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Statement by The Honorable Nicolás Eyzaguirre, Minister of Finance of Chile and The Honorable Vittorio Corbo, Governor of the Central Bank of Chile
Speaking on behalf of the Southern Cone Countries
(Argentina, Bolivia, Chile, Paraguay, Peru, Uruguay)

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I. World Economic Outlook - Prospects and Policy Issues

1. World economy is expected to have another good year in 2005, although not as dynamic as in 2004. However, there are risks that may adversely affect global growth and the external financial position in emerging economies in the near term. These risks are well identified in the WEO.

2. An area of special concern is the large imbalance in the expansion of the world economy. The U.S. has become the largest net importer of goods while the other regions barely contribute or do not contribute at all to aggregate world demand. The rebalancing process must be shared across regions to avoid a sudden adjustment of the key international currency that could lead to a sharp increase in world interest rates, with adverse consequences for many emerging economies.

3. To help limit these risks, on one hand, the U.S. must systematically implement the recently announced medium-term fiscal adjustment program. Europe, on the other hand, needs to be cautious in managing its monetary policy and should also advance in structural reforms that lead to higher potential growth rates. In both cases, inadequate policies or undue delays in the reforms could threaten international financial stability, thus endangering the progress achieved by emerging economies in the last few years.

4. The rebalancing process should also involve the emerging economies. In the case of Asia, appropriate incentives must be put in place to allow increase in domestic demand. Thus, more flexibility of the domestic currency would be appropriate. At the same time, Western Hemisphere countries have increased their contribution to world demand against a backdrop of favorable international commodity prices and financial conditions. Two elements are required for sustaining this process. On our side, continued progress toward investment friendly arrangements. On the international side, avoiding turbulence in international financial markets that may interrupt the adjustment and rebalancing process. The Fund's surveillance has an important role to play in providing early warning in these areas.

5. However, even with the best surveillance in effect it will be impossible to prevent new shocks to the international economy. An increase in economic imbalances may provoke stress in highly-indebted economies or in economies that suffer from currency, interest rate or term mismatches. To reduce these risks and allow for preventive action, the Fund needs to upgrade its capacity to undertake stress testing.

6. The second major risk for the world economy comes from persistently high oil prices, and underlines the need for increased international cooperation to ensure adequate supplies at prices that will clear the market over the medium and long-term. The lack of coordination regarding oil supplies may lead to lower growth due to the contractionary effect of high oil prices. In addition, inflationary risks in the U.S. and consequent effects on interest rates, could stress the financial position of more vulnerable emerging economies.

II. The Fund's Medium-Term Strategy

7. We fully share the key assessment that stability and sustained growth cannot be achieved without sound policies and strong institutions. Chile's own historical experience is illustrative in this regard. We think, however, that it is essential to narrow the focus of the Fund's efforts to a limited number of key directions. Resources are limited and demands multiple, and there is need for a proper division of labor among international organizations.

8. Given the above, we believe that the bulk of the Fund's work should focus on contributing to strengthen the economic and financial resilience of its member economies, and of the global monetary and financial system. While it is hard to forecast which shocks will hit our economies in the future, it is fully certain that some of them will indeed hit us.

9. The Fund should remain focused on the objectives outlined in the current Articles of Agreement, strengthening cooperation with other institutions in non-core activities. Under this scheme, the Fund may have to play a role in promoting institutions and policies related to fiscal and financial stability. Moreover, it is of greater importance that when the Fund deals with non-core expertise issues, it should consider the true priorities for the individual country, by promoting improvement in governance when it is required. *Ceteris paribus*, conditionality and policy recommendations of this type should at least be subject to scrutiny by external experts, and to a broad consensus at the Board.

10. In the key area of surveillance, an increased focus on contributing to building economic and financial institutions and improving policies that strengthen the resilience of member economies implies upgrading the Fund's capacity to perform stress-testing analysis. Also, it is essential to ensure that the Fund's staff makes a clear contribution to member countries by promptly recognizing, and taking into account, the differences across countries.

11. While it is important to promote sound policies and strong economic and financial institutions in developing economies, it is no less important that the surveillance process ensures evenhandedness between emerging and advanced economies. This is necessary not only to enhance the well being of the populations of developed countries, but to prevent imbalances in their economies from having damaging spillover repercussions throughout the rest of the world.

12. Building resilience also implies that the Fund must stand ready to provide liquidity to developing and emerging economies that have put in place adequate policies, but may face short-term difficulties attributable to factors beyond their control, and may need financial assistance to prevent a financial crisis. The timely and adequate provision of liquidity in situations of financial stress is a critical element to maintain investor confidence, and to provide affected countries with time to adopt the necessary policy adjustments.

13. While the revision of existing –or development of new– Fund facilities for direct liquidity provision to cope with adverse fluctuations must continue, we propose that the Fund include as high priority in its agenda, the exploration of new initiatives aimed at improving the provision of liquidity by private international financial markets. We believe that, working together with market participants, the Fund could play a key catalytic role in the development of markets and instruments that could provide relief during periods of liquidity shortage.

14. Open capital accounts can make a significant contribution to growth and improving living standards. Consistent with this view, Chile eliminated all restrictions to capital movements in 2001. However, we know well from experience that before moving to a fully open capital account, proper institutions need to be built in order to reduce risks and maximize the benefits associated with liberalization. The pre-requisites, including sound, credible and coherent monetary, exchange rate and fiscal policies, as well sound and well-regulated financial sector, can be very demanding. In our view, each member country should move along this path at its own pace, and the Fund should be ready to provide technical support, if required.

15. Considering that there is no current agreement on the exact sequencing or institution-building requirements necessary for financial liberalization, together with a less than satisfactory progress and consensus around a new financial architecture at a systemic level, we do not feel prepared at this juncture to endorse an extension of the Fund's mandate to include capital account transactions.

16. The thrust of the Fund's research agenda should be synchronized with the above-mentioned focus on building macroeconomic and financial resilience in member economies and in the global monetary and financial system. In this context, the research programs on institutions and contractual mechanisms that can help protect countries from external volatility, as well as that on international spillovers appear to be coherent with such a focus. Likewise, the requirement of consistency with the Fund's core area of expertise must also be satisfied by the research plan on linkages among policies, institutions, growth performance and poverty reduction.

17. Proper governance is key not only for member economies, but also for international financial institutions. The Fund, as well as other international fora, cannot remain hostage to inertia, or historical considerations, and should engage in a full review and discussion of this fundamental topic. In particular, it is evident that to make these institutions more effective, fair and legitimate, broader representation of developing economies in the Fund and other international fora is required. Improved governance and financial independence are critical to avoid conflicts of interest in surveillance, and program design and financing.

III. <u>IMF Support for Low-Income Countries</u>

18. Clearly the most important issue for low-income countries is to achieve sustained growth. Growth provides jobs and produces income gains, thus pulling people out of poverty. At the same time, growth provides more resources for the government to combat poverty and to finance social policies.

19. To free up fiscal resources, low-income countries need to attain sustainable debt levels. Therefore, we support exploring ways of reducing debt stocks on a permanent basis while ensuring that in-cash debt service also declines. However, debt reduction must involve an equal effort from these countries to resolve the problems that lead to recurrent debt crises.

20. The governments we represent at this table are all committed to help developing countries achieve the MDGs. To attain these Goals we need to raise a very substantial amount of resources (US$ 50 billion a year). The proposed International Financing Facility (IFF) put forth by the UK, and Chairman Gordon Brown in particular, seems sensible and deals with a significant part of the shortfall (US$ 10 billion a year). However, more resources are needed on an annual basis and, eventually, to pay back the bonds.

21. Here is where the initiative of Brazil, France, Chile, Spain, and Germany to identify innovative ways of raising additional resources plays a decisive role. It is not our intention to impose new taxes on everyone. What we propose is a multi-pronged approach that could include internationally coordinated and nationally applied taxes that do not impose an undue burden on anyone, but will raise real resources for development; a voluntary transfer of newly allocated SDRs to finance programs aimed at achieving the MDGs; voluntary transfers from private sources, reducing tax evasion through collaboration with tax havens, and leveraging the impact of remittances on the economies of recipient countries. On behalf of our government, we ask for your support so that the constructive spirit with which the Management and the staff have studied these proposals may now be applied to developing technically viable means to raise the resources so urgently needed.

IV. <u>The Southern Cone Countries</u>

22. Despite political difficulties and social demands, the *Bolivian* authorities continue to implement a solid economic program. During 2004 the program under the Stand-By Arrangement remained on track. Macroeconomic developments were positive, reflecting a favorable global environment. Preliminary estimates for 2004 point to real GDP growth of 3.75 percent; 12-month inflation was 4.6 percent by end-year, exceeding the program target of 3.5 percent, mainly due to imported inflation; and the current account surplus was around 3 percent of GDP, with strong growth in gas, mining, and agricultural exports. It is important to underscore the enormous effort displayed by the government of Bolivia to reduce the deficit to 5.7% of GDP in 2004, from 8.1 percent of GDP in 2003. However, the fiscal and financial situation remains fragile and growth is insufficient. In order to address these problems, it is necessary to implement a medium-term program focused on fundamental institutional and structural reforms that create a more equitable and efficient tax, reduce and better manage public expenditure, system and begin a process of financial de-dollarization. Moreover, it is essential to improve the business environment, which is hindered by governance problems, poor infrastructure and high costs of operating in the formal sector.

23. *Paraguay's* economic performance continues to be strong, and in line with the reform program supported by the IMF Stand-By Arrangement. Despite last year's drought that severely affected soy production, the country's main export crop, GDP grew almost 3 percent in 2004, the highest growth in a decade. In addition, the inflation rate declined below 3 percent, the lowest in three decades, confidence in the banking system has returned, the level of international reserves increased at record levels, and the foreign exchange market has broadly stabilized. The overall fiscal position of the central government has been brought into surplus, supported by significant improvements in tax and customs administration, while central government arrears were almost eliminated. The implementation of the new Fiscal Adjustment Law, the Customs Code, and the reform of the pension system, will contribute for long-term fiscal sustainability.

24. *Peru* has further reinforced macroeconomic stability and diminished vulnerabilities under the Stand-By Arrangement approved in June 2004. In 2004, GDP growth was around 5 percent, inflation remained within the target established by the inflation targeting framework, and the external position strengthened significantly, reflecting the current export boom (a year-on-year increase of almost 40 percent). Fiscal over-performance (a public sector deficit of 1.1 percent of GDP in 2004, vis-à-vis 1.4 percent envisaged in the program, from 1.8 percent in 2003) and progress in public pension reform have contributed significantly to enhancing market confidence. The authorities are also making substantial progress in their reform agenda, aimed at attaining higher and sustained growth over the medium term. In particular, they will continue to improve the business environment by strengthening the institutional framework and granting privately-operated concessions for public asset management.

25. The program that expired last March was critical for *Uruguay* to overcome a severe economic and financial crisis. Meanwhile, there is no doubt about Uruguay's need for a successor Fund-supported program, while regaining access to the external financial market. The Uruguayan authorities have stressed their strong commitment to macroeconomic stability as the necessary condition to achieve a higher and sustainable growth, enhance the level and quality of employment, decisively mitigate poverty conditions, and boost social equity. Likewise, the authorities will implement an ambitious agenda of structural reforms that allows the country to have stronger institutions that provide proper incentives for social and economic development.

Argentina

26. After having largely removed one of the main stumbling blocks to its medium-term economic outlook, *Argentina* is now ready to consolidate a sustainable and equitable growth process supported by the continued implementation of sound macroeconomic policies and well-timed and meaningful structural reforms.

27. The pace of both economic growth and fiscal consolidation has been exceptional over the past two years, with an average growth rate of 9 percent and a sustained and unprecedented primary surplus. Since the start of the rebound the economy has experienced eleven consecutive quarters of GDP growth, with an increase of 26 percent in the three-year span since the peak of the crisis in April 2002. During the first quarter of this year, the federal government's primary surplus was 18 percent higher than last year's -in nominal terms- and it remained at the same high level in terms of GDP observed during 2004 when the primary surplus of the federal government was close to 4 percent and over 5 percent at the consolidated level.

28. Investment in terms of GDP has already surpassed 1990s levels standing at 21 percent of GDP, the output-gap has actually expanded rather than contracted during 2004. Capacity utilization has slightly lowered thus reducing risks of supply bottlenecks and reaffirming expectations of a sustained growth process. At the same time, during 2004 the external sector remained dynamic with exports growing at 17 percent and imports at 61 percent, resulting in a trade balance close to 8 percent of GDP. Simultaneously, international reserves surpassed US$20 billion.

29. Because of the vibrant pace of economic growth, unemployment continues its downward trend, having reached 12 percent at the end of 2004 from its peak close to 25 percent in 2002. Since the emergence from the recession, the economy has created over 2.5 million new jobs; 80 percent of them in the private sector. Nonetheless, with 40 percent of the population still

living in poverty, the government of Argentina faces the vital task of maintaining the vibrant and social inclusive type growth of the recent past.

30. In this regard, the recent increase in inflationary pressures is a reason for concern given that, among other negative effects, it intensifies income inequalities by reducing the purchasing power of the poor.

31. The Argentine authorities are fully committed to taking all the necessary measures to contain the present inflationary pressures and to recuperate the declining trend in inflation that characterized the recovery process since the second half of 2002, when in fact, inflation was always lower than initially expected. The government projects an inflation rate of around 10 percent for this year, slightly above the upper limit of range established by the 2005 budget law. Continued fiscal discipline will be one important pillar of this policy.

32. The Central Bank, in turn, has already implemented a sharp tightening in the growth of monetary aggregates during the first quarter and is increasing the array of financial instruments to that end. Among them is the early cancellation of rediscounts granted to the financial system. In addition, the Central Bank has withdrawn from the foreign exchange market or kept interventions at a very low level. Consequently, it has been able to preserve relatively high reserve levels whereas maintaining monetary aggregates within the program limits. Beyond responsible macroeconomic policies, the government is resting on investment and productivity gains as the best remedies against inflationary pressures. In fact, productivity has increased sharply during past years, thus lowering unit labor costs, notwithstanding the nominal adjustment on wages that have taken place. Moreover, high-profit margins in the private sector provide room for wage adjustments without affecting prices.

33. After the successful debt exchange, Argentina's performing debt accounts for 86 percent of total public debt. As a result, Argentina's debt is back to manageable levels: and vulnerability has also been reduced as a consequence of the increase in peso-denominated debt from 3 percent in 2001 to about 37 percent at present.

34. It is important to highlight that Argentina undertook the restructuring of its debt not only without receiving any fresh money from the international organizations, but also fully respecting their preferred creditor status, thus having had in fact to make sizable net payments to those institutions in the order of US$ 11.5 billion since the crisis emerged in January 2002.

35. Considering the latter and the magnitude of the crisis it should come as no surprise that the cuts in the value of the defaulted debt were necessarily large; particularly when the government of Argentina has been guided during this process by the principle of not taking commitments that go beyond its actual payment capacity. This was considered the best way to build up certainty in the ability of the Argentine economy to meet its obligations, a clear break with past experience, while at the same time creating a favorable environment for investment and growth.

36. In sum, Argentina has followed a realistic strategy and will continue to do so in the conviction that this will enable the country to attend in due time, and within the framework of the prospectus, any debts that, out of the free choice of their holders, stayed out of the restructuring offer.

Chile

37. Overall, global economic developments have been very favorable for the *Chilean* economy. Robust world economic growth has materialized in a stronger expansion of the most important trade partners, such as Asian economies and the U.S., which has also been apparent in the high commodity prices, particularly copper. Notwithstanding these positive developments, prospects are cautiously optimistic. Indeed, despite the fact that it is not expected to significantly hamper growth prospects in Chile, the favorable world conditions would gradually decline. In addition, the persistently high oil price appears to be as a major risk factor in this soft-landing scenario, as are the continued imbalances between saving and investment within and between the main economic zones.

38. Domestic demand in Chile has strengthened notoriously in the past quarters, particularly investment. Looking forward, domestic demand will most likely replace the softer external forces. The pick-up in domestic economic activity and the gradual normalization of inflation from very low levels, determined the initiation of a gradual normalization of monetary policy towards a more neutral stance. Interest rates, however, remain substantially below historical averages, and credit and monetary conditions are still clearly stimulative. The real exchange rate has not strengthened materially, despite the marked improvement of external conditions and fundamentals in the past few years. The ability of the Chilean economy to cope with the swings in world conditions—particularly the sharp rise in the terms of trade, through a shift of the current account balance towards a sizeable surplus—undoubtedly explains part of this behavior.

39. Fiscal policy in 2004 was in line with our fiscal rule that calls for a one percent of GDP structural surplus for the central government. The operation of the rule has contributed to strengthen our credibility in international financial markets, reduce the spreads at which we borrow abroad, and open the opportunity for monetary policy to be more proactive. The higher than budgeted fiscal revenues, derived from better than projected growth and copper prices, led to a central government surplus of 2.2 percent of GDP, which fully compensates for the deficits incurred over the previous three years. The surplus was used to prepay debt and increase financial assets, leading to a reduction in central government net debt to only 4.3 percent of GDP.

40. In 2004 Chile also advanced with structural reforms. Within the public sector, the government is implementing its health care reform program, aimed at improving access and coverage for critical and expensive illnesses. To improve public sector management, a new upper management law is being implemented, which will lead to a strengthening of the quality and transparency of selection of managers and better human resource management in general. We have also advanced in correcting market distortions with the electricity law recently approved by Congress that eliminated long-term price uncertainty and consequently which limited investment in the sector. We are currently working with Congress on the second reform to the Capital Markets Law to improve financing of emerging enterprises. Finally, the draft Royalty Law, which has been submitted to Congress, will allow payments from the extraction of non-renewable mineral resources to be used for the financing of technological innovation, a crucial ingredient for sustaining the country's growth rate over the medium- and long-term.