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MAIN MESSAGES OF THE AUTONOMOUS FISCAL COUNCIL IN CHILE ON THE EXERCISE OF ITS DUTIES AND POWERS

Presentation before the
Special Joint Budget Committee of Congress

Chile's public finances are under stress, reflected in recurrent deficits and a sustained increase in debt since the global financial crisis of 2008[1]. Although this trend has persisted for the last 16 years, the phenomenon has heightened during the last five years, especially due to the pandemic.

Between 2008 and 2023, public spending exceeded structural revenues most of the time, by averaging 23.8% of GDP versus 22%. In addition to this average imbalance of 1.8% of GDP, additional financing needs equivalent to 1.4% of GDP per year were observed, associated with other capital requirements, such as the capitalization of public companies.

The projections of the Budget Office (Dipres, abbreviated in Spanish) show that the fiscal stress situation will extend in the medium term (up to its projection horizon of 2028). Therefore, there would be very limited margin for higher expenditures until that year, considering the necessary compliance with fiscal targets. At the same time, the country is in a more vulnerable position than in the last two decades to face possible crises, due to higher debt stock and lower financial assets levels in the Economic and Social Stabilization Fund (FEES, known by its Spanish acronym).

In order to improve the fiscal outlook, the CFA considers it essential to reach a broad political consensus to enhance the fiscal stress situation, involving both the Executive and Legislative Branches. This agreement should translate into an agenda comprising a series of concrete measures aimed at bolstering fiscal revenues and/or adjusting the trajectory of public spending, alongside efforts to rebuild fiscal buffers.

In particular, the CFA recommends: (i) attaining the convergence of public finances through the government's rigorous compliance with its Structural Balance targets and then continuing to advance until reaching its equilibrium (0% of GDP) as of 2027; (ii) resuming the processing of the fiscal responsibility bill with the aim of securing its approval; (iii) continuing to work on additional proposals for strengthening fiscal institutional framework in the medium and long term; (iv) achieving a balanced mix of permanent financing sources, which may come from higher trend growth, new tax revenues, reduction of evasion and avoidance, as well as permanent increases in public spending efficiency, and (v) gradually rebuilding the FEES through fiscal surpluses, or by the transformation other financial and non-financial assets held by the Central Government into liquid assets of the Public Treasury.

[1] The IMF usually understands fiscal stress as a context in which the fiscal authority must take action in the face of a persistent imbalance between revenues and expenditures over a period, or in which imbalance is short-term, reflecting a situation different from that budgeted. Therefore, the CFA understands that in a situation of fiscal stress there is a need for the Executive and Legislative Branches to take actions to balance the budget to timely avoid reaching a situation of unsustainability.

Message

Diagnosis of the fiscal situation

1. **As the Autonomous Fiscal Council (CFA, known by its Spanish acronym) had warned, certain improvements in the fiscal situation that occurred in 2022 were reversed during 2023**. Data show a deterioration in several public finance key indicators that, without implying a crisis situation, attest to a situation of stress, i.e., the need for the Executive and Legislative Branches to take fiscal measures aimed at balancing the budget and not negatively affecting the sustainability of public finances. Thus, after the significant adjustment in spending in 2022 due to the withdrawal of most of the extraordinary measures to face the pandemic, the Structural Balance (SB) shifted from a surplus of 0.2% of Gross Domestic Product (GDP) in 2022 to a deficit of 2.6% of GDP in 2023. Meanwhile, gross debt increased from 38% to 39.4% of GDP over the biennium, while net debt rose from 32% to 34.4% of GDP. This was accompanied by the use of Public Treasury assets, which led to a decrease from 6% of GDP in 2022 to 5% in 2023. It should be noted that during those years, the current methodology did not account for identifying the permanent portion of tax revenues from lithium, which the Ministry of Finance decided to apply only after 2024. If it had been considered earlier, the SB result would have shown deficits of 0.3% of GDP in 2022 and 3.6% of GDP in 2023[2] In other words, to achieve the same structural result, US$ 3.34 billion less should have been spent last year than what was actually spent. This implies that a greater effort is required to reach the structural target of -1.9% of GDP in 2024.

2. **The fiscal stress situation is not only a consequence of what has happened in recent years, particularly due to the measures to face the pandemic or the social crisis of 2019, but is the result of a trend that predates these occurrences.** The deterioration of public finances has been observed since the 2008 global financial crisis, with varying degrees of adherence to fiscal consolidation since that time. During that period, public spending exceeded structural revenues most of the time. Certainly, in the last 16 years, public spending averaged 23.8% of GDP, while fiscal revenues averaged 22% of GDP, a difference of 1.9% percentage points of GDP. Thus, in general, persistent fiscal deficits have been observed, in a context of a high increase in expenditures due to growing citizen demands, and lower dynamism of fiscal revenues affected by weak GDP growth. In fact, while in the 2010s trend growth averaged 3.4% per year, it is currently around 2%[3]. Likewise, throughout this period, it has not been possible to achieve fiscal convergence towards a balanced Structural Balance, with targets persistently in deficit, many of which have not been met in several years.

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[2] According to CFA estimates.

[3] Expert Committee's estimate of Trend Non-Mining GDP for 2023 (historical series). Trend growth refers to the annual variation of Trend Non-Mining GDP.

Other capital requirements have also played a significant role in the situation of increasing indebtedness, as the CFA has warned in previous reports.

In the last 16 years, these additional financing needs have been equivalent to 1.4% of annual GDP. They correspond to transactions involving financial assets outside the scope of the Public Treasury and financial liabilities other than gross debt, which affect the financing needs of the Central Government, such as recognition bonds, purchase of the State Guaranteed Loan (CAE, known by its Spanish acronym) portfolio, capitalization of public companies, among others[4].

3. **Fiscal deterioration since 2008 has translated into lower credit rating grades, as Chile has suffered two downgrades by each of the rating agencies since 2016**. These warn that social spending pressures and moderate economic growth make medium-term fiscal targets look challenging. In this context, Chile's country risk indicators are at similar levels to some of its regional peers with lower credit ratings, such as Peru and Paraguay. At this point, it is crucial to recall that cuts in this rating could lead to increases in the sovereign spread and in financing costs, a situation that affects not only the State, but also households and companies.

4. **The increase in treasury's indebtedness, coupled with the decrease in the Public Treasury's financial assets, leaves Chile in a more vulnerable position in the face of potential crises**. Since the 2008 global financial crisis, the aforementioned growing trend in gross and net debt has been observed, accompanied by a fall in the Public Treasury's financial assets. Gross debt rose from 3.9% of GDP in 2007 to 25.8% of GDP in 2018 (before the pandemic), and to 39.4% of GDP last year. For net debt, the figures went from -7.6% of GDP in 2007 (net creditor position) to 15.7% of GDP in 2018, and to 34.4% of GDP in 2023. Regarding Public Treasury assets, these stood at 11.5% of GDP in 2007 and 10.1% of GDP in 2018, which is more than double of the stock observed in 2023 (5% of GDP). These positions show that –in the event of a crisis– the public sector would have significantly less savings and less margin for indebtedness than in previous major crises. Furthermore, it is important to emphasize that foreign currency debt has reached a higher weight within the total (33.1% of the stock as of December 2023, compared to 10.4% a decade ago), which implies a higher incidence of exchange rate fluctuations on the overall debt level.

5. **A consequence of the increase in indebtedness has been the growing weight of interest payments within total public expenditure, which further restricts the space available for other budgetary priorities**. Interest outlays have doubled in the last decade, both as a percentage of GDP (1.1% in 2023) and as a share of total Central Government spending. In the latter case, they increased from representing 1.9% of total spending in 2013 to 4.2% in 2023, and are expected to continue rising over the next few years to 5.2% in 2028, according to the Public Finance Report (IFP, known by its Spanish acronym) of the Dipres for the fourth quarter of 2023. It is worth noting that the amount spent on interest in 2023 is slightly higher than the expenditure of the Ministry of the Interior (4.1% of total

[4] The capitalization of state-owned companies that have profits are accounted for as an increase in financial asset transactions, while those with losses are accounted for as public expenditure.

expenditure) and close to the expenditure of the Ministry of Housing and Urban Development (4.4%).

The projected increase in interest expenditure could generate additional stress, especially in view of the high debt maturity volumes expected for 2025 and 2026, along with the risk of refinancing at higher rates. In this regard, the difference between interest rates and economic growth is key to fiscal sustainability. The higher the interest rates relative to economic growth, the more likely the debt-to-GDP ratio is to increase, potentially leading to unsustainability if appropriate fiscal adjustments are not made.

It is important to note that such a situation of fiscal stress carries the risk of an increase in interest rates on sovereign bonds, as well as a downgrade in credit ratings. This, in turn, could lead to a vicious cycle of rising debt and diminished economic growth potential, accompanied by further resources deflection toward debt repayment. On the other hand, maintaining healthy fiscal sustainability indicators allows the State to borrow at lower interest rates, which implies greater possibilities to secure affordable financing for the implementation and sustain of priority public policies.

6. The medium-term outlook shows the prolongation of fiscal stress, with very limited slack for new expenditures, as the Council has warned in its recent analyses. For 2024-2028, Dipres projections show an increase in gross and net debt, together with a reduction in the Public Treasury's financial assets. However, these projections show stability from 2025 to 2028, which implies that gross debt would not exceed its prudent level of 45% of GDP, reaching 41.2% in the last year of the projection. According to the Dipres' IFP for the fourth quarter of 2023, net debt is estimated to increase 3.5 points of GDP with respect to 2023, reaching 38.2% of GDP in 2028. On the other hand, Public Treasury assets are projected to reach 3% of GDP for that year, decreasing 2 percentage points compared to 2023. Meanwhile, interest expenses are expected to continue increasing, rising from 1.1% of GDP in 2023 to 1.3% in 2028.

At the same time, Dipres estimates show very limited fiscal slack for the coming years, of 0.26% of GDP on average for 2025-2028, with negative values in 2025 and 2026 (-0.01% and -0.11% of GDP, respectively). This would prevent the implementation of public policies involving new permanent expenditures, unless they are accompanied by also permanent financing sources. It should also be remembered that the methodology for estimating fiscal slack considers strictly committed expenditures, excluding some highly probable expenditures –such as real readjustments in public sector salaries, educational subsidies and health per capita, among others–, so the situation could become even more constrained.

Medium-term fiscal stress is further evidenced by the fact that the average growth of spending compatible with the SB targets for 2025-2028 estimated by the Dipres is only 1.2% per year, while in the decade prior to the pandemic (2010-2019) spending grew by an average of 4.9% per year.

7. In the baseline scenario, the CFA estimates show that gross debt would remain below the prudent level of 45% of GDP over the entire projection horizon, if the current administration's SB targets are met and equilibrium is achieved from 2027 onwards. In this scenario, which does not address risk events that could worsen fiscal dynamics and affect the sustainability of public finances, gross debt would stabilize at around 43% of GDP in the long term. For this exercise, the CFA made projections of the Central Government's gross debt over 50 years, based on a deterministic model[5]. The results show that gross debt, while remaining below the prudent level, would be close to it throughout the projection horizon. This result calls for caution in the weighting of macrofiscal risks and implementing measures to mitigate them, as a crisis scenario could push debt levels beyond the prudent threshold.

It is important to underscore that in order to make its projection, the CFA considers the fulfillment of the SB targets between 2024 and 2026 established in the current fiscal policy decree[6], and then, from 2027 onwards, to maintain a balanced structural result. It is also essential to note that the latter figure is more demanding than the deficit of 0.5% of GDP assumed by the Dipres in its IFP for the third and fourth quarters of 2023, which would not allow stabilizing gross debt below its prudent level in the medium and long term, according to CFA estimates. This implies that a greater consolidation effort than the one envisaged by the Executive from 2027 onwards is required to achieve public finance sustainability.

8. To gauge the effect of some macrofiscal risks, the CFA also made projections of long-term debt in two alternative scenarios, both of which indicate an increase in gross debt above its prudent level. As in previous instances, the CFA carried out these simulations to illustrate possible risk situations for public finances, although without assigning them a probability. A relevant source of uncertainty comes from the estimates of public revenues that will cover the financing needs of the fiscal pact. To measure this risk, a first alternative scenario simulates the permanent execution of all expenditures outlined in the fiscal pact proposal, but with a lower effective permanent revenue collection (50% of the Executive's estimate). In this case, the prudent debt level would be exceeded in 2026 and debt would rise to 67.1% of GDP in 2040 and to 138.2% of GDP in 2073, driven by a vicious circle between debt level and interest expenses. The results of this scenario reinforce that permanent expenditures should not be committed without having permanent sources of financing, duly matched in quantity and timeliness.

On the other hand, given the aforementioned higher weight of foreign currency debt within total public debt, the Council considers, in a second alternative scenario, the effect of a 10% increase in the exchange rate on debt levels. The results of this scenario show that the prudent level of debt would also be exceeded if the shock is permanent, unlike what would have happened a decade ago, as the impact of the exchange rate on gross debt has tripled.

[5] A model in which projections are predictable from the initial conditions and equations of the model, without uncertainty or random factors.

[6] Contained in Decree No. 755 of 2022 of the Ministry of Finance, which "establishes the bases for fiscal policy in accordance with the provisions of Article 1 of Law No. 20,128, on fiscal responsibility", and which was amended by Decree No. 1,387 of 2023 of the Ministry of Finance. The current decree is available here.

This reinforces the need to be cautious about exchange rate assumptions and ensuring that the currency composition of gross debt takes into account foreign exchange exposure, an issue that the Ministry of Finance is already addressing[7].

CFA recommendations to improve the fiscal outlook

9. The CFA considers it essential to reach a broad political consensus to improve the fiscal stress situation, encompassing both the Executive and Legislative Branches. This agreement should translate into a concrete agenda with a series of measures that allow increasing available fiscal revenues and/or adjusting the expenditure path, along with rebuilding fiscal buffers. The following recommendations are addressed upon in greater detail and accompanied by concrete guidelines within the body of the report:

(i) Concretize fiscal convergence through rigorous government compliance with its SB targets. This implies achieving the established target of reducing the structural deficit to 1.9% of GDP in 2024, 1.1% in 2025, and 0.5% in 2026. Additionally, according to CFA estimates, to stabilize gross debt below its prudent level of 45% of GDP, it will be required to achieve and maintain the SB in balance from 2027 onwards.

(ii) Resume the processing of the fiscal responsibility bill (Bulletin No. 14,615-05), with the aim of its prompt approval. This bill contains important measures to improve fiscal institutionality, including: establishing rules for the usage of escape clauses of the fiscal rule and its subsequent correction mechanisms, outlining a legal framework for the dual fiscal rule[8], enhancing the regulation of the financial reporting of bills, short-term strengthening and expansion of the CFA's functions, and greater accountability of the fiscal authority. It is noteworthy that this bill is in the second constitutional procedure, after having been introduced in Congress on September 28, 2021.

(iii) Continue to strengthen fiscal institutionality for the medium and long term. Beyond the aforementioned bill, the CFA has proposed recommendations to encourage ex post compliance with SB targets through automatic correction mechanisms, through a control account; to evaluate liabilities and assets relevant to the fiscal rule and their due transparency; to establish an institutional framework ensuring fiscal sustainability of regional governments (in case they are granted greater autonomy); and to consider the CFA that the country requires for the future, including new functions and more resources.

(iv) Advance in a broad agreement that enables financing current fiscal deficits and possible new permanent expenditures, through a substantive effort and a balanced

[7] By 2024, the Ministry of Finance plans to issue 90% of the government bonds in local currency (UF and Chilean pesos), reducing foreign currency debt from 35.7% to 34.0%. For more information see the press release of the Ministry of Finance, available here.

[8] In the case of Chile, the two specific rules included in the dual fiscal rule are the Structural Balance and the prudent level of debt rules.

combination of different sources of permanent financing, involving concrete actions and a detailed plan to achieve: (a) higher trend growth, (b) new tax revenues, (c) reduction of tax evasion and avoidance, and (d) permanent efficiency gains in public spending.

(v) Gradually rebuild the FEES. In this regard, the Council recommends reaching and maintaining a level between 5% and 7% of GDP for the FEES in the medium term, as suggested by the International Monetary Fund (IMF). Reconstructing the FEES is fundamental to strengthen fiscal buffers and improve the government's ability to respond to potential economic crises. To this end, the Council suggests that SB targets should consider this gradual rebuilding of the FEES, and that the Ministry of Finance should explore the option of converting illiquid assets into Public Treasury assets to expedite the process.

PRESENTATION BEFORE THE SPECIAL JOINT BUDGET COMMITTEE OF NATIONAL CONGRESS

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