August 22, 2024

CHILE – Tightening the screws on the fiscal framework

- Experts and policymakers have long called for an enhancement of Chile's fiscal institutional framework, which, while still strong, allowed for a gradual and persistent deterioration of the fiscal accounts over the past decade. Recently approved legislation, to come into effect on September 1, strengthens the fiscal institutional framework by providing the structural balance rule with more flexibility, under exceptional circumstances, and complementing the flow-based rule along with a stock-based debt threshold set by annual gross public debt targets. Also, the legislation enhances the Autonomous Fiscal Council's role in the monitoring and assessing of fiscal targets (ex-ante and ex-post) and allows the MoF to implement measures that should strengthen the liquidity of the domestic fixed income market, among others. Of note, however, in our view, approved legal changes to the sovereign wealth funds are likely to lead to even fewer saving inflows to the Stabilization Fund, over time, while the Pension Reserve Fund is no longer mandated an annual inflow.

- While the approved changes are welcome improvements to Chile's fiscal institutional framework, their importance in ensuring the sustainability of the fiscal accounts is likely to be tested in the years to come, especially if spending remains strong and trend growth low. In our view, the stabilization of gross public debt requires significantly slower spending growth, higher economic growth, and spending efficiency measures.

Context on the legislation.

Chile has implemented fiscal policy based on a structural balance target since 2001. Rules-based fiscal policy allowed for public savings to build up in sovereign wealth funds (SWFs) during business cycle upswings that were associated to fiscal surpluses. The public sector's balance sheet improved reaching low gross debt levels, elevated savings in SWFs, and high investment-grade status.

However, Chile's fiscal accounts began to experience a gradual and persistent deterioration after 2013, even with the fiscal policy run by the structural rule. Why? Well, first, for several years, fiscal policy targeted a structural deficit, rather than a balance. Separately, structural revenues were likely overestimated as key ex-ante unobservable parameters such as potential growth and copper prices were persistently above ex-post assessments; higher structural revenues allowed for greater spending and higher nominal deficits. Also, the government's financing needs increased due to below-the-line measures that required financing.

Responding to the concerns of rising public debt and sovereign rating downgrades, President Sebastián Piñera's administration presented a bill that formalized the Autonomous Fiscal Council by law (up until, an Advisory Council existed by decree), and strengthened macro-fiscal forecasts with quarterly Public Finance Reports (up until then only two were published per year) that also included medium-term debt forecasts, among other initiatives. Then, the administration presented a bill that modified the Fiscal Responsibility Law in September 2021, which was finally approved by Congress in July 2024.

The legislation's approval is also positive from a broader institutional perspective, considering that it reflects that technically backed consensus on initiatives that enhance Chile's macro-financial framework in Congress is still feasible, despite the increasing fragmentation and polarization in the legislative body. Other recent initiatives that fall in this same bucket are the law that creates a consolidated debt registry (July 2024, see here) and the law that strengthens the resilience of the financial system and its infrastructures (December 2023, see here).

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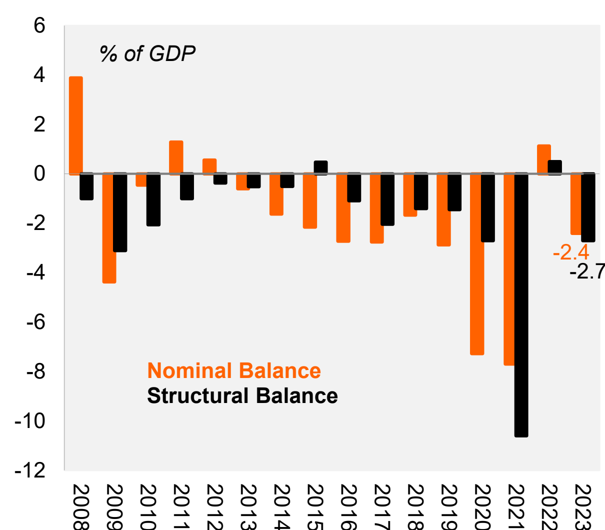
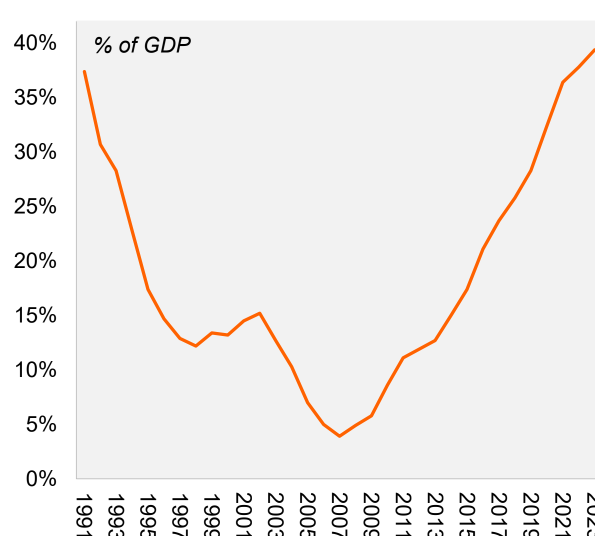
Fiscal Balance



Source: Budget Office

Gross Public Debt



Source: Budget Office

The law, adequately titled as one that "Promotes Responsibility and Transparency in the Financial Management of the State" is available here, and its main changes are described in detail below.

More detailed fiscal plans to be published early on…

During its first 90 days, each incoming administration must publish a decree that lays out the implications and effects of its fiscal policy based on the structural balance, on an annual basis for its term, and specify the gross public debt-to-GDP ratio it envisages at least by the end of its term. For context, in the previous Fiscal Responsibility Law, the decree only required the specification of the structural balance target by the end of the administration's term and did not refer to a debt anchor.

In the following 60 days, the Autonomous Fiscal Council (AFC) must provide it's view on the government's fiscal targets with respect to the sustainability of public finances. Also, the government's quarterly Public Finance Report that follows the decree must specify methodologically how the structural balance targets are consistent with the debt targets and include a chapter on the administration's policy for the use of assets.

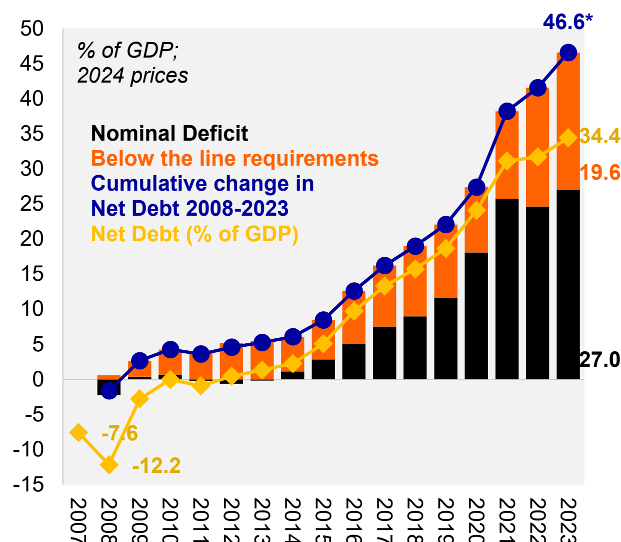
After the closure of each calendar year and in the context of the publication of the quarterly Public Finance Report (should be in May of each year, in our view), the Ministry of Finance must report on the previous year's structural balance and debt targets. When the administration does not meet its annual targets, it must present measures that allow for fiscal policy to converge back to a sustainable path; with the AFC also providing its opinion on these measures.

The MoF may replace the decree on an exceptional basis when an escape clause is triggered or due to extraordinary circumstances, such as a natural disaster or a significant macro shock (further described in the next section), that require changing the structural balance targets.

In principle, the proposed changes are designed to provide greater clarity on fiscal policy, early on in each administration, as the reporting requirements enhance monitoring and accountability at a higher frequency. We believe greater insights on the assets side of the government's balance sheet are especially valuable, considering the ample and frequent use of the Stabilization Fund in recent years, even in the absence of an external shock. Moreover, an explicit medium-term debt anchor linked to annual structural balance targets should further bolster credibility on the fiscal accounts, after almost two decades of sequential gross debt build up; importantly, this change should force each administration to disclose their forecasts for "below-the-line" spending needs that have been very relevant in recent years (accounting for roughly 42% of the increase in the sovereign's net debt between 2008-2023, according to the AFC, see chart below). Greater participation of the AFC throughout these processes is also welcome. Of note, some

changes formalize measures that were already implemented in practice; for example, while now required by law to be included in the decree, administrations were already publishing non-binding annual structural balance targets in their medium-term forecasts.

Cumulative Change in Net Debt



Source: Autonomous Fiscal Council, based on Budget Office data.

The Escape Clause & Correction Mechanism

Several administrations in Chile over the past few years have deviated from their structural policy paths, even in the absence of a large shock, which has led to discussions among policymakers and academics regarding fiscal credibility and reputation, as well as questions on the pace in which the administration returns to the structural policy path.

To formally address concerns on deviations during significant shocks, the law allows for the government to trigger an escape clause under exceptional and transitory circumstances not driven by the administration, that significantly affect domestic economic activity or employment, or considerably deteriorate the financial, economic or social sustainability of the country in such a way that fiscal needs exceed those consistent with the structural policy path and debt targets. Some examples that could trigger such a scenario could be natural disasters or domestic / external shocks that significantly deteriorate macroeconomic conditions. The escape clause may be triggered starting in 2025.

Formally, the escape clause is triggered by a decree that includes the rationale sustaining the decision and determines how long the administration plans on drifting from the structural path, which cannot exceed two years. Also, this decree must lay out the correction mechanisms that will be implemented to return fiscal policy to a sustainable path. In addition, the following Public Finance Report must detail how gross public debt is projected to return to sustainable levels in a four-year horizon. The AFC must also provide their view. In case the administration fails to comply with their revised targets, the MoF will be summoned by Congress to explain the situation and must provide measures to return fiscal policy to a sustainable path. In our view, the main consequence of missing a fiscal target is strictly reputational, which would lead to an erosion of fiscal credibility.

On the Sovereign Wealth Funds

Up until now, the Fiscal Responsibility Law required the MoF to save at least 0.2% of GDP in the Pension Reserve Fund (PRF) every year. However, under the new legislation, the PRF is no longer required to receive this minimum inflow. Now, the PRF will have an inflow when a nominal fiscal surplus is achieved, capped at 0.5% of the previous year's GDP.

The withdrawal rule from the PRF was revised up from a cap related to state-financed pension expenditures (0.1% of GDP, equivalent to USD304 million in 2024) to a maximum of 0.5% of GDP of the previous year. However, withdrawals from the PRF must now comply with two objectives, annual withdrawals from the PRF must be stable and

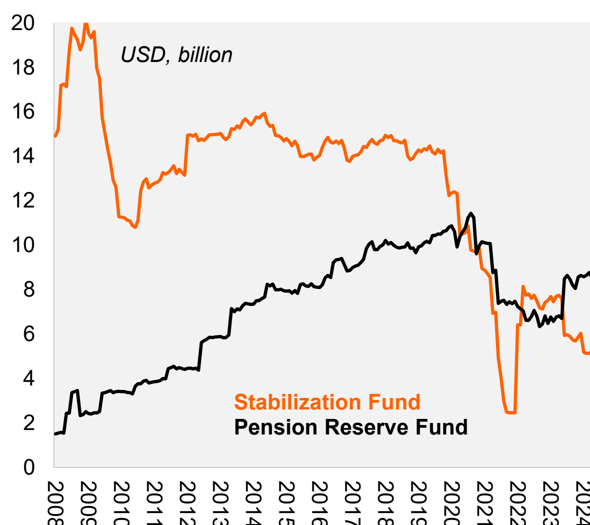
predictable, and the real value of the Fund must be maintained over time; withdrawals under these two objectives come into effect in 2026, suggesting the MoF is likely to withdraw the maximum allowed of 0.5% of GDP in 2025.

Regarding the Stabilization Fund, the law (finally) grants the fund an explicit objective, that is, the stability of Chile's public finance and the provision of public goods and services over time, subject to abrupt changes in the business cycle or extraordinary events. The Fund is still projected to receive a mandatory inflow equivalent to nominal fiscal surpluses in excess of 0.5% of GDP, whenever these take place. However, these injections are not mandatory when the nominal surplus is below the structural surplus, such as in 2022 when the former reached 1.1% of GDP, and the latter 0.5% of GDP. As such, over time, this cap should lead to even smaller and fewer injections to the Stabilization Fund. Rules on withdrawals remained unchanged, that is, at the discretion of the MoF to finance the deficit, amortizations of public debt, and inflows to the PRF.

The Stabilization Fund reaches roughly 1.6% of GDP (USD4.5 billion in AUM by the end of June), well below the 5-7% of GDP recommended by the IMF (see Technical Assistance report here) as an adequate size for a liquidity buffer for Chile. The approved legislation does not refer to a minimum or desirable size for the Stabilization Fund. The MoF does not forecast nominal fiscal surpluses over the following years, suggesting inflows to the Stabilization Fund seem unlikely; in fact, its AUM may continue to decline as it continues to be used as a regular source of financing, with withdrawals totaling USD1.6 billion in 2024. The PRF reaches USD9.1 billion (2.7% of GDP) in AUM by the end of June 2024.

Also of note, the MoF had presented amendments to the bill in August 2022 (see press release here) to create a new sovereign wealth fund to finance responses to natural disasters, which led to its inclusion in this bill throughout the legislative process. Yet, Congress did not approve the creation of this new sovereign wealth fund.

Sovereign Wealth Funds



Source: Budget Office

Bolstering the liquidity of the domestic fixed income market.

The legislation allows for the MoF to implement a market-makers program for Treasury Bonds. The MoF should announce the program's characteristics via a decree. This measure comes on the back of several other policies that the MoF has implemented to improve liquidity in the domestic fixed income market, such as the issuance of benchmark-sized bonds at key maturities, frequent liability management operations, and the direct participation of non-residents in local currency bond issuances, among others.

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Raising legal requirements on fiscal reporting for bills

The Budget Office will now be legally required to prepare financial reports for bills and international conventions presented by the Executive branch (note, not bills presented by Congress), that specify the spending implications and lower revenues associated to the proposed measures. Amendments presented during the legislative discussion must also have a financial report. It is important to note that the Budget Office already prepared these reports yet is now required to do so by law. Also, now the Budget Office must publish a consolidated financial report once a bill becomes law, up to thirty days after it is published in the Official Gazette; this proposed measure is relevant for those tracking the fiscal implications of reforms once they are approved, considering that the Budget Office currently publishes a financial reports for each bill, and reports of amendment's usually only refer to the incremental impact of the proposed measure, making it difficult to track the overall fiscal effects. Separately, the Budget Office may publish estimates of the actual costs and revenues of approved laws that have a significant effect on fiscal accounts, compared to those of the original financial report forecasts, on an annual basis in the Public Finance Report (May).

While the approved changes are welcome improvements to Chile's fiscal institutional framework, their importance in ensuring the sustainability of the fiscal accounts is likely to be tested in the years to come, especially if spending growth remains strong and trend growth remains low.

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