

## 2016 ARTICLE IV CONSULTATION WITH CHILE

### Concluding Statement of the IMF Mission

October 25, 2016

*Chile's fundamentals and policy framework remain strong. However, economic prospects are being shaped by lower dynamism in key trading partners, slower trend growth in Chile, and mounting social demands for inclusive growth. Important reforms are underway that have the potential to lift growth and reduce inequality. Against this background, the mission's analysis explores options to balance trade-offs between growth, stability, and social objectives, while assessing the macroeconomic policy mix during this challenging transition.*

#### I. Context

##### 1. **New realities are shaping Chile's economic prospects.**

- **Beyond the near-term, activity in key trading partners will be less dynamic than in the past.** Economic rebalancing in China is slowing its demand for raw materials, including copper. Incomes are growing less rapidly in the U.S., and Europe, and structural problems in Latin America—notwithstanding a better outlook for next year—will weigh on external demand and investment.
- **Structural changes have lowered Chile's trend growth.** Medium-term growth is estimated at around 3 percent, down from over 4 percent a few years ago. Population aging is slowing labor supply and infrastructure bottlenecks and workers' low skills are hampering sectoral reallocation, dampening investment, and suppressing productivity growth.
- **Addressing income disparities has become more urgent.** Income inequality remains high despite recent improvements, and public demand for adequate pensions and health care provision are mounting. As the population ages, these pressures will rise over the medium-term, and better diagnoses and policy solutions are needed.
- **Much needed structural reforms forge new avenues for growth but weigh on the near-term outlook.** Competition in the energy sector has increased and red tape is being reduced. A fundamental education reform is upgrading human capital. The new corporate income tax used to finance it, albeit needed, is slowing capital formation. The growth implications of the new labor reform are uncertain given legal ambiguities.

2. **Despite these challenges, Chile has grown faster than others in the region.** This owes to a credible and effective fiscal and monetary framework, a modern and stable

financial system, and a flexible exchange rate. Since 2014, growth averaged 2 percent, substantially below rates of 4 percent a few years ago, but well above the Latin-American six largest countries average of 0.3 percent during the last 3 years.

## II. Outlook and Risks

3. **Conditions are in place for a modest recovery next year.** GDP is forecast to grow moderately faster at 2 percent in 2017, slightly up from 1.7 percent this year. Faster growth in the region and advanced economies should lift exports but domestic demand is set to pick up only gradually. A weak labor market and a slow recovery in sentiment are, however, holding back private consumption and investment.

Chile: Near-Term Projections			
	2016	2017	2018
	(Calendar Year, Growth Rate)		
Real GDP	1.7	2.0	2.7
CPI inflation	4.0	2.8	2.9
CA balance 1/	-2.2	-2.2	-2.4

4. **The outlook remains uncertain.**

Externally, an unexpected slowdown in China or setbacks from pending adjustments in Brazil could dampen exports and investment. Domestically, the recovery in confidence could be further delayed by a drawn-out resolution of legal uncertainty embedded in the new labor bill. Should a pension reform be approved, an increase in contribution rates could dampen growth over the medium-term relative to the baseline, although growth effects would be relatively moderate.

Source: IMF staff estimates.  
1/ In percent of GDP.

5. **The impact of downside risks materializing could be amplified by high leverage among households and corporates.** Accelerated job losses could lead to larger-than-expected defaults on mortgages and consumer credit. A deterioration in external financing conditions could impair the ability of highly leveraged firms to honor their debt payments—all resulting in tightening credit and shrinking domestic demand. Thanks to sufficient buffers, the financial sector would remain safe.

6. **On the upside, should global growth strengthen more than expected, Chile would be well placed to take advantage of new growth opportunities.** Its open economy would also greatly benefit from the fading of the current global protectionist sentiment.

## III. Policy Recommendations

*The policy mix remains moderately supportive of activity in the face of structural shocks and transitions. Monetary policy could become more accommodative should disinflationary pressures broaden. Structural reforms should focus on key growth bottlenecks in skill formation and firm growth.*

## A. Fiscal Policy

7. **Maintaining fiscal credibility while addressing skill and infrastructure gaps requires a careful balancing act.** For some time, the government has made use of fiscal space. However, permanently lower copper revenue and diminished trend growth now call for gradual adjustment.

8. **The 2017 budget has appropriately tilted the needle towards fiscal consolidation.** The budget proposal is in line with the consolidation path announced last year of about ¼ percent per year in structural terms. It aims to maintain pro-growth spending within a tight budget envelope. To limit the scaling back of such spending, a concerted effort should be made to identify and eliminate inefficiencies in public spending.

9. **Fiscal consolidation needs to continue, but Chile can proceed slowly for now.** Debt is projected to increase rapidly and reach 25 percent of GDP next year. However, a gradual adjustment path over 2017–18 is justified given that public net worth is still positive; low financing costs have kept the debt interest low; and expenditures are used to build human capital and infrastructure. As growth recovers, and spending needs are addressed, a more ambitious fiscal consolidation path should be adopted. Any new spending commitments should be part of a balance neutral package. To buttress fiscal credibility, the Advisory Fiscal Council could be given financial independence and its mandate broadened to assessing annual and medium-term fiscal targets.

## B. Pension Reform

10. **Chile's pension system is rooted in sound principles, but shortcomings are becoming evident.** Over the last 30 years, the fully-funded defined-contribution system has raised national savings, aided the development of capital markets, and reduced fiscal risks. The governance of the system is sound: pension investments are well protected and supervision is effective. However, the system is not delivering adequate benefits for a large share of retirees (Bravo Commission, 2015). Low pension contribution periods and rates are the main reasons. In addition, contributions have not been adjusted to rising life expectancy, the coverage of workers is too narrow, and the solidarity pillar is not providing adequate minimum pensions.

11. **The pension reform should preserve the current system, but strengthen its delivery.**

- *For future retirees*, raise contribution rates for individual accounts. Rates need to be increased materially above 10 percent to ensure adequate pensions. Given that life expectancy is projected to rise by about 5 years by 2050, gradually increasing the mandatory retirement age, especially for women, should be considered. At the same time,

contributions of self-employed should be made mandatory to cover a larger share of workers under the system.

- *For current retirees*, raise minimum pension and solidarity pillar benefits. Given fiscal constraints, any increases in benefits need to take future aging-related commitments into account. Specifically, growth and equity implications of different financing modalities should be studied carefully. For instance, IMF analysis suggests that a pension reform package funded by a mix of higher contributions and indirect taxes would carry lower growth costs than one funded exclusively by increased contribution rates.

Overall, a pension reform is desirable as it will lead to more stable life-time incomes for broader segments of the population and likely raise Chile's savings. Over the medium term, however, higher tax or contribution rates could generate growth costs. For these reasons, the economic effects of any reform need to be assessed carefully alongside its impact on current and future pensions.

### C. Monetary Policy

12. **Central bank policy has become more accommodative this year.** Since the beginning of this year, the policy rate has remained unchanged at 3½ percent. And in successive policy meetings the central bank has softened its policy guidance, dropping its tightening bias in August.

13. **In recent months, inflation has decelerated more rapidly than expected.** After remaining above the 2–4 percent target band for extended period, inflation has declined from 4 percent in July to 3.1 percent in September. Although largely the result of a stronger peso since earlier this year, the risk of disinflation spreading to the non-tradable sector has risen with the slowdown in economic activity.

14. **The central bank should cut rates if disinflation becomes broad based and more persistent, and growth risks deepen in coming months.** The expected widening of the output gap and slowing wage growth have raised the risk that inflation could undershoot the target for some time. The decision whether to ease now or wait for further evidence needs to weigh the benefits from safeguarding against the risks of a decline in inflation expectations, against the cost of prematurely reacting to temporary factors. Balancing these considerations, staff agrees with the central bank's recent adjustments to its forward guidance, its decision to keep rates on hold for now, and remaining data dependent.

### D. Structural Reform Agenda

15. **Structural reforms adopted since 2014 are setting the stage for stronger growth.** Bottlenecks in the electricity sector have lessened, costs for attending secondary and tertiary

education are declining, and 50,000 additional childcare facilities have opened. Nonetheless, transitional costs are inevitable and should be managed carefully.

16. **There is scope to strengthen the effectiveness of the reform agenda:**

- **The creation of a new Infrastructure Fund (IF)—geared to attract private capital—should be fast-tracked.** Chile has a successful record of collaborating with the private sector in developing and managing transportation projects via Private-Public-Partnerships (PPPs). The scope of the IF should be narrowed to infrastructure projects suitable for PPPs and additional safeguards should be adopted to strengthen proposed governance provisions and to limit fiscal risks from contingent liabilities.
- **Workers' skills should be enhanced further and legal uncertainties related to the new labor bill tackled.** Chile's labor productivity is substantially below the average in OECD countries. In addition to ongoing education reforms, more targeted professional and vocational training is essential, including by fostering linkages between industries and education institutions and by creating incentives for on-the-job training and apprenticeship programs. The recently passed labor law lays out new standards for relations between workers and employers. The new framework needs to carefully balance equity and efficiency considerations. Legal ambiguities in the new law need to be addressed swiftly to avoid drawn-out implementation costs.
- **The ability of productive firms to grow should be strengthened further.** New competition and productivity laws are easing the financing of productive investments, supporting service exports, and cutting red tape. Further efforts are needed to help small and medium-size enterprises (SME) grow. Programs to improve business management skills and record keeping should be expanded. For medium-sized firms, regulatory requirements for accessing capital markets could be tailored to different firm sizes to help them tap domestic capital.

**E. Financial Stability and Financial Sector Policies**

17. **Financial sector balance sheets are healthy, but risks to financial stability bear close monitoring.** Banks' earnings slowed in 2016 as a result of low economic activity. However, non-performing loans remain low and capital buffers are well above current legal requirements. Life insurance companies and pension funds continue to be pressured by the low-yield environment and have kept on shifting their portfolios towards higher yield but potentially riskier or less liquid assets. Weaker-than-expected growth could strain the solvency of highly leveraged firms and less resilient SMEs, with potential for amplification

via strong inter-sectoral balance sheet linkages. This risk calls for continued strengthening of financial sector regulation and supervision.

**18. The regulatory framework risks falling further behind international standards.** Adoption of key regulations on bank solvency and insurance supervision should not be further delayed. The revision of the General Banking Law that would implement Basel III capital requirements for Chilean banks during the term of the current administration is at risk. In addition, the law that would implement risk-based supervision for Chile's insurance sector has been with Congress since 2011. The adoption of both reforms will greatly contribute to more efficient supervision, to enhance the credibility of Chile's financial sector, and to strengthen its resilience against domestic or external shocks.

**19. Better coordination and information sharing among financial sector supervisors and the central bank is key.** The proposed creation of the Financial Markets Commission is an important step towards an integrated view of financial sector supervision that may allow a more effective oversight of financial conglomerates. However, its implementation should not delay the adoption of other important reforms (that is, Basel III and risk-based supervision of insurers) and should be used as an opportunity to broaden the scope of supervision to shadow banking activities (for instance, factoring companies and *cajas de compensacion*).

**20. There is scope to improve corporate governance and investor protection.** Chilean companies are, on average, relatively opaque and levels of compliance with best practices in corporate governance are low. Given their important role in Chile's financial system, institutional investors, such as pension fund administrators, can encourage Chilean businesses to improve corporate governance. For instance, institutional investors could give preference to investments in companies with high governance standards and protection of minority shareholder interests. These standards could be enshrined in a new governance code (also known as Stewardship Codes) which firms could subscribe to on a voluntary basis. Such codes have been successfully introduced in the UK and Japan. Similarly, enhanced governance practices could also be incentivized through a targeted new stock market index for companies with high governance standards – similar to a recently created sustainability index at the Chilean stock market.

*The mission is grateful to the authorities and other counterparts for excellent discussions and their hospitality.*