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CHILE

July 2014

2014 ARTICLE IV CONSULTATION - STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR CHILE

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2014 Article IV consultation with Chile, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on June 27, 2014, following discussions that ended on May 9, 2014, with the officials of Chile on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 11, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Press Release** summarizing the views of the Executive Board as expressed during its June 27, 2014 consideration of the staff report that concluded the Article IV consultation with Chile.
- A **Statement by the Executive Director** for Chile.

The following document has been or will be separately released.

Selected Issues Paper

The publication policy for staff reports and other documents allows for the deletion of market-sensitive information.

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CHILE

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

June 11, 2014

KEY ISSUES

Politics: President Bachelet won the Presidential election on a platform to foster inclusive growth and reduce inequality. Her government took office in March 2014 and is launching an ambitious policy agenda that includes important reforms in several areas, including taxation, education, productivity, and energy.

Outlook and risks: Chile's global environment is shifting, with a dimmer outlook for its main export, copper, and normalization of global monetary conditions. Growth has slowed markedly, resulting in a modest output gap. The peso has depreciated, feeding into inflation. Staff projects growth to bottom out in 2014 and then gradually recover. Key risks relate to a large and lasting drop in copper prices and global financial volatility.

Policy mix: The freely floating peso is working as a shock absorber and will support the economic recovery. The policy mix with broadly neutral fiscal and accommodative monetary policy is appropriate. Room for further monetary easing has narrowed but space remains if domestic demand flounders, so long as inflation expectations remain well anchored. On fiscal, given the strong public finances, automatic stabilizers should be allowed to operate unimpeded and there is space for stimuli in the event of a major downturn. The commitment to close the structural fiscal deficit by 2018 is appropriate and should be phased in a way that avoids undue drag on the recovery. Should risks materialize, the freely floating currency is the first line of defense.

Growth and equity reforms: Achieving strong growth while reducing inequality will require structural reforms. The authorities' agenda focuses on the right areas but many details remain work in progress. Clarity on the details, timetables, and prioritization will reduce uncertainty and the risk of delays.

Financial stability: Risks to financial stability appear contained, but it will be important to push through with regulatory reforms underway, including initiatives currently in Congress. Further effort will be needed to close regulatory gaps, in particular bank capital requirements, relative to international benchmarks.

Approved By
Charles Kramer and Tamim Bayoumi

Discussions were held in Santiago during April 28–May 9. The staff comprised Mr. Erickson von Allmen (head), Ms. Petrova, Mr. Rodriguez-Delgado, Ms. Ture (all WHD), and Mr. Arregui (MCM) with research assistance from Mr. Tawfik and editorial support from Ms. Addo and Mr. Moreno. Mr. Schatan (FAD) provided support from headquarters. Mr. Rojas-Olmedo (Executive Director, OEDAG) and Mr. Carrière-Swallow (Advisor, OEDAG) attended selected meetings. The mission met with Central Bank Governor Vergara and Ministers Arenas (Finance), Céspedes (Economy), Eyzaguirre (Education), Pacheco (Energy), and Blanco (Labor), and other senior officials, think tanks, academics, representatives from the financial and business community, and international organizations.

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CONTEXT

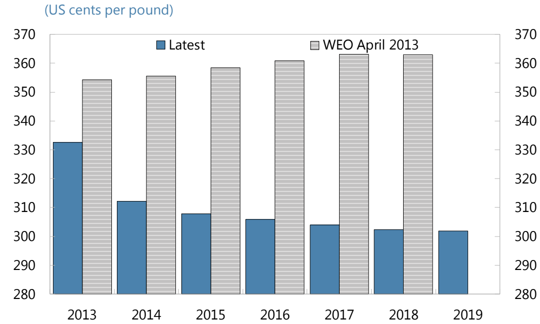
1. **Chile is confronting a changing external environment.** As the world's leading copper exporter and with a large, internationally integrated financial sector, Chile profited greatly from recent years' global copper boom and easy international financial conditions (Figure 1). Chile achieved a substantial increase in per capita income, a fall in poverty, and an improvement, if more modest, in its skewed income distribution.[1] Growth tailwinds are now reversing as the Fed has started to normalize policy ("tapering") and the commodity boom is petering out. Although Chile is in a strong position to cope with these changes and associated turbulence thanks to its freely floating currency, credible monetary policy framework, robust public finances, and a track-record of macro-financial stability, the changing environment poses challenges for macroeconomic policy and, in particular, for the prospects for strong and more inclusive growth.

2. **A new government has taken office.** Former President Michelle Bachelet won the November 2013 elections and assumed office on March 11, 2014 for a four year term. Her coalition also won majority in both chambers in Congress. President Bachelet was elected on a platform to improve equity through major tax and education reforms. The platform also includes energy, labor, and productivity reforms, and a clear commitment to prudent fiscal policy. Annex I summarizes past Fund advice.

CURRENT CONDITIONS

3. **So far, spillovers have been mixed: mild from tapering and severe from the dimmer global copper outlook.** Though not immune, Chile has been remarkably resilient to the tapering-spillovers (Figure 2). The corporate sector has maintained access to external funding, capital inflows have remained buoyant, albeit with recent moderation, and the effect on EMBI spreads has been modest. Notably, Chile's local currency long-term government bond yields have *declined*, reflecting policy credibility, monetary policy expectations, and low foreign participation.[2] In contrast, the worsening global copper outlook has taken a toll on investment and growth and the effect seems bigger in Chile than in other copper exporters (Annex II). The peso has depreciated by 17 percent against the dollar since April 2013—amid monetary easing—and 11 percent in real effective terms.

A Dimmer Outlook for Copper
(US cents per pound)



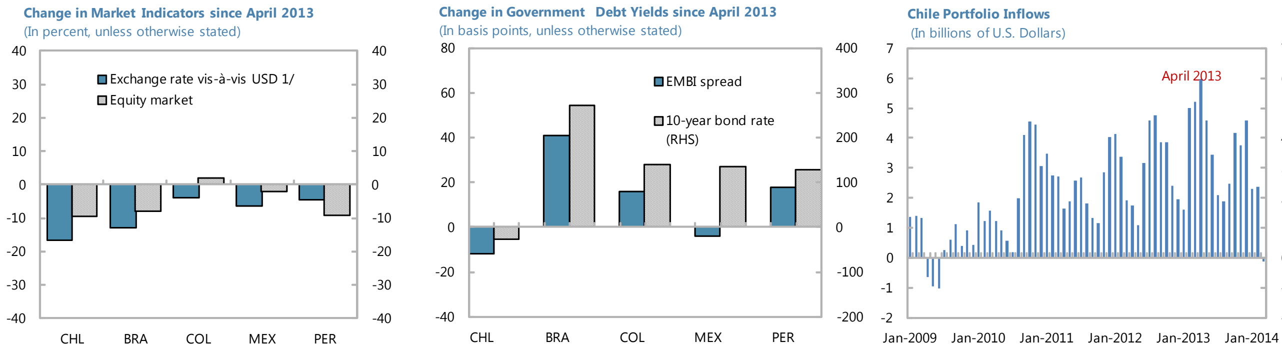
Sources: World Economic Outlook (WEO) and Fund staff estimates.

[1] For an analysis of Chile's recent growth performance, see *A Tale of Two Recoveries: The Post-Crisis Experience of Brazil and Chile*, by D. Rodriguez-Delgado, Selected Issues Paper, 2013.

[2] See *Why is Foreign Ownership of Locally Issued Bonds So Low in Chile?*, by Y. Wu, Selected Issues Paper.

Financial Market Indicators During the Recent Turmoil

In line with its strong fundamentals, during recent episodes of financial volatility, Chile experienced a mild impact and a fast recovery.



Sources: Central Bank of Chile, Bloomberg and Fund staff estimates.
1/ Negative means local currency depreciation.

4. **Activity has slowed markedly (Figure 3)**. The growth moderation that started in 2012 became more pronounced in 2013 as private investment ground to a halt late in the year. The anticipated completion of large projects launched in previous years coincided with postponement of new projects. The first quarter of 2014 saw some recovery in activity and private investment, but durable goods consumption contracted on the back of a softer, if still quite tight, labor market. Net exports are providing an important offset. Although the slowdown has been sharp, much of it reflects an adjustment toward trend after a period of strong growth, and staff estimates a modest negative output gap.

Recent GDP Developments

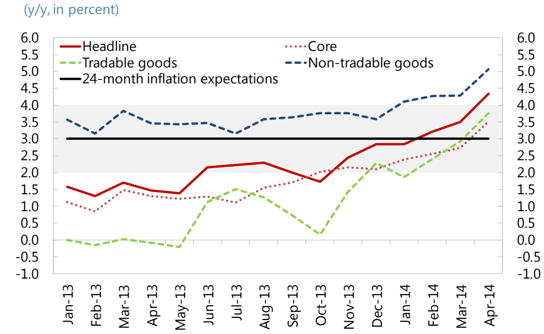
	2012 avg	2013Q1	2013Q2	2013Q3	2013Q4	2014Q1
	(qoq sa annualized rate; in percent)					
GDP	5.2	5.4	-0.5	6.1	-0.4	3.0
Private consumption	6.5	6.7	4.7	2.6	5.8	1.8
of which: Durable	13.3	18.4	6.1	6.8	15.1	-12.5
Gross fixed capital formation	14.2	-11.4	8.7	-0.6	-36.1	16.3
Exports	6.4	-9.5	16.2	-1.5	-4.9	12.7
Imports	13.1	-12.3	9.0	-14.9	-1.1	-5.2
Memo items:	(yoy; in percent)					
GDP	5.4	4.9	3.8	5.0	2.7	2.6
Gross fixed capital formation	12.1	8.2	10.2	-1.5	-12.3	-5.0

Sources: Haver and Fund staff calculations.

5. **The central bank has eased monetary policy.** In October 2013, with inflation below target and a weakening economic outlook, the central bank bucked the tightening trend among emerging markets and cut the policy rate from 5 to 4 percent by April 2014 (Figure 4). The cuts transmitted quickly to interbank and lending rates, and added to peso depreciation. Nonetheless, credit growth has moderated for all types of credit, except for mortgages, which remain brisk.

6. **Inflation has picked up.** The pass through from peso depreciation to consumer prices has been surprisingly swift. Inflation was 4.3 percent (y/y) in April, up from 1.7 percent in October 2013. More worrisome, although the largest spike was in tradable goods inflation, as would be expected, non-tradable and core inflation measures have also risen. Still, inflation expectations remain anchored at 3 percent over the two-year policy horizon.

Despite a Rise in Inflation, Expectations Remained Anchored
(y/y, in percent)



Sources: Central Bank of Chile and Haver.

7. Fiscal policy has stayed broadly neutral (Figure 5). The structural deficit in 2013 was 0.8 percent of GDP (staff estimate), roughly unchanged from 2012 net of a one-off capital gains tax windfall (equal to 0.4 percent of GDP). The fiscal stance, measured by staff as the change in the non-mining primary structural balance, was broadly neutral. The fall in copper revenue shifted the headline balance to a deficit of 0.6 percent of GDP from a surplus of equal size in 2012, but central government net assets remained at 6.7 percent of GDP helped by valuation gains.

8. External imbalances have declined. Real depreciation and weaker domestic demand kept the current account deficit at 3.4 percent of GDP in 2013 (a year ago, staff had projected a widening to 4.7 percent of GDP) and shrunk it in the first quarter of 2014 to 3.1 percent of GDP (annual basis). Foreign direct investment has declined but remains the main source of financing, albeit with a growing debt component. According to the Fund's EBA estimates, the peso is in line with fundamentals, and this view is supported by a broader set of indicators—brisk (copper and non-copper) export volume growth, adequate reserves, and strong international investment position (Figure 6). That said, external debt has increased and gross external financing needs, though smaller than in 2013, remain sizeable at 17 percent of GDP, roughly half of which is non-bank corporate debt.

Peso Overvaluation

Methodology	April 2013	April 2014
EBA/CA	4%	2%
EBA/REER	2%	1%
EBA/ES		1%
Current account 1/	-3.5%	-3.4%

Sources: Central Bank of Chile and Fund staff estimates.

1/ Unadjusted current account deficit for the previous year.

9. Financial stability risks are contained. Bank capitalization appears adequate, profitability remains comfortable, and nonperforming loans are low and fully provisioned. Domestic deposits are the main funding source, and reliance on foreign financing (excluding capital) is low, at 8.5 percent of total liabilities. In the important life insurance sector, profitability appears healthy, with returns on equity above the OECD median. Chilean insurance companies conservatively tend to accumulate more capital than required by regulations and solvency requirements are being strengthened. In recent years, the sector has expanded into lower-liquidity, higher-risk investments (e.g., real estate). As for corporates in the context of easy global financial conditions, firms have increased their indebtedness to about 92 percent of GDP, surpassing pre-crisis levels, though most of the increase reflects FDI-related debt with likely less roll-over risk (Annex III).

Financial Soundness Indicators

(In percent)

	2009	2010	2011	2012	2013
Regulatory capital to risk-weighted assets 1/	14.3	14.1	13.9	13.3	13.0
Of which, large banks	13.3	13.5	13.6	12.9	...
mid-sized banks	13.9	13.5	13.0	11.9	...
retail banks	18.3	18.3	17.6	16.1	...
Reg. tier 1 capital to risk-weighted assets 1/	10.9	10.1	10.1	10.0	9.7
Regulatory capital to total assets 1/	10.4	10.9	10.7	10.5	10.5
Non-performing loans to total gross loans	2.9	2.7	2.3	2.2	2.1
NPLs net of provisions to capital	4.7	1.7	0.2	-0.6	-1.6
Return on assets	1.5	1.7	1.6	1.4	1.5
Return on equity	21.4	20.7	20.8	17.3	18.4
Liquid assets to total assets	9.8	10.1	15.2	13.3	13.2
Foreign financing/bank total liabilities	8.7	9.0	10.3	8.7	9.8

Sources: Financial Soundness Indicators (IMF) and Fund staff calculations.

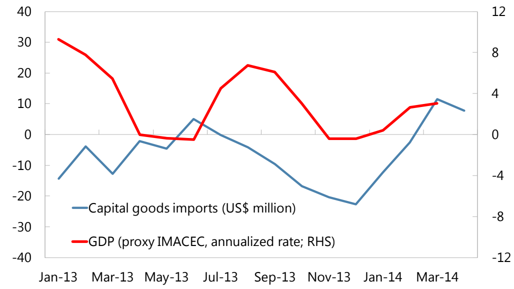
1/ Value for 2013 corresponds to November.

10. Real estate remains dynamic. Real mortgage credit expanded by 9 percent (y/y) in April, and house prices, following some deceleration, are rising again though with large regional variation (Figure 8). However, household indebtedness (mostly bank-financed) has remained broadly stable at about 55 percent of disposable income. Commercial real estate data are spottier, but an apparent oversupply of office space poses some risk to life insurers.

OUTLOOK AND RISKS

11. In staff's baseline scenario, growth bottoms out in 2014 and then gradually recovers. In line with recent data prints, the driving forces behind this scenario are a continued gradual turn-around in private fixed investment, including in mining, and strong net exports, both underpinned by the monetary easing, real depreciation, and the recovering global economy (Box 1). Activity will gather strength in 2015, with growth reaching 4¼ percent (staff's estimate of long-run potential) in 2016. But there is a clear risk that the recovery could be underpowered and bumpy, held back by sluggish private consumption, near-term policy uncertainty, and international shocks. Inflation will decline to 3 percent over the next 12–18 months as the temporary effects from the peso depreciation wears off.

Activity Has Started to Strengthen at the Margin
(qoq s.a. growth; in percent)



Sources: Central Bank of Chile and Fund staff calculations.

12. Two risks dominate the outlook (Annex IV).

- ***Copper prices.*** Copper represents over half of Chile's exports, equaling 15 percent of GDP. A further sharp and sustained decline in copper prices—triggered, for example, by a drop in demand from China (which consumes about 40 percent of world copper)—would hurt investment, crimp growth, and require another round of substantial real depreciation. Previous staff analysis suggested that a 10 percent fall in copper prices reduces Chile's GDP by 0.8 percent over eight quarters.

External Conditions
(Average; percent change; unless otherwise indicated)

	2009-13	Projection 2014-19
Copper price (US$ per lb)	3.34	3.06
6-month LIBOR (in percent)	0.65	2.26
Real GDP of trade partners	3.5	3.7
China real GDP	9.2	7.1
US real GDP	0.8	2.7
Terms of Trade	5.0	-0.6

Source: World Economic Outlook (WEO) database.

- ***Global financial volatility.*** Financial spillovers to Chile from tapering and emerging market turmoil have been muted. And as shown in the *Spring 2014 World Economic Outlook*, Chile is less vulnerable to capital flow volatility than most other emerging markets thanks to its robust macroeconomic framework and deep local capital market (including large pension funds). Still, Chile's large and internationally integrated financial system, the significant real-financial linkages, the increased corporate leverage, and the sizeable gross external financing need expose Chile to sudden stop risk.

13. The authorities are in the process of reassessing their macroeconomic forecasts but broadly agreed with staff on the outlook and risks. On external risks, they saw a disorderly slowdown in China as most important, especially if associated with further postponement of copper-related investment projects. On financial spillover risks, they no longer see tapering as an immediate risk, as the earlier uncertainty has been resolved, but will remain vigilant of any major deviations from announced plans. Medium-term growth prospects and potential growth should improve with implementation of structural reforms.

POLICY IMPLICATIONS

Given the structural character of the growth slowdown and the modest-sized output gap, structural reform rather than demand-side policies should have the primary role in strengthening prospects for strong and inclusive growth. Continued efforts to reinforce financial stability will also be important.

A. Policy mix

14. Monetary policy should remain vigilant to the inflation outlook. The present accommodative stance is consistent with keeping inflation in check over the policy horizon and supporting the baseline's recovery. However, the recent broad-based spurt in inflation calls for caution and for interest rates to be left on hold absent a further weakening in domestic demand. Monetary policy normalization should proceed as the economy reverts toward potential.

15. A broadly neutral fiscal stance would be appropriate. It would be consistent with full execution of the 2014 budget (approved last year with a structural deficit of 1 percent of GDP) and would allow for a robust increase in expenditure, investment in particular, after under-execution in 2013. At the same time, the headline deficit will double to 1.2 percent of GDP and central government net assets will decline by about 1 percentage point. The government's target of a balanced structural position by 2018 is welcome and should be feasible as activity recovers, though the consolidation should be calibrated to avoid an unduly contractionary stance. The strong public finances allow for automatic stabilizers to operate fully.

16. There is room to react if risks materialize. The floating exchange rate should be the first line of defense, in particular in case of a further sharp and lasting fall in copper prices and capital flow reversals. Foreign exchange intervention could help avoid excessive currency volatility, if needed. If domestic demand falters, further monetary easing could be appropriate though room has shrunk. Fiscal support—beyond automatic stabilizers—could be considered if there is a large decline in activity. In the event of a capital flow reversal, the authorities should also be prepared to contain liquidity pressures, including through expanding repo operations, broadening the range of accepted collateral, and setting up dollar swap auctions.

17. The authorities broadly agreed. The central bank stressed that monetary policy will continue to focus on inflation. The pick-up in inflation had been stronger than expected but the central bank was confident that this increase was temporary, as suggested also by market expectations, and that inflation would revert toward 3 percent during 2015. Still, the rapid rise in inflation was a concern. Fiscal policy will be cast around a target of a structural balanced position by 2018. The government is considering revisions to the 2014 budget that would likely include additional outlays relating to costs of the recent earthquake in the north and widespread fires in Valparaiso. They also noted that the macroeconomic assumptions on which the 2014 budget was based have turned out to be too optimistic and, therefore, a somewhat larger headline deficit could be expected this year. The government is committed to bring the structural budget to a balanced position by 2018 using receipts from tax reform.

B. Fostering strong and inclusive growth

18. Chile faces two important medium-term challenges: fostering strong and sustained growth and reducing inequality.

- ***Growth***. Rapid growth over the past decade was led by investment and employment expansion, while total factor productivity increased a paltry 0.4 percent a year (and was particularly lackluster in the copper sector). The shifting tailwinds raise doubts about the mining sector as a driver for future growth—even if some recovery is projected—and the scope for employment expansion is constrained by low unemployment and the decelerating working-age population (from 1.6 percent in 2013 to 1.1 percent by 2019).The floating exchange rate and the flexible labor market will be key in facilitating the needed economic adjustment. But fostering strong and sustained growth will also require structural reforms.

Contribution of Factors of Production to Output Growth
(Average annual percentage contribution)

	1990-1999	2000-2013
Output	6.6	4.3
Capital Stock	2.2	2.1
Total Hours	0.8	1.3
Human Capital	0.9	0.5
TFP	2.6	0.4

Sources: Central Bank of Chile, Ministry of Finance, and Fund staff estimates.

Alternative Scenarios for Medium-Term Growth
(Average annual percentange change)

	2014-2019
Baseline	4.1
Continuation of TFP trend growth of 2000-2013	3.4
Female labor force participation growing 1 percent more than in baseline	4.6

Sources: Central Bank of Chile, Ministry of Finance, and Fund staff estimates.

- ***Equity***. Inequality has declined but it remains high compared with the region and OECD countries. Chile's inequality is reflected also in low intergenerational social mobility, which is largely caused by unequal access to quality education. Social public spending has risen significantly over the last two decades, especially on health and education, but still lags regional and OECD averages. The Chilean tax-transfer system is characterized by low progressivity and has been less effective in reducing poverty and income inequality compared with the experience in OECD.[3]

Socioeconomic Indicators Relative to Comparators

	Chile			Other LA6 /1 /2	OECD /2 /3
	1990	2000	2012 or latest	2012 or latest	
GDP per capita PPP (in 2005 $US)	6,914	10,990	15,848	11,145	31,248
Poverty (percent of population living below $4 PPP/day)	41.6	23.3	11.9	28.0	-
Extreme poverty (percent of population living below $2.5 PPP/day)	21.2	9.0	4.3	14.0	-
Gini Index (in percent)	57.1	55.2	50.8	48.5	31.3
Skill premium (ratio of wages: tertiary/secondary education)	2.8	3.1	2.7	2.3	1.6
Gender wage gap (in percent)	36	36	19	17	-
Female labor force participation rate (ages 15-64; in percent)	35	39	55	62	62
Public Social Expenditure (in percent of GDP)	11.9	15.0	16.7	17.2	-
Public Expenditure on Education (in percent of GDP)	2.4	3.7	4.2	4.6	5.8

Sources: World Bank World Development Indicators, PovcalNet Database, OECD, Socioeconomic Database of Latin America and the Caribbean (CEDLAS), Economic Commission for Latin America and the Caribbean (CEPAL) and Fund staff calculations.

1/ Brazil, Colombia, Mexico, Peru, Uruguay

2/ Simple averages

3/ Values not shown if incomparable. See *Chile's Experience with Inclusive Growth* , Selected Issues Paper, for alternative comparisons with the OECD.

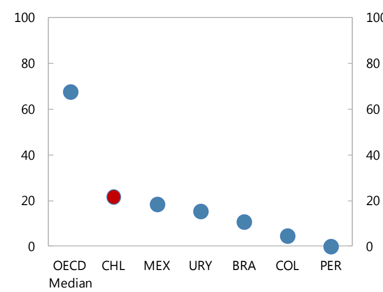
[3] See *Chile's Experience with Inclusive Growth*, by E. Ture, Selected Issues Paper.

19. The government is launching an ambitious policy agenda that could galvanize strong and inclusive growth, while preserving Chile's record of prudent macroeconomic policy. The plans, most of which are under development, focus on the following areas:

- ***Education and tax reforms.*** The government has proposed a major tax reform to reduce regressivity and raise 3 percent of GDP by 2018 in revenue to fund education reform, increase outlays on health, and raise public savings (see Box 2). The mission supported these objectives. The proposal prudently matches new spending with permanent revenue.

  - *Education***.** Chile's PISA score improved over the past decade and is the highest in the region but still well below OECD averages. In Chile, student performance is also highly dependent on the student's socio-economic background. Thus, improving education will help on both growth and equity fronts. Chile's public spending on education is low by international standards and has limited scope for efficiency gains, so improvements would require more resources.[4] The government's immediate reform priorities include expanding the coverage of daycare, increasing education subsidies for low and middle-income students, and overhauling the schools' selection process to foster equal access to education (text table). The mission supported the general direction of the reform and underlined the importance of leveling the playing field and raising quality of early-childhood education.[5]

In education, Chile ranks the highest within the region, but well below OECD countries.
(PISA Learning Outcomes; percentile ranks; higher is better)



Source: OECD PISA (2012) and Fund staff calculations.
Sample includes 69 countries.

Elements of the Education Reform Agenda

Element	Status
Early education	
Expand coverage of childcare	Sent to Congress on May 20 2014
Modernize preschool institutional framework and establish Preschool Deputy Ministry	Sent to Congress on May 20 2014
Primary and secondary education	
Exclude from receiving public funding (e.g. vouchers) profit seeking schools.	Sent to Congress on May 20 2014
Eliminate copayments by increasing public subsidy	Sent to Congress on May 20 2014
Eliminate any form of student admission selection at the school level.	Sent to Congress on May 20 2014
Replace municipal school management with a national administration with local branches.	To be sent during 2014H2
Revamp teachers' education and training	To be sent during 2014H2
Tertiary education	
Gradually achieve free access to tertiary education. 4-year target: 70% of the population	To be sent during 2014H2
Establish Superintendence of Tertiary Education to modernize institutional framework	To be sent within first 100 days (by June 19, 2014)

Source: National authorities

[4] See *A Hybrid Approach to Estimating the Efficiency of Public Spending on Education in Emerging and Developing Economies,* by F. Grigoli, IMF Working Paper No. 14/19, January 2014.

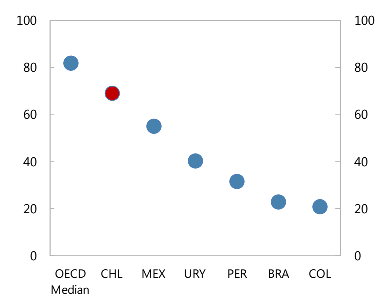
[5] See, e.g., *Starting Strong III: Early Childhood Education and Care*, OECD 2012.

- *Tax reform (Box 2)*. The reform involves several changes to Chile's integrated tax regime.[6] The current system of tax deferral for undistributed earnings (in place since 1984) has become a source of significant tax planning and evasion—mainly benefitting those with higher incomes—and challenging to administer. The tax reform (expected to be approved in September 2014) is tilted toward taxing the upper-income brackets, including through its focus on capital income and closing loopholes, and should reduce the regressivity of the current tax system. Given the size and complexity of the reform there is some uncertainty over its expected revenue yield and economic impact. Further, there is not much international experience to draw on for the proposed new profit/dividend tax regime but higher taxation of corporate profits and capital income would likely dampen investment and, in particular, corporate savings, while instant depreciation and higher public savings would provide some offset. Strengthening the tax authority will help support the expected revenue yield; and the planned gradual implementation is welcome and would allow fine-tuning if needed.

- ***Energy (Box 3).*** While demand for electricity has risen steadily (and will continue to rise), investment in the sector, including in generation, has stalled. Energy reform is a top concern for the business sector and a priority for the government. The mission commended the government's plan to promote energy investment and efficiency, and to facilitate entry and the use of new, clean technologies.

- ***Infrastructure.*** Chile ranks well in international comparisons but with scope for improvement. The mission welcomed the government's focus on transportation and logistical hubs (including, importantly, ports) and water and telecommunication infrastructure. Frontloading infrastructure investment could also boost investment and growth in the near term.

Infrastructure quality is high in Chile by regional standards, but lags behind the OECD countries.
(Percentile ranks; higher is better)



Source: World Economic Forum Global Competitiveness Report (2013-2014) and Fund staff calculations. Sample includes 148 countries.

- ***Labor market.*** The government is considering a number of labor market reforms. The mission encouraged in particular reforms to promote female labor force participation (e.g., training and improved access to daycare), which, despite important progress over the last decade lags OECD and regional averages and is particularly low for lower-income groups. As for the minimum wage, which is quite binding in Chile, the government's commitment implies an increase by about 20 percent over three years at the time of a weaker labor market. The mission stressed the importance of maintaining a labor market that allows for sufficient flexibility while fostering equity.

[6] See *Chile's Tax System and Reform*, by D. Rodriguez-Delgado, Selected Issues Paper.

- ***Business climate.*** In World Economic Forum and World Bank Doing Business rankings, Chile scores high in the region in most categories, and compares well with OECD peers. The "business-in-a-day" reform approved in 2013 pushed Chile up in business environment rankings. And the Bankruptcy Law approved in early 2014 addressed one area where Chile lagged the most. The authorities' plans to promote research and development, job training, small and medium-enterprise management, and competition should help spur innovation, growth, and economic diversification.

Selected Indicators of Competitiveness
(percentile rank; higher means better score)

	Chile	OECD 1/	Other LA6 1/
Global Competitiveness (WEF)	77	82	56
Overall Labor Market Flexibility	56	52	31
Flexibility of wage determination	87	41	34
Hiring and firing practices	50	39	20
Redundancy costs, weeks of salary	19	63	45
Innovation	71	83	47
Innovation capacity	57	82	48
Quality of scientific research inst.	68	85	48
Company spending on R&D	61	79	50
Goods Market Competition	76	72	33
Ease of Doing Business (WB)	82	85	64
Starting a Business	88	68	62
Dealing with Construction permits	47	67	51
Resolving Insolvency	46	86	63

Sources: World Economic Forum (WEF), Global Competitiveness Rankings 2013-2014, World Bank Doing Business 2014 and Fund staff calculations.
1/ Mean. LA6 includes Brazil, Chile, Colombia, Mexico, Peru and Uruguay

20. The authorities emphasized that the reform agenda is designed to provide a strong boost to medium-term growth and achieve a fairer distribution of income, which is important for social stability. The tax reform will bring needed fresh fiscal resources that will be used prudently on education and health and on increasing public savings. Improving access to high quality education will strengthen long-term growth prospects but also attack a root cause of inequality. And the planned agendas for energy reform and productivity, innovation and growth will address the main concerns of Chilean industry. All in all, the authorities were convinced that the implementation of their bold reform program should have an important positive impact on medium-term growth prospects and potential output.

C. Reinforcing financial stability

21. Chile's financial system is large, with significant links to the local economy, the region, and the rest of the world. Financial system assets exceed 200 percent of GDP. Chilean banks (and corporations) are net borrowers in world markets. Subsidiaries of foreign banks account for a large share of bank assets. Foreign participation is also significant in the insurance and pension fund sectors. Moreover, in recent years, domestic banks have expanded their operations outside of Chile. Further, bank credit equals 77 percent of GDP, so bank linkages to the real economy are large. Thus, the system is exposed to regional and international developments and has extensive linkages to the real economy. So far, the tapering effects have been mild and financial system risks remain contained.[7]

Financial System Structure (2012)
(assets as a share of system total and GDP; in percent)

	Share of total	Share of GDP
Banks	52.4	107.7
Pension fund administrators 1/	28.9	59.4
Insurance companies	10.0	20.5
Property and casualty	1.1	2.3
Life	8.9	18.2
Other fund administrators 1/ 2/	8.7	17.8
Total	100	205.4

Source: Superintendence of Banks and Financial Institutions, Superintendence of Insurance and Securities, Superintendence of Pensions, and Fund staff calculations.
1/ Assets under management.
2/ Includes mutual funds, investment funds, investment funds for foreign capital.

[7] See *Systematic Risk Assessment and Mitigation in Chile*, by N. Arregui, Selected Issues Paper, 2013.

22. Chile has made considerable progress in enhancing oversight, but further efforts would strengthen the resilience of the system. Much of the progress has built on the 2011 FSAP (Annex V). But important parts of the agenda remain unfinished. The mission encouraged the new authorities to push forward with reforms to buttress the resilience of the bank and nonbank system.

Financial Sector Reforms in Progress

1. Legal reforms currently in Congress
Risk-based insurance supervision
Comprehensive credit registry
Stronger governance and independence for the Securities and Insurance Superintendence (SVS)
New legal framework for the Financial Stability Council, improving coordination and data sharing
2. Regulatory changes currently under public consultation
Standardized bank mortgage credit provisioning model linked to LTV levels
Enhanced liquidity regulation and reporting, in line with Basel III

Source: National authorities.

23. Banking sector soundness is being reinforced. While bank soundness indicators do not point to immediate risks, real estate, funding, and corporate leverage developments merit watching.

- ***Real estate exposure.*** Mortgage loans represent about one-quarter of banks' loan portfolio and the share of mortgages with elevated (80 percent or higher) loan-to-value (LTV) ratios has stabilized at a relatively high 60 percent. Prompt implementation of regulation underway linking mortgage credit provisioning to LTV levels would be important, and further action (hard limits on LTVs and debt-to-income ratios) might need to be considered. The mission also encouraged the authorities to address real estate data gaps, in particular for commercial real estate.

- ***Bank funding.*** The banking system's loan-to-deposits ratio—an often-used measure of liquidity risk—is high by international comparisons.[8] The main reason is its heavier reliance on institutional deposits and, on the asset side, its higher share of loans. The Basel III Net Stable Funding Ratio (NSFR) is a broader measure and the 2011 FSAP Update found Chilean banks well-positioned to meet the NSFR**.** The mission welcomed the work of the Superintendence of Banks and Financial Institutions (SBIF) and the Central Bank to enhance liquidity regulation and reporting, taking into consideration recent proposals of the Basel Committee on Banking Supervision.

- ***Corporate exposure.*** In recent years, corporate debt has risen (as a share of GDP), and profits and liquidity ratios have worsened from pre-crisis levels, especially in the construction and retail trade sectors that also have a large share in bank commercial debt. Corporate loans represent roughly half of banks' portfolios, so banks' exposure is significant. That said, local and global appetite for Chilean corporate debt remains strong, firms' currency mismatches appear limited, and other indicators of corporate debt vulnerabilities do not point to acute risks (see Annex III). Central bank stress-tests find the banking sector solvent even under extreme scenarios.[9]

[8] See *Chilean Banks' Loan-to-Deposits Ratio,* by N. Arregui, Selected Issues Paper.

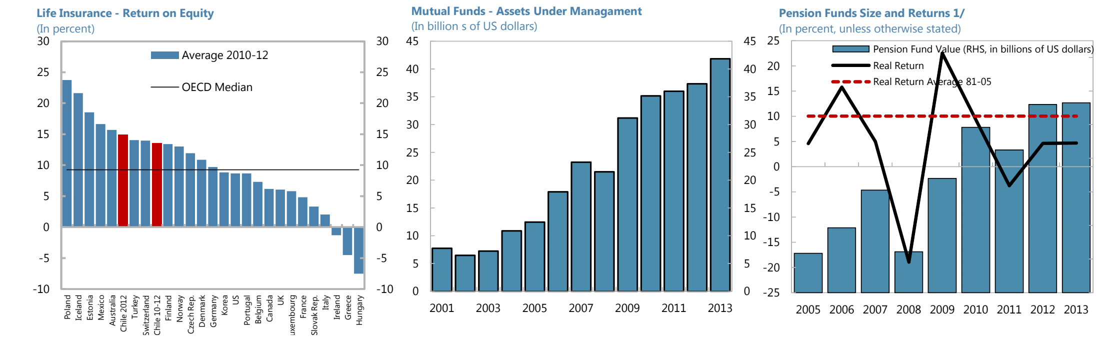
[9] In a test involving a 6 percentage point output drop relative to baseline and subdued growth over the medium term, a 300 basis points rise in interest rates in the short term and 100 basis points in the long term, and 20 percent peso depreciation, all banks maintain regulatory capital to risk-weighted assets above 8 percent.

Non-Bank Financial Institutions

Profitability in Chile's important life insurance sector is healthy. The sector has grown to 18 percent of GDP ...

...while mutual funds have doubled their size in the last 5 years, reaching 14 percent of GDP in 2012.

With assets of almost 60 percent of GDP, pension funds are the largest non-bank financial institutions.



Sources: Superintendence of Banks and Financial Institutions, Superintendence of Insurance and Securities, Superintendence of Pensions, OECD and the Chile's Mutual Funds Association. 1/ Returns are showed for Pension Funds type C, out of pension funds type A to E (ranked from more to less risk appetite).

24. The soundness of the non-bank system is also being strengthened further.

- ***Insurance companies***.[10] The important life insurance sector (with assets equal to 20 percent of GDP) is expected to expand as the number of retirees increase. Longevity risk is being mitigated by regular review of mortality tables to reflect future life expectancy improvements, as recommended in the 2004 FSAP. As for credit risk, a longer average maturity for assets than for liabilities exposes life insurers to a decrease in interest rates. Life insurers' growing direct exposure to commercial real estate merits watching, though stress tests undertaken by the Securities and Insurance Supervisor (SVS) find no significant concerns. Exposures to domestic corporate bonds (almost one-third of life insurers' investments) also merit continued monitoring. The mission encouraged speedy approval of the law now in Congress that would introduce a risk-based supervisory system, including changes in solvency requirements.

- ***Fund management industry***. Chile's fund industry is led by the rapidly expanding mutual fund sector, which is large relative to other emerging markets. Its assets (14 percent of GDP) are primarily in fixed income securities, and about half in money market funds (fixed income with maturity of 90 days or less). The 2013 law *Ley Unica de Fondos* which became effective on May 1, 2014, puts the industry under a unified legal framework, modernizes the regulatory framework, and improves investor protection by enhancing the supervisory powers of the SVS and setting qualification requirements for fund managers.

- ***Pension funds***. Chile's privately-administered pension system is large by international standards. The government has appointed a commission to propose parametric changes to ensure adequate replacement rates in the face of declining investment returns and rising life expectancy. The government also plans to create a publicly-managed pension fund to complement the six privately-managed funds. In response to concern from the mission on

[10] See *Chile's Insurance Sector*, by N. Arregui, Selected Issues Paper.

how this might affect the industry, the authorities stressed that the new fund manager would operate under the same legal and regulatory framework as the others and that it would focus on enrolling workers not currently picked up by private funds (e.g. self-employed, rural).

25. Multiple agencies provide close and active financial oversight but the framework and governance could be strengthened. The financial industry is regulated by the Central Bank, and supervised by SBIF, SVS, and the Superintendence of Pensions. The Financial Stability Council, chaired by the Minister of Finance, facilitates coordination and data sharing. Two laws currently in Congress, which will provide a legal framework to the Financial Stability Council and strengthen the operational independence of SVS, should be implemented promptly once approved. But it will also be important to strengthen the independence of the banking supervisor (SBIF).

26. Conglomerates pose a challenge for supervision and a consolidated approach would be more effective. Most financial institutions in Chile are part of conglomerates, which tend to be large, complex, and prone to regulatory arbitrage and intra-group contagion. Chile's financial oversight structure relies on a silo approach, based on sectoral supervision and built-in firewalls (such as related-party exposure limits). The authorities have strengthened oversight of conglomerates within the current legal framework, including by advancing risk identification based on case studies, tightening related-party exposure limits for banks, and improving the coordination and information exchange mechanisms among supervisors. When approved, the Financial Stability Council law will remove data sharing constraints among supervisory bodies that have hampered effective supervision. While these advances are important, a more comprehensive approach (as suggested by the 2011 FSAP) would be more effective. This would require a clear allocation of powers and responsibilities for continuous consolidated supervision, prudential regulation at conglomerate level, and corrective actions to address compliance with the framework.

27. Implementation of other initiatives would strengthen financial resilience further. The mission encouraged prompt congressional approval of legislation expanding the credit registry with comprehensive credit history from banks and nonbanks. Furthermore, the revision of the General Banking Law mentioned in last year's staff report remains unfinished, and the mission recommended that the authorities give it a new push, focusing on incorporating Basel III capital standards, improving the legal framework for bank resolution, and strengthening the SBIF's independence.

28. The authorities explained that they are committed to push ahead with financial sector reforms. They are committed to ensuring prompt approval of the legislative initiatives already in Congress. They are also committed to pushing forward with other financial sector reforms, including revising the General Banking Law to complete the adoption of Basel bank capital standards, strengthen SBIF's independence, and modernize the banking resolution, though the timing of these reforms would require careful consideration given the broader policy agenda. In the shorter run, the Central Bank has already put in consultation the new proposed regulation for the sound management of banks' liquidity risk.

D. Enhancing the fiscal framework

29. There is scope to refine Chile's fiscal framework. Chile has a well-earned track record of prudent fiscal policy, formalized, since 2001, in a fiscal rule that has become a model for other countries. The rule was strengthened with the creation in 2013 (by ministerial decree) of a Fiscal Council to oversee its implementation. Though there is no urgent need for changes to the framework, the mission suggested consideration of some modifications.

- ***The rule/target.*** The rule is simple and understood by the public and markets, and has shielded the budget from the business cycle and changes in copper prices, while allowing for a flexible response when warranted. The structural target is set by each administration for its four-year term and can be changed mid-stream. To provide more predictability and a stronger anchor for fiscal policy, especially after deviations, clearer guidance on medium-term objectives (e.g., structural balance or net assets) could be embedded in the rule itself. When the rule was created the authorities set a structural surplus target of 1 percent of GDP. While circumstances are now different (e.g., the government net asset position) and this target may not be appropriate, a small structural surplus for "steady state" would help preserve the government net asset position. Further, an explicit escape clause to allow discretionary policy in the event of large, clearly defined shocks would enhance clarity while preserving flexibility.

- ***The Council.*** A law now in Congress will give the Council a stronger legal basis and will hopefully be approved soon. The authorities could also consider strengthening the Council's autonomy and broadening its mandate (e.g., to include assessing outturns against targets).

30. The authorities appreciated the recommendations but did not see, given the already heavy agenda, revisions to the fiscal framework or the Council's mandate as immediate priorities. They also noted that the appropriate medium-run fiscal target is a topic that will need further consideration and public discussion.

STAFF APPRAISAL

31. Chile is confronting a challenging macroeconomic environment. Activity has slowed markedly, mostly reflecting an adjustment toward trend after a period of rapid growth. There are signs of a budding recovery but it is subject to considerable uncertainty and risk. And looking ahead, Chile's growth prospects are affected by waning, even reversing, tailwinds to growth as global monetary policy begins to normalize and the copper price boom peters out. Chile also faces the headwind of a slowing working-age population.

32. Strengthening the prospects for strong and inclusive growth will require structural reforms. Chile is ahead of the curve in terms of building strong and credible policy institutions, flexible markets, and achieving macroeconomic stability. There is no single bottleneck to growth that stands out. Rather a comprehensive reform effort will be needed to rekindle productivity, spur investment, and boost human capital.

33. The government's reform focuses on the right areas. The tax reform stands to achieve a welcome reduction in regressivity, close loopholes, and raise permanent revenue to fund education reform and additional health spending, and raise public savings. While the tax reform would likely dampen investment and, in particular, corporate savings, other key elements of the reform agenda could boost medium and long-run growth prospects. In particular, a well-designed education reform that focuses on improving access and quality at all levels of schooling, especially at younger ages, would be a win-win for growth and equity. Likewise with reforms that boost female labor force participation. Labor market reforms should make sure the market remains flexible to support a dynamic economy and the needed adjustments, while fostering equity. Reforms to upgrade key infrastructure and spur innovation would help boost productivity growth and investment. Greater clarity on details, timetables, and priorities—followed by rigorous implementation—will be critical to reduce uncertainty and risk of delays.

34. The current macroeconomic policy mix is broadly appropriate. The freely floating exchange rate is acting as a shock absorber, facilitating adjustment, and supporting the recovery. Monetary policy can remain accommodative so long as inflation expectations remain anchored. Fiscal policy should remain broadly neutral and with full operation of automatic stabilizers. The authorities' commitment to achieve a balanced structural fiscal position by 2018 is appropriate—and the path should calibrated to avoid excessive drag that could scupper the recovery—and the resulting increase in public savings is welcome.

35. Enhancing the fiscal framework would help preserve fiscal space. Providing clearer guidance on medium-term fiscal objectives in the framework itself would provide a stronger anchor for fiscal policy, especially after deviations. A small structural surplus target over the cycle would help preserve strong fiscal buffers. An escape clause for discretionary policy in the event of shocks could enhance clarity further while preserving flexibility. The authorities' plan to put the Fiscal Council on a more solid legal basis is an important step, but strengthened autonomy and a broader mandate would improve its effectiveness.

36. Chile should build on the progress achieved in recent years in enhancing financial oversight. Chile has made significant progress, building on the 2011 FSAP, but important parts of the agenda remain unfinished. It will be important to complete the initiatives now in Congress relating to risk-based insurance supervision, a comprehensive credit registry, stronger governance and independence of the Securities and Insurance Supervisor, and a new legal framework to the Financial Stability Council. It will also be important to follow up with reforms to align capital standards with Basel III, and provide greater independence to the Supervisor of Banks and Financial Institutions. As the economy is adjusting, corporate sector financial health and leverage, as well as the developments in the still dynamic real-estate sector should be monitored closely. Finally, given their dominant role in the financial system, the ongoing strengthening of supervision of financial conglomerates is important and welcome. Building on the progress achieved, consideration should be given to a more consolidated approach to oversight of conglomerates.

37. Staff proposes to hold the next Article IV consultation on the standard 12-month cycle.

Box 1. Spillover Transmission Channels and Effects

Chile is a highly open economy. Its trade and financial openness indicators are the highest in the region. Chile is also highly dependent on commodities exports (see Figure 9).

Openness Scores
(In percent of GDP)

In Percent of GDP	Chile	Regional Average 1/
Trade Openness (exports+imports)	69.5	46.0
Trade Exposure to US (exports)	11.1	11.3
Financial Openness (international assets + liabilities)	226.5	131.4
Exposure to Capital Flows (st. dev. of nonofficial flows)	3.0	3.0
Commodity Concentration (net commodity exports)	14.4	9.1

Source: *Spring 2014 World Economic Outlook.*

1/ Average includes Argentina, Brazil, Chile, Colombia, Mexico, and Venezuela

Interest rates and commodity prices are key transmission channels for shocks. Recent IMF work in the *Western Hemisphere Department Regional Economic Outlook* and *World Economic Outlook* highlight Chile's sensitivity to various types of shocks and are summarized in the table below.

Potential Spillover Effects

Shock	Effect on GDP growth (In percent) 1/	
	On Chile	Regional Average 2/
1 ppt increase in the U.S. federal funds rate	-0.61	-0.42
1 ppt increase in the 10-year U.S. Treasury bond yield	-0.64	-0.13
1 ppt increase in U.S. growth	1.73	2.89
1 ppt increase in the EMBI yield	-0.9	-2.41
1 standard deviation negative shock to Argentina's GDP	-0.04	
Stable net commodity price index in 2014-19	-0.8	-0.9

Source: *Spring 2014 Regional Economic Outlook Western Hemisphere and World Economic Outlook.*

1/ Effect in 8 quarters for all shocks except the commodity price index.

2/ Average includes Argentina, Brazil, Chile, Colombia, Mexico, and Venezuela, except for the impact of commodity prices, which averages Bolivia, Brazil, Chile, Colombia, Ecuador, Peru, and Uruguay.

3/ Average effect in 2014-19 relative to 2012-13 average growth rate.

Under the baseline, there is a robust medium-term impact from the U.S. growth pick-up and a more moderate impact from the increase in interest rates. For example, the recovery in U.S. growth in the second half of 2013 will have a negligible effect on Chile's growth in 2014, but a more substantial effect by end-2015 (all else equal). The increases in the effective U.S. federal funds rate, the 10-year U.S. Treasury bond yield, and Chile's EMBI yield in the second half of 2013 impart a modest moderation on Chile's growth by end 2014 and 2015.

Box 2. Tax Reform 1/

The authorities' tax reform proposal has three main objectives: (i) to raise 3 percent of GDP in revenue to finance an increase in spending on education (1.5 percent of GDP) and other social program (0.5 percent), and close the structural fiscal deficit (1 percent); (ii) to make the tax system more progressive; and (iii) to streamline savings and investment incentives and reduce tax avoidance and evasion. The reform will be implemented over four years.

Key elements are:

- Reform the taxation of dividends. A key part of the reform is to include undistributed profits in the shareholders' personal income tax base. While the current tax system—under which the progressive personal income tax on profits is deferred until distribution (as dividends)—was designed to foster savings and investment, it has also created some challenges. The monitoring and enforcement of the system requires substantial resources from the tax authority to track retained profits (in a ledger called FUT), some dating back decades. Further, the system has become prone to tax planning and evasion (activities that primarily benefit the well-off).

Tax Reform Key Measures
(in percent of GDP)

Measure	Yield 1/
Personal income taxation of undistributed profits /2	0.80
Increase in corporate tax rate	0.59
Measures to reduce evasion and avoidance	0.52
Real-estate related taxes	0.39
Diesel vehicles import tax and emission tax	0.17
Increase in stamp tax	0.15
Alcoholic and/or low nutritial value beverages tax	0.15
Other measures	0.25
Total	3.02

Source: Ministry of Finance (Dipres)
1/ Steady state level.
2/ Includes reduction of max. personal rate (-0.10% of GDP)

- Raise the flat corporate income tax rate from 20 to 25 percent and lower the top marginal personal income tax from 40 to 35 percent.
- Introduce measures to foster investment for small and medium-size enterprises. Measures include instant depreciation of investment (large companies would be eligible for 12 months); establishing a unique simplified tax regime with greater coverage; and increased tax credit for fixed-asset purchases.
- Modify real-estate related taxes and strengthen some excise and green taxes. VAT will be charged on the sale of new houses; the existing VAT credit to builders of small houses will be reduced; and capital gains from house sales will be taxed (except from seller-occupied houses). The financial transaction (stamp) tax will also be increased. As for green taxes, the reform includes an import tax on highly-polluting diesel vehicles and an emission-based tax for industrial activity.
- Strengthen the administrative capacity of the revenue authority by revamping international tax norms and auditing practices, improving access to information, and strengthening equipment and staffing.

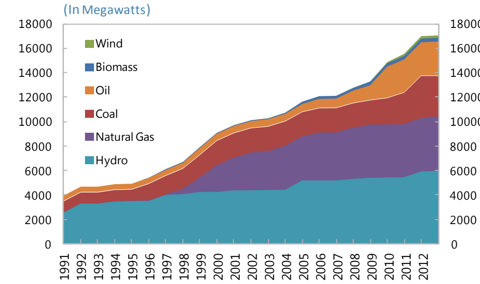
____

1/ See *Chile's Tax System and Reform*, by D. Rodriguez-Delgado, Selected Issues Paper.

Box 3. Electricity Sector in Chile

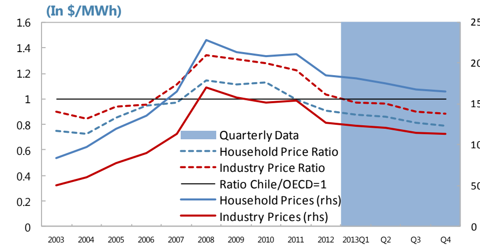
Chile imports about three-quarters of its energy needs, including for electricity generation. The Central (SIC) and Northern (SING) Interconnected Systems represent 75 and 24 percent of installed generation capacity. SIC is mostly hydropower and serves the central part of the country with over 90 percent of the population. SING is mostly thermal power, based on coal, natural gas and oil, and it serves the northern parts where the mining industry is located. Though demand for electricity has been rising steadily, several generation projects have been delayed due to environmental and administrative reasons.

Installed Capacity by Source
(In Megawatts)



Source: Ministry of Energy.

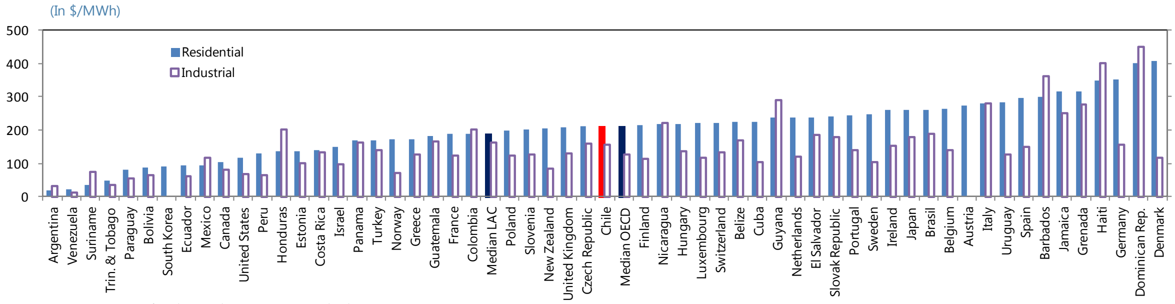
Chilean Electricity Prices Compared to Median OECD
(In $/MWh)



Source: OECD/IEA.

Average prices in Chile are not very different from the rest of the world. There can be large prices differences across sectors and regions in Chile, but the averages are broadly in line (in levels or trend) with regional and OECD averages.

Electricity Prices by Sector, 2011, Cross Country Comparison
(In $/MWh)



Sources: OECD and Latin American Energy Organisation (OLADE).

The government's energy agenda, launched in May 2014, seeks to promote investment and competition, while building consensus with local communities. The focus is on facilitating new entrants, clean technologies, and energy efficiency, and improving the interconnection of the SIC and SING grids.

Energy Reform Agenda: Targets by Numbers

Objective	Timeline
Reduce marginal electricity costs in SIC by 30 percent	2017
Reduce bid prices for electricity supply by 25 percent	2025
Reduce energy use by 20 percent	2025
Achieve 20 percent share of renewables in the energy matrix	2025

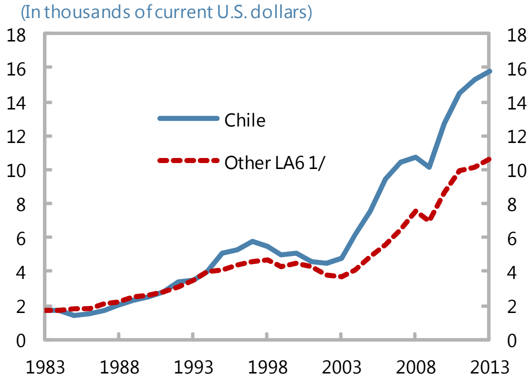
Source: National authorities.

Figure 1. Chile: Past Growth Performance and Challenges Ahead

Chile's changing external environment poses a policy challenge.

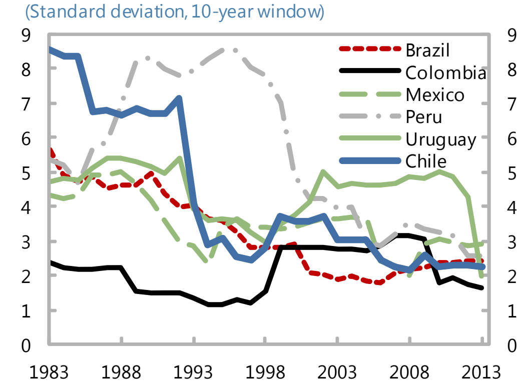
Chile has seen a substantial increase in per capita income...

GDP per Capita
(In thousands of current U.S. dollars)



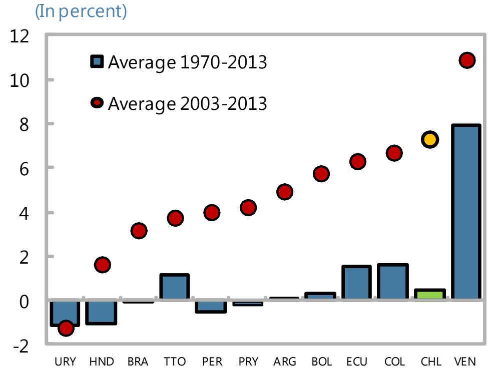
...and a reduction in macroeconomic volatility.

Real GDP Growth Volatility
(Standard deviation, 10-year window)



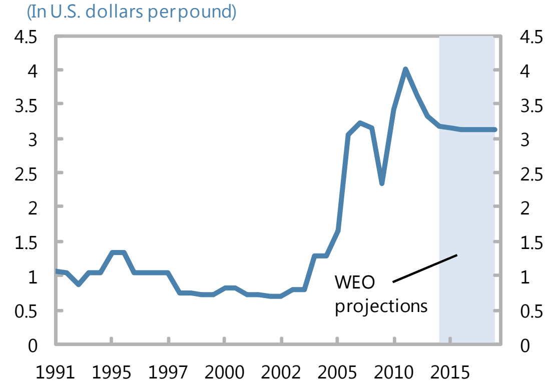
The strong growth has been driven by a commodity boom, from which Chile benefited more than other LA countries...

LAC Commodity Price Growth
(In percent)



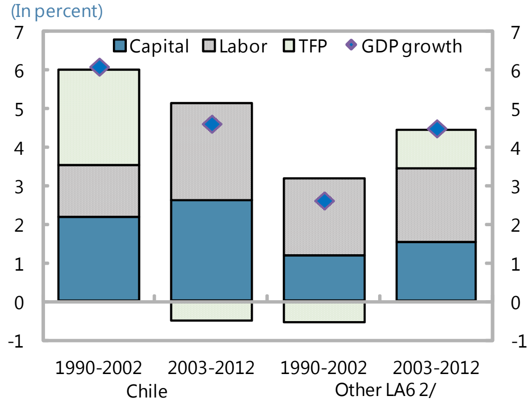
...however the tailwinds have now reversed.

Copper Price
(In U.S. dollars per pound)



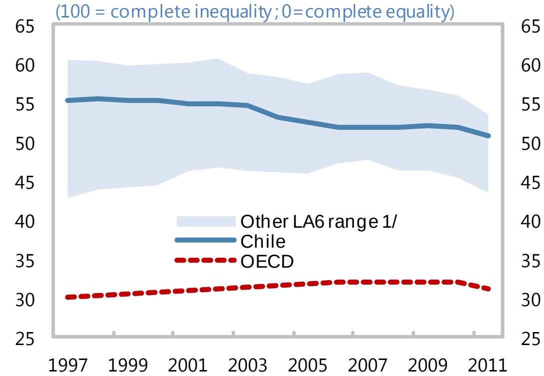
In this context, a key medium-term challenge is to re-ignite productivity growth...

Contribution to Real GDP 2/
(In percent)



... and make growth more inclusive, including by tackling the still high income inequality.

GINI index 3/
(100 = complete inequality; 0=complete equality)



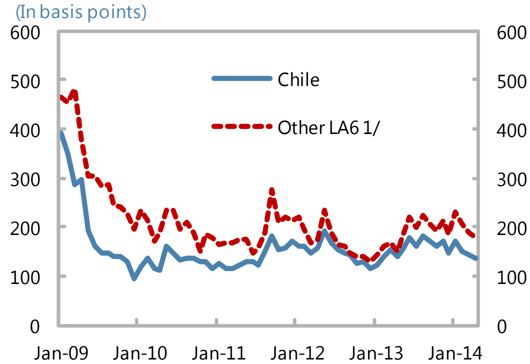
Sources: World Economic Outlook (IMF), OECD, World Development Indicators (World Bank), UN Comtrade, and Fund staff calculations.
1/ Other LA6 includes Brazil, Colombia, Mexico, Peru, and Uruguay.
2/ Based on Sosa, Tsounta and Kim (2013).
3/ Linear interpolation used to fill in missing data.

Figure 2. Chile: Financial Market Developments

Financial markets have remained orderly but with some asset repricing.

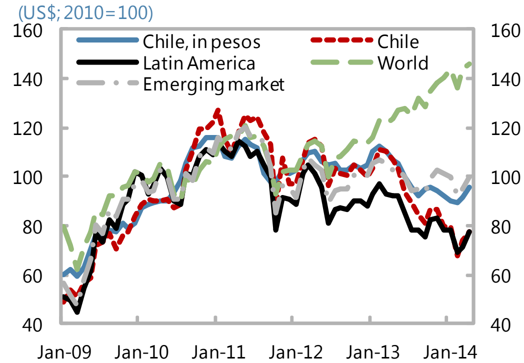
Chile's sovereign spread is among the lowest in the region.

Sovereign Spreads (EMBIG)
(In basis points)



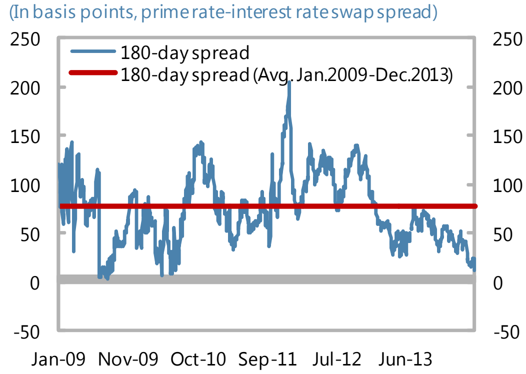
The stock market has underperformed both the world average but moved broadly in line with the region.

Stock Market Performance, MSCI 2/
(US$; 2010=100)



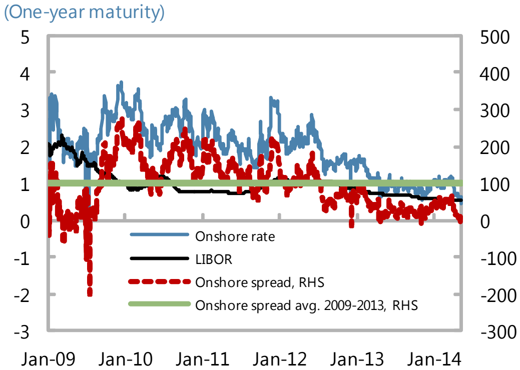
There is ample liquidity in pesos...

Liquidity Pressures in the Peso Money Market
(In basis points, prime rate-interest rate swap spread)



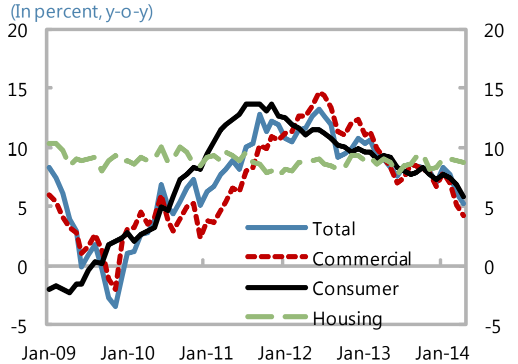
...as well as in dollars.

Liquidity Pressures in the Dollar Money Market
(One-year maturity)



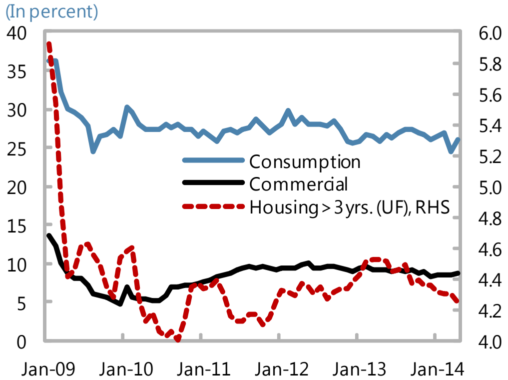
Still, real credit growth has moderated, except for housing which remains brisk...

Real Credit Growth
(In percent, y-o-y)



... and some lending rates have declined lately.

Lending Rates by Sector 3/
(In percent)



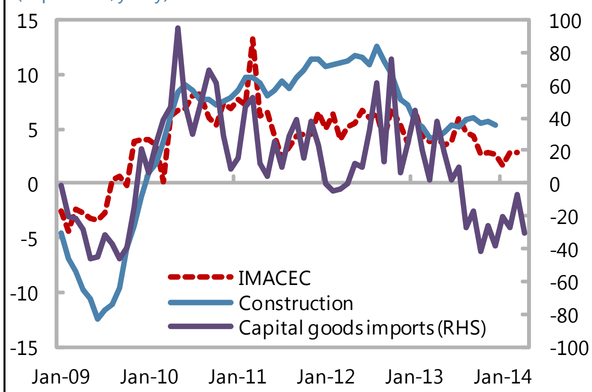
Sources: Bloomberg, Central Bank of Chile, and Fund staff calculations.
1/ Other LA6 includes Brazil, Colombia, Mexico, Peru, and Uruguay.
2/ Morgan Stanley Composite Indices.
3/ Unidad de Fomento (UF) is a unit of account adjusted for inflation.

Figure 3. Chile: Cyclical Position

Activity has moderated markedly, especially investment; while the tight labor market has also started to ease.

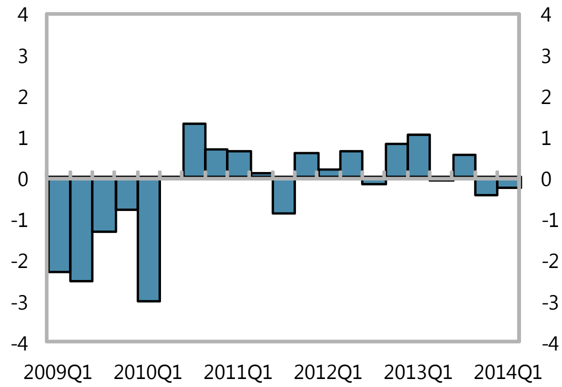
Activity has decelerated, especially investment...

Selected Economic Activity Indicators
(In percent, y-o-y)



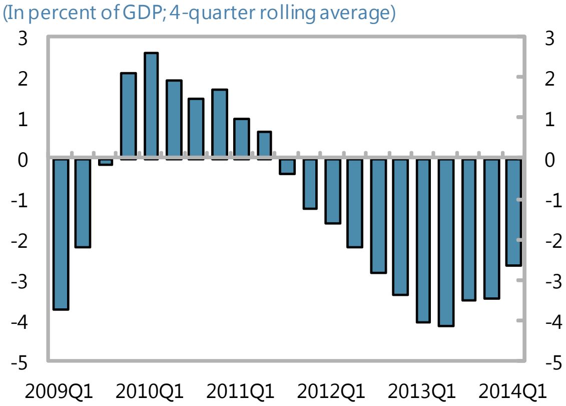
... causing the output gap to swing into negative territory...

Output Gap
(In percent of potential GDP)



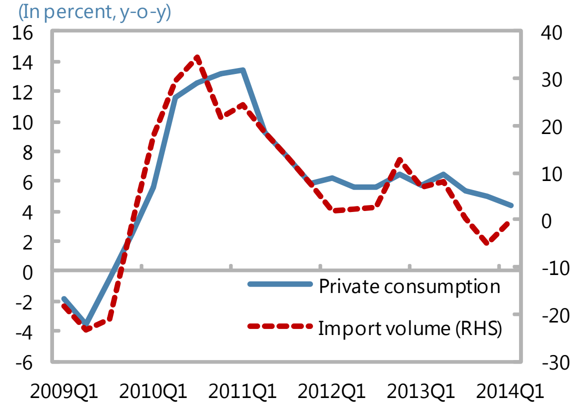
...and the current account deficit to improve somewhat.

Current Account Balance
(In percent of GDP; 4-quarter rolling average)



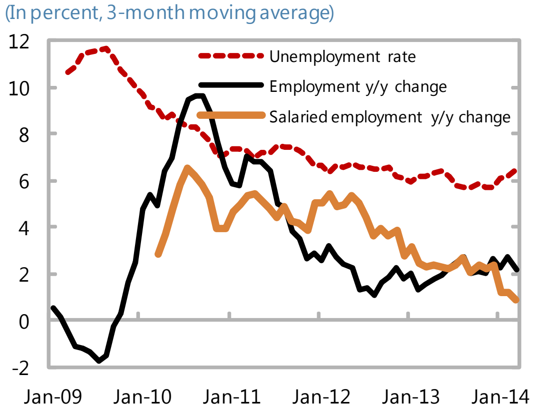
Private consumption has also decelerated somewhat.

Private Consumption and Import Volume Growth
(In percent, y-o-y)



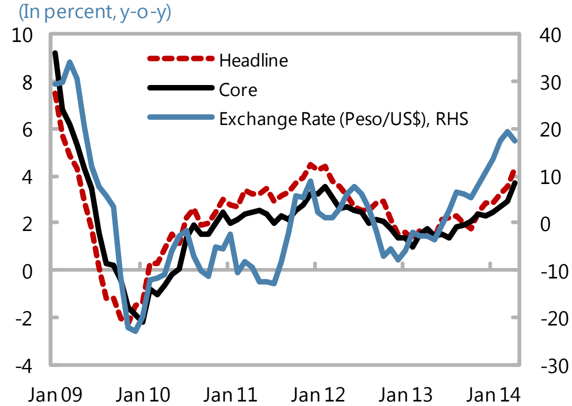
Employment growth has relied on non-salaried employment lately, and the unemployment rate has edged up.

Labor Market
(In percent, 3-month moving average)



Inflation has picked up amid peso depreciation.

Consumer Prices and the Exchange Rate 1/
(In percent, y-o-y)



Sources: Central Bank of Chile, Haver Analytics, and Fund staff calculations.
1/ Core inflation excludes fuels, fresh fruits and vegetables.

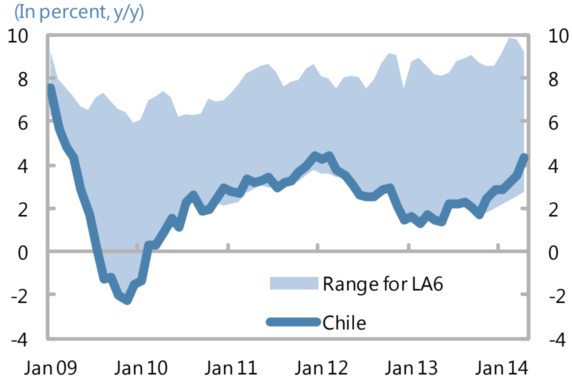
Figure 4. Chile: Monetary Policy and Inflation

Amid contained inflation pressures and marked activity moderation, the Central Bank reduced the monetary policy rate

After being among the lowest in the region during most of 2013, inflation edged up somewhat lately....

LA6 Consumer Prices

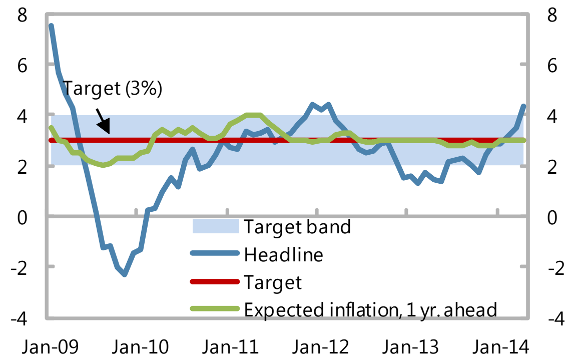
(In percent, y/y)



...yet inflation expectations remain well-anchored.

Consumer Prices and Inflation Expectations

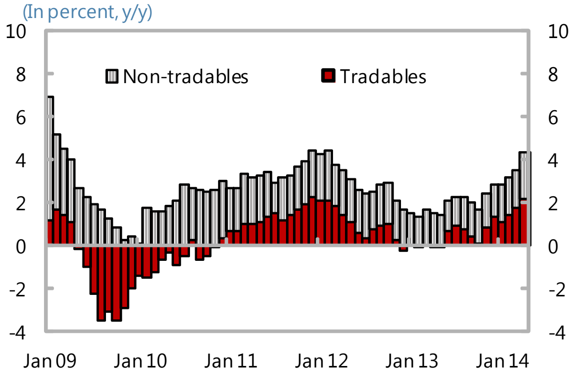
(In percent, y/y))



Contributing factors include an increase in tradable inflation.

Inflation in Tradable and Non-tradable Items

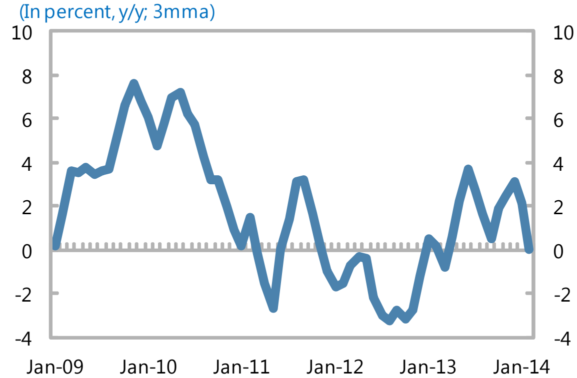
(In percent, y/y)



Unit labor costs have also increased lately.

Unit Labor Costs

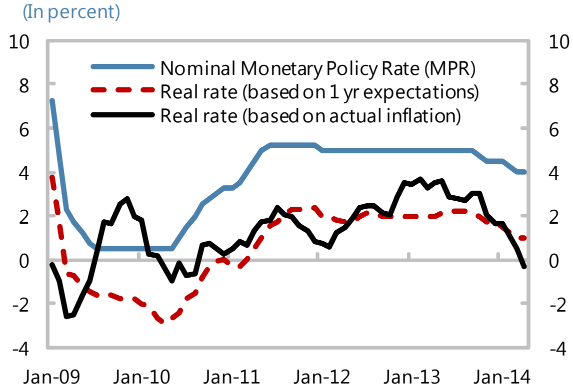
(In percent, y/y; 3mma)



The recent policy rate cuts -100bp since Oct. 2013- have resulted in an accomodative policy stance...

Policy Rate

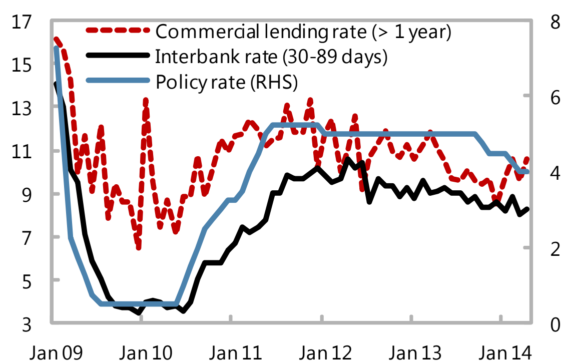
(In percent)



...and have led to some decline in lending and interbank rates.

Policy Transmission into Lending Rates

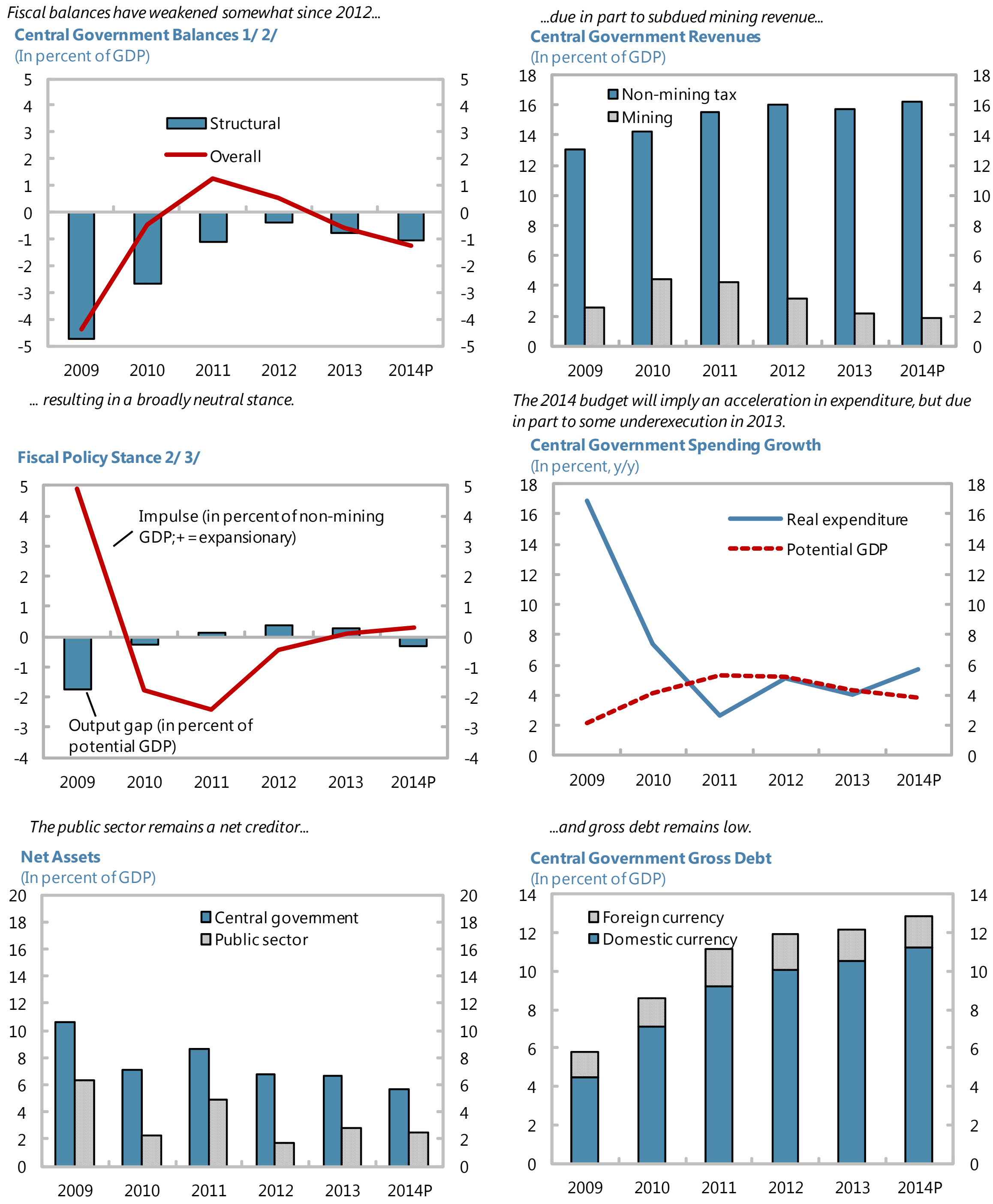
(In percent)



Sources: Central Bank of Chile, Haver Analytics, and Fund staff calculations.

Figure 5. Chile: Fiscal Policy and Public Finances

Since 2012 the fiscal stance has remained broadly neutral and the public sector financial position is fairly strong.



Sources: Ministry of Finance, Central Bank of Chile, and Fund staff calculations.

1/ For 2012, includes capital gains tax windfall (US$1bn or 0.4 percent of GDP) from a copper-related transaction.

2/ For 2014, includes the expected yield of the 2014 tax reform as submitted to Congress.

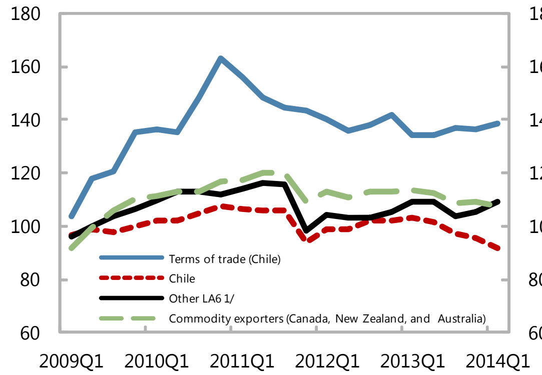
3/ Change in the non-mining structural primary deficit.

Figure 6. Chile: External Stability

The current account deficit has narrowed and external stability risks remain contained.

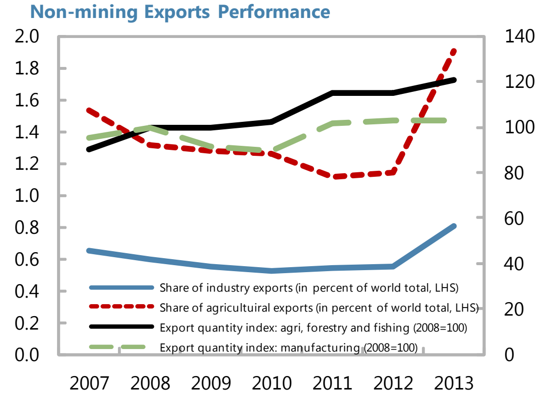
Chile's REER has moved broadly in line with other commodity exporters but has depreciated somewhat lately.

Real Effective Exchange Rate
(Index avg. 1996-2013=100)



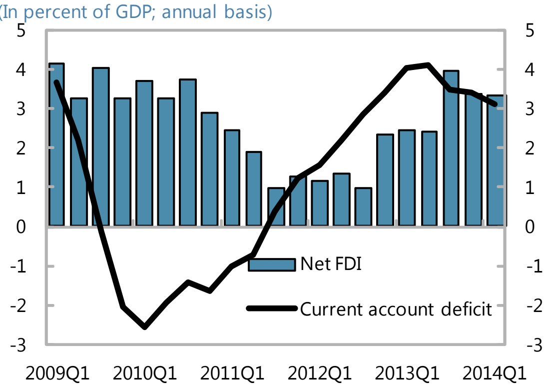
The world market share of non-mining exports have remained broadly stable.

Non-mining Exports Performance



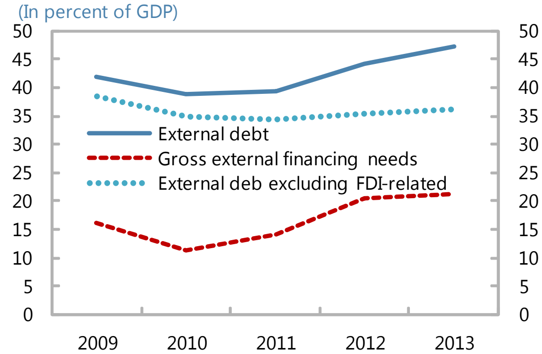
The current account deficit remains mostly financed by FDI...

Balance of Payments and Foreign Direct Investment
(In percent of GDP; annual basis)



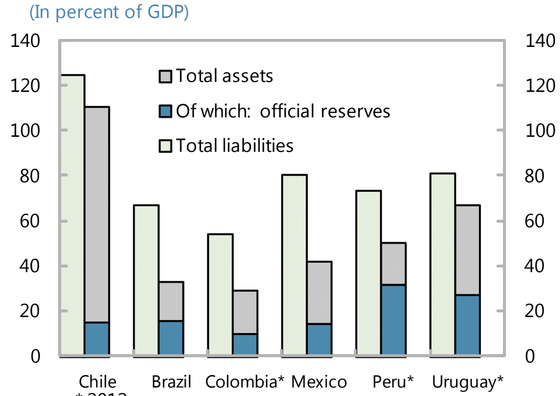
... but with a growing debt component. Financing needs have also increased.

Gross External Debt
(In percent of GDP)



Still, Chile's international investment position remains strong...

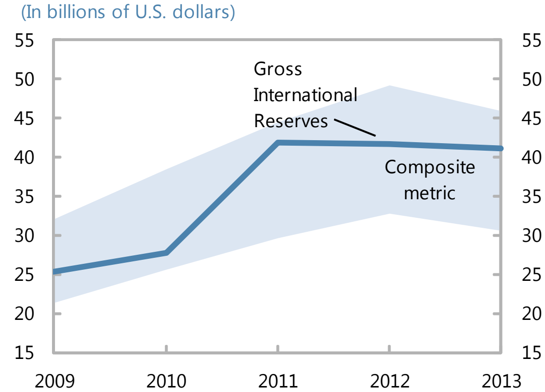
International Investment Position, 2013
(In percent of GDP)



* 2012.

...and gross international reserves are adequate.

Gross Reserves and Reserve Adequacy Metric 2/
(In billions of U.S. dollars)



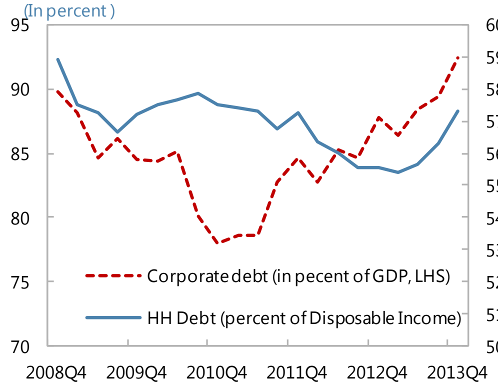
Sources: Central Bank of Chile, Fund staff calculations Haver Analytics, Inc. and World Bank WITS.
1/ Other LA6 includes Brazil, Colombia, Mexico, Peru, and Uruguay.
2/ *Assessing Reserve Adequacy*, IMF, February, 2011.

Figure 7. Chile: Macro-Financial Stability

Risks to financial stability appear contained but some aspects warrant continued vigilance.

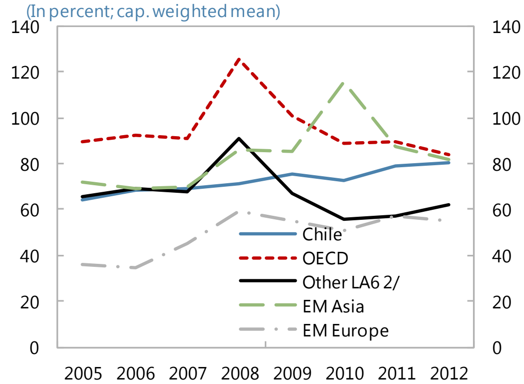
Corporate indebtedness has increased, while household indebtedness has remained broadly stable.

Corporate (Non-financial) and Household Indebtedness
(In percent)



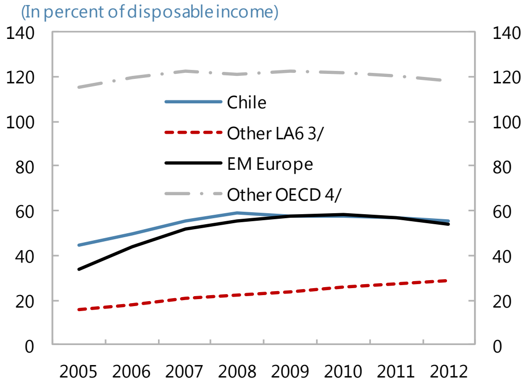
From an international perspective, corporate debt remains broadly in line with other regions...

Corporate (Non-financial) Sector Debt to Equity Ratio
(In percent; cap. weighted mean)



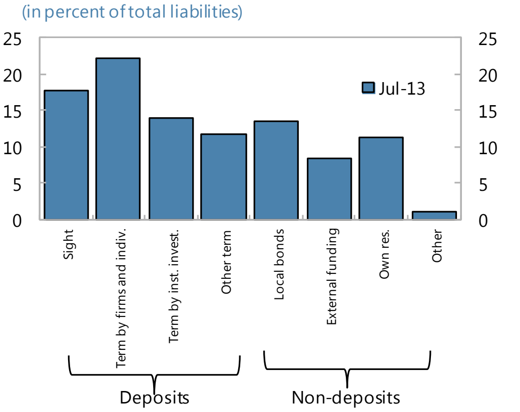
....while household debt is higher than in some other emerging markets but remains well below the OECD average.

Household Debt
(In percent of disposable income)



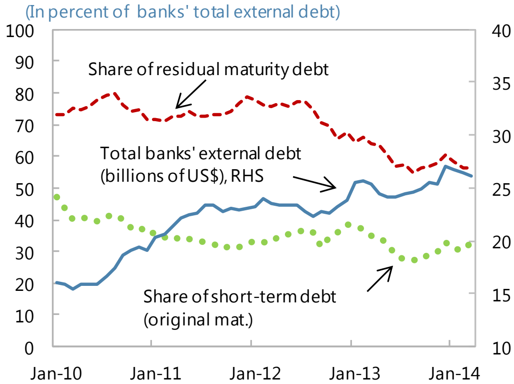
Bank funding is dominated by deposits and reliance on external funding is low...

Sources of bank funding
(in percent of total liabilities)



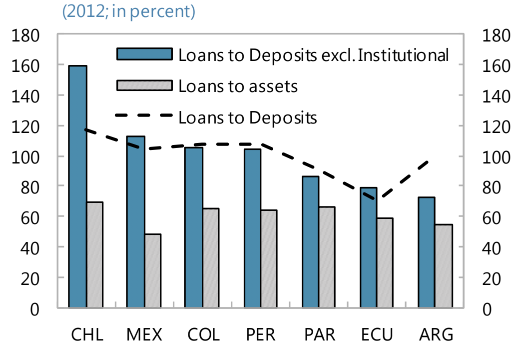
...at the same time, external debt has increased somewhat, while the share of short-term debt has remained broadly stable.

Bank External Debt, by Maturity
(In percent of banks' total external debt)



The loan to deposit ratio is somewhat higher in Chile than in the region, but there are mitigating factors.

Loans to Deposits and Loans to Assets
(2012; in percent)



Sources: Bankscope, IMF FSI.

Sources: Central Bank of Chile, Superintendence of Banks and Financial Institutions, World Development Indicators (World Bank), Financial Stability Indicators (IMF), and Fund staff calculations.

1/ Other LA6 includes Brazil, Colombia, Mexico, Peru, and Uruguay.

2/ Other LA6 includes Brazil, Colombia, Mexico, and Peru.

3/ Other LA6 includes Brazil and Mexico.

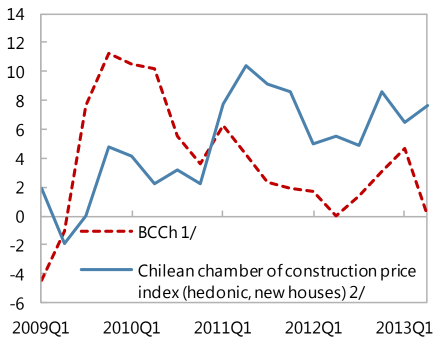
4/ Other OECD includes Canada, France, Germany, Italy, Japan, United Kingdom and United States.

Figure 8. Chile: Real Estate Developments

There are no clear signs of significant misalignment with fundamentals.

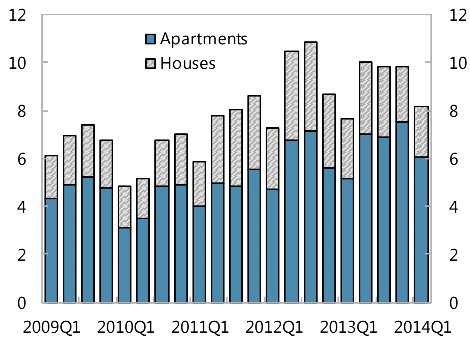
The increase in housing prices has moderated somewhat but remains brisk.

Real Residential Price Index
(In percent, y/y)



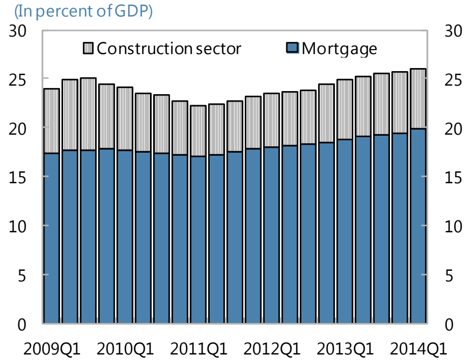
Residential property sales have stabilized at a high level...

Residential Property Sales in Greater Santiago 3/
(In thousands of units)



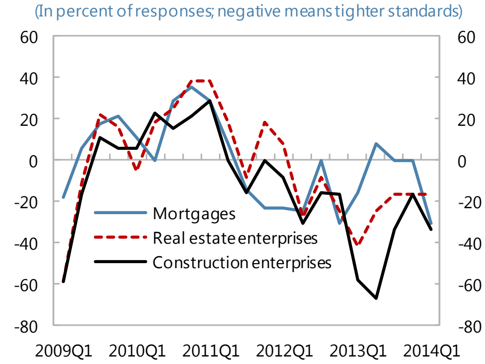
...in part fueled by credit availability...

Banking Credit to the Real Estate Sector
(In percent of GDP)



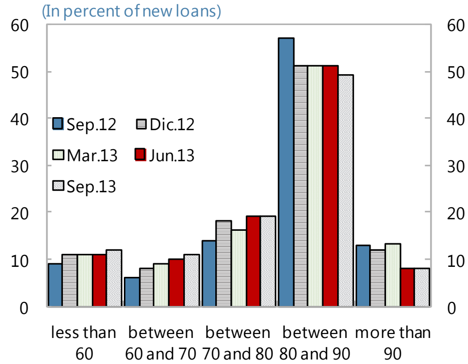
...however, banks have tightened credit standards lately.

Bank Lending Conditions to Real-Estate Sector
(In percent of responses; negative means tighter standards)



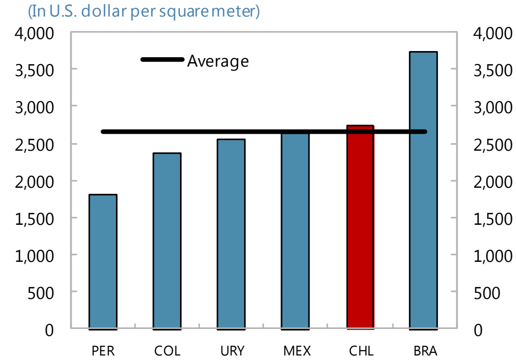
The share of mortgages with high LTV (80+) has declined somewhat, but remains at about 60 percent

Mortages Loan to Value Ratio
(In percent of new loans)



Chile's apartment prices are broadly in line with the region.

LA6 Apartment Prices (2013, except Mexico, 2012) 4/
(In U.S. dollar per square meter)



Sources: Central Bank of Chile, Superintendence of Banks and Financial Institutions, Chilean Chamber of Construction, Global Property Guide, and Fund staff calculations.

1/ Compiled by the Central Bank of Chile controlling for home characteristics.

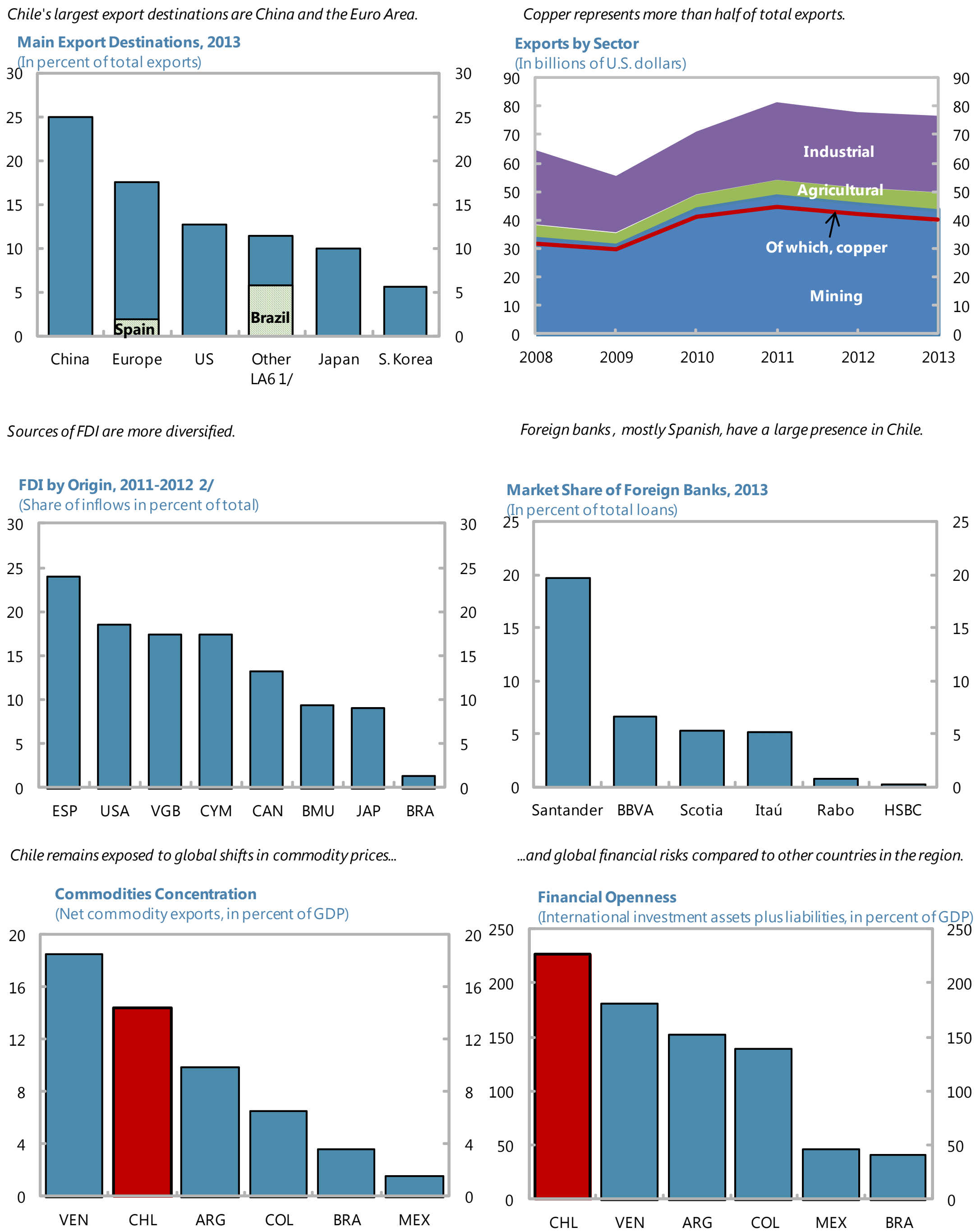
2/ Compiled by the Chilean Chamber of Construction, which only covers Greater Santiago, using the hedonic price methodology.

3/ Includes purchase commitments.

4/ Apartments located in the center of the most important city of each country; information compiled by the Global Property Guide.

Figure 9. Chile: Spillovers and Exposures

Chile remains exposed to global conditions both through financial and real channels.



Sources: Central Bank of Chile, Superintendence of Banks and Financial Institutions, World Economic Outlook, and Fund staff calculations.
1/ Other LA6 includes Brazil, Colombia, Mexico, Peru, and Uruguay.
2/ VGB= British Virgin Islands, CYM=Cayman Islands and BMU=Bermuda.

Table 1. Chile: Selected Social and Economic Indicators

GDP (2012), in billions of pesos	129,553	Quota	
GDP (2012), in billions of U.S. dollars	266.3	in millions of SDRs	856
Per capita (U.S. dollars)	15,302	in % of total	0.36%
Population (2012), in millions	17.4	Poverty rate (2011)	14.4
Main products and exports	Copper	Gini coefficient (2011)	0.52
Key export markets	China, Euro area, U.S.	Literacy rate (2011)	98.9

	2009	2010	2011	2012	2013	Proj. 2014	Proj. 2015
	(Annual percentage change, unless otherwise specified)						
Output							
Real GDP	-1.0	5.7	5.8	5.5	4.2	3.2	4.1
Total domestic demand	-5.6	13.6	9.2	7.0	3.8	2.7	4.2
Consumption	0.8	9.7	7.8	5.6	5.4	3.8	4.2
Private	-0.8	10.8	8.9	6.0	5.6	3.2	4.1
Public	9.2	4.6	2.5	3.7	4.2	6.0	4.3
Investment	-23.6	27.5	14.4	10.9	-0.8	-0.6	4.3
Fixed	-12.1	12.2	14.4	12.2	0.4	1.8	4.6
Private	-17.6	17.8	15.2	13.1	0.7	0.7	4.5
Public	37.7	-18.4	8.4	4.0	-2.7	11.8	5.2
Inventories 1/	-3.1	2.9	-0.2	-0.1	-0.3	...	...
Net exports 1/	4.5	-7.7	-4.1	-1.7	0.6	1.3	-0.6
Exports	-4.5	2.3	5.5	1.1	4.3	3.7	3.2
Imports	-16.2	25.9	15.6	5.0	2.2	0.1	4.2
Employment							
Unemployment rate (annual average) 2/	10.8	8.2	7.1	6.4	5.9	6.4	6.4
Consumer prices							
End of period	-1.5	3.0	4.4	1.5	3.0	4.4	3.0
Average	1.5	1.4	3.3	3.0	1.8	4.5	3.3
	(In percent of GDP, unless otherwise specified)						
Public sector finances							
Central government revenue	19.1	21.6	22.6	22.2	20.9	20.9	21.4
Central government expenditure	23.4	22.0	21.3	21.6	21.5	22.2	22.3
Central government fiscal balance	-4.4	-0.5	1.3	0.6	-0.6	-1.3	-0.9
Structural fiscal balance 3/	-4.7	-2.7	-1.1	-0.4	-0.8	-1.1	-0.7
Nonmining structural primary fiscal balance 4/	-7.4	-5.7	-3.3	-2.9	-3.0	-3.4	-2.7
Fiscal impulse	4.9	-1.7	-2.4	-0.4	0.1	0.4	-0.7
Public sector net debt	-6.5	-2.2	-4.9	-1.7	-2.8	-2.4	-0.9
Public sector gross debt	27.5	25.9	34.8	34.5	34.3	34.3	34.2
Central government gross debt	5.8	8.6	11.1	12.0	12.5	13.2	14.0
Of which, share of FX-denominated debt (in percent)	22.8	17.3	17.2	16.1	13.4	12.0	10.4
Money and credit							
Broad money (percentage change)	-5.3	9.3	18.5	7.6	14.9	...	...
Credit to the private sector (percentage change)	-1.4	7.1	16.9	12.1	9.7	...	...
3-month central bank bill rate (%)	1.8	1.7	4.9	5.1	5.0	...	...
Balance of payments							
Current account	2.0	1.6	-1.2	-3.4	-3.4	-3.1	-2.8
Current account (in billions of U.S. dollars)	3.5	3.6	-3.1	-9.1	-9.5	-8.1	-7.7
Foreign direct investment inflows	7.5	7.2	9.3	10.7	7.3	7.7	7.2
Gross international reserves (in billions of U.S. dollars)	25.4	27.9	42.0	41.6	41.1	41.1	41.1
In months of next year's imports of goods and services	4.5	3.9	5.6	5.5	5.4	5.3	5.1
Gross external debt	41.8	38.9	39.2	44.1	47.2	52.4	51.7
Public	7.7	7.9	8.2	9.5	9.2	9.5	9.4
Private	34.1	30.9	31.1	34.7	38.0	42.8	42.3
	(Annual percentage change)						
Exchange rate							
Real effective exchange rate (real appreciation +)	-2.2	5.9	0.9	3.7	-1.2	...	...
Terms of trade	4.3	22.0	1.6	-6.1	-2.5	-3.0	0.7

Sources: Central Bank of Chile, Ministry of Finance, Haver Analytics, and Fund staff calculations and projections.

1/ Contribution to growth.
2/ The methodology to compute the unemployment rate changed in 2009.
3/ Headline balance adjusted for the economic and copper price cycles.
4/ In percent of non-mining GDP.

Table 2. Chile: Summary Operations of the Central Government

(In percent of GDP; unless otherwise indicated)

						Projections 1/	
	2009	2010	2011	2012	2013	2014	2015
Revenues	**19.0**	**21.5**	**22.7**	**22.2**	**20.9**	**20.8**	**21.4**
Taxes	13.9	15.9	17.4	17.6	16.7	16.9	17.8
Private mining companies	0.8	1.7	1.9	1.6	1.1	0.8	0.7
Other tax revenues, non-mining	13.0	14.2	15.5	16.0	15.7	16.2	17.0
Social contributions	1.4	1.3	1.3	1.4	1.4	1.4	1.4
Grants	0.1	0.1	0.1	0.1	0.1	0.0	0.1
Other revenue	3.7	4.3	3.9	3.2	2.7	2.4	2.2
Codelco revenues	1.7	2.7	2.3	1.5	1.0	1.1	0.9
Income on assets	0.7	0.4	0.5	0.5	0.5	0.5	0.5
Operating income	0.6	0.5	0.5	0.5	0.5	0.5	0.5
Other income	0.8	0.6	0.7	0.7	0.7	0.4	0.3
Expenditures	**23.4**	**22.0**	**21.4**	**21.6**	**21.5**	**22.1**	**22.3**
Expense	20.9	19.9	19.3	19.6	19.6	20.0	20.2
Compensation of employees	4.4	4.2	4.1	4.2	4.3	4.4	4.5
Purchases of goods and services	2.3	2.1	2.2	2.0	2.0	2.1	2.0
Interest payments	0.5	0.5	0.6	0.6	0.6	0.6	0.7
Subsidies and grants	7.0	6.7	6.3	6.7	7.0	7.5	7.2
Social benefits	4.8	4.5	4.2	4.2	4.0	3.8	4.1
Other expense	1.9	1.9	2.0	2.0	1.7	1.5	1.6
Capital transfers	1.9	1.8	1.9	1.9	1.7	1.5	1.5
Net acquistion of nonfinancial assets	2.5	2.1	2.1	2.0	2.0	2.1	2.2
Investment	2.6	2.1	2.1	2.1	2.0	2.2	2.2
Sale of physical assets	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Gross operating balance	**-1.8**	**1.6**	**3.4**	**2.6**	**1.4**	**0.8**	**1.2**
Net lending/borrowing	**-4.4**	**-0.5**	**1.3**	**0.6**	**-0.6**	**-1.3**	**-0.9**
Non-mining overall balance	-6.8	-4.9	-2.9	-2.5	-2.7	-3.1	-2.6
Net financial transactions	**-4.4**	**-0.5**	**1.3**	**0.6**	**-0.6**	**-1.3**	**-0.9**
Net acquistion of financial assets	-4.0	2.0	3.1	1.6	0.4	0.2	0.7
Currency and deposits	0.0	-0.2	-0.2	0.3	-1.8	0.0	0.0
Securities other than shares	-4.1	2.2	3.4	1.3	2.2	0.2	0.7
Loans	0.1	0.0	-0.1	0.0	0.0	0.0	0.0
Net incurrence of liabilities	0.3	2.5	1.8	1.0	1.0	1.5	1.6
Domestic	1.5	2.5	2.0	1.4	1.9	2.1	2.3
Securities other than shares	1.7	2.8	2.4	1.9	2.5	2.4	2.9
Amortization	0.3	0.3	0.4	0.5	0.6	0.3	0.7
External	-0.4	0.7	0.5	0.3	-0.3	-0.1	0.0
Securities other than shares	0.0	0.7	0.5	0.6	0.0	0.0	0.0
Amortization	0.4	0.1	0.1	0.3	0.4	0.1	0.0
Recognizion bonds	-0.8	-0.7	-0.7	-0.6	-0.6	-0.5	-0.6
Memorandum items							
Structural balance 2/	-4.7	-2.7	-1.1	-0.4	-0.8	-1.1	-0.7
Nonmining structural primary balance 3/	-7.4	-5.7	-3.3	-2.9	-3.0	-3.3	-2.7
Fiscal impulse	4.9	-1.7	-2.4	-0.4	0.1	0.4	-0.7
Expenditure growth (in real terms)	16.9	7.4	2.6	5.1	4.0	5.4	4.4
Expense	16.0	8.3	2.6	5.3	4.4	4.8	4.4
Net acquisition of nonfinancial assets	21.1	-6.6	7.5	-0.3	0.0	11.4	4.4
Net assets of the central government	10.6	7.0	8.6	6.8	6.7	5.6	4.3
Gross debt	5.8	8.6	11.1	12.0	12.5	13.2	14.0
Peso-denominated assets	6.1	6.2	7.8	7.2	7.2	6.7	6.7
Foreign currency-denominated assets	10.3	9.4	12.0	11.6	12.0	12.2	11.6
Nominal GDP (trillions of pesos)	96.3	110.9	121.3	129.6	137.2	146.9	157.1
Long term price of copper, USD per pound	1.99	2.13	2.6	3.02	3.06	3.04	3.04
Copper price, USD per pound (WEO)	2.34	3.42	4.0	3.61	3.33	3.12	3.08

Sources: Ministry of Finance and Fund staff calculations.

1/ Based on the authorities' medium-term fiscal projections in the 2014 Budget Law, adjusted for staff's GDP and copper price projections and includes Tax Reform Bill as sent to Congress on April 2014.

2/ Based on staff's output gap estimates and WEO copper prices. 3/ In percent of non-mining GDP.

Table 3. Chile: Summary Operations of the Public Sector 1/
(In percent of GDP)

	2009	2010	2011	2012	2013	Projections 2014	2015
Central Government							
Balance	-4.4	-0.5	1.3	0.6	-0.6	-1.3	-0.9
Total revenue	19.1	21.6	22.6	22.2	20.9	20.9	21.4
Of which: Intragovernmental receipts	1.3	0.9	0.9	0.9	0.9	0.9	0.9
Total expenditures	23.4	22.0	21.3	21.6	21.5	22.2	22.3
Of which: Intragovernmental transfers	0.9	0.8	0.8	0.8	0.8	0.8	0.8
Current	19.0	18.1	17.3	17.7	17.9	18.5	18.6
Capital	4.4	3.9	4.1	4.0	3.7	3.7	3.7
Net assets	10.6	7.0	8.6	6.8	6.7	5.6	4.3
Municipalities 2/							
Balance	0.1	0.1	0.1	0.1	-0.1	-0.1	-0.2
Total revenue	3.0	2.9	2.9	3.1	2.9	3.0	3.0
Of which: Intragovernmental receipts	0.9	0.8	0.8	0.8	0.8	0.8	0.8
Total expenditures	2.9	2.8	2.8	3.0	3.0	3.1	3.1
Of which: Intragovernmental transfers	1.3	0.9	0.9	0.9	0.9	0.9	0.9
Current	2.6	2.5	2.6	2.7	2.7	2.8	2.8
Capital	0.3	0.3	0.2	0.3	0.3	0.3	0.3
Central Bank							
Balance 3/	-2.9	-1.3	0.9	-1.6	-0.2	-0.1	-0.1
Net assets	1.5	0.7	2.0	1.1	2.3	3.0	2.7
State-Owned Non-Financial Enterprises							
Balance	1.6	1.3	1.1	1.0	0.8	0.8	0.8
Total revenue	12.5	10.9	10.6	10.5	10.2	10.2	10.2
Of which: Intragovernmental receipts	0.7	0.2	0.2	0.2	0.2	0.2	0.2
Total expenditures	10.9	9.6	9.5	9.5	9.4	9.4	9.4
Current	9.1	8.2	8.1	8.2	8.1	8.1	8.1
Capital 4/	1.8	1.4	1.3	1.4	1.3	1.3	1.3
Net Assets	-5.7	-5.5	-5.6	-6.1	-6.2	-6.2	-6.2
Consolidated Public Sector							
Balance	-5.5	-0.5	3.4	0.0	-0.1	-0.8	-0.4
Net assets	6.4	2.2	4.9	1.7	2.8	2.4	0.9

Sources: Ministry of Finance and Fund staff calculations.

1/ This table reflects the authorities' revisions to historical official data to bring the fiscal accounts in line with *GFSM 2001* .

2/ On a cash basis. Municipalities hold neither sizable financial assets nor debt.

3/ Includes the effects of valuation changes (exchange rate).

4/ The data reported here does not include depreciation as an expense.

Table 4. Chile: Balance of Payments

	2009	2010	2011	2012	2013	Projections 2014	2015
	(In millions of U.S. dollars)						
Current account	3,519	3,581	-3,070	-9,081	-9,485	-8,105	-7,745
Trade balance	15,361	15,737	11,039	2,507	2,117	2,853	2,696
Exports	55,463	71,109	81,438	77,965	76,684	78,172	80,015
Copper	29,695	41,361	44,670	41,988	40,158	40,010	40,689
Non-copper	25,768	29,748	36,768	35,978	36,527	38,162	39,326
Imports	40,102	55,372	70,399	75,458	74,567	75,319	77,318
Net services	-2,010	-1,881	-3,054	-2,276	-2,908	-2,597	-2,795
Net income	-11,395	-14,686	-13,920	-11,503	-11,102	-10,600	-9,959
Net transfers	1,563	4,411	2,865	2,191	2,408	2,238	2,313
Capital account balance 1/	14	6,240	11	12	12	0	0
Financial account balance	2,532	5,944	-17,828	-9,041	-11,280	-8,105	-7,745
Foreign direct investment	-5,654	-6,265	-3,192	-6,212	-9,335	-8,898	-8,444
Abroad by Chilean residents	7,233	9,461	20,252	22,330	10,923	11,360	11,814
In Chile by foreign residents	12,887	15,725	23,444	28,542	20,258	20,258	20,258
Of which, debt instruments	463	3,200	3,297	11,026	7,102	...	...
Portfolio investment	12,399	6,421	-11,484	2,217	-5,042	-4,871	-5,001
Abroad by Chilean residents	14,269	15,710	-799	13,130	10,699	...	...
In Chile by foreign residents	1,870	9,289	10,685	10,913	15,740	...	...
Of which, equities	328	1,764	4,650	5,640	6,027	...	...
Of which, debt	1,542	7,525	6,035	5,272	9,714	...	...
Financial derivatives	1,049	934	2,418	-10	778	...	...
Other investments	-5,261	4,854	-5,570	-5,036	2,318	...	...
Abroad by Chilean residents	612	6,385	-661	-2,514	-993	...	...
In Chile by foreign residents	5,873	1,531	4,909	2,522	-3,311	...	...
Change in reserves assets	1,648	3,024	14,190	-367	311	0	0
Errors and omissions	646	-855	-581	-337	-1496	0	0
Change in official reserves ($ billion)	2.2	2.5	14.1	-0.3	-1	0	0
Central bank operations with commercial banks	0.0	0.0	12.0	0.0	0	0	0
Other 2/	2.2	2.5	2.1	-0.3	-1	0	0
Gross official international reserves	4.5	3.9	5.6	5.5	5.4	5.3	5.1
(In months of imports of goods and services)							
	(In percent of GDP)						
Current account	2.0	1.6	-1.2	-3.4	-3.4	-3.1	-2.8
Trade balance	8.9	7.2	4.4	0.9	0.8	1.1	1.0
Exports	32.2	32.7	32.5	29.3	27.7	29.7	28.6
Copper	17.3	19.0	17.8	15.8	14.5	15.2	14.6
Non-copper	15.0	13.7	14.7	13.5	13.2	14.5	14.1
Imports	23.3	25.5	28.1	28.3	26.9	28.6	27.7
Net services	-1.2	-0.9	-1.2	-0.9	-1.0	-1.0	-1.0
Net income	-6.6	-6.8	-5.5	-4.3	-4.0	-4.0	-3.6
Net transfers	0.9	2.0	1.1	0.8	0.9	0.9	0.8
Financial account balance	-1.5	-2.7	7.1	3.4	4.1	3.1	2.8
Total export volume	-2.9	-0.2	4.1	2.1	3.5	3.8	3.2
Copper export volume	1.3	0.4	-2.0	2.5	6.3	5.1	2.5
Agricultural exports volume	-0.2	2.5	12.6	-0.4	5.4	1.1	3.8
Industrial exports volume	-8.6	-2.1	13.8	1.0	0.0	1.6	3.8
Total import volume	-19.4	31.2	16.2	7.0	1.0	-0.3	4.2
Terms of trade	4.3	22.0	1.6	-6.1	-2.5	-3.0	0.7
Total export prices	-11.4	28.6	10.2	-5.8	-4.7	-1.9	-0.8
Copper export prices	-9.1	40.4	11.0	-8.6	-9.8	-5.5	-0.8
Total import price	-15.4	5.7	8.6	0.3	-2.2	1.2	-1.4
Memorandum items:							
Copper price (LME; U.S. cents per pound)	234	342	400	361	333	312	308
Volume of copper exports (2004=100)	99	99	97	100	106	111	114

Sources: Central Bank of Chile, Haver Analytics, and Fund staff calculations.

1/ In 2010 reflects insurance payment associated with the earthquake.

2/ "Other" variations in reserves largely reflect changes in deposits by commercial banks and the government with the central bank.

Table 5. Chile: Monetary Survey
(In billions of pesos; unless otherwise indicated)

	2008	2009	2010	2011	2012	2013
Central bank						
Net foreign assets	14,630	12,254	12,508	21,307	19,396	20,943
Net international reserves	14,572	12,849	13,051	21,891	19,933	21,523
Net international reserves (in millions of US$)	23,163	25,372	27,865	41,980	42,231	45,216
Other foreign assets, net	58	-595	-543	-584	-537	-580
Net domestic assets	-10,400	-7,672	-6,983	-14,456	-11,505	-12,189
Net credit to general government	738	580	559	143	367	738
Net claims on banks and financial corporations	-1,659	-2,854	-2,964	-4,593	-4,202	-4,370
Credit to the private sector	957	904	861	805	717	609
Other items (net)	-10,436	-6,302	-5,439	-10,811	-8,388	-9,166
Monetary base	4,230	4,582	5,525	6,851	7,891	8,754
Currency	2,676	2,935	3,423	3,892	4,480	4,981
Required reserves	1,554	1,647	2,102	2,959	3,411	3,773
Other depository institutions						
Net foreign assets	-3,395	-4,014	-4,767	-6,995	-6,477	-6,581
Net foreign assets (in millions of US$)	-5,397	-7,926	-10,178	-13,414	-13,722	-13,826
Net domestic assets	63,777	64,965	66,513	81,620	84,909	94,558
Net credit to general government	-3,923	-2,269	-2,240	-1,709	-716	-237
Credit to the private sector	69,870	68,879	73,786	86,276	96,702	106,064
Other items (net)	-2,170	-1,645	-5,033	-2,947	-11,077	-11,269
Liabilities to the private sector	60,382	60,951	61,746	74,625	78,432	87,977
Demand deposits	8,417	11,150	13,465	14,749	16,080	17,799
Quasi-money	51,965	49,801	48,281	59,876	62,352	70,178
Banking system						
Net foreign assets	11,235	8,240	7,741	14,313	12,919	14,363
Net domestic assets	57,936	61,147	61,579	72,887	79,803	87,827
Net credit to general government	-3,185	-1,689	-1,681	-1,566	-349	501
Credit to the private sector	70,827	69,783	74,647	87,081	97,419	106,673
Other items (net)	-9,705	-6,710	-11,387	-12,627	-17,268	-19,347
Liabilities to the private sector	69,171	69,387	69,320	87,200	92,722	102,190
Money	11,093	14,086	16,888	18,641	20,560	22,780
Quasi-money	58,078	55,301	52,432	68,559	72,162	79,410
Memorandum items						
	(Annual percentage change)					
Monetary base	15.2	8.3	20.6	24.0	15.2	10.9
Liabilities to the private sector	18.1	0.3	-0.1	25.8	6.3	10.2
Credit to the private sector (banking system)	18.4	-1.5	7.0	16.7	11.9	9.5
	(In percent of GDP)					
Monetary base	4.5	4.7	5.0	5.7	6.1	6.3
Liabilities to the private sector	73.8	71.8	62.9	72.6	71.6	73.6
Credit to the private sector (banking system)	75.6	72.2	67.7	72.5	75.3	76.8

Sources: Central Bank of Chile and Haver Analytics.

Table 6. Chile: Medium-Term Framework

					Projections					
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
National accounts	(Annual percentage change, unless otherwise specified)									
Real GDP	5.7	5.8	5.5	4.2	3.2	4.1	4.2	4.3	4.3	4.3
Total domestic demand	13.6	9.2	7.0	3.8	2.7	4.2	4.4	4.2	4.2	4.2
Consumption	9.7	7.8	5.6	5.4	3.8	4.2	4.3	4.0	4.0	4.1
Private	10.8	8.9	6.0	5.6	3.2	4.1	4.4	3.8	3.6	3.7
Public	4.6	2.5	3.7	4.2	6.0	4.3	4.1	5.4	6.1	6.1
Investment	27.5	14.4	10.9	-0.8	-0.6	4.3	4.5	4.8	4.8	4.6
Private	17.8	15.2	13.1	0.7	0.7	4.5	4.5	4.6	4.6	4.6
Public	-18.4	8.4	4.0	-2.7	11.8	5.2	4.3	5.6	6.2	4.2
Fixed	12.2	14.4	12.2	0.4	1.8	4.6	4.5	4.7	4.8	4.6
Inventories 1/	2.9	-0.2	-0.1	-0.3	…	…	…	…	…	…
Net exports 1/	-7.7	-4.1	-1.7	0.6	1.3	-0.6	-0.3	-0.2	-0.1	-0.1
Consumer prices										
End of period	3.0	4.4	1.5	3.0	4.4	3.0	3.0	3.0	3.0	3.0
Consumer prices (average)	1.4	3.3	3.0	1.8	4.5	3.3	3.0	3.0	3.0	3.0
Balance of payments	(In percent of GDP)									
Current account	1.6	-1.2	-3.4	-3.4	-3.1	-2.8	-2.8	-2.6	-2.6	-2.5
Trade balance	7.2	4.4	0.9	0.8	1.1	1.0	0.8	0.7	0.6	0.6
Financial account balance	-2.7	7.1	3.4	4.1	3.1	2.8	2.8	2.6	2.6	2.5
Of which, foreign direct investment (net)	2.9	1.3	2.3	3.4	3.4	3.0	2.7	2.4	2.1	1.9
Change in reserves assets	-1.4	-5.7	0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
	(Annual percentage change)									
Total export volume	-0.2	4.1	2.1	3.5	3.8	3.2	4.0	4.4	4.4	4.5
Of which, copper export volume	0.4	-2.0	2.5	6.3	5.1	2.5	2.5	2.5	2.5	2.5
Total import volume	31.2	16.2	7.0	1.0	-0.3	4.2	4.4	4.3	4.3	4.3
Terms of trade	22.0	1.6	-6.1	-2.5	-3.0	0.7	-0.3	-0.4	-0.5	-0.1
Total export prices	28.6	10.2	-5.8	-4.7	-1.9	-0.8	-0.9	-0.4	-0.2	-0.1
Copper export prices	40.4	11.0	-8.6	-9.8	-5.5	-0.8	-0.6	-0.6	-0.5	0.0
Total import price	5.7	8.6	0.3	-2.2	1.2	-1.4	-0.6	0.0	0.3	0.0
External debt	(In percent of GDP)									
Gross external debt	38.9	39.2	44.1	47.2	52.4	51.7	50.8	49.9	49.0	47.6
Public	7.9	8.2	9.5	9.2	9.5	9.4	9.2	9.0	8.8	8.2
Private	30.9	31.1	34.7	38.0	42.8	42.3	41.6	40.9	40.2	39.4
Gross int. reserves (in billions of U.S. dollars)	27.9	42.0	41.6	41.1	41.1	41.1	41.1	41.1	41.1	40.1
Savings and investment										
Gross domestic investment	22.4	23.7	25.0	24.0	23.2	23.1	23.1	23.2	23.2	23.2
Public	2.4	2.4	2.4	2.3	2.5	2.5	2.5	2.5	2.6	2.6
Private	20.1	21.3	22.7	21.7	20.7	20.6	20.6	20.6	20.7	20.7
National saving	24.1	22.5	21.6	20.6	20.1	20.4	20.3	20.5	20.6	20.7
Public	2.0	3.7	3.0	1.5	0.9	1.3	1.6	1.9	2.1	2.1
Private	22.1	18.8	18.6	19.1	19.2	19.1	18.8	18.6	18.5	18.6
Public sector finance										
Net debt	-2.2	-4.9	-1.7	-2.8	-2.4	-0.9	0.2	0.9	1.4	1.8
Excluding public enterprises	-7.8	-10.6	-7.9	-8.9	-8.6	-7.0	-5.9	-5.2	-4.8	-4.3
Public sector gross debt 2/	25.9	34.8	34.5	34.3	34.3	34.2	33.8	33.3	32.6	32.0
Central government gross debt	8.6	11.1	12.0	12.5	13.2	14.0	14.4	14.7	14.8	14.8
Central government balance	-0.5	1.3	0.6	-0.6	-1.3	-0.9	-0.7	-0.3	-0.1	-0.1
Total revenue	21.6	22.6	22.2	20.9	20.9	21.4	21.7	22.3	22.9	22.9
Total expenditure	22.0	21.3	21.6	21.5	22.2	22.3	22.3	22.6	23.0	23.0
Central government structural balance	-2.7	-1.1	-0.4	-0.8	-1.1	-0.7	-0.5	-0.2	0.0	0.0
Employment	(Annual percentage change, unless otherwise specified)									
Working age population	1.6	1.5	1.5	1.6	1.5	1.4	1.3	1.1	1.1	1.1
Labor force	4.2	3.8	1.1	1.6	1.5	1.4	1.3	1.1	1.1	1.1
Employment	7.4	5.0	1.9	2.1	1.0	1.4	1.3	1.1	1.1	1.1
Unemployment rate (in percent)	8.2	7.1	6.4	5.9	6.4	6.4	6.4	6.4	6.4	6.4

Sources: Central Bank of Chile, Ministry of Finance, National Statistics Institute, Haver Analytics, and Fund staff calculations and projections.

1/ Contribution to growth.

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

Table 7. Chile: Indicators of External Vulnerability

(In percent; unless otherwise indicated)

	2009	2010	2011	2012	2013	Proj. 2014
Financial indicators						
M3 (percent change)	-1.4	11.2	18.9	6.2	13.9	...
Less pension funds' deposits (annual percentage change)	0.7	16.5	21.5	4.5	14.7	...
Private sector credit to GDP	71.5	66.5	71.1	74.6	77.3	...
90-day central bank promissory note (nominal) interest rate (avg.)	1.8	1.7	4.9	5.1	5.0	...
Share of foreign currency deposits in total deposits	13.2	15.4	12.8	12.7	14.0	...
Share of foreign currency loans in total credit	11.5	10.7	12.7	12.9	13.5	...
External indicators						
Exports, U.S. dollars (annual percentage change)	-14.0	28.2	14.5	-4.3	-1.6	1.9
Imports, U.S. dollars (annual percentage change)	-31.4	38.1	27.1	7.2	-1.2	1.0
Terms of trade (annual percentage change)	4.3	22.0	1.6	-6.1	-2.5	-3.0
REER (annual percent change, period average)	-2.2	5.9	0.9	3.7	-1.2	...
Exchange rate (pesos per U.S. dollar, period average)	560	510	484	486	495	558
Current account balance (percent of GDP)	2.0	1.6	-1.2	-3.4	-3.4	-3.1
Financial account less reserves accumulation (percent of GDP)	-1.1	-3.1	6.9	3.3	3.5	3.1
Gross official reserves (in billions of U.S. dollars) 1/	25.4	27.9	42.0	41.6	41.1	41.1
Gross official reserves, months of imports of goods and services	4.5	3.9	5.6	5.5	5.4	5.3
Gross official reserves to M3	14.8	13.5	19.0	16.3	15.5	...
Gross official reserves to short-term external debt 2/	101.8	97.4	109.5	99.2	114.0	130.3
Total external debt (percent of GDP)	41.8	38.9	39.2	44.1	47.2	52.4
Of which: External public sector debt	7.7	7.9	8.2	9.5	9.2	9.5
Total external debt to exports of goods and services	112.5	102.7	104.1	130.0	146.1	151.3
External interest payments to exports of goods and services	2.4	2.3	2.3	3.3	3.3	3.6
External amortization payments to exports of goods and services	48.8	34.5	34.1	50.6	55.2	39.6
Financial market indicators						
Stock market index (in U.S. dollars; period average) 3/	1601	2362	2564	2434	2173	...
Sovereign long-term foreign currency debt rating (end of period)						
Moody's	A1	Aa3	Aa3	Aa3	Aa3	...
S&P	A+	A+	A+	AA-	AA-	...
Fitch ratings	A	A	A+	A+	A+	...

Sources: Central Bank of Chile, Haver Analytics, WEO, and Fund staff calculations.

1/ Gold valued at end-period market prices.
2/ Includes amortization of medium/long-term debt due during the following year.
3/ Morgan-Stanley Capital International index (Dec/1987=100).

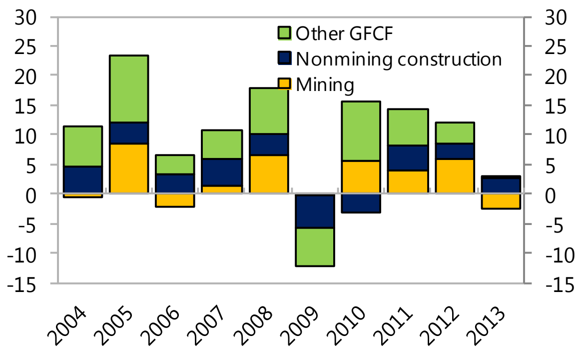
Annex I. Past Fund Advice

Macroeconomic policies, and financial and structural reform priorities of the authorities have been broadly in line with the Fund advice in recent years.	
Recommendation	**Traction**
Fiscal Policy: Withdrawal of the fiscal stimulus injected in 2009 and continuing gradual fiscal consolidation with the aim of a positive structural fiscal balance over the medium term.	The authorities gradually withdrew the fiscal stimulus injected in 2009 between 2011 and 2012, and adopted a tighter fiscal stance than implied by the 2013 budget. Their medium term objective is to achieve a balanced structural position by 2018 from the current structural deficit target of 1 percent of GDP.
Monetary Policy: Normalization of easy monetary policy stance following the global financial crisis to avoid inflationary pressures, and maintaining a neutral stance to support an orderly deceleration in activity towards trend. Cutting the monetary policy rate if (expected) inflation remains low and activity slows down. Letting the floating exchange rate be the first line of defense against external shocks.	The central bank accelerated the pace of policy normalization in early 2011 to help bring inflation expectations closer to the target, and maintained a neutral stance in 2012. Amidst a low inflation environment and slowing economy, the central bank has cut the policy rate gradually starting in mid 2013. The authorities see the exchange rate as a key shock absorber and let it adjust broadly without intervention.
Financial Sector: See Annex V on 2011 FSAP update.	See Annex V on 2011 FSAP update.
Structural Reforms: i) Establishing a reform agenda for boosting productivity growth ii) Improving labor market efficiency and flexibility, including by streamlining the high minimum wage and severance payments, increasing the flexibility of working hours, raising (female and youth) labor participation, and improving the efficiency of training programs iii) Enhancing energy supply and infrastructure iv) Improving income distribution and access to quality education	The government launched several initiatives in recent years aimed at boosting productivity by improving the business environment, such as by reducing the cost of doing business, increasing competition (facilitating entry of new firms), making credit more accessible to small and medium enterprises, supporting innovation, strengthening the protection of intellectual rights, speeding the business incorporation process, streamlining the bankruptcy procedures and reducing international trade costs. Recent reforms to improve (female) labor force participation -and in turn equity- include extending the length of maternity leave, employment subsidies for low income women and youth, and employment support and training services, albeit not used up extensively. Authorities had difficulty in achieving consensus on other measures to increase labor market flexibility and efficiency, which is also true for enhancing generation and transmission of electricity. On the other hand, the authorities established an education quality assurance system, improved access to scholarships and state-guaranteed loans with lower interest rates, and strengthened (conditional) cash transfer programs recently.

Annex II. A Closer Look at Investment[11]

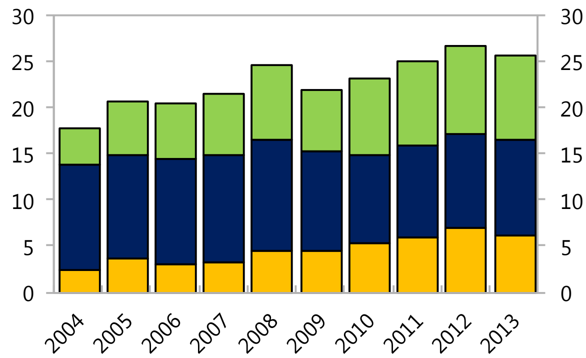
The global copper boom has triggered a gradual transformation of investment in Chile. Investment has become less focused on construction and much more on mining. Conventional (non-mining) construction traditionally represented well above 50 percent of total gross fixed capital formation (GFCF), but its importance has diminished in recent years due both to the growth in mining investment (construction and equipment) and to the increasing accumulation of equipment in other rapidly growing sectors, such as retail and services. Mining has increased its share in GFCF from 15 percent in the early 2000s to 26 percent in 2012, and the increase has been particularly pronounced since 2008. As a share of GDP, mining investment increased from 2.5 percent on average in 1976–2007 to 4.7 percent in 2008–2012.[12]

Components of GFCF
(contribution to total GFCF growth, in percent)



Sources: Central Bank of Chile, Cochilco, and Fund staff estimates.

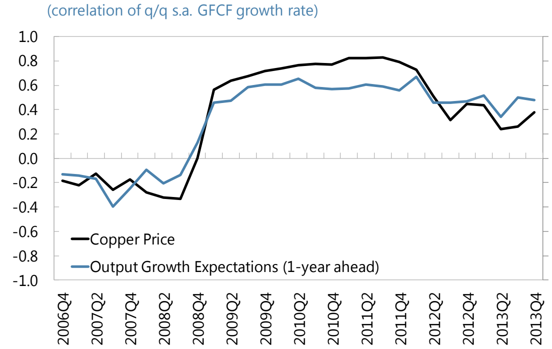
Components of GFCF
(shares in percent of GDP)



Sources: Central Bank of Chile, Cochilco, and Fund staff estimates.

GFCF growth has become more tightly linked with copper demand. The correlation between private GFCF growth and copper prices strengthened in the last five years (both on q/q and y/y basis). The strong link reflects both direct dependence of mining investment on global commodity demand and its spillover to an auxiliary investment growth in other sectors. As a consequence, a large swing in copper demand and prices, such as the 10 percent drop that occurred in 2013, is likely to have a broad-based effect on investment growth. More broadly, China's copper demand, which represents more than 40 percent of total world copper consumption, is an important

GFCF is Tightly Correlated with Copper Demand
(correlation of q/q s.a. GFCF growth rate)



Sources: Haver and Fund staff calculations.

[11] Prepared by I. Petrova (WHD).

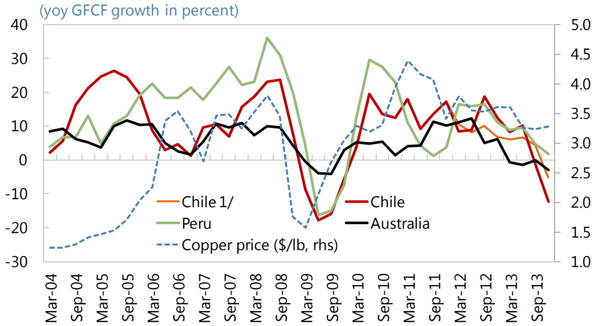
[12] See, *Learning about the Commodity Cycles and Saving-Investment Dynamics in a Commodity-Exporting Economy*, by Fornero, J, and M. Kirchner, Central Bank of Chile Working Paper N. 727, 2014.

determinant of copper prices and Chile's growth outlook (mining represents more than 13 percent of Chile's GDP and more than 50 percent of Chile's exports).

Investment growth collapsed in 2013. The decline was particularly sharp in the fourth quarter when private GFCF dropped by 12 percent y/y (11.4 percent q/q s.a.), amidst a pronounced global decline in copper prices. Quartely national accounts data on mining investment are not available, and a precise assessment of the behavior of mining investment is difficult to establish. Nonetheless, information from the Chilean Corporation of Capital Goods (CBC)—which compiles data about planned investment projects—suggests a double digit decline in mining projects both q/q and y/y at end-2013. The downward dynamics of Chile's GFCF in 2013 also appeared broadly similar to that of other commodity-exporting countries, but significantly more pronounced in the fourth quarter. The more precipitous decline was largely due to one-off base effects in transportation equipment in 2012 and changes in the statistical treatment of inventories (and GFCF). Construction also tapered off, with the completion of the post-2010 earthquake reconstruction, and had a modest additional adverse effect on private GFCF. Nonetheless, even after accounting for the one-off base effect and construction moderation, an additional unexplained idiosyncratic domestic effect remains. Many in the business community point to uncertainty arising from new government's reform agenda, in particular the tax reform, though this is difficult to evaluate empirically.

The investment slowdown in Chile in late 2013 was bigger than in other copper-exporting countries

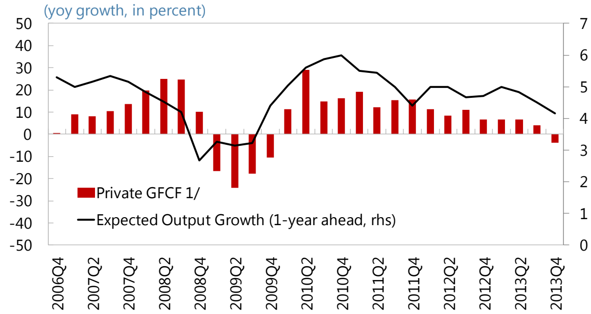
(yoy GFCF growth in percent)



Sources: Haver and Fund staff calculations.
1/ Growth in investment corrected for imports of capital (other transportation) goods.

The growth outlook put a brake on private investment

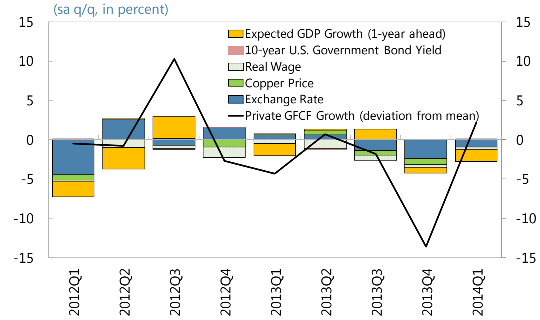
(yoy growth, in percent)



Sources: Haver and Fund staff calculations.
1/ Growth in investment corrected for imports of capital (other transportation) goods.

Regression analysis provides some further insights in the performance of private GFCF.[13] The copper price decline and exchange rate depreciation—both largely driven by demand deceleration in China— had a significant negative impact on private investment since mid-2013. Weakening in the 1-year forward GDP growth expectations also appears to have had an effect on investment in the fourth quarter, while interest rates and real wages had a negligible effect. Beyond these factors, it is evident that there are large idiosyncratic effects in specific quarters, such as the spike in transportation equipment in the third quarter of 2012, and the unusual drop at end-2013.

GFCF Growth Factors
(sa q/q, in percent)



Sources: Haver, Central Bank of Chile, and Fund staff estimates.
Note: Out of sample projection for 2014Q1.

Investment Determinants: Regression Analysis

	Exchange rate (LC/US)	Copper price	Real wage	Bank lending rate	Expected GDP growth rate	10y US Govt Rate
Coefficient	-0.54	0.09	-0.83	0.07	4.63	-0.04
t-statistic	-4.22	1.73	-1.27	-0.13	-2.72	-2.37
Statistical significance 1/	***	*			***	**

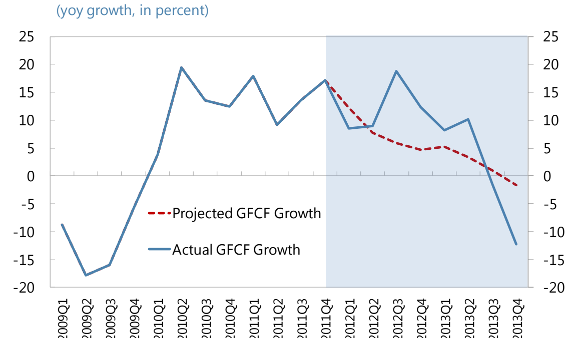
Source: Fund staff calculations. See text

1/ ***=1 percent confidence, **=5 percent, *=10 percent

Identifying clearly all factors affecting investment is marred by caveats.

- First, alternative models and specifications are not able to eliminate the large residuals in 2012Q3 and 2013Q4. For example, a projection using a structural vector autoregression (VAR) model shows significant errors in those quarters.[14]

The error in forecasting GFCF growth remains high
(yoy growth, in percent)



Source: Fund staff estimates.

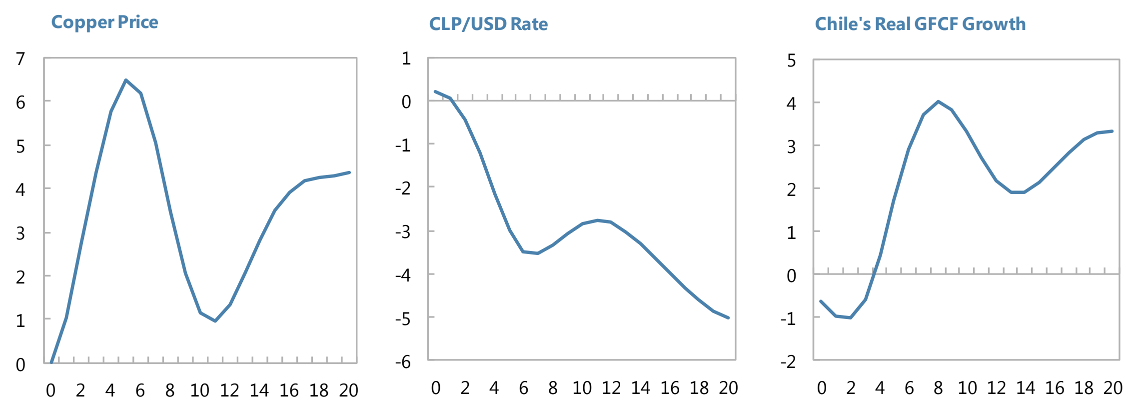
[13] Dependent variable: quarterly growth of seasonally adjusted private GFCF; Explanatory variables: first lag in the change of the exchange rate and real wages; second lag in the change of copper prices, interest rates, and expected GDP growth rate. Due to the high correlation of the copper price change, the exchange rate depreciation, and Chile's growth expectations with China's growth, the latter appears insignificant in the regressions and has been omitted. Expected GDP growth rate refers to 1-year forecasts. Regression with robust standard errors, 41 quarterly observations in 2003-13, and R^2=0.62. Alternative specifications using real effective exchange rate changes and terms-of-trade growth yield significant coefficients, but a poorer fit.

[14] The VAR model used in this analysis is described in Chapter 4 of the April 2014 *World Economic Outlook (WEO)*. As in the WEO, to avoid "overfitting" due to the small number of observations and large number of variables, the model is estimated using Litterman's (1986) Bayesian approach. The terms of trade variable in the WEO model is replaced with growth in the copper price, while the real exchange rate is replaced with the change in the nominal CLP/USD exchange rate. Real wage growth is also added to the model.

- Second, as mentioned above, the copper price, the exchange rate—and the growth outlook in Chile—are very highly correlated and their movement is likely to be jointly affected by an external factor, such as China's demand for copper. The VAR model suggests that a 1-percentage point increase in China's growth leads to an increase in the copper price and appreciation of the Chilean peso by about 3.5 percentage points in 8 quarters and to a 4-percentage point increase in GFCF growth over the same horizon.[15]

One percentage point increase in China's growth affects the copper price, the exchange rate, and Chile's real GFCF growth

(Cumulative impulse response, in percent)



Source: Fund staff estimates.

- Third, some short-term effects appear counterintuitive. China's growth seems to have a negative impact on Chile's investment growth in the short-run. As Fornero and Kirchner (2014) explain, investment reaction to commodity price shocks could be sluggish since economic agents initially perceive the price change as transitory. As agents observe persistence in the copper price change, they revise their beliefs, and investment growth starts following the direction of the commodity price change (i.e., the direction of China's growth). Alternatively, one might also need to specify different and more closely representative proxies for China's demand for copper—e.g., growth in China's energy investment instead of China's GDP growth. The negative effect of exchange rate depreciation on investment is another example of a counterintuitive result. In the short run the depreciation does make imports of capital goods more costly; however, in the medium-term, the depreciation helps regain competitiveness and is likely to encourage investment growth.

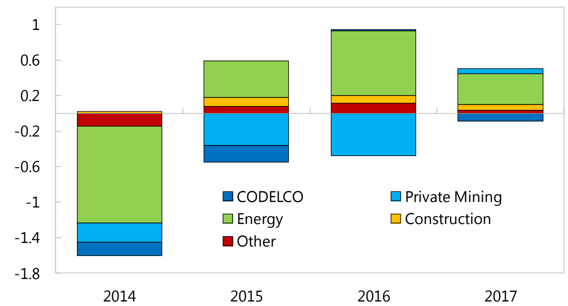
With Chile's mining investment boom coming to an end, copper prices on a downward trend, and weakening growth expectations, the short-term GFCF growth outlook remains uncertain. With an 8-percent depreciation of the peso—which weighs on the cost of imported capital goods—and a slight drop in the copper price in 2014Q1, investment growth is likely to remain weak in the

[15] The variable measuring Chile's growth expectations is not included in the VAR estimations in order to retain longer time series. Chile's real GDP growth is included.

short run. An improvement in the 1-year forward output growth expectations is likely to have tangible effects only after the first half of 2014. In terms of sectors, CBC data suggests that a significant rebound in the second half of 2014 can be expected only in energy projects.

Planned investment is a source of cautious optimism for medium-term GFCF growth. With the deterioration in investment conditions in 2013, planned investment projects have been scaled down. Energy and the mining sector have been affected the most. Compared to investment plans at end 2013, mining projects will remain short by about 0.4 percent of GDP in 2014–17. Projects in the energy sector have only been postponed and will be about 0.4 percent higher in the medium-term, and construction is also expected to be scaled up. While, the across-the-board postponement of planned 2014 investment is unlikely to recover fully in 2015–17, the government's reforms agenda on energy and infrastructure—not reflected in these projections—is likely to be an important impelling force in investment recovery. Finally, the exchange rate adjustment will foster export growth eventually, which should help propel investment growth in the medium term, as well.

GFCF Outlook: Postponed Mining Investment Unlikely to Recover in the Medium Term
(March 2014 vs. Decemebr 2013, percent of GDP)



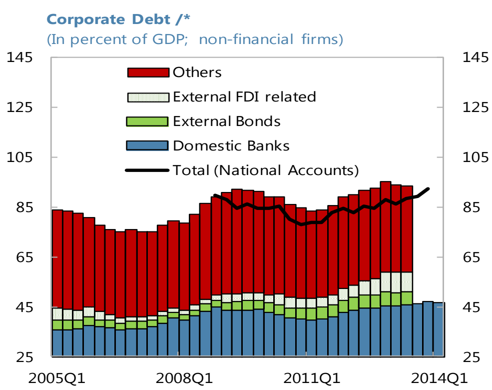
Source: Corporation of Technological Development on Capital Goods.

Annex III. Recent Developments in Corporate Debt[16]

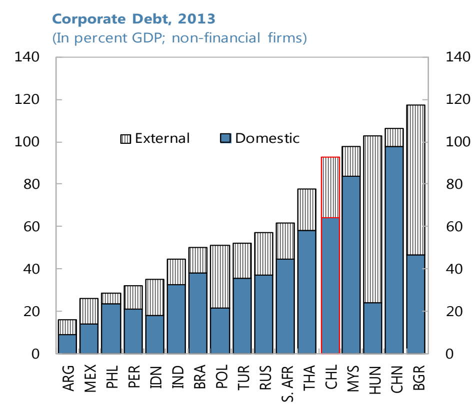
Corporate leverage has risen over the last two years, surpassing pre-crisis (2008) levels.[17] Currently at about 93 percent of GDP, corporate debt has increased by about 10 percentage points since mid-2011 and is high compared to other emerging economies.

As a mitigating factor, FDI-related (external) debt accounts for most of this increase. FDI-related debt, which is mostly in mining, likely has a lower rollover risk than other forms of financing (e.g., bonds and bank loans) as it is between related parties.

In terms of stocks, local bank credit remains the most important source of debt, followed by local bonds and foreign bank credit. About 50 percent of corporate debt is in the form of local bank credit. Reliance on bank financing fell significantly in the aftermath of the global financial crisis, but has since recovered to pre-crisis levels. Local bonds and foreign bank credit have declined in significance and together now represent each about 13.5 percent. In the context of easy global financial conditions, firms have also increased their issuance of external bonds to reach 6 percent of total corporate debt. Despite this increase, corporate maturing external debt will remain at about 6.5–7.25 percent of GDP a year over the next three years, in line with the 2005–13 average.



Source: Central Bank of Chile.
*/ For 2013H2 and 2014 only bank credit data is available.

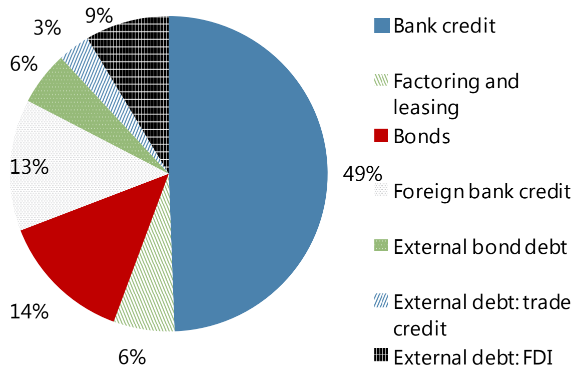


Sources: Global Financial Stability Report April 2014 and Central Bank of Chile. For Chile June 2013.

[16] Prepared by N. Arregui (MCM) and D. Rodriguez-Delgado (WHD).

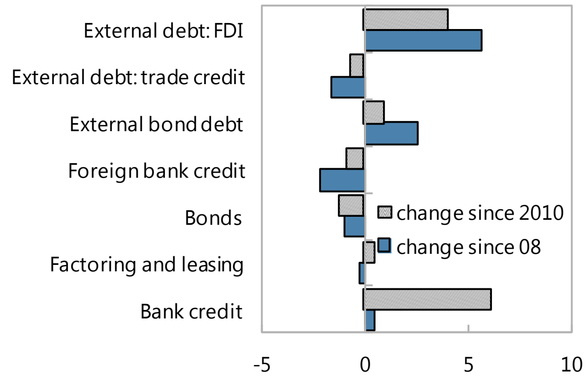
[17] This annex focuses on debts of the non-financial corporate sector.

Sources of Financing
(In percent of total non-financial corporate debt)



Source: Central Bank of Chile.

Sources of Financing
(In percent of GDP; non-financial firms)



Source: Central Bank of Chile.

The composition of debt varies across sectors. Community services (mainly health and education) and the trade sector—the two sectors with the largest share of aggregate corporate debt—rely relatively less on external debt (20 percent of total debt). Mining, on the other hand, relies heavily on external debt, of which about half is in the form of FDI-related debt. Construction and agriculture depend almost exclusively on domestic financing (in particular, bank financing).

Sectoral Distribution of Debt
(in percent)

Sector	2009	2012	2009	2012	2009	2012
	(share of total debt)		(share of FDI-related debt in total debt)		(share of other external debt in total debt)	
Community services	20.3	22.2	1.6	4.9	17.3	14.4
Trade	15.3	18.3	3.6	3.9	7.2	15.1
Manufacturing	13.8	13.3	4.7	4.4	25.6	24.8
Transportation	14.8	13.2	6.5	8.2	35.3	40.4
Electricity, gas and water	12.7	10.3	1.2	2.7	33.3	29.5
Mining	5.2	7.4	11.1	33.5	59.9	34.9
Construction	11.5	9.6	1.1	2.1	3.1	0.9
Agriculture	6.3	5.6	1.8	0.7	3.4	3.0
Total/average	**100**	**100**	**3.9**	**7.6**	**23.1**	**20.4**

Sources: Central Bank of Chile and Fund staff calculations.

Microeconomic data suggest that a handful of firms account for a significant part of the expansion in corporate debt. The Capital IQ database includes data on 319 Chilean firms reporting in 2008 and 2012. Their total debt amounted to roughly 60 percent of GDP in 2012 (or about two-thirds of total corporate debt). The increase in the indebtedness of five firms (between 2008 and 2012) equaled six percentage points of GDP. For example, in 2012 LAN made a large acquisition of TAM to become the LATAM Airlines Group. Cencosud (consumer retail), Codelco (mining), Antar Chile (industrial conglomerate), and Empresas CMPC (materials-cellulose producer) also contributed significantly.

Selected Corporate Debt Evolution

Company	Industry	Change in Debt (2008-2012; percentage points of GDP)	Debt to Assets 2008	Debt to Assets 2012
LATAM Airlines Group S.A.	Industrials	2.1	0.55	0.47
Cencosud S.A.	Consumer Staples	1.4	0.31	0.37
Corporación Nacional del Cobre de Chile	Materials	1.2	0.35	0.32
AntarChile S.A.	Industrials	1.0	0.22	0.31
Empresas CMPC S.A.	Materials	0.6	0.17	0.28
Total		**6.1**		

Sources: Haver Analytics, Standard & Poor Capital IQ database, and Fund staff calculations. Based on firms reporting both in 2008 and 2012.

In aggregate, corporate profitability, leverage, and liquidity indicators have worsened, but there are important differences across sectors. In 2013, the food and transportation and telecommunication sectors experienced a marked decline in profitability and liquidity, and an increase in leverage. The construction sector has almost doubled its leverage from the 2002–08 average; its profitability is also lower but it has remained stable since 2009. The services sector has the highest leverage but it also among the most profitable and liquid.

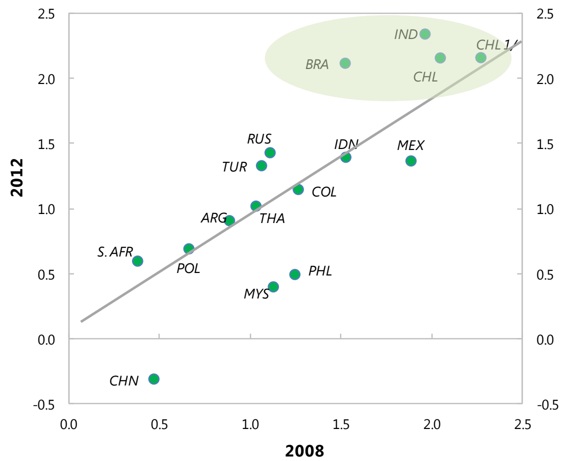
Selected Corporate Financial Indicators by Sector

	Construction	**Consumer**	**Transport. & Telec.**	**Food**	**Services**	**Electricity**	**Forestry**	**Total**
Profitability (return over assets; in percent)								
2002-2008	7.60	6.50	6.90	7.40	6.10	6.20	5.40	6.40
2009-2012	4.30	5.45	6.03	8.73	7.38	9.60	5.60	7.33
2013	4.40	2.80	3.00	6.20	7.50	8.90	5.20	5.80
Leverage (ratio of debt to equity)								
2002-2008	0.45	0.71	0.70	0.43	0.79	0.65	0.28	0.63
2009-2012	0.67	0.80	0.95	0.46	1.25	0.59	0.43	0.67
2013	0.83	0.76	1.07	0.61	1.16	0.53	0.52	0.71
Liquidity (ratio of current assets minus inventories to current liabilities)								
2002-2008	0.91	0.86	1.15	1.03	1.44	1.14	1.36	1.10
2009-2012	0.80	0.83	0.92	1.18	1.28	1.18	1.62	1.09
2013	0.72	0.64	0.78	0.93	1.20	1.17	1.32	0.94

Sources: Central Bank of Chile and Fund staff calculations.

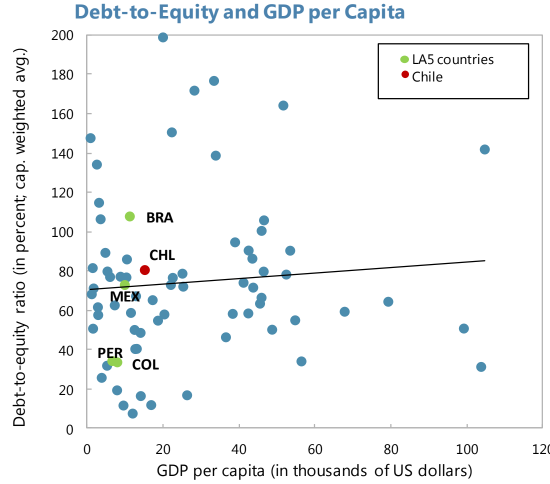
Still, other aggregate indicators of vulnerability do not point to acute risks. Currency mismatches, as reported by the central bank, remain limited.[18] Indicators for debt service capacity do not show a uniform picture. The median of the net debt to EBITDA (earnings before interest, taxes, depreciation, and amortization) ratio, is quite high compared with other emerging market economies, but has remained stable.[19] A broader cross-country comparison of debt-to-equity ratios shows that the number for Chile is roughly in line with its income level. In a comparison of the interest coverage ratios (EBITDA divided by interest expenses) Chilean companies appear to have a relatively good capacity to service debt. The IMF's April 2014 Global Financial Stability Report (GFSR) includes a stress testing exercise assuming a 25 percent increase in borrowing costs and a 25 percent decline in earnings that shows a low increase in Chilean debt-at-risk relative to other

Net Debt to EBITDA Ratio



Sources: Central Bank of Chile, Standard & Poor Capital IQ database, and Fund staff calculations.
1/ This value corrects the database excluding subsidiary companies.

Debt-to-Equity and GDP per Capita



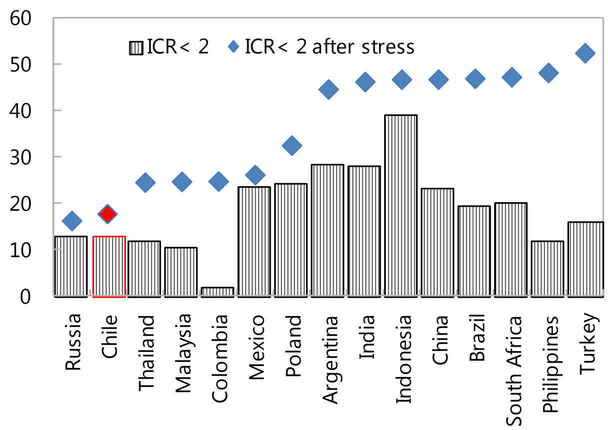
emerging economies.[20]

[18] Data to conduct a foreign currency stress testing exercise was not available to staff. However, to the extent that an exchange rate shock (peso depreciation) would affect interest rate expenses and earnings, the stress test mentioned below provides some indirect evidence that Chile is in a relatively good position to face such shock.

[19] The figure is similar to Figure 1.20.3 in the IMF's April 2014 GFSR. However, the GFSR computed the median only for firms with positive net debt and positive EBITDA. The share of Chilean firms with negative net debt in the Capital IQ database increased by 10 percent points from 2008 to 2012. In this Annex we compute the median for firms with positive or negative net debt and positive EBITDA. The relative position of the medians for Chile is not significantly affected.

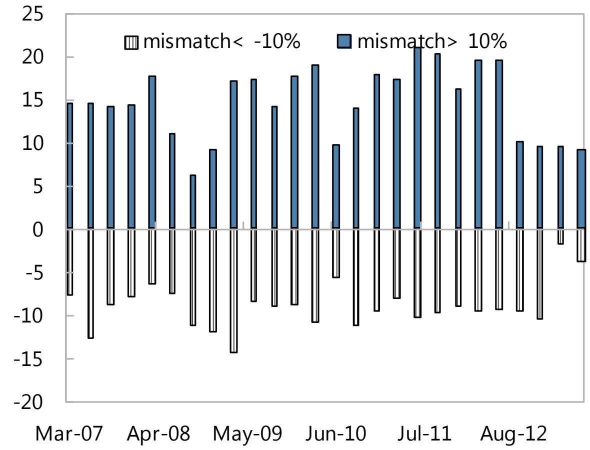
[20] Debt-at-risk refers to the share of debts of firms with an interest coverage ratio below two after the shocks.

Distribution of Debt-at-Risk by Interest Coverage Ratio
(in percent of total debt)



Source: Global Financial Stability Report April 2014.

High Currency Mismatch Firms 1/
(in percent of total assets)



Source: Central Bank of Chile.
1/ Dollar liabilities minus dollar assets, minus net derivative pos.

Finally, corporate debt represents a large share of the Chilean financial system's assets. Commercial loans account for roughly 50 percent of banks' portfolios. Domestic corporate bonds account for 30 and 10 percent of life insurance companies' and pensions funds' investments, respectively. The potential exposure of the financial sector to corporate sector vulnerabilities is thus significant. However, central bank stress tests find the banking sector solvent even under extreme scenarios. All banks maintain capital adequacy ratio above 8 percent in a test involving a 6 percentage point drop in output relative to baseline and subdued growth over the medium term; a 300 basis points rise in interest rates and 100 basis points in the long term; and a 20 percent peso depreciation.

Annex IV. Risk Assessment Matrix[1]

	Nature of Shock	Likelihood	Impact	Recommended Policy Response
Potential External Shocks				
	Sharp slowdown in China's economic growth and a decline in the copper price.	Low in the short run; medium over the medium run	*High*. As China constitutes 25 percent of Chile's total exports of goods and nearly 40 percent of exports of mining products, Chile's net exports and growth prospects are vulnerable to China's outlook.	The floating exchange rate is the first-line of defense. Foreign exchange intervention could help avoid excessive currency volatility, if needed. As long as inflation expectations remain well anchored over the policy horizon, there is room for monetary easing to support demand. In case of more severe output drop, there would be ample room for a robust fiscal response.
	Surges in global financial market volatility related to revised expectations on the exit from unconventional monetary policy.	High	*Medium*. Chile's gross external financing requirements have declined since 2013, but remain at 17 percent of GDP, exposing the country to a sudden stop.	The floating exchange rate remains the first line of defense. Foreign exchange intervention could help avoid excessive currency volatility, if needed. Nonetheless, the authorities should be prepared to react as they did at the onset of the global financial crisis and use measures to contain liquidity pressures: expanded repo operations, broadening the range of accepted collateral, and setting up dollar swap auctions.
Potential Domestic Shocks				
	Sharp decline in real estate prices.	Low/Medium	*Medium/Low*. About 1/3 of banks' loan portfolio contains mortgage and construction company loans, and about 1/4 of life insurance companies' assets is in mortgage-related instruments. A decline in real estate prices could affect the construction and financial sectors and through a drop in collateral values trigger a cycle of tighter credit, lower economic activity, financial stress, and real estate prices.	The priority should be to strengthen further the financial oversight and regulation, including through macroprudential policies, as needed, to help prevent excessive exposure of the financial system. In the event of a sharp correction in real estate prices, the authorities should be ready to consider actions (easing off macroprudential and/or monetary policy) to dampen the possible vicious feedback loop between real estate prices, credit, and activity.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly

Annex V. 2011 FSAP Update—Status of Main Recommendations

Recommendation[1] (priority H/M, time frame S/M)	Status
Reduce information gaps, including through a consolidated credit registry and standardized residential and commercial property price indices (M, M)	A bill was submitted to Congress in August 2011 to create a public credit bureau, which would consolidate data provided by financial institutions (banks, retailers, insurance companies, and others). It will include both positive and negative information for individuals and companies. It will be managed by the Superintendence of Banking and Financial Institutions (SBIF). The Central Bank has started publishing residential housing price data back to 2001. The working group on Housing Market of the Financial Stability Council (CEF) has produced data on Loan-to-Value ratios. The BCCh intends to publish series on regional housing prices starting June 2014. Compiling a commercial property price index remains a working project.
Develop a strategy to ensure adequate replacement rate for retirees (H, M)	The 2008 Pension Reform contained several measures to address the issue of low pension and replacement rates, including the introduction of a new solidarity pillar to prevent old-age poverty and measures to reduce the gender gap in old-age income (e.g. division of balance in case of divorce). To increase coverage, subsidies for young workers and a gradual mandatory participation of independent workers were introduced (2012 was the first year of the phase-in transition).The mechanisms for voluntary pension savings with tax incentives were improved and widened. The measures, particularly the collective voluntary saving mechanism, have not yielded the expected results. The Superintendence of Pensions (SP) has developed two new methodologies to measure and forecast replacement rates. One model uses administrative and survey data at the individual level, and has been improved over the last year to better fit the observed data. The other is a pension risk model, which is used in a public web-based pension simulator that allows users to estimate their pension under different return assumptions. The simulator has been updated to simplify its use and improve accuracy, and additional improvements are planned for 2014. Since its launching, the simulator has averaged 10 thousand visits per month. The SP has launched a web tool for members to check if employers have paid contributions on behalf of

[1] For a full description of the recommendations including their implementation requirements, see Chile: Financial System Stability Assessment at http://www.imf.org/external/pubs/cat/longres.aspx?sk=25192.0

Recommendation[1] **(priority H/M, time frame S/M)**	**Status**
	workers. There is also ongoing joint work with the OECD on computing replacement rates. The new government has appointed a commission of 25 national and international experts to work on proposals to improve replacement rates and other aspects of the pension system. A report by the commission is expected by January 2015.
Strengthen the independence and legal protection of regulatory agencies (H, M)	In 2013, the Government submitted a draft law to Congress, which envisages improving governance of the Superintendence for Securities and Insurance (SVS) by converting it to a Commission managed by a five-member council. The Chairman is still appointed by the president, but can no longer be removed remove at will, and the Commissioners are submitted by the President to the Senate for approval. Commissioners are protected from dismissal for political reasons. The draft law also proposes improvements to the enforcement process and transparency (an annual report will be published and regulatory impact assessment will be made prior issuing new regulations) and extends legal defense in the performance of their official duties to Commissioners and the Prosecutor. In addition, it grants the Commission significant increases in budget and staff. The bill has been approved by the lower house and is currently being discussed in the upper house. No action has been taken to enhance the independence of the other agencies including banking supervisor (SBIF).
Strengthen the enforcement powers of securities regulators (H, S)	Enhancement of enforcement powers of the SVS is envisaged in the draft law mentioned above. The law would establish Securities and Insurance Prosecutor—an autonomous body in charge of investigation and enforcement proceedings. Sanctions will be applied by the Commission, upon conclusion of the investigation by the Prosecutor. The bill of law enhances the supervisor's power to request information, access and share confidential information. It also introduces the figure of plea bargain and whistleblowers, providing the Commission with additional investigative tools.
Complete the incorporation of Basel bank capital standards (H, M), and strengthen the legal framework for bank resolution (H, M)	With regard to the reform to the General Banking Law, a draft bill focused on the incorporation of Basel bank capital standard has been elaborated. However, amendments to enhance independence of the SBIF and major changes to the legal framework for bank resolution were not included in that reform. The new administration is in the process of deciding how to proceed with this project. The SBIF and the Central Bank are also working on improvements in liquidity regulation and reporting, taking into consideration recent proposals of the Basel Committee on Banking Supervision.
Establish legal framework to enable the consolidated oversight of financial conglomerates (H, M)	The Committee of Financial Superintendents (CSSF) is developing a methodology for supervision of financial conglomerates, including assessment of overall risks and identification of lead supervisors. The CSSF has established formal rules for sharing information relevant for supervision and regulation. The new Financial Stability Council (CEF) builds up on the work of the CSSF. The Council is supported by three working groups: Risk Analysis, Regulation and Legislation, and Financial

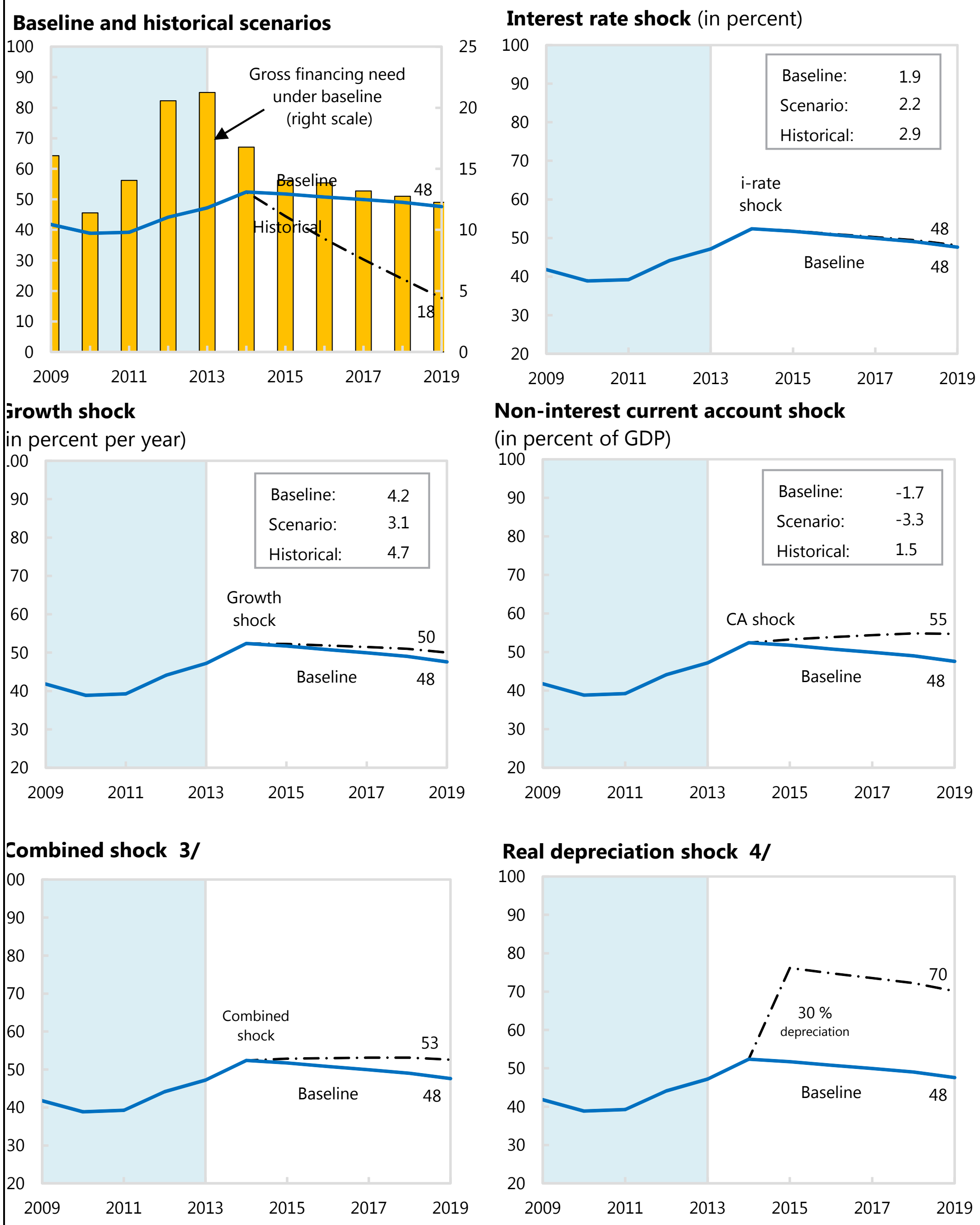
Recommendation[1] (priority H/M, time frame S/M)	Status
	Conglomerates, the latter is working on identifying key indicators of financial health for conglomerates. In 2013 a draft bill was submitted to Congress to grant legal status to the CEF and improve coordination and information exchange between staff of the regulatory agencies, with a view to assessing systemic risks as well as supervision of financial conglomerates.
Enhance uniformity in business conduct regulation for asset management services and investment advice (H, M)	In December 2011, the SVS issued regulation on internal control and risk management for securities intermediaries, which sets minimum requirements for control and risk management. Securities intermediaries will be required to have an Internal Audit Unit, and an internal risk management system consistent with the complexity of operations. The senior executives will be accountable for the implementation of the internal control and risk management. A staff's code of conduct will also be required. The Ley Unica de Fondos that standardizes regulation in the fund industry was approved in 2013 and became effective on May 2014. Within this framework, the bill allows the SVS to establish minimum knowledge and professional standards for directors, managers, executives and other people performing relevant functions for the fund management company. Likewise, it allows the establishment of fit and proper requirements for managers of individual portfolios.
Introduce comparable transparency standards for fixed income securities traded outside exchanges (H, M)	The SVS is still reviewing the topic and assessing the necessity of amending the law to address the matter. Notwithstanding it is within its short/medium term goals to standardize the information contained in the CSDs, CCPs, and Stock Exchanges' trade repositories to facilitate the access of OTC trades done, cleared or settled through those entities.
Adopt a comprehensive approach to custodial, clearing, and settlement infrastructure (M, M)	The SVS is still working on the draft rules that will improve corporate governance and risk management standards of CSDs, CCPs, and Stock Exchanges. IOSCO PFMIs will be taken into account during the rule making process.
Further enhance the AML/CFT framework (M, M)	In April 2011, the Financial Analysis Unit (UAF), SVS, SBIF, and the SP issued regulations against corruption of senior government officials. They established criteria to define Politically Exposed Persons (PEP), and procedures for financial intermediaries to determine the source and destination of funds of such persons. In addition, all entities supervised by the UAF are required to register all transactions of PEP and inform of any suspicious operations. Progress has been made on GAFISUD recommendation to require foreign subsidiaries to inform about activities carried out in countries that are not in compliance with the set standards. In 2013, the UAF initiated 315 punitive procedures for non-compliance with anti-money

Recommendation[1] **(priority H/M, time frame S/M)**	**Status**
	laundering regulations. In January 2013, Circular #49 came into force, consolidating the supervised entities' main obligations related to AML/CFT, particularly regarding record keeping, information and reporting, and prevention system functions and implementation. In March 2013 the ministers of Interior and Finance jointly launched the "National strategy against money laundering," a task force (involving more than 20 public institutions) aiming to provide a diagnosis of the situation of the public sector. A document was produced suggesting a total of fifty measures to give concrete solutions for the challenges identified. During 2013 the Congress continued its review in second reading of a draft law that seeks to adapt the current legal regulation on prevention and sanction of crimes of money laundering and terrorism financing, to international standards established by FATF-GAFI.
Consider introduction of a premium-based limited deposit insurance system (M, M)	There have been no changes to date.
Examine options to establish a framework for dealing with a systemic crisis and with the potential failure of a financial conglomerate (M, M)	The Finance Ministry, Central Bank, and the SBIF conducted a joint crisis exercise in 2011, coordinated by Crisis Management Analytics. In addition, there has been progress in enhancing the supervision of conglomerates. As mentioned above, a draft bill will be submitted to Congress to provide the CEF a legal framework and to strengthen the capacity of supervisors to request information on conglomerates. Further information mechanisms have been developed by financial regulators. The SBIF signed MoUs for information sharing with supervisory authorities in Panama and Colombia, and MoUs with Brazil and Peru are under review, as well as amendments to the MoU signed with the U.S. and Spain. The SVS signed a MoU with the Peruvian Securities Market Superintendence and the Financial Superintendence in Colombia, in the context of an integration project of stock exchanges of Peru, Colombia, and Chile.

Annex VI. Debt Sustainability Analysis

Figure A6.1. Chile: External Debt Sustainability: Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: Fund staff calculations.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

Table A6.1 Chile: External Debt Sustainability Framework, 2009-2019
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Debt-stabilizing non-interest current account 6/
Baseline: External debt	**41.8**	**38.9**	**39.2**	**44.1**	**47.2**	**52.4**	**51.7**	**50.8**	**49.9**	**49.0**	**47.6**	**-4.6**
Change in external debt	6.3	-2.9	0.4	4.9	3.0	5.2	-0.7	-0.9	-0.9	-0.9	-1.4	
Identified external debt-creating flows (4+8+9)	-3.7	-12.5	-5.8	0.8	-1.3	-1.5	-2.1	-1.9	-1.9	-1.6	-1.5	
Current account deficit, excluding interest payments	-2.9	-2.5	0.4	2.3	2.3	1.8	1.6	1.8	1.7	1.8	1.8	
Deficit in balance of goods and services	-66.6	-69.3	-72.2	-67.8	-64.9	-69.2	-66.7	-64.7	-63.1	-61.5	-59.9	
Exports	37.2	37.8	37.7	34.0	32.3	34.6	33.4	32.3	31.5	30.7	29.9	
Imports	-29.4	-31.5	-34.5	-33.9	-32.6	-34.5	-33.4	-32.4	-31.6	-30.9	-30.0	
Net non-debt creating capital inflows (negative)	-3.2	-2.2	-1.8	-0.3	-3.0	-3.0	-2.8	-2.6	-2.4	-2.3	-2.1	
Automatic debt dynamics 1/	2.4	-7.8	-4.4	-1.2	-0.6	-0.3	-0.9	-1.1	-1.1	-1.1	-1.2	
Contribution from nominal interest rate	0.9	0.9	0.9	1.1	1.1	1.2	1.2	1.0	0.9	0.8	0.8	
Contribution from real GDP growth	0.4	-1.9	-1.9	-2.0	-1.8	-1.6	-2.0	-2.0	-2.0	-2.0	-1.9	
Contribution from price and exchange rate changes 2/	1.2	-6.8	-3.3	-0.3	0.1	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	10.0	9.6	6.2	4.1	4.3	6.7	1.4	1.0	1.0	0.7	0.1	
External debt-to-exports ratio (in percent)	112.5	102.7	104.1	130.0	146.1	151.3	155.1	157.4	158.6	159.7	159.2	
Gross external financing need (in billons of US dollars) 4/	**28**	**25**	**35**	**55**	**59**	**44**	**39.28**	**41**	**42**	**44**	**45**	
in percent of GDP	16.1	11.4	14.1	20.6	21.2	16.8	14.1	13.8	13.2	12.7	12.3	
Scenario with key variables at their historical averages 5/						**52.4**	**44.5**	**37.1**	**30.3**	**23.9**	**17.7**	**-5.2**
Key macroeconomic assumptions underlying baseline												
Real GDP growth (in percent)	-1.0	5.7	5.8	5.5	4.2	3.2	4.1	4.2	4.2	4.3	4.3	
GDP deflator in US dollars (change in percent)	-3.2	19.4	9.2	0.7	-0.2	-7.9	2.0	2.4	2.5	2.9	3.0	
Nominal external interest rate (in percent)	2.4	2.6	2.5	3.0	2.5	2.5	2.3	2.0	1.9	1.8	1.7	
Growth of exports (US dollar terms, in percent)	-15.0	28.6	14.9	-4.4	-1.0	1.8	2.3	3.3	4.3	4.5	4.7	
Growth of imports (US dollar terms, in percent)	-28.1	35.2	26.5	4.2	0.1	0.7	2.7	3.7	4.2	4.6	4.3	
Current account balance, excluding interest payments	2.9	2.5	-0.4	-2.3	-2.3	-1.8	-1.6	-1.8	-1.7	-1.8	-1.8	
Net non-debt creating capital inflows	3.2	2.2	1.8	0.3	3.0	3.0	2.8	2.6	2.4	2.3	2.1	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium-and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection

Table A6.2. Chile: Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

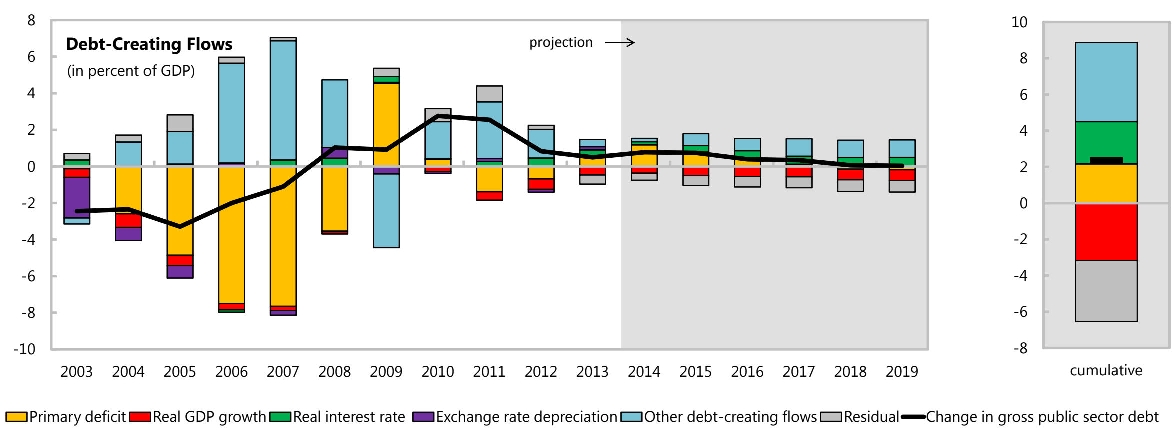
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2003-2011 [2/]	2012	2013	2014	2015	2016	2017	2018	2019
Nominal gross public debt	7.7	12.0	12.5	13.2	14.0	14.4	14.7	14.8	14.8
Public gross financing needs	-0.5	0.9	2.1	2.3	2.3	1.2	1.6	0.9	1.2
Net public debt (excludes Pension Reserve Fund)	-5.2	-4.6	-3.9	-2.6	-1.3	-0.4	0.1	0.4	0.6
Real GDP growth (in percent)	4.6	5.5	4.2	3.2	4.1	4.2	4.2	4.3	4.3
Inflation (GDP deflator, in percent)	6.0	1.3	1.7	3.8	2.8	2.8	2.9	2.9	3.0
Nominal GDP growth (in percent)	10.9	6.8	5.9	7.0	7.0	7.2	7.3	7.2	7.4
Effective interest rate (in percent) [4/]	9.9	5.7	5.2	5.3	5.7	6.1	6.3	6.5	6.7

As of May 19, 2014		
Sovereign Spreads		
Bond Spread (bp) 3/		143
5Y CDS (bp)		73
Ratings	Foreign	Local
Moody's	Aa3	Aa3
S&Ps	AA-	AA+
Fitch	A+	AA-

Contribution to Changes in Public Debt

	Actual			Projections							
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-0.4	0.8	0.5	0.8	0.7	0.4	0.3	0.1	0.0	2.3	
Identified debt-creating flows	-0.9	0.6	1.0	1.2	1.3	1.0	0.9	0.7	0.7	5.7	
Primary deficit	-2.5	-0.7	0.5	1.2	0.8	0.4	0.1	-0.2	-0.2	2.2	0.9
Primary (noninterest) revenue and grants	21.9	21.7	20.5	20.4	20.8	21.1	21.7	22.3	22.3	128.6	
Primary (noninterest) expenditure	19.4	21.1	21.0	21.6	21.6	21.5	21.8	22.2	22.1	130.7	
Automatic debt dynamics [5/]	-0.5	-0.3	0.1	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	-0.8	
Interest rate/growth differential [6/]	-0.2	-0.1	-0.1	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	-0.8	
Of which: real interest rate	0.2	0.5	0.4	0.2	0.3	0.4	0.4	0.5	0.5	2.3	
Of which: real GDP growth	-0.4	-0.6	-0.5	-0.4	-0.5	-0.6	-0.6	-0.6	-0.6	-3.2	
Exchange rate depreciation [7/]	-0.4	-0.2	0.2	…	…	…	…	…	…	…	
Other identified debt-creating flows	2.2	1.6	0.4	0.2	0.7	0.7	1.0	1.0	1.0	4.4	
Deposits/asset accumulation (negative)	2.2	1.6	0.4	0.2	0.7	0.7	1.0	1.0	1.0	4.4	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	0.5	0.2	-0.5	-0.4	-0.5	-0.6	-0.6	-0.6	-0.6	-3.4	



Source: Fund staff calculations.

1/ Public sector is defined as central government.

2/ Based on available data.

3/ EMBIG (bp).

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ) times previous period debt ratio, with r = effective nominal interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

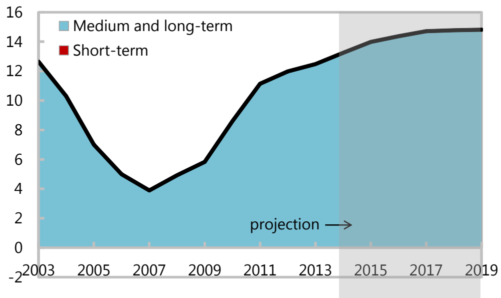
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table A6.3. Chile: Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

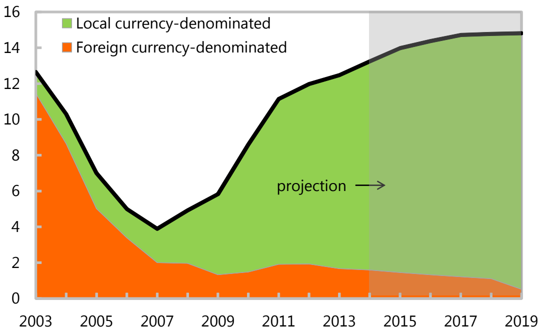
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

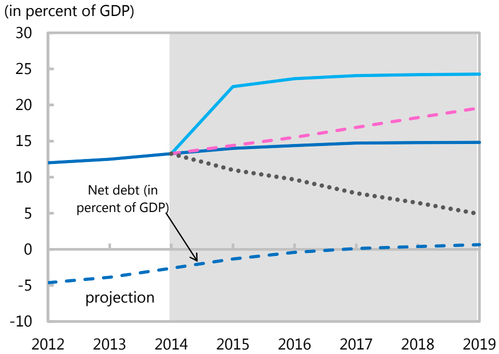


Alternative Scenarios

Baseline
Contingent Liability Shock
Historical
Constant Primary Balance

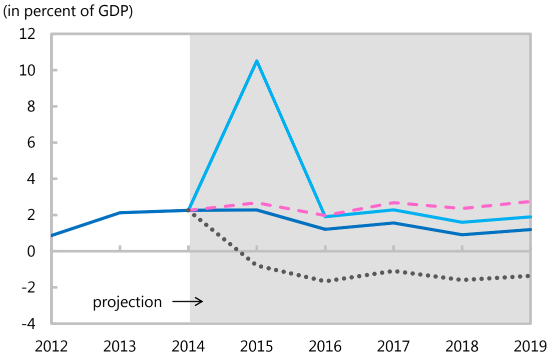
Gross Nominal Public Debt [1/]

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	3.2	4.1	4.2	4.2	4.3	4.3
Inflation	3.8	2.8	2.8	2.9	2.9	3.0
Primary Balance	-1.2	-0.8	-0.4	-0.1	0.2	0.2
Effective interest rate	5.3	5.7	6.1	6.3	6.5	6.7
Constant Primary Balance Scenario						
Real GDP growth	3.2	4.1	4.2	4.2	4.3	4.3
Inflation	3.8	2.8	2.8	2.9	2.9	3.0
Primary Balance	-1.2	-1.2	-1.2	-1.2	-1.2	-1.2
Effective interest rate	5.3	5.7	6.1	6.2	6.4	6.5

Historical Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	3.2	4.7	4.7	4.7	4.7	4.7
Inflation	3.8	2.8	2.8	2.9	2.9	3.0
Primary Balance	-1.2	2.3	2.3	2.3	2.3	2.3
Effective interest rate	5.3	5.7	6.3	6.6	7.1	7.7
Contingent Liability Shock						
Real GDP growth	3.2	1.8	2.0	4.2	4.3	4.3
Inflation	3.8	2.2	2.2	2.9	2.9	3.0
Primary Balance	-1.2	-8.7	-0.4	-0.1	0.2	0.2
Effective interest rate	5.3	7.9	6.9	6.9	7.0	7.1

Source: Fund staff calculations.

INTERNATIONAL MONETARY FUND

CHILE

June 11, 2014

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By The Western Hemisphere Department

CONTENTS

FUND RELATIONS

(As of April 30, 2014)

Membership Status
Joined: December 31, 1945; Article VIII

General Resources Account	**SDR Million**	**Percent Quota**
Quota	856.10	100.00
Fund holdings of currency	630.23	73.62
Reserve Tranche Position	225.87	26.38
Lending to the Fund		
New Arrangements to Borrow	183.50	

SDR Department	**SDR Million**	**Percent Allocation**
Net cumulative allocation	816.89	100.00
Holdings	788.26	91.18

Outstanding Purchases and Loans
None

Latest Financial Arrangements

Type	**Date of Arrangement**	**Expiration Date**	**Amount Approved** (SDR Million)	**Amount Drawn** (SDR Million)
Stand-By	Nov 08, 1989	Nov 07, 1990	64.00	64.00
EFF	Aug 15, 1985	Aug 14, 1989	825.00	806.25
Stand-By	Jan 10, 1983	Jan 09, 1985	500.00	500.00

Projected Payments to Fund (in SDR Million)[1/]

			Forthcoming		
	2014	**2015**	**2016**	**2017**	**2018**
Principal					
Charges/Interest	0.07	0.10	0.10	0.10	0.10
Total	**0.07**	**0.10**	**0.10**	**0.10**	**0.10**

[1/] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Exchange Rate System
Chile has accepted the obligations of Article VIII, Sections 2, 3, and 4 and maintains an exchange rate system free of restrictions on the making of payments and transfers for current international transactions. Chile has a floating exchange rate system.

STATISTICAL ISSUES

(As of May 22, 2014)

Assessment of Data Adequacy for Surveillance
General: Data provision is adequate for surveillance. The National Institute of Statistics (INE) regularly publishes a full range of economic and financial data. The Central Bank of Chile (CBC) also publishes comprehensive macroeconomic and financial data. The Ministry of Finance publishes fiscal data. Key publicly accessible websites for macroeconomic data and analysis are: National Institute of Statistics: http://www.ine.cl/ Central Bank of Chile: http://www.bcentral.cl/ Ministry of Finance: http://www.minhda.cl/ **Recent Developments:** The Central Bank started to publish housing real estate price data in 2012, which allows better monitoring and identification of risks. The National Institute of Statistics (INE) has revised the basket and methodology of the Consumer Price Index (CPI) including to address some limitations in the clothing sub-index.

Data Standards and Quality	
Subscriber to the Fund's Special Data Dissemination Standard (SDDS) since May 17, 1996. In coordination with STA, Chile is in the process to gain adherence to SDSS plus.	A data ROSC was published September 17, 2007.

Reporting to STA (Optional)
The CBC uses the standardized report forms (SRFs) to report monthly data for the central bank, other depository corporations (ODCs), other financial corporations (OFCs), and monetary aggregates. However, data for the ODCs exclude savings and credit cooperatives and OFCs exclude investment funds, general funds, housing funds, foreign capital investment funds, factoring societies, leasing companies, and financial auxiliaries. The CBC reports all core and 7 of 28 encouraged financial soundness indicators on a monthly basis.

Chile–Table of Common Indicators Required for Surveillance

(As of May 22, 2014)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memo items[7]: Data Quality – Methodological Soundness[8]	Memo items[7]: Data Quality Accuracy and Reliability[9]
Exchange Rates	May 22 2014	May 22 2014	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	May 7, 2014	May 15, 2014	W	W	W		
Reserve/Base Money	May 7, 2014	May 15, 2014	W	W	W	O, O, LO, O	O, O, O, LO, O
Broad Money	April 2014	May 2014	M	M	M		
Central Bank Balance Sheet	January 2014	March 2014	M	M	M		
Consolidated Balance Sheet of the Banking System	January 2014	March 2014	M	M	M		
Interest Rates[2]	May 22 2014	May 22 2014	D	D	D		
Consumer Price Index	April 2014	May 8, 2014	M	M	M	LO, LNO, LNO, LO	LO, LO, LO, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2012	July , 2013	A	A	A	O, LO, LNO, LO	LO, O, O, LO, O
Revenue, Expenditure, Balance and Composition of Financing3– Central Government	March 2014	April 9, 2014	M	M	M		
Stocks of Central Government and Central Government – Guaranteed Debt[5]	September 2013	December 2013	Q	Q	Q		
External Current Account Balance	Q1 2014	May 19 , 2014	Q	Q	Q	O, O, LO, LO	O, O, O, O, O
Exports and Imports of Goods and Services	March 2014	May 19, 2014	M	M	M		
GDP/GNP	Q1 2014	May 19, 2014	Q	Q	Q	O, LO, LO, LO	LO, LO, LO, LO, O
Gross External Debt	March 2014	May , 2014	M	M	M		
International Investment Position[10]	Q1 2014	May 19, 2014	Q	Q	Q		

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

[7] Reflects the assessment provided in the data ROSC, (published September 17, 2007 and based on the findings of the mission that took place during April 18-May2, 2007) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).

[8] Same as footnote 7, except referring to international standards concerning source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

[9] Same as footnote 8, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

[10] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

WORLD BANK—FUND COUNTRY-LEVEL WORK PROGRAM UNDER JMAP

Title	Products	Provisional Timing of Missions	Expected Delivery Date*
1. Bank work program	**A. Investment Loans**		
	1. Second Public Expenditure Management Project (P1035441)		August 2007
	2. Ministry of Public Works Institutional Strengthening TAL (P102931)		June 2007
	3. Tertiary Education Finance for Results Project III (P111661)		March 2012
	4. Market Instruments for climate change mitigation in Chile (P130378)		September 2014
	5.		
	B. Technical Assistance		
	1. Subnational Doing Business in Chile Presentation		July 2014
	2. Chile Public Policies Evaluation System		June 2014
	3. An External Evaluation of the Teacher Exit Examination in Chile "Prueba inicia"		July 2014
	4. Open Innovation to improve municipal services in Conception		July 2014
	5. Support to the Institutional Reform Plan for Water Resource Management		July 2014
	6. Poverty: policy recommendation to improve the institutional framework for poverty measurement		May 2014
	7. RAS Planning Water Infrastructure		May 2014

*Delivery date refers to the Board date in lending projects and to delivery to client in case of AAA.

INTERNATIONAL MONETARY FUND
COMMUNICATIONS DEPARTMENT

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FOR IMMEDIATE RELEASE
July 22, 2014

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2014 Article IV Consultation with Chile

On June, 27, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Chile.

Chile is confronting a challenging macroeconomic environment. After several years of strong economic performance, Chile's investment has weakened and growth slowed markedly due in part to a weaker copper price outlook, with the economy performing slightly below potential. At the same time, the depreciation of the peso has fed into higher inflation, but medium-term expectations remain anchored around the Central Bank's target. The current account deficit has narrowed rapidly to 3.1 percent of GDP in the first quarter of 2014, but gross external financing needs, though smaller than in 2013, remain high at 17 percent of GDP. The labor market—albeit still tight—has softened.

Monetary policy has eased; fiscal policy has stayed broadly neutral. The central bank reduced the policy rate from 5 to 4 percent between October 2013 and April 2014 amid a weakening economic outlook and inflation below target. The cuts have been transmitted to interbank and lending rates and contributed to peso depreciation. Nonetheless, credit growth has moderated for all types of credit, except for mortgage credit, which remains brisk. The 2013 structural deficit was 0.8 percent of GDP (staff estimate). The fall in copper revenue shifted the headline balance to a deficit of 0.6 percent of GDP from a surplus of equal size in 2012. However, central government net assets remained at 6.7 percent of GDP.

Growth is expected to bottom out in 2014 and gradually return to trend. Growth will reach 3.2 percent in 2014 and recover to its potential level by 2016, supported by monetary easing, the peso depreciation, and recovery in the global economy. Key risks to the outlook stem from the potential of further declines in copper prices and global financial volatility. Although there are signs that investment is stabilizing and could pick up later in the year, consumption of durable

[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.

goods has declined and further weakening cannot be ruled out. Net exports should continue to provide a boost to the recovery.

The government has launched an ambitious policy agenda to bolster long-term growth and reduce inequality. It includes important reforms in taxation, education, productivity, and energy. The authorities' tax reform aims to create a more progressive tax structure and raise 3 percent of GDP in revenue to fund greater spending on education and health, while raising public savings. The education reform focuses on early childhood education, and fostering equal access and improving quality and accountability in education. The energy agenda aims to promote investment and efficiency and facilitate the use of clean technologies. The authorities' plans to bolster competitiveness include improving infrastructure, promoting research and development and job training, and providing new services for small and medium-enterprises.

The financial sector is large, but risks are contained. Financial system assets exceed 200 percent of GDP. Bank capitalization appears adequate, profitability remains comfortable, and nonperforming loans are low and fully provisioned. Life insurers' growing exposure to commercial real estate merits watching, but stress tests do not show significant concerns. Investment returns of the private pension system have declined, and the government has appointed a commission to propose parametric changes to ensure adequate replacement rates. The authorities have sent to congress legislation that establishes risk-based insurance supervision and a comprehensive credit registry, and strengthens the legal framework of the Securities and Insurance Supervisor and the Financial Stability Council.

Executive Board Assessment[2]

Executive Directors commended the authorities for their sound macroeconomic management, which has contributed to Chile's robust economic performance in recent years. At the same time, Directors noted that the end of the copper price boom and the normalization of global monetary conditions pose challenges to the growth outlook. They acknowledged, however, that Chile, with its strong fundamentals and policy frameworks, including a floating exchange rate, is well placed to cope with these challenges.

Directors agreed that the current macroeconomic policy mix is broadly appropriate. They concurred that, with inflation expectations well anchored and some remaining slack in the economy, monetary policy can remain accommodative although continued vigilance is needed in light of recent inflation developments. Directors supported a broadly neutral stance of fiscal policy, with full operation of automatic stabilizers. They welcomed the authorities' commitment to move toward a balanced structural fiscal position by 2018 while minimizing the drag on the recovery.

[2] 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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Directors emphasized the need for structural reforms to strengthen prospects for strong and inclusive growth. They agreed with the authorities' focus on improving education, fostering female labor force participation, upgrading key infrastructure, and promoting energy efficiency. Directors also supported the tax reform's objectives of increasing progressivity and generating permanent revenue to finance additional social spending, while maintaining incentives for private investment.

Directors commended the authorities for their track record of fiscal prudence, anchored in a credible fiscal rule. They welcomed the plan to strengthen the legal framework for the Fiscal Council, noting that consideration could be given in the medium term to increase its autonomy and broaden its mandate. In due course, further refinements to the rule-based fiscal framework could also be considered. Directors saw the benefits of setting a small structural surplus target over the cycle in preserving adequate buffers.

Directors recognized the progress in enhancing financial sector oversight and the resilience of the financial system, and looked forward to full implementation of the recommendations from the Financial Sector Assessment Program. They underscored the importance of focusing efforts on completing legislative initiatives, aligning capital standards with Basel III, and strengthening the independence of the Supervisor of Banks and Financial Institutions. The dominant role of financial conglomerates in the financial system also calls for a more consolidated approach to their oversight. Directors encouraged close monitoring of corporate leverage, the real estate sector, and the growing exposure of insurance companies to commercial real estate.

Chile: Selected Social and Economic Indicators

GDP (2012), in billions of pesos	129,553	Quota	
GDP (2012), in billions of U.S. dollars	266.3	in millions of SDRs	856
Per capita (U.S. dollars)	15,302	in % of total	0.36%
Population (2012), in millions	17.4	Poverty rate (2011)	14.4
Main products and exports	Copper	Gini coefficient (2011)	0.52
Key export markets	China, Euro area, U.S.	Literacy rate (2011)	98.9

						Proj.	
	2009	2010	2011	2012	2013	2014	2015
	(Annual percentage change, unless otherwise specified)						
Output							
Real GDP	-1.0	5.7	5.8	5.5	4.2	3.2	4.1
Total domestic demand	-5.6	13.6	9.2	7.0	3.8	2.7	4.2
Consumption	0.8	9.7	7.8	5.6	5.4	3.8	4.2
Private	-0.8	10.8	8.9	6.0	5.6	3.2	4.1
Public	9.2	4.6	2.5	3.7	4.2	6.0	4.3
Investment	-23.6	27.5	14.4	10.9	-0.8	-0.6	4.3
Fixed	-12.1	12.2	14.4	12.2	0.4	1.8	4.6
Private	-17.6	17.8	15.2	13.1	0.7	0.7	4.5
Public	37.7	-18.4	8.4	4.0	-2.7	11.8	5.2
Inventories 1/	-3.1	2.9	-0.2	-0.1	-0.3	...	...
Net exports 1/	4.5	-7.7	-4.1	-1.7	0.6	1.3	-0.6
Exports	-4.5	2.3	5.5	1.1	4.3	3.7	3.2
Imports	-16.2	25.9	15.6	5.0	2.2	0.1	4.2
Employment							
Unemployment rate (annual average) 2/	10.8	8.2	7.1	6.4	5.9	6.4	6.4
Consumer prices							
End of period	-1.5	3.0	4.4	1.5	3.0	4.4	3.0
Average	1.5	1.4	3.3	3.0	1.8	4.5	3.3
	(In percent of GDP, unless otherwise specified)						
Public sector finances							
Central government revenue	19.1	21.6	22.6	22.2	20.9	20.9	21.4
Central government expenditure	23.4	22.0	21.3	21.6	21.5	22.2	22.3
Central government fiscal balance	-4.4	-0.5	1.3	0.6	-0.6	-1.3	-0.9
Structural fiscal balance 3/	-4.7	-2.7	-1.1	-0.4	-0.8	-1.1	-0.7
Nonmining structural primary fiscal balance 4/	-7.4	-5.7	-3.3	-2.9	-3.0	-3.4	-2.7
Fiscal impulse	4.9	-1.7	-2.4	-0.4	0.1	0.4	-0.7
Public sector net debt	-6.5	-2.2	-4.9	-1.7	-2.8	-2.4	-0.9
Public sector gross debt	27.5	25.9	34.8	34.5	34.3	34.3	34.2
Central government gross debt	5.8	8.6	11.1	12.0	12.5	13.2	14.0
Of which, share of FX-denominated debt (in percent)	22.8	17.3	17.2	16.1	13.4	12.0	10.4
Money and credit							
Broad money (percentage change)	-5.3	9.3	18.5	7.6	14.9	...	...
Credit to the private sector (percentage change)	-1.4	7.1	16.9	12.1	9.7	...	...
3-month central bank bill rate (%)	1.8	1.7	4.9	5.1	5.0	...	...
Balance of payments							
Current account	2.0	1.6	-1.2	-3.4	-3.4	-3.1	-2.8
Current account (in billions of U.S. dollars)	3.5	3.6	-3.1	-9.1	-9.5	-8.1	-7.7
Foreign direct investment inflows	7.5	7.2	9.3	10.7	7.3	7.7	7.2
Gross international reserves (in billions of U.S. dollars)	25.4	27.9	42.0	41.6	41.1	41.1	41.1
In months of next year's imports of goods and services	4.5	3.9	5.6	5.5	5.4	5.3	5.1
Gross external debt	41.8	38.9	39.2	44.1	47.2	52.4	51.7
Public	7.7	7.9	8.2	9.5	9.2	9.5	9.4
Private	34.1	30.9	31.1	34.7	38.0	42.8	42.3
	(Annual percentage change)						
Exchange rate							
Real effective exchange rate (real appreciation +)	-2.2	5.9	0.9	3.7	-1.2	...	...
Terms of trade	4.3	22.0	1.6	-6.1	-2.5	-3.0	0.7

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

1/ Contribution to growth.
2/ The methodology to compute the unemployment rate changed in 2009.
3/ Headline balance adjusted for the economic and copper price cycles.
4/ In percent of non-mining GDP.

Statement by Alvaro Rojas-Olmedo, Executive Director for Chile
And Yan Carrière-Swallow, Advisor
June 24, 2014

On behalf of our Chilean authorities, we would like to thank the staff for the Staff Report and Selected Issues papers on the occasion of the 2014 Article IV Consultation. As a small, open, and financially integrated economy, the Chilean authorities appreciate the importance of contributing to and benefiting from a healthy global economy. The constructive discussions and thoughtful analysis conducted during the consultation process reflect the tradition of candid dialogue between the authorities and Fund staff.

Chile's solid macroeconomic policy framework is based on three long-standing pillars: a structural fiscal rule that takes into account the long-term price of copper and the business cycle; price stability under an inflation targeting framework implemented by an independent central bank; and a financial system that is well capitalized and adequately regulated. These pillars have been instrumental in securing Chile's long-term macroeconomic stability, and there is a broad consensus across the political spectrum and civil society on the importance of such policy framework.

Background

After a period of strong growth above trend, the economy has been decelerating since early 2013, and the Central Bank of Chile has recently revised downwards its forecast for output growth in 2014, from a range between 3.0 and 4.0 percent to a range between 2.5 and 3.5 percent. The deceleration has been somewhat more pronounced than initially expected, and reflects a cyclical slowdown in investment along with the easing of private consumption in recent months. As the copper boom recedes, the dynamism of investment in the mining sector has eased accordingly and a negative output gap has opened. While unemployment remains low by historical standards, a number of indicators are beginning to show signs of slack in the labor market. Going forward, growth is expected to recover gradually starting in the second half of 2014 as a result of the adjustment of key variables such as the real exchange rate and long-term interest rates, as well as the policy responses being implemented by the central bank and the operation of automatic stabilizers on the fiscal side. The main risk to this outlook stems from China's rate of growth and its implications for global metal prices.

After a long period of exceptionally favorable external conditions, financing conditions and the terms of trade are normalizing and are expected to return to their longer-term averages. Overall external demand from trading partners has remained stable, although its composition is shifting as the gradual recovery in advanced economies continues, and emerging market economies have decelerated significantly. Adjustment to these changing external conditions has come primarily through the nominal exchange rate, which has depreciated approximately 20 percent since May 2013. Such depreciation of the Chilean peso has allowed for the necessary adjustment in relative prices to increase the competitiveness of the tradable sector, leading to strong export performance and a steady reduction of the current account deficit, which is now expected to shrink to 2.5 percent of GDP in 2014. Such reduction in the current account deficit reflects the adjustment process towards improving the external balance position, thus reducing external vulnerability. The authorities coincide with the staff assessment that the real exchange rate remains in line with its long-run fundamentals, and agree that the risks from external imbalances have diminished substantially. The authorities' estimation of potential growth is slightly higher than the staff's, but they agree on the importance of productivity-enhancing reforms to boost long-term growth.

Monetary policy

The Central Bank of Chile sets its monetary policy based on a long-standing inflation-targeting framework within a flexible exchange rate regime. These policies have ensured that price stability is delivered by meeting the inflation target, while affording monetary policy the flexibility to respond to economic fluctuations. In light of the cyclical deceleration in growth in 2013 which extended to the first half of 2014, the Central Bank of Chile has cut the monetary policy rate 4 times since October 2013 with a cumulative cut of 100 basis points from 5 percent to 4percent. The monetary policy rate has been kept at 4 percent since March of 2014, which represents an expansionary monetary policy stance to provide a stimulus to domestic demand given the deceleration in growth and its implications for the inflationary forecasts.

As mentioned before, the nominal exchange rate has played the role of shock absorber while monetary policy has been able to focus on stabilizing domestic demand. The depreciation of the peso has passed through to domestic price inflation, with year on year inflation reaching 4.7 percent in May, above the upper limit of the target band. The authorities expect this pass-through to be transitory and for inflation to converge to the 3 percent target within the two-year policy horizon. This view is reaffirmed by private inflation expectations, which have remained firmly anchored in the 3 percent target.

Going forward, monetary authorities will evaluate further monetary easing should domestic and external conditions imply a deviation from the objective of maintaining price stability. While the cyclical downturn is expected to reduce inflationary pressures, they are aware that monetary conditions are already supportive and that recent price dynamics have been higher than expected. They will proceed with caution and weigh the risks involved in order to fulfill their mandate of price stability.

Fiscal policy

A new administration took office in March 2014, and they will continue to implement prudent fiscal policy in line with the structural fiscal rule. Following a decisive fiscal expansion in response to the 2009 financial crisis, the stimulus has been gradually withdrawn in recent years. The structural budget balance for FY 2013 was -0.7 percent. The budget law considers a structural deficit of -1 percent in FY 2014, and the new government has announced its intention to eliminate it gradually in order to reach structural balance by the end of their term in 2018. This announcement is in line with the Fiscal Responsibility Act of 2006, which requires incoming governments to announce structural fiscal targets for the full length of their mandate within the first 90 days of their administration. Such announcements provide a clear anchor for fiscal policy over the medium-term.

The Chilean government remains a net creditor, with assets in the sovereign wealth funds having been built back up to pre-crisis levels. The authorities note the staff's warning that maintaining structural balance would erode these buffers as a share of GDP, and the recommendation of adopting a small structural surplus in order to preserve them. The authorities see these buffers as an important asset that allows favorable access to debt markets and to respond to large external shocks. However, they point out that carrying large buffers also imposes substantial opportunity costs in terms of forgone social investment. Defining the appropriate target level for the structural balance requires a careful cost-benefit analysis of this trade-off, and the authorities are open to further discussions on this topic.

The authorities welcome the Fund's recommendations to strengthen the institutionality of the Fiscal Council. They see merit in the proposal, but do not see it as an immediate priority. That being said, the institutionality of fiscal prudence and transparency in Chile has been continually improved over the past decades.

Financial sector

Recent cuts to the monetary policy rate have been effectively transmitted to local financial markets, combining with low risk premiums to generate historically low rates on public and private fixed income instruments. These favorable financing conditions in bond markets have not generated excessive growth in household credit, and the financial sector remains broadly resilient. However, the combination of a cyclical economic slowdown and loose financing conditions poses potential risks that the central bank and financial supervisors are watching carefully.

The corporate sector has taken advantage of such favorable financing conditions to increase their debt levels. While leverage ratios remain contained, increases have reduced the sector's resilience to large shocks. The real estate sector remains dynamic, but the vacancy rate in commercial real estate has increased in recent quarters. Mortgage growth has remained stable, and there has been a slight moderation in the share of mortgages with high LTV ratios, as well as a slight tightening of credit conditions for this type of loans. The monetary authorities are vigilant of the risks these developments may pose, and have dedicated extensive analysis to each in their recent Financial Stability Reports. Over the past two years, they have made recurrent calls warning market participants not to extrapolate recent price dynamics in real estate markets, which have been effective in moderating some of the incipient trends observed in the past.

The authorities welcome the staff's support for the regulatory reforms that are currently before Congress. The Financial Stability Council law will strengthen the institutionality of this important body, and will give it broader powers to share information across supervisory agencies. This will increase its ability to adequately supervise large conglomerates, whose operations often span banking, insurance, pension fund administration, as well as commercial undertakings.

Reform agenda

As presented in the Staff Report, Chile's economy has performed exceptionally well for several decades, with high average growth rates and declining macroeconomic volatility. These gains have allowed the country to improve its income status, and achieve substantial reductions in the poverty rate. However, the authorities agree that two important challenges currently face the Chilean economy: boosting productivity growth and lowering excessive inequality. Overcoming these challenges will require extensive structural reforms in order to address the permanent challenge of enhancing growth prospects of the Chilean economy over the medium term.

President Bachelet has identified the education system as being a key bottleneck to both objectives, and has proposed an agenda of reforms to education, taxes, productivity and energy aimed at delivering inclusive growth. As the staff points out, current public spending on education is low by international standards, so fresh resources will be required to improve access and quality. Future economic growth will provide a part of these resources, but in keeping with the authorities' commitment to fiscal prudence, all new permanent expenditures will be matched by increases in structural revenues.

In order for the proposed education reform to be fully funded, a tax reform has been proposed in order to raise structural revenue by 3 percent of GDP. Two-thirds of these resources will be ear-marked for financing the education reform and other social spending, with the remaining third being used to increase public savings by eliminating the current structural deficit of 1 percent of GDP by 2018. This will complete the gradual withdrawal of the stimulus that was initially deployed in response to the 2009 crisis.

The design of the tax reform has been tailored to raise this revenue while maintaining adequate incentives for private investment and activity, while also making the tax system more progressive. The existing tax system is regressive and places a proportionately large burden on low-income households. With indirect taxes representing more than half of fiscal revenue, the reform will focus on shifting the tax burden towards direct taxes by (i) raising the corporate income tax and (ii) closing an existing benefit that allows firms to defer payment of taxes on undistributed profits, which has been used extensively for tax evasion. The top personal income tax bracket will also be lowered in order to reduce the gap between the Personal Income Tax (PIT) and Corporate Income Tax (CIT) rates, and thus the incentive to elude payment through the creation of shell companies. In view of the size of the changes being proposed, they will be implemented gradually over the coming years.

The authorities agree that passing the legislation quickly is important in order to avoid creating uncertainty, but point out that a reform of this size must be given sufficient time to be debated within the legislative process. That being said, the main aspects of the proposal have not changed since their initial presentation during the Presidential campaign almost one year ago, and have already been approved by an ample majority in the lower house. As part of the ongoing legislative process, the authorities will discuss additional measures intended to increase corporate savings and investment, while maintaining the objectives and main aspects of the reform.

Finally, we take the opportunity to welcome the Fund's decision to co-host the upcoming High-Level Conference on "Inclusiveness and Growth in Latin America" with the Government of Chile in Santiago later this year within the events scheduled as part of the Road to Lima 2015. This event will consider the longer-term challenges faced by Latin American countries as they reach middle-income status. We see the Fund as being well-placed to offer broad international experience that can help members achieve their development goals.