on regulatory reforms to strengthen the financial system, in line with the 2021 FSAP recommendations and the gradual phase-in of Basel III regulation. In this context, the Government submitted bills to Congress to strengthen the resilience of the financial system and its infrastructure, improve consolidated credit registry of information on personal debt, and grant the financial supervisor (CMF) powers to regulate the liquidity buffers of mutual funds. Furthermore, in line with FSAP recommendations, the CBC unwound the extraordinary collateral policies implemented during the pandemic, returning to its usual framework. The authorities remain committed to further progress on the FSAP recommendations.

The authorities are encouraged by the opportunities provided by the Fintech sector to foster innovation, competition, and inclusion in the financial system within a sound regulatory framework and continue monitoring developments in this area. The recent Fintech law includes various activities and business models into the regulatory perimeter, establishing a minimum standard to ensure the proper functioning of financial services. Additionally, the CBC is moving forward with its medium-term strategy for digital payments, including the exploration of pros and cons of establishing a CBDC in Chile.

Structural policies

The government presented a comprehensive tax reform that is being discussed by Congress. As staff points out in the Staff Report, the tax burden as a percentage of GDP is below the average of OECD countries and has changed very little in the last three decades. Compared to OECD countries, Chile collects significant revenue from corporate income tax and VAT, but relatively little from personal income tax. The tax reform includes increases in taxes on personal income and personal wealth, reduction of tax exemptions, administrative measures to deter aggressive tax planning, evasion, and avoidance, as well as a review of the tax on mining royalties. Throughout 2023, the government expects to submit a new bill introducing corrective taxes and other measures to address environmental externalities, including those related to climate change and biodiversity.

The tax reform under discussion is expected to gradually raise revenues by about 3.5 percent of GDP by 2026. The additional revenues will be allocated to strengthen social expenditure on health, education, pensions and caregiving, investment on productive diversification, research and development (R&D) and innovation, support balanced regional development, as well as ensuring fiscal sustainability in line with the Fiscal Responsibility Law. The government estimates that the tax reform will have net positive effects on real GDP mainly through its impact on R&D expenditures. While the authorities are confident that the reform and administrative measures will deliver the expected revenues, they acknowledge that its implementation will be protracted, so they agree with staff on the need to proceed cautiously on new spending commitments until permanent revenues are obtained.

The authorities concur with staff's view that the social security reform must focus on improving pension outcomes, while mindful of its implications for aggregate savings, capital markets, and the availability of long-term financing. The pension reform under discussion in Congress addresses the problem of low pensions by gradually increasing retirement contributions from 10 to 16.5 percent of workers' income, boosting the publicly guaranteed minimum pension, and introducing changes in the industrial organization of the pension system to increase competition and reduce administrative costs.

The government estimates that the pension reform will contribute to recover the long-term savings base of the economy and the depth of capital markets diminished by extraordinary withdrawals from pension funds during the pandemic. The workers' contribution to social security (10.5 percent) and most of the gradual increase in social security contribution from employers (6 percent) will be capitalized and will contribute to national savings in the medium term. The private sector will continue to provide investment management services to the savings accumulated on workers' individual accounts.

Chile maintains a strong commitment to climate action, with a solid track record of policies and an ambitious agenda ahead. There have been significant changes in the energy matrix towards renewable sources, including hydro, solar, and wind power. The country is also developing a national green hydrogen strategy. In a decade, Chile is expected to stop depending on imported fossil fuels entirely.

In the past year, Chile published the Framework Law on Climate Change, which sets goals, institutions, and tools to achieve the Nationally Determined Contribution (NDC) and the Energy Efficiency Law to reduce emissions by 2 percent per year, with a focus on the industrial, mining, and transport sectors. Furthermore, it has updated its NDC, committed to reducing methane emissions by 2025, and expanding the scope of its ecosystem protection by 2030. In this context, the authorities welcome staff's assessment on carbon pricing and concur that a higher carbon price would contribute to delivering on the country's climate goals. At the same time, the calibration of the gradual increase in carbon taxes should consider other complementary tools to achieve these goals.

Following the rejection of the draft constitution proposal in the September referendum and extensive negotiations, a broad political agreement was reached last December to start a new process. The political agreement includes a new constitutional body, with a mix of experts and elected members, which will draft the new proposal within an agreed framework of basic principles.