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Chile: 2001 Article IV Consultation—Staff Report; Public Information Notice; IMF Staff Statement; and Statement by the Executive Director for Chile

- the staff report for the 2001 Article IV Consultation, prepared by a staff team of the IMF, following discussions that ended on **May 10, 2001,** 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 22, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of July 16, 2001, updating information on recent economic developments.

- a Public Information Notice (PIN), summarizing the **views of the Executive Board as expressed during its July 16, 2001, discussion** of the staff report that concluded the Article IV consultation.

- a statement by the authorities of Chile.

The document listed below has been or will be separately released.

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CHILE

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for
the 2001 Consultation with Chile

Approved by Claudio M. Loser and Liam P. Ebrill

June 22, 2001

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EXECUTIVE SUMMARY

Recent developments

Chile's economic performance was very strong during most of the 1990s, but the economy suffered a recession in 1998–99. Real GDP growth rebounded in the first half of 2000, but decelerated later in the year. Inflation reached 4.5 percent at end-2000, partly reflecting rising oil prices, but later declined to levels within the inflation target band of 2–4 percent that became effective this year.

After a moderate tightening in early 2000, monetary policy took an expansionary stance as the slowdown in output growth reduced the inflation risk. The fiscal position strengthened in 2000, reflecting an improvement at the central government level, which reversed the trend of the previous few years. The external current account deficit widened moderately, to 1.4 percent of GDP, and other indicators of external vulnerability remained at comfortable levels.

Policy discussions

The authorities explained that monetary policy will continue to be focused on keeping inflation within the target band, under a floating exchange rate, and fiscal policy will target a central government "structural" surplus of 1 percent of GDP every year, starting this year. Unemployment, which above 9 percent remains a concern, is being addressed by reallocating government expenditure towards labor-intensive projects, and by a program to facilitate the rescheduling of debts of small and medium-sized firms. The staff is broadly in agreement with the authorities' overall policy approach, though the program to help debt rescheduling has some drawbacks. Staff projects for 2001 real GDP growth of 4 percent, end-year inflation of 3.2 percent, and a current account deficit of about 2 percent of GDP.

The authorities are consolidating a number of important initiatives which should enhance economic performance. They introduced the inflation target band; started setting their fiscal target on the basis of a structural balance measure that removes the revenue effects of output gaps and deviations of copper prices from a reference price; eliminated remaining restrictions on capital flows; and submitted draft legislation for a capital market reform. On fiscal policy, it will be important to use a realistic copper reference price in the measure of the structural balance, and to continue monitoring the public sector accounts not included in that measure (central bank losses and the balance of state-owned enterprises). The banking system remains sound, though there is still room to strengthen the supervisory framework further.

Some elements of the labor reform proposal in congress could introduce rigidities in labor markets, with adverse consequences for employment. Chile has a very open trade regime and continues reducing unilaterally its uniform external tariff. However, the price-band scheme that generates higher tariffs on certain agricultural products should be reconsidered.

The medium-term outlook for the economy remains favorable. The main risks arise from a weaker external environment, but Chile's level of reserves, strong banking system, credible policy framework, and exchange rate flexibility should help the country deal with those risks.

I. Introduction

1. The 2001 Article IV consultation discussions with Chile were held in Santiago during April 26–May 10.[1] The staff team met with the ministers of finance, and economy, mining and energy, the president of the central bank, senior officials in the government and the central bank, private sector representatives, and academics.

2. At the conclusion of the last consultation on July 7, 2000 (EBM/00/68), Directors praised Chile's long record of sound economic policies, which in the 1990s had resulted in high economic growth and declining inflation. They considered that the downturn in economic activity in 1999 had been reversed with the aid of more accommodating macroeconomic policies, and viewed the move to a more neutral policy stance in early 2000 as appropriate. Directors welcomed the authorities' decision to enhance their inflation-targeting framework by shifting the focus from a specific year-end inflation level to a continuous inflation band starting in 2001, and by increasing transparency in the formulation and implementation of monetary policy. Directors supported the authorities' intention to strengthen the fiscal position beyond 2000, and the idea of formulating fiscal policy on the basis of a measure of the structural fiscal balance that would exclude the effects of transitory fluctuations in output and copper prices. They also supported the decision to float the peso, measures to liberalize capital flows, and the continued unilateral reduction of Chile's uniform external tariff. Directors noted Chile's strict bank supervision practices, and encouraged the authorities to advance in the introduction of supervision of consolidated balance sheets of financial holdings. They welcomed the authorities' intention to improve the system of unemployment protection, but recommended that the planned package of other labor reforms be crafted in a way that preserves flexible labor markets.

II. Background and Recent Developments

3. **Chile's economic performance was very strong during most of the 1990s, but the economy suffered a recession in 1998–99** (Table 1 and Figure 1). In early 1998 the authorities were facing a widening external current account deficit (resulting from surging domestic demand and a large drop in copper prices), which together with turbulence in world financial markets weakened investor confidence and put downward pressure on the currency.[2] In response, the authorities raised the "policy" real interest rate markedly, which led to higher lending rates and a slowdown in bank credit to the private sector (Table 2).[3] The combination of an adverse terms of

[1] The staff team comprised Messrs. Lizondo (Head, WHD), Hviding (PDR), Luzio, Nadal-De Simone, and Phillips (all WHD). Mr. Le Fort, Alternate Executive Director for Chile, participated in the discussions. Chile accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund Articles of Agreement on July 27, 1977. Relations with the Fund are presented in Appendix I.

[2] Copper accounts for about 40 percent of Chile's exports. Since around 35 percent of copper output is produced by the state-owned company Codelco, changes in copper prices also have important effects on the fiscal accounts.

[3] The central bank uses the "policy" real interest rate to signal its monetary stance, and manages liquidity to keep the overnight market interest rate close to the policy rate.

trade shock, diminished supply of external finance, and contractionary monetary policy caused a sharp fall in domestic demand and a decline in economic activity. Monetary and fiscal policies were eased starting in late 1998, which together with an increase in copper prices helped reverse the recessionary trend. All in all, the economy registered negative growth (year-on-year) for eleven months starting in October 1998, but was growing at a healthy pace again by late 1999. However, unemployment at end-1999 was considerably higher than before the recession (Figure 2).

4. **Real GDP grew by 5.4 percent for 2000 as a whole, despite a slowdown that began in the second half of the year, and continued into 2001**. Output recovered strongly in the first part of 2000, as a result of rapid export growth and, to a lesser extent, expanding domestic demand. Subsequently, however, consumption decelerated markedly, presumably as the persistence of high unemployment became clear to consumers, inducing them to revise their expected income and thus their spending plans. In the end, real GDP growth fell gradually from 6 percent (year-on-year) in the second quarter of 2000 to 3.3 percent in the first quarter of 2001.

5. **Despite the growth in economic activity in 2000 and early 2001, unemployment remained high**. As of March 2001, the seasonally-adjusted unemployment rate stood at 9.6 percent, compared with 5.7 percent in mid-1998.[4] The persistence of high unemployment may reflect a number of cyclical, structural, and institutional factors (Box 1).

6. **After a moderate tightening in early 2000, the authorities adopted an expansionary monetary stance starting in August as the slowdown in economic activity reduced the inflation risk** (Figure 3). In the first quarter of 2000, and in the context of rapid output growth, the central bank raised the policy real interest rate by 50 basis points (to 5.5 percent) to contain the inflationary pressures arising from higher oil prices. However, in light of evidence that the recovery of output was weakening, the central bank cut the policy rate back to 5 percent in August, and gradually down to 3.5 percent over the first half of 2001. While headline inflation rose during 2000 to reach 4.5 percent by end-year, it subsequently declined to 3.5 percent by March 2001, within the target band of 2–4 percent that became effective in January; underlying inflation (which excludes fuels and certain food items with volatile prices) remained around 3 percent throughout this period.[5]

7. **The public sector accounts strengthened in 2000, reversing the trend of the previous few years** (Table 3). The central government position improved significantly, as a result of increased revenue from the recovery of output and of copper prices, as well as

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[4] The number for March 2001 includes jobs (at the time equivalent to 0.3 percent of the labor force) created by state-supported employment programs introduced in 1999.

[5] Monetary policy focuses on bringing *headline* inflation to the midpoint of the band over an horizon of 1–2 years. The targeting regime has no formal caveats, but the authorities indicated that it takes into consideration that headline inflation and underlying inflation tend to converge over the 12 to 24 months horizon. Consequently, in explaining the deviation of headline inflation from the band, the central bank noted that *underlying* inflation had remained within the band.

Box 1. Unemployment Persistence in Chile [1]

A number of factors may have contributed to the persistence of unemployment in Chile following the 1998–99 economic downturn, including: (i) temporary shocks to the economy as a whole, possibly not evenly distributed across sectors; (ii) structural shocks of a more microeconomic, presumably permanent, nature; and (iii) certain rigidities in the labor market.

Evidence from other countries shows that aggregate **cyclical shocks** can lead to temporary but long-lived labor market fluctuations. A typical pattern is that recovery of employment not only lags that of output, as average hours worked first increase with output recovery before firms increase their hiring, but also proceeds at a slower pace. Models that include frictions in labor markets, such as job search costs, provide a rationale for the slow adjustment of employment to temporary shocks. In particular, these models suggest that shocks that are concentrated on labor-intensive sectors add significantly not only to the rise in unemployment but also to its persistence.

During the 1998–99 economic downturn in Chile, sectors such as construction and commerce, together representing 30 percent of nonagricultural employment, suffered the sharpest output contraction. The background paper on unemployment prepared for this consultation suggests that the variance of changes in employment across economic sectors may have been a significant factor explaining the persistence of unemployment in Chile, after controlling for the impact of aggregate shocks. If the shocks responsible for the slowdown in employment were indeed temporary, the protracted unemployment cycle would run its own course as recovering economic activity in labor-intensive sectors would eventually translate into higher job creation.

The arguments based on **structural, presumably permanent changes** as the reason for high unemployment hysteresis note that sectors such as agriculture, fishing, commerce and industry had been undergoing a significant transformation in Chile, and claim that this could have reduced the economy's employment capacity, at a given real wage structure and output level. The case of small and medium-sized enterprises (many of which have been facing financial difficulties) may be a relevant example, to the extent that it involves displacement of labor-intensive firms by large capital-intensive firms benefiting from increasing-return-to scale technologies. On the other hand, Chile experienced major economic transformations for more than a decade prior to the recent recession, apparently without adverse consequences on employment. In fact, formal tests have found no significant evidence of a structural shift in the aggregate elasticity of labor demand to output during the 1990s.[2]

The degree of **rigidity in labor markets** also helps explain high unemployment persistence. Empirical evidence shows that the 25 percent real *increase in the minimum wage* since 1998 contributed to increase unemployment among young workers. Also, *pervasive wage indexation* has probably limited downward adjustment of real wages despite a sharp increase in unemployment. Moreover, *high severance costs*[3] reduce the job creation response to output recovery as firms want to be sure that growth is sustained before hiring additional workers. Finally, uncertainties over a long-debated and contentious *labor market reform proposal* represent yet another factor that may have inhibited job creation.

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[1] See also the background paper with the same title, Chapter 2 in the Selected Issues Paper for this consultation.
[2] See Martinez C., G. Moralez and R. Valdés (2000) "Cambios Estructurales en la Demanda por Trabajo en Chile," *Revista de Economía Chilena,* (forthcoming), Central Bank of Chile.
[3] For a comparative analysis, see Heckman, J. and C. Pagés (2000) "The Cost of Job Security Regulation: Evidence from Latin American Labor Markets," IDB Working Paper 430, August 2000.

moderate growth in expenditure.[6] At the same time, the deficit of the state-owned enterprises rose somewhat, partly due to a domestic fuel price subsidy, and the central bank operational deficit declined slightly to 0.9 percent of GDP.[7] As a result, the combined public sector deficit fell to 2.6 percent of GDP, from 3.6 percent of GDP in 1999.

8. **The external current account deficit increased to 1.4 percent of GDP in 2000, from near balance the previous year** (Table 4). As a significant part of the expansion in domestic demand fell on imports, the trade surplus declined. In addition, profits on foreign investment in Chile's mining sector increased (mainly due to higher copper prices in average for the year), and net interest payments abroad also grew (reflecting higher medium- and long-term external debt and higher interest rates).

9. **As net capital inflows just about covered the external current account deficit, international reserves remained stable in 2000, and indicators of external vulnerability continued at comfortable levels** (Table 5).[8] Net foreign direct investment turned negative for the first time in several years, with inflows declining below historical levels and outflows continuing strong. In contrast, short-term net capital flows turned positive, this increase mostly consisting of credit lines to finance the acquisition of a large Chilean firm (some of these lines were replaced by a bond issue in early 2001). At end-2000 international reserves amounted to US$14.7 billion (eight months of imports of goods and services, and about twice the level of short-term external debt on a residual maturity basis, excluding direct trade credits). The Chilean peso, which had been floating freely since September 1999, appreciated by 2.4 percent in real effective terms during 2000, but at end-year it was still 12 percent weaker than at its peak in late 1997 (Figure 4). Moody's and Standard and Poor's have maintained their investment grade ratings for Chile's sovereign long-term debt (Baa1 and A-, respectively), the highest among Latin American countries.

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[6] In the staff's presentation of the fiscal accounts, the central government deficit fell from 2.4 percent of GDP in 1999 to 1 percent of GDP in 2000. In the official presentation, which includes drawings from the Copper Stabilization Fund and certain privatization receipts above the line, the central government moved from a deficit of 1.5 percent of GDP in 1999 to a slight surplus in 2000. Appendix IV of SM/00/116 explains the differences in presentation.

[7] These losses result from the low yield on the bank's foreign currency-denominated assets (international reserves and claims against the treasury) compared with the carrying cost of its indexed domestic liabilities.

[8] Even without intervention in the foreign exchange market, international reserves could vary due to changes in the foreign currency deposits at the central bank held by the nonfinancial public sector and financial institutions, direct foreign exchange transactions of the central bank with the government interest earnings on reserves, and valuation changes. Reserves could also vary due to direct foreign exchange transactions with Codelco, but the authorities indicated that no such transaction has taken place in the last two years.

10. **Chile has experienced little contagion from the difficulties in some emerging markets during early 2001**. While the Latin American Composite bond spread index increased by more than 200 basis points from its low level in early February to its peak in late April, the spread on Chilean sovereign debt declined slightly, and remained much lower than that for other Latin American sovereign debt (Figure 5). The spread on large Chilean corporate borrowers, however, increased slightly, and the peso depreciated by 6 percent with respect to the U.S. dollar during this period.

11. **In 2000, the authorities took measures to liberalize capital flows and further develop domestic financial markets**. The central bank eliminated an important rule that prevented certain capital inflows from being repatriated before one year, and reduced the minimum risk classification required on banks to issue ADRs and bonds abroad. It also widened the type of operations that banks may undertake to hedge against exchange and credit risk, and eased restrictions on banks' investment and credit operations abroad.

12. **Congress approved in late 2000 legislation to enhance corporate governance**, which is expected to increase the attractiveness of investing in Chilean stocks. The law seeks to protect minority shareholders by setting clear rules for tender offers, increasing their role in the auditing of the company and in the approval of transactions with related parties, and more generally enhancing their access to information on the company's operations.

13. **Chile has a very open trade regime**, rated 1 on the 1–10 scale of the Fund's trade restrictiveness index. The country has continued to reduce unilaterally its uniform external tariff by 1 percentage point a year since 1999; the uniform tariff is now 8 percent and will continue to be lowered to 6 percent by January 1, 2003. For a long time Chile has maintained the price of certain agricultural products (wheat, wheat flour, sugar, and edible oils) within *bands* related to past international prices. In late 1999 Chile introduced safeguards on the importation of those goods, as the tariffs implied by the price-bands exceeded Chile's WTO limit for these goods of 31.5 percent (the safeguards allow temporary exceptions to this limit). Subsequently, import safeguards were also introduced on milk, a good not subject to the price bands. The government has started negotiations to increase its WTO-agreed tariff limit on sugar, to avoid any future conflict with the price-band scheme. Trading partners have turned to the WTO to persuade Chile to abandon the safeguards and the price-band scheme. In 2000, Chile continued trade negotiations with the European Free Trade Association and Korea, and started negotiating a free trade agreement with the United States, and a political and economic cooperation agreement with the European Union.

14. During 2000 the authorities **privatized** three water and sewage companies, for receipts equivalent to 1.3 percent of GDP. They also granted two private concessions involving roads, for 0.8 percent of GDP.

III. Policy Discussions

A. Macroeconomic Policies

15. The authorities explained their basic economic strategy, which includes monetary policy focused on keeping inflation within a band of 2–4 percent, under a freely floating exchange rate, and fiscal policy geared to maintaining a central government "structural" surplus of 1 percent of GDP, starting this year (see Box 2). Unemployment concerns are being addressed mainly by reallocating government expenditure towards labor-intensive projects, and through a program to facilitate the rescheduling of certain debts of small- and medium-sized enterprises (SMEs), which are an important source of employment in Chile. The authorities expected the current slowdown in output growth to be reversed later in the year, aided by the more accommodating monetary policy of the last several months and an envisaged gradual improvement in world economic activity and copper prices. The staff was broadly in agreement with the authorities regarding their overall policy approach and the outlook for the economy. Staff projected for 2001 real GDP growth of 4 percent, end-period inflation of 3.2 percent, and an external current account deficit of 2.2 percent of GDP.[9] These projections are similar to those in surveys of private forecasts.

16. **There was broad agreement with the authorities on the stance of monetary policy.** The level of the policy real interest rate, at an historical low, seems consistent with maintaining inflation within the 2–4 percent target band. Output is expected to be below its potential level during most of the relevant policy horizon, and the risks around the central bank's baseline inflation projection appear to be well balanced. **The authorities said that they were satisfied with the working of their inflation targeting framework under the freely floating exchange rate**, and indicated that they might reduce the publication lag of minutes of monetary policy meetings from the current three months.[10]

17. On fiscal policy, the staff agreed with the authorities' projection of a central government *structural* surplus of 0.9 percent of GDP in 2001, following a surplus of 0.2 percent of GDP in 2000. (The authorities consider this projection to be sufficiently close to their target, and thus do not plan an adjustment in policies). At the same time, the staff projects a central government *actual deficit* of 0.9 percent of GDP, broadly unchanged from

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[9] The main risks to the output projection include a less favorable external environment, and continued consumer reticence despite lower interest rates and the envisaged increase in employment from the authorities' recent initiatives.

[10] Chapter 3 of the Selected Issues Paper examines the relationship between inflation and output volatility for a group of countries, some of them (including Chile) under inflation targeting.

Box 2. Chile's New Structural Balance Target [1]

Soon after taking office in March 2000, Chile's new government committed itself to tightening the central government accounts, defining its objective in terms of a new *structural* balance measure. The announced objective was a surplus of 1 percent of GDP, to be first achieved in 2001 and then maintained in each subsequent year.

Potential benefits of the new fiscal framework. By removing apparent short-term "noise" from the fiscal balance, the new measure helps focus policy discussions on medium-term considerations. Since the target refers to a more controllable concept, it permits a tighter standard of accountability, and the commitment to a precise target does not imply suppressing automatic stabilizers. Consistent application of the new framework would rule out a trend deterioration of the central government balance, potentially bringing benefits from enhanced credibility. Chile already enjoys a low ratio of total public sector debt to output; whether this would decline further would depend on, inter alia, how policy responds to copper export price shifts, the performance of accounts not covered by the new target (see below), and the pace of economic growth.

Derivation of the structural balance begins with a set of accounting adjustments, deriving from the traditional central government balance the new "adjusted balance," which better captures changes in net worth (e.g., all flows related to privatization and government lending are put below the line). Adjustments are then made for the estimated effects on revenue of the output gap and deviations of copper export prices from a notional "reference price."

International comparison. Chile's fiscal balance target is notable for applying in every year, and for making an allowance for changes in export (copper) prices but no allowance for cyclical expenditure fluctuations. The framework is without escape clauses or other formal room for maneuver; but neither is it legally binding, being a self-imposed commitment of the current government.

Interpretation. The adjustments noted above yield a much smoother, more controllable fiscal balance measure, but two main issues arise if it is interpreted as an indicator of the underlying position of the public sector. One is that the measure does not capture the public enterprises, off-budget military expenditure, or the central bank losses. A second issue concerns the determination of the reference copper price, around which "cyclical" movements are defined. Here arises a fundamental problem that complicates fiscal policymaking in Chile more generally: it is very difficult to predict copper prices in the future, thus it is unclear how to set the reference price. [2] Using a fixed reference price would imply no policy adjustment at all to copper price shocks. On the other extreme, using the spot price as a reference would imply full and immediate policy adjustment to price shocks. So far, the reference price used in Chile has been quite smooth in relation to actual prices.

Evolution of the new framework. Looking ahead, as experience with the new framework grows, a number of questions will be relevant. Will the framework be made legally binding and otherwise become formalized? Will it address, ex ante, possible deviations from the point-target level, and specify consequences and responses in those situations? Will the framework continue to require little policy adjustment to copper price movements? Would the level of the ongoing target ever be revised? What procedures will be developed to determine the output gap and copper price adjustments both accurately and transparently?

[1] See also the background paper, "Chile's Structural Balance Target: Aspects of Design and Implementation," Chapter 1 in the Selected Issues Paper for this consultation.
[2] See "*Prediciendo El Precio Del Cobre: ?Más Allá del Camino Aleatorio?*" E. Engel and R. Valdes (2001).

last year, as both revenue and expenditure are envisaged to grow in line with GDP.[11] The modest overall deficit of the state-owned enterprises would shrink by about ½ percentage point of GDP this year, as the cost of last year's oil price subsidy would not be repeated owing to a change in the rules for setting the subsidy.[12] Central bank losses would be unchanged at 0.9 percent of GDP. Overall, the deficit of the combined public sector would decline from 2.6 percent of GDP last year to 2.1 percent of GDP in 2001. Staff considers this stance broadly appropriate in the current economic environment and in consonance with the easing of monetary policy.

18. **The mission discussed the official methodology for calculating the structural fiscal balance, and the use of a fixed-point target to be achieved every year.** The staff favored using a comprehensive measure of the structural balance, including (in addition to the central government balance) the central bank losses, and preferably also the overall balance of the state-owned enterprises. The government has influence on the operations of these enterprises (for instance, by approving their budgets), and some of these firms have performed quasi-fiscal activities. Also, as the government is presumably the ultimate guarantor of their liabilities, the performance of these firms is relevant for the net worth of the government. The authorities, however, considered that the current measure of the structural balance provides the proper yardstick for the stance of fiscal policy in the case of Chile. They said that state-owned enterprises operate with a market orientation and not as a fiscal policy instrument, and noted that central bank losses were taken into account in setting the level of the target for the structural balance.

19. The staff also recommended using a copper reference price that reflects expected prices over the next few years, rather than a notional "long-run" price. The long-run value of copper prices is highly uncertain, so temporary shocks are difficult to identify. Also, these shocks seem to disappear quite slowly. Thus, using a reference price that is very different from the current price runs the risk that the actual price would remain substantially different from the reference price for a very long and uncertain period; in that case, the measured structural

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[11] For the official presentation of the central government accounts, staff projects an actual deficit of 0.6 percent of GDP. These figures of actual deficits do not include the provision of liquidity to banks (up to 0.4 percent of GDP) in the program to help SMEs (see below), although this could be considered a net lending operation.

[12] The government operates a fund (based on taxes and subsidies) aimed at stabilizing the domestic prices of oil products. Under the rules introduced last year the subsidy rate declines gradually to zero if the resources of the fund decline to zero (thus preventing persistent large subsidies); the fund's resources are now very low. The staff considers that it would have been preferable to eliminate the fund (so that consumers face undistorted prices), but sees the new rules as a significant improvement that addresses the main problems of the previous scheme. For more details, see SM/00/116.

balance might not accurately capture the underlying fiscal situation. On this basis, it would be preferable to use as a reference price the best available projection of average prices over the next few years, rather than a value less directly related to the current price. The staff also suggested introducing some flexibility in the fiscal target (a band around the point-target, or explicit escape clauses that would justify departures from the target) to respond to major events.[13] The authorities said that they were considering the possibility of using a medium-term (rather than long-term) horizon for the copper reference price, and were contemplating establishing a commission that periodically would revise that price.

20. The authorities expressed interest in having the **fiscal transparency** ROSC module prepared for Chile for the next consultation. They also explained that the government had made commitments to congress that will enhance the transparency of fiscal policy, including the preparation of studies on important aspects of the public sector operations (for instance, on contingent fiscal liabilities). The mission welcomed these plans, and noted the importance of making these studies available to the public. Regarding transparency in the pursuit of the structural balance target, the mission recommended formalizing and making transparent the setting of the copper reference price, publishing the method used to estimate the output gap, and regularly publishing in detail the various accounting and cyclical adjustments used to derive the structural balance measure.

21. The authorities estimated that the recently approved **law on tax evasion and tax avoidance** would increase government revenue by about 1 percent of GDP over the medium term (the projected effect for this year is very small). The law seeks to reduce tax evasion by strengthening the administrative power of the tax and customs authorities, raising fines and defining new tax crimes, and to reduce tax avoidance by closing certain tax loopholes.

22. The authorities' strategy to address high unemployment includes the **reallocation of government expenditure** towards labor-intensive projects and some new employment programs (involving resources for about 0.7 percent of GDP). This effort will be concentrated in the months with high seasonal unemployment, and will give priority to regions with high unemployment rates and to heads of households that became unemployed. Some of the programs aim at helping generate jobs in the private sector by contracting projects with the private sector or by subsidizing private employment. For instance, a new wage subsidy program provides payments for the equivalent of 40 percent of the monthly minimum wage

[13] For instance, a natural disaster or a sharp drop in output leading to very high unemployment may justify a transitory increase in certain types of expenditure; under the current framework, such expenditure increases would have to be offset by a simultaneous cut in other expenditure or an increase in taxes.

for a period of four months, plus an initial payment of about 50 percent of the monthly minimum wage (to finance training), for the hiring of a new worker.

23. The authorities also explained the recent **measures to help SMEs**, intended to support employment in this labor-intensive sector. These measures include the rescheduling of arrears on taxes and pension contributions (for up to 1.3 percent of GDP), and incentives for the rescheduling of commercial bank loans to these firms. The government will provide a partial guarantee (for up to 0.6 percent of GDP) on rescheduled loans, and will place long-term deposits (for up to 0.4 percent of GDP) in those banks that reschedule loans, in order to facilitate maturity-matching between assets and liabilities. The authorities considered that the risk of moral hazard from these measures was small: (i) the program for bank loans could be used to reschedule performing as well as nonperforming loans (so it would not provide incentives to delay payments); (ii) the previous rescheduling of pension contributions was done 16 years earlier (so firms would not expect it to be repeated in the foreseeable future); and (iii) the rescheduling of tax arrears was undertaken together with renewed government emphasis on tax collections (including through their legislative initiative on tax evasion and tax avoidance).

24. The staff sees the authorities' decision to reallocate government spending towards labor-intensive projects as a reasonable response to a problem for which no immediate and complete solution is available. This effort is in part aimed at generating private-sector jobs and improving the skills of unemployed workers, and will be covered by resources already budgeted. The measures to help SMEs, on the other hand, are less well-targeted to reduce unemployment, create a contingent fiscal liability, and could weaken firms' discipline in the timely payment of their obligations; however, to the extent that these measures are not expanded in coverage, and are not repeated in the future, these drawbacks seem to be limited. In any case, the staff sees the role of these initiatives as providing temporary relief to unemployment problems until a strong and sustained pickup in economic activity starts to generate employment again. However, for unemployment to decline on a sustained basis it will be crucial to maintain labor market flexibility. In this regard, the staff considers that the increase in the **minimum wage** of 5.5 percent granted on May 2001 is likely to add pressure on unemployment, particularly among young workers, for whom the unemployment rate is above 20 percent. The authorities were of the opinion that the impact of the recent minimum wage adjustment would be limited as it was small in real terms. However, as a significant share of workers is believed to receive wages close to the minimum wage, even a modest increase could represent a constraint to hiring decisions.

25. The external **current account deficit** is projected to increase moderately in 2001, reflecting mainly a deterioration in the terms of trade of about 2 percent, as growth of both export and import volumes is envisaged to slow. Exports would be affected by the decline in foreign demand and only a modest increase in copper production, while imports would be limited by lower output growth and the recent real depreciation of the currency. The current account deficit is expected to be financed mainly by bank loans and bond issuance. Net foreign

direct investment inflows are envisaged to be positive, although small, following large gross inflows in the first quarter of the year.

B. Financial Sector and Structural Issues

26. **Indicators of banks soundness remain favorable.** The share of nonperforming loans in total bank loans was 1.8 percent in March 2001, unchanged from a year earlier; [14] as of February 2001, loan provisions amounted to 140 percent of nonperforming loans and the risk-weighted capital-assets ratio was 14.8 percent for the banking system (and above 10.5 percent for every bank). The staff noted Chile's strict bank supervision practices, but observed the absence of a legal framework for the supervision of financial conglomerates on a consolidated basis. The authorities said that a committee of the various agencies supervising the financial system had initiated a coordinated monitoring of the largest financial conglomerates in Chile, with the final objective of eventually supervising these groups on a consolidated basis. Also, to enhance its ability to combat money laundering, the government submitted to congress a proposal that would create a financial intelligence unit to analyze suspicious transactions and report the cases that merit investigation to the judicial authorities.

27. The staff was provided with an assessment of Chile's compliance with the Basel Core Principles of banking supervision, prepared by external consultants hired by the bank supervisory agency (SBIF). The assessment is generally positive, and most of the issues that were identified as needing improvement were being addressed at the time the report was completed (February 2000). The staff considered that it was also important for Chile to make progress on two issues not yet addressed, enhancing the operational independence of the SBIF and providing officials of the SBIF with proper legal protection in the discharge of their responsibilities. The authorities saw those matters as relevant to further strengthen the institutional capacity of the SBIF, but did not include them in their work program because they felt that addressing them was not urgent and the legislative agenda for this year was already very heavy.

28. The authorities indicated that they were discussing ideas for the **capitalization of the central bank**, but were not sure when a specific plan would be finalized and implemented.[15] They explained that the current situation does not hamper the central bank's ability to pursue

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[14] The measure of nonperforming loans used in Chile includes only the *loan installments* in arrears. The bank supervisory agency does not have a precise estimate of the share of nonperforming loans using a measure that includes the *entire loan* as nonperforming, but considers that such share would not exceed 3.6 percent.

[15] The capitalization of the central bank would not affect the combined public sector deficit (additional government interest payments—on the debt issued to capitalize the bank—would be equal to additional central bank interest receipts).

its objectives. The mission agreed with this point, but considered it important to solve this problem promptly, in order to enhance fiscal transparency and consolidate public confidence in the central bank's independence.

29. The mission shared the authorities' view that the **elimination of remaining restrictions to capital flows** and the plan for a **capital market reform**, both announced in April, would be important to increase the efficiency and liquidity of Chilean financial markets. These initiatives constitute the last step in a slow and careful relaxation of restrictions imposed both on the domestic financial markets and the capital account in the aftermath of the banking crisis in the early 1980s (see Box 3).

30. The main restrictions eliminated by the central bank include (i) remaining authorization requirement for some capital transactions (which together with a major simplification of regulatory prerequisites removed administrative burden and uncertainty); (ii) the nonremunerated reserve requirement on capital inflows (which had a zero rate since September 1998); (iii) the minimum rating and maturity requirements for bond issues; and (iv) remaining restrictions on ADR issues. These measures were welcomed by private market participants.

31. Also welcomed was the proposed capital market reform, which among other measures would: (i) eliminate certain capital gains taxes for both foreigners and residents; (ii) reduce taxes that foreigners pay on interest from bonds issued domestically by Chilean residents (to equal the rate on bonds issued abroad); (iii) create a stock exchange for "emerging" companies (those deemed to have high growth potential); (iv) widen the choices for individuals to invest their pension savings; and (v) deregulate the mutual funds and insurance industries. The authorities have already submitted draft legislation for this reform.

32. The authorities noted that the **unemployment insurance scheme** approved by congress in April 2001 was an important step in enhancing the social safety net. The new scheme is based on a combination of *individual accounts* financed by employers and employees (these accounts can be accessed in the event of lay-off, voluntary separation, retirement, or work disability) and an *insurance fund* financed by employers and the government (to ensure a minimal level of protection for workers with low balances in their individual accounts). The pre-existing system of severance payments (one month of salary for every year worked at the firm, up to a maximum of eleven months of salary) is maintained, but some of its adverse effects on labor market flexibility are reduced. Severance payments may discourage employers from laying-off workers, and also discourage workers from voluntarily changing jobs (as they would forego "severance payments rights" they have accumulated in their current job); these effects are particularly important for long-tenure workers. Under the new unemployment insurance scheme, the employer contribution to an individual account would be counted against the required severance payments in the event of lay-off (thus reducing the *marginal* cost of laying-off workers), and the worker keeps the amounts deposited in his individual account in the event of voluntary separation (thus reducing the

Box 3. Liberalization of the Capital Account

In April 2001, Chile completed a long and careful process of capital account liberalization, and the country is now essentially free of capital account controls.

Compared to most other emerging market economies, Chile's approach to capital account liberalization has been particularly cautious, reflecting the lessons the authorities drew from the currency and banking crisis of the early 1980s. The rapid capital account liberalization in preceding years was considered to have contributed to the overvaluation of the peso and the large foreign borrowing which—together with weak banking regulation and supervision—were identified to be the main causes of the crisis. In order to help prevent a similar episode, the Chilean authorities decided to impose strict prudential regulations on financial institutions and restrictions on external capital flows.

The new central bank charter of 1990 gave the central bank authority to impose or remove a number of restrictions on foreign exchange operations. The central bank used these powers over the following years in a process that led to a comprehensive liberalization of the capital account. The process was asymmetric, as restrictions on outflows were relatively rapidly removed but restrictions on inflows were maintained during most of the 1990s. Some controls on capital inflows were judged useful as the central bank sought to maintain some monetary policy independence, to limit the real appreciation of the currency, and to prevent a heavy reliance on short-term borrowing, which was suspected to be destabilizing. In part reflecting these additional objectives, the process of liberalization was not always smooth, and in some instances was reversed. For instance, the unremunerated reserve requirement on capital inflows was used actively throughout the period, being tightened at times of substantial inflows (e.g., 1992, 1995, 1996).

Toward the end of the 1990s, the process of capital account opening gained renewed impetus, reflecting complementary policy developments and a reduced supply of capital to emerging markets in general, including Chile. The unremunerated reserve requirement on capital inflows was set to zero in September 1998, and the minimum holding period was eliminated in May 2000. In April 2001 the remaining restrictions were removed as the central bank considered that the conditions for completing the liberalization were in place, including: (i) solid macroeconomic fundamentals; (ii) successful adoption of a floating exchange rate and inflation targeting regime; (iii) convergence of the inflation rate to that of industrial countries; (iv) a fiscal policy framework aimed at a small structural surplus; (v) a high standard of solvency of the financial system, including the development of instruments to hedge exchange rate risk and regulations that take into account the exchange-rate risks of bank clients; (vi) increased diversification of foreign trade; and (vii) a high level of international reserves.

Sources: Le Fort G., 1994, "Financial System Macroeconomic Stability: The Chilean Experience," in "Financial Sector Reforms, Economic Growth and Stability," ed. Shakil Faruqui in *Economic Development Institute of the World Bank Seminar Series*; and Nadal-De Simone, F and P. Sorsa, 1999, "A Review of Capital Restrictions in Chile in the 1990s." *IMF Working Paper*, WP/99/52.

disincentives for voluntary changing jobs). The new scheme will be introduced gradually, with individuals starting employment after May 2002 being required to participate, and those already employed by that date being able to do so on a voluntary basis. The new unemployment insurance system will increase indirect labor costs by up to 3 percent of wages. On balance, the staff considers this scheme an advance over the previous situation.

33. The authorities explained that the **labor reform** proposal currently in congress seeks to strengthen workers' rights and introduce additional flexibility in labor contracts.[16] The mission viewed favorably certain aspects of the proposal (such as reducing restrictions on work schedules, and allowing part-time contracts and work at a distance). However, it expressed concern over other elements (such as allowing collective negotiations at the inter-firm level, and increasing the cost of replacing striking workers) which would reduce labor market flexibility, imposing further constraints on employment creation.

34. **The mission supported Chile's open trade regime**, and the continued unilateral reduction of its uniform external tariff. The mission considered that the **price-band scheme** on certain agricultural products has resulted in high tariffs that distorted resource allocation and generated a negative response from trading partners, and thus argued for its elimination. The authorities said that the price bands are used in response to distortions in international markets in these products owing to subsidies and protection to industrial countries' producers; subsequent to the mission the bands were renewed through late-2002 and early-2003. The authorities also said that they had no plans to renew the safeguards on products under price bands when these safeguards expire later this year. (Whether the tariffs resulting from the operation of the price bands will conflict with the WTO limit for these goods will depend on the evolution of international prices). The authorities indicated that they were making progress in their **trade negotiations**. They also restated their interest in becoming a full member of Mercosur, but said that this would be considered only if Chile is not required to adopt Mercosur common external tariff rates, and maintains its independence to negotiate trade agreements until Mercosur external tariff rates converge to that of Chile.

35. The authorities explained that they are not planning further sales of **state-owned enterprises**, but instead are considering changes to the statutes of those enterprises to improve their efficiency (by giving them incentives to behave as if they were privately owned),

[16] This reform is a contentious issue in Chile. The proposal has been modified since it was submitted to congress (late-2000) and is likely to undergo further modifications.

and to enhance the transparency of their operations.[17] They also explained that operation of all the water utility companies that remain in state hands (which serve about 25 percent of customers) would be transferred to the private sector under concessions for 20–30 years, moving away from the previous approach of selling water companies to the private sector (with the state keeping of the shares). The authorities prefer concessions because this will keep the public sector away from the management of the firms, thus avoiding conflict of interest with its regulatory activities, and water rights as well as the residual value of the companies will remain in state hands, which the authorities consider positive as it widen the choices for future public policies. Other concessions being planned for 2001 include the management of roads, railways, airports, dams, and prisons. The mission considered that the envisaged changes in the statute of state-owned enterprises was likely to represent an improvement over the current situation, but that it would be difficult to replicate completely the set of incentives that private ownership would provide. Thus, it would be advisable to move in the direction of privatizing some of those firms.

C. Medium-Term Outlook

36. The staff prepared a medium-term scenario, presented in Table 6, based on the assumptions of a recovery of copper prices (close to 20 percent in U.S. dollar terms over the next five years), a gradual strengthening of world economic activity, the continuation of sound macroeconomic policies, and continued progress with structural reforms. On that basis, real GDP growth is envisaged to recover over the next few years, and settle at 5½ percent over the medium term. Admittedly, there is considerable uncertainty about the rate of potential growth for the Chilean economy. The difficulty in sustaining a strong recovery from the recent recession has led to a general downward revision of potential growth estimates, from the rates of 7 percent or higher that were usual until recent years.[18] However, revisions based on the behavior of output over the last few years, which has an important cyclical component that is difficult to isolate, necessarily carry significant uncertainty. Thus, the staff does not rule out

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[17] The revenues of state-owned enterprises amount to about 12 percent of GDP. The main enterprises include Codelco, the national oil company, the national mining company, and a commercial bank. For various reasons, the planned changes to the statutes would not apply to Codelco, the commercial bank, the National TV station, and firms in the area of defense.

[18] These revisions reflect the idea that in coming years, when compared with the period of the 1990s before the recent recession, there will be less margin for catch-up with more advanced economies, lower marginal gains from past structural reforms, somewhat smaller capital inflows, and slower expansion of the mining sector in particular. Chapter 4 of the Selected Issues Paper discusses alternative estimates of potential output growth for Chile, separating the role played by the copper sector.

the possibility that important advances in structural areas could result in growth rates somewhat higher than those in Table 6.[19]

37. The medium-term scenario envisages a gradual widening of the external current account deficit to about 3 percent of GDP, a level that would be consistent with declining debt and debt-service ratios (Table 7). Domestic investment would remain broadly unchanged as a ratio to GDP, while national savings would decline modestly. Public sector savings would grow, mainly reflecting an increase in central government revenue resulting from the closing of the output gap and the increase in copper prices. In contrast, private sector savings would decline to levels more similar to those observed during 1990–98.

38. Regarding competitiveness, the staff understands that the authorities are inclined to focus directly on the current account rather than on exchange rate-based indicators, and correspondingly on influencing national savings rather than the nominal exchange rate. The staff believes that this focus is appropriate, particularly under the current system of a flexible exchange rate and inflation targeting. In any case, as of end-May 2001 the peso was estimated to be about 14 percent weaker in real effective terms than at its peak in late 1997; such a level should be consistent with continued growth of export volumes.

39. As regards risks in the medium-term scenario, the staff considers that plausible negative shocks would be unlikely to induce an external crisis or disorderly adjustment, but these shocks could imply a period of slower growth.[20] Among possible shocks, considerable uncertainty attaches to copper export prices; although the consensus view is that there is more

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[19] These advances may include continuing with the planned reduction in the uniform external tariff, reaching a free trade agreement with the United States, implementing the proposed capital market reform, strengthening the regulatory framework for certain activities, maintaining flexibility in labor markets, undertaking further privatizations, and a successful implementation of the ongoing education reform.

[20] The staff view of potential external vulnerability has not changed significantly since the last Article IV consultation, when it was examined extensively; see SM/00/116 Box 3, and Chapter IV of Selected Issues paper SM/00/129. That background paper compared Chile with other high-rated emerging markets and with certain small advanced economies, for a wide range of liquidity and solvency indicators. On the basis of those comparisons, Chile's position appeared stronger than most other high-rated emerging markets, and not far behind that of the higher-income countries, on average. In addition to cross-country comparisons, Chile's position was discussed in terms of various qualitative factors. Among Chile's identified strengths were the level of international reserves in relation to short-term debt, banking system soundness, and a low level of public sector debt. The size of the private's sector external debt was identified as a potential issue, but this needed to be considered with respect to its foreign assets; the latter were thought to be substantial, but no definite data are available.

room for these to rise than fall, it is possible that the recovery envisaged in the medium-term scenario would not fully materialize.[21] Also, although foreign investors are expected to continue to favorably distinguish Chile among emerging markets, it is possible that developments abroad could reduce gross investment flows into Chile. The authorities indicated that in the event of adverse external shocks they would allow the exchange rate to adjust freely and continue with their approach of moving the policy interest rate only to the extent that it is needed to meet their inflation target, a view that was shared by the mission.

D. Statistical Issues

40. The staff considers that Chile's economic data are broadly adequate for surveillance purposes. The authorities are working to enhance information on the financing items of the fiscal accounts, and to obtain reliable estimates for direct trade credits (which are currently missing from the official statistics on external debt). Progress in these areas, as well as in improving the coverage of military transactions in the fiscal and external data, would enhance the usefulness of the official statistics. The authorities are also revising the national accounts, updating the base-year from 1986 to 1996 to reflect important changes in the structure of the economy and relative prices that occurred in the intervening period. The publication of the revised series, planned for March 2002, will permit a better assessment of economic developments and prospects.

41. The mission that recently prepared the ROSC Data Module for Chile concluded that: (i) Chile is in full observance of the SDDS since March 30, 2000 and meets the specifications for the data dimension for all data categories, using two SDDS flexibility options, and for the dissemination of Advance Release Calendars; (ii) all agencies have a legal and institutional framework that supports statistical quality, demonstrate professionalism, and are transparent in their practices and policies; (iii) statistics generally follow international accepted standards for compilation, with a few exceptions largely due to the transition to the most current methodologies; (iv) accuracy and reliability are high in most data categories, but could be improved in others; and (v) accessibility of data and metadata is high, and assistance to data users is of high quality. These issues are discussed in detail in the ROSC Data Module issued separately as a background paper for this consultation.

IV. Staff Appraisal

42. Chile's long record of very strong economic performance was interrupted by a downturn in economic activity in the late 1990s, from which output started to recover in late-1999. In 2000, the authorities restrained government expenditure to reverse a previous trend

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[21] If copper prices were 10 percent lower than envisaged, other things constant, the external current account and the actual fiscal balance would be weaker than envisaged by about 0.4 percent of GDP.

for a weakening of the public accounts, and early in the year firmed-up monetary policy to contain inflationary pressures arising in part from rising oil prices. As output growth started to slow in the second half of the year, the outlook was for inflationary pressures to decline, and the authorities started easing monetary policy.

43. The staff believes that the authorities' macroeconomic policy stance for 2001 is appropriate. Monetary policy, with interest rates at an historical low, seems consistent with maintaining inflation within the target band of 2–4 percent under present circumstances. Fiscal policy is geared toward achieving a central government surplus of 1 percent of GDP on a structural basis, defined to exclude the revenue effects of output gaps and deviations of copper prices from a notional reference level. This objective implies this year a moderate strengthening of the fiscal position at the combined public sector level.

44. Unemployment, which has remained high, is being addressed mainly through reallocating government spending towards labor-intensive projects, and a program to facilitate rescheduling of debt of small and medium-sized enterprises, which are an important source of employment in Chile. The reallocation of spending is a pragmatic and reasonable response to a difficult problem for which no easy solution is available. The rescheduling of debts seems less appropriate, as it creates a contingent fiscal liability and runs the risk of generating moral hazard; thus, it would be advisable not to expand the coverage of these measures. All these initiatives will contribute to alleviate unemployment problems transitorily, and it would be important to accompany them by caution in granting adjustments to the minimum wage and to keep labor markets flexible more generally.

45. Assuming that demand strengthens later in the year on account of the recent easing of monetary policy and a gradual improvement in the external environment, real GDP in 2001 is expected to grow by about 4 percent and inflation to converge close to the center of the band by the end of the year. The external current account deficit and other indicators of external vulnerability would remain at comfortable levels.

46. In 2001, the authorities are consolidating a number of important initiatives to enhance macroeconomic management. The target band for inflation became effective this year, and monetary policy continues to be managed transparently with the primary objective of maintaining low and stable inflation. The authorities also started to set their fiscal target on the basis of a measure of structural balance, which helps guide fiscal policy with a medium-term perspective, and enhances credibility in the government's commitment to a sound fiscal position. As the official definition of the structural balance includes only the accounts of the central government, it will be important also to monitor the evolution of central bank losses and the operations of state-owned enterprises to have a more comprehensive view of the public accounts. Also, to have a more reliable indicator of the underlying fiscal position, it would be important to use a copper reference price that reflects projected prices over the next few years, rather than a notional long run price, to limit the possibility that actual prices would differ substantially from the reference price for a very long and uncertain period. The authorities also are taking steps to increase fiscal transparency, including participation in the

fiscal transparency ROSC module, which is welcome. Early progress in the capitalization of the central bank would also add to transparency, and would help consolidate public confidence in the central bank's independence.

47. The banking system remains sound, and the banking supervisory agency (SBIF) continues to apply strict standards. The SBIF is coordinating the monitoring of financial conglomerates with the other supervisory agencies of the financial system; this important step should be followed by the establishment of a legal framework for the supervision of these conglomerates on a consolidated basis. To strengthen the supervisory framework further, it would be important to increase the operational independence of the SBIF and provide its officials with proper legal protection in the discharge of their responsibilities.

48. The authorities have continued to take steps to further develop domestic financial markets and strengthen Chile's financial integration with the rest of the world. Congress approved legislation to enhance corporate governance; the central bank widened the type of transactions that banks may undertake—including for hedging purposes—and eliminated remaining restriction on capital flows; and the government has submitted to congress a proposal for a capital market reform. All these measures should contribute to deeper and more efficient domestic financial markets, proper incentives for capital flows in the context of a sound banking system, and ultimately a higher potential growth for the economy.

49. The recently-approved unemployment insurance scheme, which will enhance the social safety net and reduce distortions generated by severance payments but increase indirect labor costs, is, on balance, an advance. The government also has submitted to congress a labor reform proposal, which seeks to strengthen workers' rights and introduce some flexibility in labor contracts. The authorities should remain watchful, as some elements of this proposal have the potential to introduce rigidities in labor markets, with adverse consequences on the economy's ability to generate employment.

50. Chile has a very open trade regime and has continued to reduce unilaterally its uniform external tariff, which is commendable. It would be desirable that the authorities also reevaluate the long-standing practice of keeping the domestic prices of certain agricultural products within bands, with a view to helping improve resource allocation and solidify Chile's reputation as a country committed to open international trade.

51. Although the pace of the recovery from the 1998–99 recession has not met all expectations, Chile's medium-term outlook remains favorable. Growth will be supported by continued prudent monetary and fiscal policies—to ensure an environment of low and stable inflation—and by recent structural reforms, including capital account liberalization and import tariff reduction. Protecting labor market flexibility will be important, and consideration could be given to new privatizations. As both monetary and fiscal policies have a rules-orientation, risks to the medium-term outlook mainly arise from a less favorable external environment, including lower global growth, weaker copper prices, and reduced capital flows to emerging economies. Such factors could reduce the pace of growth for a few years, but Chile's

comfortable level of reserves, strong banking system, credible policy framework, and exchange rate flexibility, should help the country adjust to a changing external environment.

52. The recently-completed ROSC data module provides a positive overall assessment of Chile's data dissemination practices and data quality, and data received by the staff are timely and broadly adequate for surveillance purposes. The authorities should persevere in their efforts to improve the statistical base, and it would be particularly useful to widen the coverage of fiscal and external statistics to fully capture military transactions.

53. It is expected that the next Article IV consultation with Chile will take place on the standard 12-month cycle.

Table 1. Chile: Selected Economic Indicators

	1996	1997	1998	1999	Est. 2000	Proj. 2001
	(Annual percentage change)					
Production, prices, and trade						
Real GDP	7.4	7.4	3.9	-1.1	5.4	4.0
Real domestic demand	7.9	9.1	3.9	-10.0	6.6	4.0
Consumption	8.8	7.9	4.3	-2.5	4.1	3.9
Investment	7.0	11.8	3.2	-25.5	13.7	4.5
Fixed capital formation	8.0	11.5	4.1	-17.4	4.3	5.5
Consumer prices						
End of period	6.6	6.0	4.7	2.3	4.5	3.2
Average	7.4	6.1	5.1	3.3	3.8	3.6
Underlying inflation 1/	7.4	5.4	6.2	2.1	3.4	3.0
Real wages	4.1	2.4	2.7	2.4	1.4	...
Unemployment rate (average, in percent)	6.5	6.1	6.2	9.7	9.2	...
Exports (U.S. dollars)	-3.9	8.2	-11.0	5.3	16.3	2.4
Imports (U.S. dollars)	12.7	10.5	-4.8	-19.6	19.9	4.5
Terms of trade	-15.5	2.6	-12.6	0.9	0.1	-1.7
Real effective exchange rate 2/	4.0	9.7	-6.1	-6.3	2.4	...
Money, credit, and interest rates						
Broad money (M3)	22.0	13.0	8.5	5.1	5.1	7.9
Credit to the private sector	20.8	18.0	11.2	3.0	10.7	8.0
Three-month real interest rate 3/	7.3	6.8	9.6	6.0	5.4	...
Velocity of money (M1A)	9.9	9.5	10.7	9.1	9.2	9.4
	(In percent of GDP)					
Savings and investment						
Gross domestic investment	26.9	27.2	27.4	22.1	23.4	24.8
Public	5.2	5.3	5.2	4.3	3.7	4.0
Private	21.6	21.9	22.2	17.8	19.7	20.8
National savings	21.8	22.3	21.8	22.0	22.0	22.6
Public 4/	6.5	5.3	3.3	1.5	2.3	2.9
Private	15.3	17.0	18.4	20.5	19.8	19.7
External savings	5.1	5.0	5.7	0.1	1.4	2.2
Public sector						
Nonfinancial public sector balance	2.1	1.0	-1.2	-2.5	-1.7	-1.2
Central government balance	2.6	2.1	-0.1	-2.4	-1.0	-0.9
Public enterprise balance	-0.5	-1.1	-1.1	-0.1	-0.7	-0.3
Central bank balance	-0.7	-1.1	-1.1	-1.1	-0.9	-0.9
Combined public sector balance	1.4	-0.1	-2.3	-3.6	-2.6	-2.1
Balance of payments						
Current account	-5.1	-5.0	-5.7	-0.1	-1.4	-2.2
Capital and financial account 5/	6.8	9.2	2.8	-0.9	1.7	2.6
Overall balance of payments	1.7	4.3	-2.8	-1.0	0.3	0.4

Sources: Central Bank of Chile; and Fund staff estimates.

1/ Excluding fuel and volatile food items, end-of-period.
2/ End of period. A decline indicates a depreciation of the peso.
3/ Yield on 90-day indexed central bank paper (PRBC-90), in percent per annum (period average).
4/ Net of estimated losses of the central bank.
5/ Includes errors and omissions.

Table 2. Chile: Selected Indicators of the Financial System 1/

	1996	1997	1998	1999	2000	Proj. 2001
I. Central Bank						
(Annual flows in millions of U.S. dollars)						
Net international reserves	1,181	3,209	-2,066	-683	198	292
Medium- and long-term net foreign liabilities	-1,488	0	0	-1	0	0
(Annual percentage change with respect to liabilities to the private sector)						
Net domestic assets	-222.1	-359.8	209.4	91.9	-21.6	-19.1
Net credit to nonfinancial public sector	-24.1	-40.7	30.6	82.2	20.1	9.1
Net credit to financial intermediaries	-67.0	-116.5	-29.7	-66.0	-90.3	-74.2
Central bank promissory notes	-62.9	-108.5	73.7	5.2	-23.7	59.6
Other	-68.2	-94.0	134.9	70.4	72.4	-13.8
Liabilities to private sector	9.5	14.6	-0.9	21.7	-4.9	6.8
II. Financial System						
(Annual flows in millions of U.S. dollars)						
Net international reserves	1,732	5,421	-1,562	2,314	-686	292
Medium- and long-term net foreign liabilities	-1,478	-161	-1,817	-3,645	197	-903
(Annual percentage change with respect to liabilities to the private sector)						
Net domestic assets	7.4	-0.5	13.0	7.0	10.8	9.3
Credit to the private sector	12.6	11.7	4.1	2.0	6.5	5.2
Liabilities to private sector	16.9	16.3	9.7	15.7	9.5	11.3
Of which: pension funds	6.2	7.4	3.9	11.0	6.1	6.4
(In percent of GDP)						
Narrow money (M1A) 2/	10.1	10.6	9.4	11.0	10.8	10.7
Broad money	42.1	42.6	43.4	44.5	42.7	42.3
Liabilities to private sector 3/	89.3	93.0	96.0	108.9	109.1	111.8
Of which: pension funds	41.4	42.9	43.8	53.1	54.5	56.4
Credit to private sector	71.2	73.3	72.8	73.6	74.1	73.5
(Annual percentage change)						
Memorandum items:						
Growth of credit to private sector	16.1	15.0	5.8	3.5	9.7	7.7
Growth of credit to private sector, excluding pension funds	20.8	18.0	11.2	3.0	10.7	8.0
Inflation rate (CPI)	6.6	6.0	4.7	2.3	4.5	3.2
Narrow money (M1A)	10.5	16.6	-5.5	20.4	7.9	7.6
Broad money	22.0	13.0	8.5	5.1	5.1	7.9
(In percent: annual average)						
Interest rates (in real terms) 4/						
Commercial banks deposits	6.9	6.4	9.5	5.9	5.2	...
Commercial banks loans	9.3	8.8	11.9	8.2	7.5	...
On 90-day central bank promissory notes	7.3	6.8	9.6	6.0	5.4	...

Sources: Central Bank of Chile; and Fund staff estimates.

1/ Flows measured at constant exchange rates (at the level of the end of the year under consideration). The financial system comprises the central bank, commercial banks, nonbank financial institutions, and private pension funds.
2/ Defined as currency plus sight deposits.
3/ Includes time and savings deposits, deposits in U.S. dollars, and pension funds' liabilities.
4/ Annual average yield on 90-365 days indexed operations.

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

	1996	1997	1998	1999	2000	Staff Proj. 2001
	I. Central Government					
Total revenue	**24.2**	**23.9**	**22.9**	**22.0**	**23.1**	**23.1**
Current revenue 2/ 3/	24.1	23.8	22.7	21.9	23.0	23.0
Of which: tax revenue (excl. Codelco)	18.4	18.0	17.7	16.9	17.5	17.7
copper income (Codelco) 3/	1.4	1.5	0.4	0.4	1.0	0.9
Capital revenue	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure	**21.6**	**21.8**	**23.0**	**24.4**	**24.1**	**24.0**
Current expenditure 3/	18.0	18.0	19.1	20.3	20.4	20.1
Of which: pensions	6.0	6.0	6.4	7.1	7.1	6.9
wages	4.1	4.2	4.4	4.8	4.7	4.7
Capital expenditure 4/	3.6	3.7	3.9	4.0	3.7	3.9
Central government balance	**2.6**	**2.1**	**-0.1**	**-2.4**	**-1.0**	**-0.9**
	II. Public Enterprises					
Current revenue	**12.6**	**12.0**	**10.4**	**11.0**	**13.3**	**12.3**
Current expenditure	**11.6**	**11.4**	**9.7**	**10.0**	**12.8**	**11.4**
Of which : net taxes and transfers to CG	4.3	3.9	2.7	2.8	3.7	3.9
Current account balance	**1.1**	**0.6**	**0.8**	**1.0**	**0.5**	**0.9**
Capital revenue	0.9	0.3	0.1	0.1	0.0	0.0
Capital expenditure	2.5	2.0	1.9	1.2	1.3	1.2
Overall balance	**-0.5**	**-1.1**	**-1.1**	**-0.1**	**-0.7**	**-0.3**
	III. Nonfinancial Public Sector					
Total revenue	**33.4**	**32.2**	**30.7**	**30.3**	**32.8**	**31.5**
Current revenue	32.5	31.9	30.5	30.2	32.7	31.3
Capital revenue	1.0	0.4	0.2	0.1	0.1	0.2
Total expenditure	**31.4**	**31.3**	**31.9**	**32.8**	**34.5**	**32.6**
Current expenditure	25.3	25.5	26.1	27.6	29.5	27.6
Capital expenditure	6.1	5.8	5.8	5.2	5.0	5.1
Overall surplus or deficit	**2.1**	**1.0**	**-1.2**	**-2.5**	**-1.7**	**-1.2**
Privatization receipts	0.0	0.2	0.1	0.5	1.3	0.3
Financing needs	**-2.1**	**-1.2**	**1.1**	**2.1**	**0.4**	**0.9**
Foreign	-0.1	-0.2	0.5	0.5	-0.1	0.2
Domestic (including statistical discrepancies)	-2.0	-1.0	0.6	1.6	0.5	0.6
	IV. Combined Public Sector					
Central bank balance	-0.7	-1.1	-1.1	-1.1	-0.9	-0.9
Combined public sector result	**1.4**	**-0.1**	**-2.3**	**-3.6**	**-2.6**	**-2.1**
Memorandum items:						
Central government balance, authorities' presentations						
Traditional presentation 5/	*2.3*	*2.0*	*0.4*	*-1.5*	*0.1*	*-0.6*
Adjusted balance (basis for structural balance)	*2.1*	*2.0*	*0.0*	*-2.4*	*-0.8*	*-0.3*
Structural balance (authorities' methodology)	*1.4*	*1.1*	*0.3*	*-0.8*	*0.2*	*0.9*
Central government fiscal impulse 6/	-0.3	0.4	0.7	1.1	-0.8	-0.8
Deposits at Copper Stabilization Fund (flows)	0.3	0.1	-0.5	-0.7	-0.2	-0.2
CG balance at constant copper price 7/	2.1	1.6	0.5	-1.4	-0.6	-0.3
Current account of NFPS	7.2	6.4	4.4	2.6	3.1	3.8
Public sector size index I 8/	18.5	18.3	19.0	19.3	19.1	18.6
Public sector size index II 9/	24.1	23.8	24.9	25.6	25.4	25.2
Central government employment 10/	2.5	2.5	2.5	2.6	2.7	...
External debt of the NFPS	6.3	6.1	7.3	8.0	7.4	7.4
Domestic debt of the NFPS 11/	0.4	0.4	0.8	1.2	1.0	1.0

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

1/ Nonfinancial public sector and operational losses of the central bank.
2/ Includes taxes paid and transfers made by the public enterprises.
3/ Includes amounts transferred directly by CODELCO to the military.
4/ Including net lending, with the exception of the special program in 2001 in which banks rescheduling their loans to PYMEs will receive government deposits of up to US$300 million (0.4 percent of GDP).
5/ Differs from staff's presentation in treatment of copper stabilization fund and privatization receipts.
6/ Change in the actual balance in excess of the cyclically neutral balance in relation to the preceding year.
7/ Calculations made at a price of copper of 0.90 U.S. dollar per pound.
8/ Central government expenditure less interest payments and transfers plus investment of public enterprises.
9/ Central government expenditure plus investment of public enterprises.
10/ Percentage of total employment.
11/ Credit from the banking system (excluding the central bank). There are no outstanding domestic bonds, and data on suppliers' credit are not available.

Table 4. Chile: Balance of Payments

	1996	1997	1998	1999	Est. 2000	Proj. 2001
	(In millions of U.S. dollars)					
Current account	**-3,512**	**-3,728**	**-4,143**	**-78**	**-989**	**-1,495**
Trade balance	-1,091	-1,556	-2,516	1,664	1,436	1,128
Exports, fob	15,405	16,664	14,830	15,616	18,158	18,601
Copper	6,029	6,841	5,332	5,889	7,347	7,347
Noncopper	9,376	9,823	9,498	9,727	10,811	11,254
Imports, fob	-16,496	-18,220	-17,346	-13,951	-16,722	-17,473
Financial services (net)	-2,667	-2,738	-1,976	-1,881	-2,404	-2,435
Other services and transfers (net)	247	567	349	138	-21	-188
Capital account, incl. errors and omissions	**4,692**	**6,937**	**2,077**	**-605**	**1,186**	**1,787**
Foreign investment	4,627	5,740	1,328	4,526	-1,364	19
Chilean investment abroad	-1,318	-2,105	-4,217	-7,221	-4,926	-7,045
Direct investment	-1,187	-1,867	-2,797	-4,855	-4,778	-5,245
Portfolio investment	-130	-238	-1,419	-2,366	-148	-1,800
Foreign investment in Chile	5,945	7,845	5,545	11,747	3,562	7,063
Direct investment	4,715	5,243	4,955	9,251	3,674	5,711
Portfolio investment	1,230	2,602	590	2,496	-113	1,353
Medium- and long-term loans (net)	558	3,333	3,676	722	370	768
Disbursements	5,315	6,236	6,077	4,105	4,196	5,067
Public sector	840	718	1,034	991	370	550
Private sector	4,475	5,519	5,043	3,114	3,826	4,516
Amortizations	-4,756	-2,903	-2,401	-3,384	-3,826	-4,299
Public sector	-2,752	-715	-337	-359	-507	-395
Private sector	-2,005	-2,188	-2,064	-3,025	-3,319	-3,904
Other capital (net) 1/	157	-1,696	-1,747	-6,011	2,193	1,001
Public sector	206	-125	-264	-148	219	0
Private sector	-49	-1,570	-1,484	-5,862	1,974	1,001
Errors and omissions (net)	-650	-441	-1,180	158	-12	0
Overall balance of payments	**1,181**	**3,209**	**-2,066**	**-683**	**198**	**292**
Reserve assets (increase -)	-1,181	-3,209	2,066	683	-198	-292
Valuation adjustment	-512	-842	217	-598	-167	0
Change in official reserve stock (increase -)	-669	-2,367	1,849	1,282	-31	-292
Memorandum items:						
Current account (percent of GDP)	-5.1	-5.0	-5.7	-0.1	-1.4	-2.2
Trade balance (percent of GDP)	-1.6	-2.1	-3.4	2.5	2.1	1.6
External debt, all maturities (percent of GDP)	33.5	35.6	43.4	50.5	52.7	56.7
Copper price (LME; U.S. cents per pound)	103.2	103.2	75.0	71.3	82.3	80.0
Copper exports (thousands of metric tons)	2,885.3	3,432.0	3,651.3	4,205.4	4,443.5	4,543.0
CODELCO	1,116.6	1,328.0	1,442.1	1,528.6	1,565.5	1,491.0
Other	1,768.7	2,104.0	2,209.2	2,676.8	2,878.0	3,052.0
GDP (billions of U.S. dollars)	68.6	75.0	73.0	67.6	70.0	69.3
	(Annual change in percent)					
Copper export price (net of discount)	-24.4	-4.6	-26.7	-4.1	18.1	-2.2
Copper export volume	22.9	18.9	6.4	15.2	5.7	2.2
Noncopper export prices	-8.7	0.0	-10.1	-2.4	4.4	-1.2
Noncopper export volume	7.3	4.7	7.4	4.9	6.5	5.3
Total export price	-15.2	-2.0	-17.1	-2.6	9.8	-1.6
Total export volume	13.4	10.4	7.3	8.1	5.9	4.1
Total import price	0.3	-4.5	-5.2	-3.5	9.7	0.1
Total import volume	11.8	15.6	0.8	-16.5	9.0	4.4
Terms of trade	-15.5	2.6	-12.6	0.9	0.1	-1.7

Sources: Central Bank of Chile; and Fund staff estimates.

1/ Includes short-term flows and Chilean residents' holdings of medium- and long-term assets (other than equity) overseas.

2/ Does not include short-term direct trade credits.

Table 5. Chile: Indicators of External Vulnerability

(In percent; unless otherwise indicated)

	1992-96	1997	1998	1999	Est. 2000	Proj. 2001
Financial indicators						
Broad money (percent change)	20.1	13.0	8.5	5.1	5.1	7.9
Ratio of bank credit to GDP	51.4	60.9	63.5	63.9	64.5	63.9
90-day central bank promissory note (nominal) interest rate (averages) 1/	...	13.4	16.4	10.7	10.8	...
90-day central bank promissory note (real) interest rate (averages)	6.4	6.8	9.6	6.0	5.4	...
Share of foreign currency deposits in total deposits	6.9	3.7	6.9	9.9	11.8	12.9
Share of foreign currency loans in total credit (excl. pension funds)	14.5	8.3	9.1	8.6	9.5	9.5
Share of nonperforming loans in total loans	1.0	1.0	1.4	1.7	1.7	...
Loan-loss provisions as percent of nonperforming loans	211.9	147.6	131.2	152.1	144.6	...
Risk-based capital-assets ratio, end of period 2/	...	...	12.5	13.5	13.3	...
Return on bank capital	12.4	13.7	11.5	9.4	11.0	...
External indicators						
Exports, U.S. dollars (percent change)	12.8	8.2	-11.0	5.3	16.3	2.4
Imports, U.S. dollars (percent change)	17.7	10.5	-4.8	-19.6	19.9	4.5
Terms of trade (percent change)	1.1	2.6	-12.6	0.9	0.1	-1.7
REER (end of period, percent change)	4.8	9.7	-6.1	-6.3	2.4	...
Exchange rate (pesos per US$, period average)	399.2	420.6	460.7	509.1	539.5	...
Current account (percent of GDP)	-3.7	-5.0	-5.7	-0.1	-1.4	-2.2
Capital account (percent of GDP) 3/	7.0	9.2	2.8	-0.9	1.7	2.6
Gross official reserves (in US$ billion) 4/	12.8	17.8	16.0	14.7	14.7	15.0
Central bank short-term foreign liabilities (in US$ billion)	0.1	0.0	0.0	0.0	0.0	0.0
Gross official reserves, months of imports of goods and services	8.8	9.9	10.6	8.3	8.0	7.5
Gross official reserves to broad money (M3)	39.5	58.3	51.9	50.6	52.4	51.9
Gross official reserves to total short-term external debt 5/	269.1	496.4	385.2	367.8	215.9	195.8
Short-term foreign assets of commercial banks (in US$ billion) 6/	0.5	1.2	1.8	4.2	3.4	3.4
Short-term foreign liabilities of commercial banks (in US$ billion) 6/	2.9	0.8	0.9	0.3	0.4	0.4
Total external debt (percent of GDP)	39.8	35.6	43.4	50.5	52.7	56.7
Of which: public sector debt (percent of GDP) 7/	16.0	6.8	7.8	8.6	8.0	7.9
Total external debt to exports of goods and services	141.0	128.5	167.2	176.1	167.0	173.3
External interest payments to exports of goods and services	7.4	6.8	8.0	7.8	8.6	8.8
External amortization payments to exports of goods and services	14.3	14.0	12.7	17.4	17.3	19.0
Financial market indicators						
Stock market index (in US$; period average)	...	104.4	74.8	75.6	82.9	...
Sovereign long-term foreign-currency debt rating 8/						
Moody's	Baa2 (2/17/94)			Baa1 (6/29/95 to present)		
S&P	BBB+ (12/21/93)			A- (7/11/95 to present)		

Sources: Central Bank of Chile; and Fund staff estimates.

1/ The series starts in July 1997.

2/ This indicator is not available before 1998.

3/ Includes errors and omissions.

4/ Gold valued at end-period market prices.

5/ Total short-term external debt is measured as the official figure on short-term debt (which includes amortization of medium- an debt falling due during the following year). Total short-term external debt does not include direct trade credits.

6/ Refers to the commercial banking sector including the Banco del Estado de Chile.

7/ Includes private debt with public guarantee.

8/ Ratings are only shown for the dates on which they were revised by the rating agencies.

Table 6. Chile: Balance of Payments—Medium-Term Projections

			Projections					
	1999	2000	2001	2002	2003	2004	2005	2006
(In billions of U.S. dollars)								
Current account	-0.1	-1.0	-1.5	-1.6	-2.2	-2.7	-3.1	-3.4
Trade balance	1.7	1.4	1.1	1.2	1.2	1.1	1.0	0.9
Exports	15.6	18.2	18.6	20.0	21.9	23.7	25.5	27.5
Copper	5.9	7.3	7.3	8.0	8.7	9.5	10.0	10.7
Noncopper	9.7	10.8	11.3	12.1	13.1	14.2	15.5	16.8
Imports	-14.0	-16.7	-17.5	-18.9	-20.7	-22.6	-24.5	-26.6
Financial services (net)	-1.9	-2.4	-2.4	-2.5	-3.0	-3.4	-3.6	-3.7
Other services and transfers (net)	0.1	0.0	-0.2	-0.3	-0.4	-0.5	-0.5	-0.6
Capital account 1/	-0.6	1.2	1.8	2.2	2.8	3.4	3.9	4.2
Foreign investment (net)	4.5	-1.4	0.0	2.1	2.4	2.8	3.3	3.8
Assets	-7.2	-4.9	-7.0	-4.6	-4.7	-4.9	-5.0	-5.1
Liabilities	11.7	3.6	7.1	6.7	7.1	7.6	8.3	8.9
Other capital flows	-5.1	2.6	1.8	0.1	0.4	0.6	0.6	0.5
Medium- and long-term (net)	0.7	0.4	0.8	0.8	0.3	0.3	0.3	-0.2
Disbursements	4.1	4.2	5.1	5.3	5.1	4.6	4.8	5.1
Amortizations	-3.4	-3.8	-4.3	-4.5	-4.8	-4.3	-4.5	-5.3
Other capital (net) 1/	-5.9	2.2	1.0	-0.7	0.1	0.3	0.3	0.6
Overall balance	-0.7	0.2	0.3	0.6	0.7	0.7	0.8	0.8
Reserve assets (increase -)	0.7	-0.2	-0.3	-0.6	-0.7	-0.7	-0.8	-0.8
Valuation adjustment	-0.6	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Change in official reserve stock (increase -)	1.3	0.0	-0.3	-0.6	-0.7	-0.7	-0.8	-0.8
(In months of imports of goods and services)								
Gross official international reserves 2/	8.3	8.0	7.5	7.2	6.8	6.6	6.3	6.1
Main assumptions								
Copper price (LME; U.S. cents per pound)	71.3	82.3	80.0	85.0	88.0	91.0	93.0	95.0
Volume of copper exports (thousand metric tons)	4,205	4,444	4,543	4,679	4,960	5,187	5,389	5,593
CODELCO	1,529	1,566	1,491	1,591	1,667	1,702	1,697	1,752
Other	2,677	2,878	3,052	3,088	3,293	3,485	3,692	3,841
(Annual change in percent)								
Copper export prices 3/	-4.1	18.1	-2.2	5.2	3.4	3.8	2.1	2.4
Copper export volumes	15.2	5.7	2.2	3.0	6.0	4.6	3.9	3.8
Noncopper export prices	-2.4	4.4	-1.2	1.7	1.9	1.8	2.0	1.8
Noncopper export volume	4.9	6.5	5.3	5.4	6.8	6.4	6.7	6.7
Total export prices	-2.6	9.8	-1.6	3.1	2.5	2.6	2.0	2.0
Total export volume	8.1	5.9	4.1	4.5	6.5	5.7	5.6	5.6
Total import volume	-16.5	9.0	4.4	6.7	7.2	7.2	6.3	6.6
Total import price	-3.5	9.7	0.1	1.2	2.1	1.9	2.1	1.9
Terms of trade	0.9	0.1	-1.7	1.8	0.4	0.7	-0.1	0.1
Real GDP	-1.1	5.4	4.0	4.7	6.0	5.7	5.5	5.5
LIBOR (in percent)	5.5	6.6	4.3	5.0	5.0	5.0	5.0	5.0
(In percent of GDP)								
Gross domestic investment	22.1	23.4	24.8	25.3	25.4	25.4	25.5	25.5
Public sector	4.3	3.7	4.0	4.2	4.2	4.4	4.3	4.3
Private sector and inventory change	17.8	19.7	20.8	21.1	21.1	21.1	21.1	21.2
External current account balance	-0.1	-1.4	-2.2	-2.1	-2.6	-3.0	-3.2	-3.2
Gross national savings	22.0	22.0	22.6	23.2	22.7	22.4	22.3	22.3
Combined public sector	1.5	2.3	2.9	4.0	4.5	5.1	5.3	5.5
Private sector	20.5	19.8	19.7	19.1	18.2	17.3	16.9	16.8

Sources: Data provided by the Chilean authorities; and Fund staff estimates.

1/ Includes errors and omissions.

2/ Gold at market valuation. End-year stock of reserves in relation to imports of the following year.

3/ Chilean export price.

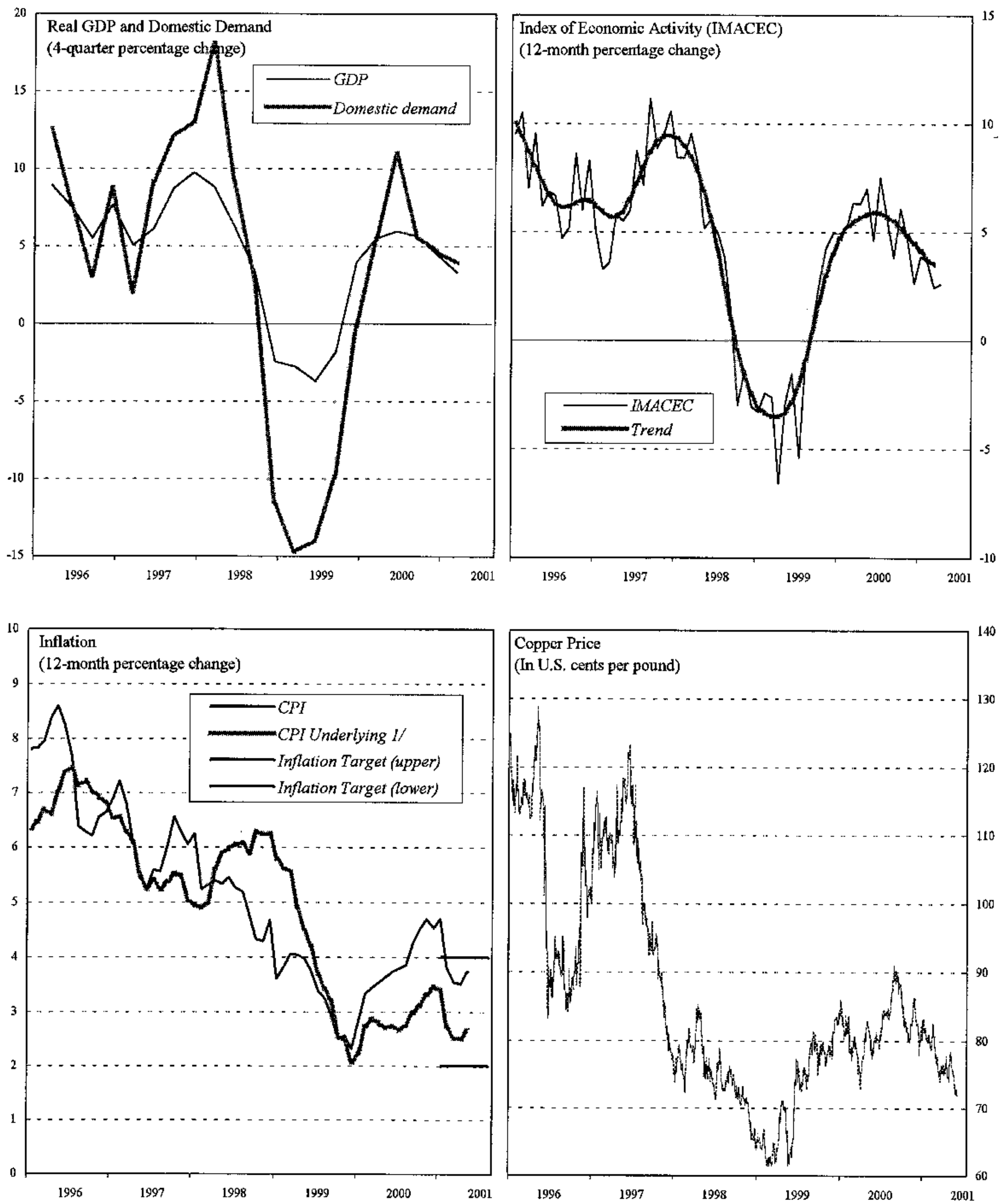
Table 7. Chile: External Debt and Debt Service

	1999	2000	2001	2002	2003	2004	2005	2006
			Projections					
(In billions of U.S. dollars, end of period)								
Total debt outstanding 1/	**34.2**	**36.9**	**39.3**	**40.7**	**42.4**	**44.4**	**46.5**	**48.0**
Medium- and long-term loans and bonds 2/	33.0	34.4	36.1	37.6	38.7	39.8	40.9	41.6
International organizations	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.7
Official lenders	1.8	1.6	1.4	1.2	1.1	0.9	0.8	0.7
Private creditors	29.6	31.2	33.1	34.8	36.0	37.2	38.5	39.2
Short-term debt 1/ 2/	1.2	2.5	3.1	3.0	3.7	4.6	5.6	6.4
Short-term debt, residual maturity basis 1/	4.0	6.8	7.7	7.8	8.0	9.1	10.9	10.9
Total debt service	**4.9**	**5.7**	**6.3**	**6.6**	**6.9**	**6.6**	**6.8**	**7.7**
Amortization	3.4	3.8	4.3	4.5	4.8	4.3	4.5	5.3
Interest	1.5	1.9	2.0	2.1	2.2	2.3	2.4	2.4
IMF								
Credit outstanding	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repurchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(In percent of GDP)								
Total external debt, end-period 1/	50.5	52.7	56.7	54.7	51.9	49.6	47.5	44.8
Of which: external public debt	8.6	8.0	7.9	7.7	7.2	6.6	6.0	5.7
Interest payments on external debt	2.2	2.7	2.9	2.8	2.6	2.5	2.4	2.3
(In percent of exports of goods and services)								
Debt-service payments	25.2	25.9	27.8	27.1	26.0	22.8	22.0	23.1
Of which: interest	7.8	8.6	8.8	8.5	8.1	7.9	7.6	7.3
IMF repurchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total external debt outstanding at year-end 1	176.1	167.0	173.3	166.9	159.6	154.3	149.5	143.1
IMF credit outstanding	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum item:								
Net financial services payments, percent of G	2.8	3.4	3.5	3.3	3.7	3.8	3.7	3.4

Sources: Central Bank of Chile; and Fund staff estimates.

1/ Excludes direct short-term trade credits.
2/ Original maturity basis.

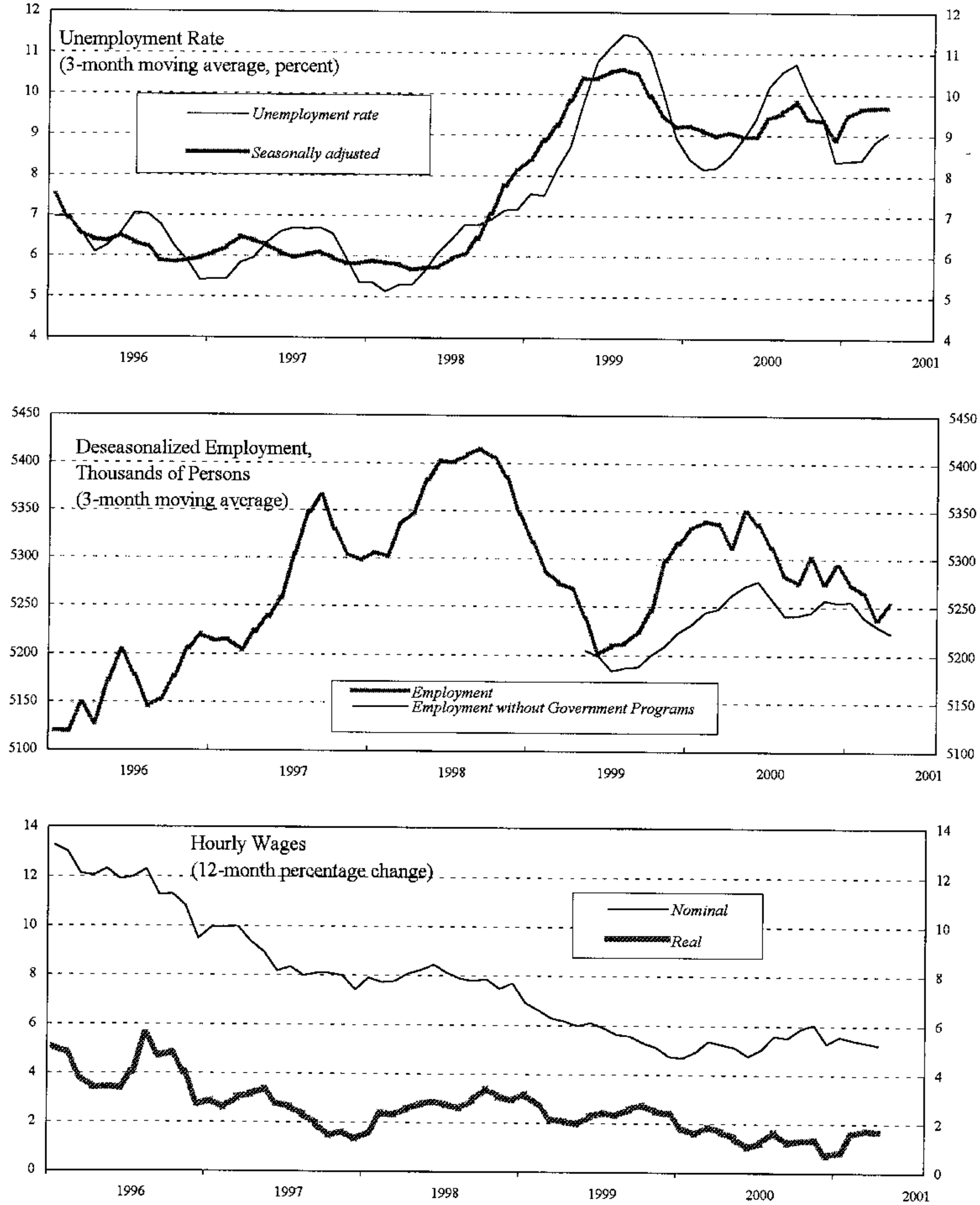
Figure 1. Chile: Selected Economic Indicators, 1996 - 2001



Source: Central Bank of Chile; and London Metal Exchange.

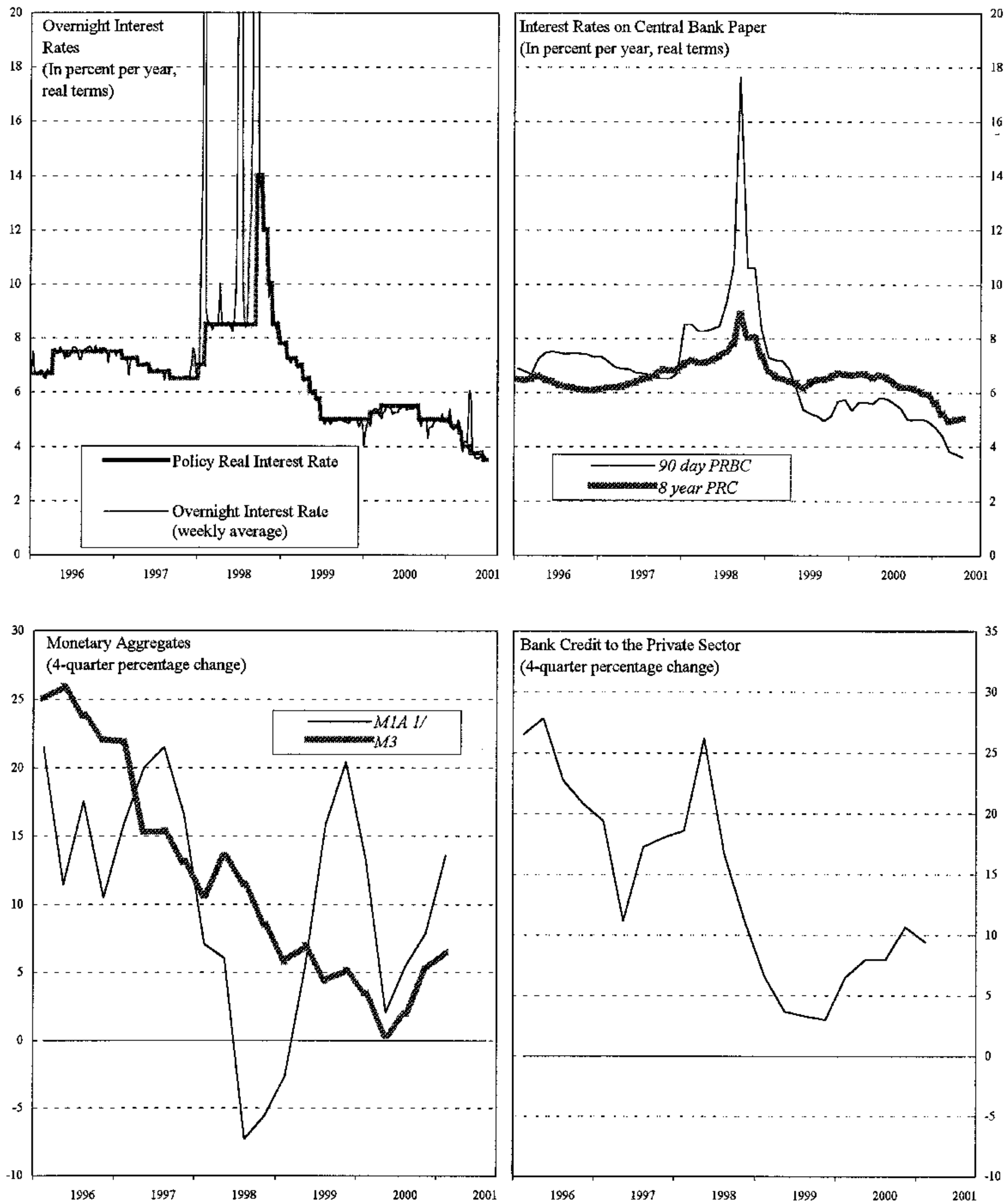
1/ Excluding fuels and perishable agricultural products.

Figure 2. Chile: Labor Market Developments, 1996 - 2001



Source: Central Bank of Chile.

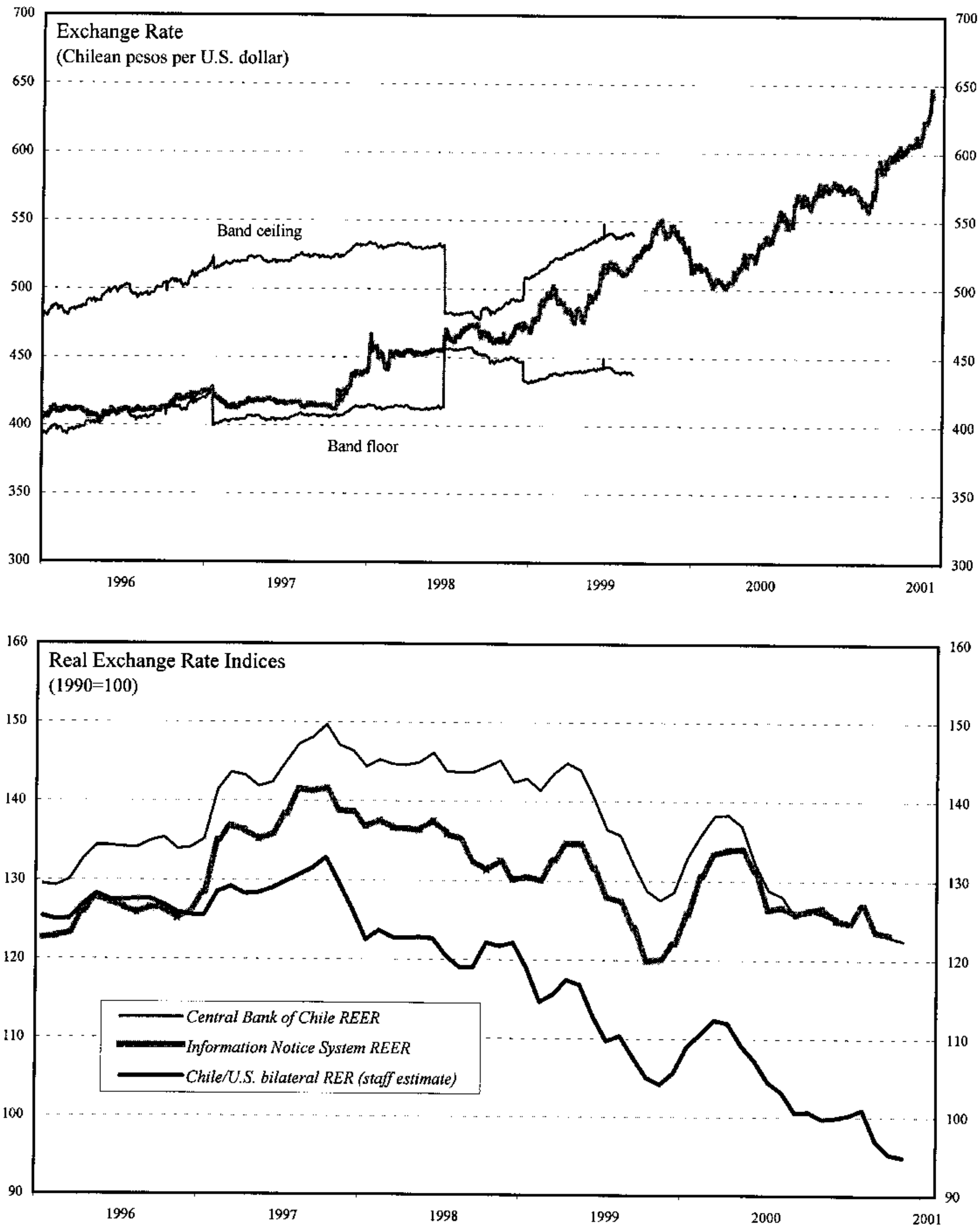
Figure 3. Chile: Financial Sector Indicators, 1996 - 2001



Source: Central Bank of Chile.

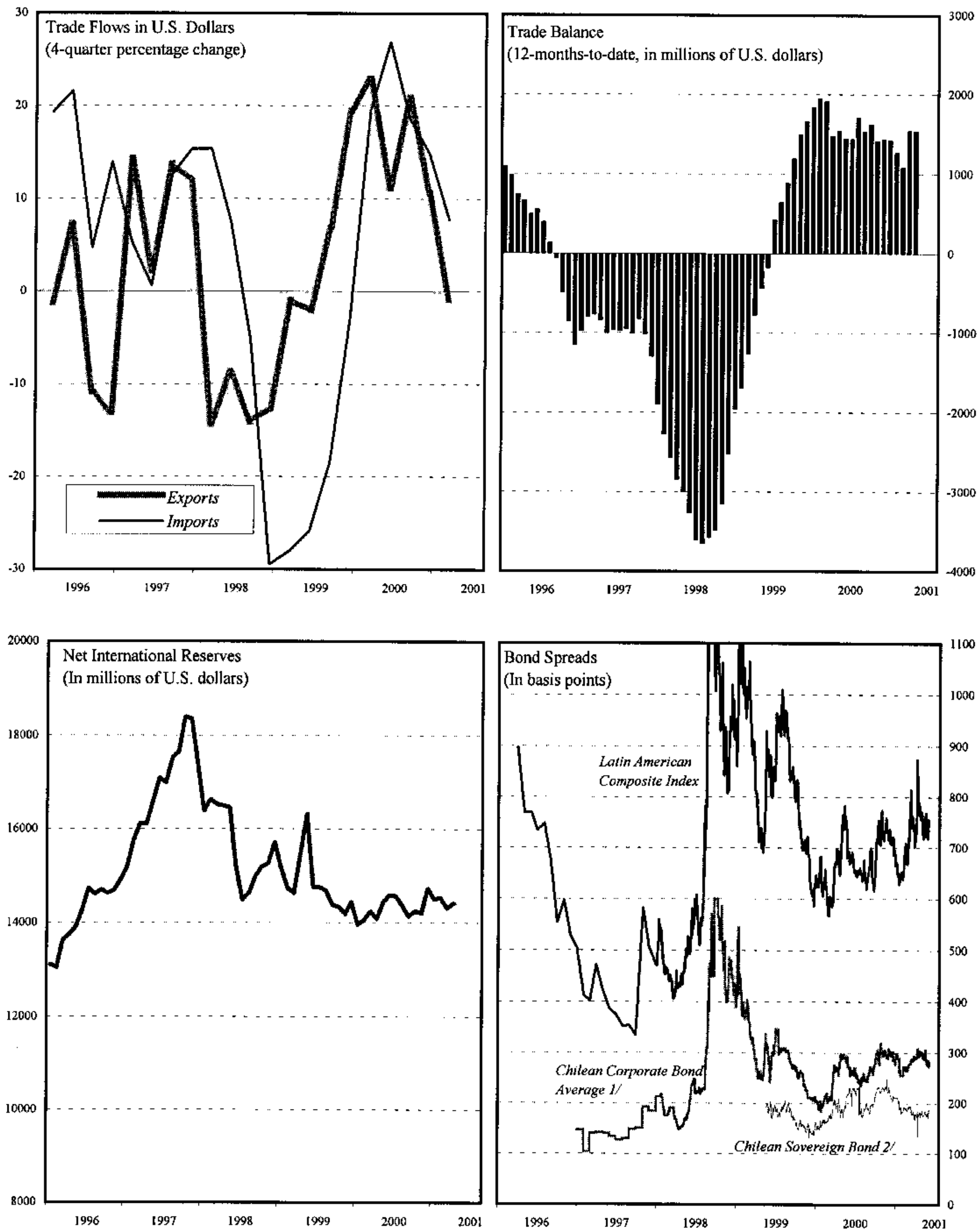
1/ M1 plus savings accounts.

Figure 4. Chile: Exchange Rate Developments, 1996 - 2001



Source: *El Mercurio*; Central Bank of Chile; IMF's Information Notice System; International Financial Statistics; Fund staff estimates.

Figure 5. Chile: External Sector Indicators, 1996 - 2001



Source: Central Bank of Chile; Bloomberg; and J.P. Morgan.

1/ Average spread on five corporate bonds (data not available before 1997)

2/ Chilean sovereign bond issued April 1999, matures 2009.

Chile: Fund Relations
(As of May 31, 2001)

I. **Membership Status:** Joined 12/31/45; Article VIII. Chile's exchange system is currently free of restrictions on the making of payments and transfers for current international transactions.

II. **General Resources Account**

General Resources Account	SDR Million	Percent Quota
Quota	856.10	100.0
Fund holdings of Chilean pesos	597.43	69.8
Reserve tranche position	258.67	30.2

III. **SDR Department**

SDR Department	SDR Million	Percent Allocation
Net cumulative allocation	121.92	100.0
Holdings	20.18	17.4
Designation plan	10.00	

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:**

Type of Arrangement	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
SBA	11/08/89	11/07/90	64.00	64.00
EFF	8/15/85	8/14/89	825.00	806.25
SBA	1/10/83	1/09/85	500.00	500.00

VI. **Projected Obligations to Fund** (SDR Million; based on existing use of resources and present holdings of SDRs): None

VII. **Exchange Arrangements**: The exchange rate is permitted to float freely. On June 21, 2001 the interbank exchange rate was Ch$622.96 per U.S. dollar.

VIII. **Article IV Consultations:** The Executive Board concluded the 2000 Article IV consultation on July 7, 2000 (SM/00/116).

IX. **Technical Assistance:** In May 1997 a mission from the Fiscal Affairs Department (FAD) assisted the authorities in the evaluation of Chile's tax system. In June 1998 an FAD mission advised on the desirability of moving to a system of accrual accounting and budgeting. In June 1999 a mission from FAD and STA advised on public expenditure management, the implementation of accrual based accounting, and government finance statistical systems. In May 2000 a mission from STA advised on money and banking statistics. In March 2001, a mission from STA assessed the quality of national account statistics. In March-April 2001, a mission from STA assessed Chile's data dissemination practices against the IMF's SDDS. In April–May 2001, a mission from FAD advised on VAT administration issues.

Chile: Financial Relations with the World Bank

The most recent Country Assistance Strategy (CAS) for Chile was discussed by the Board in April 1995. The emphasis of the Bank's assistance program for Chile was on selectivity and an increased reliance on the government in determining future assistance priorities for both sector work and new lending, through a strategic and productive dialogue with the Bank. It aimed at implementing about one new project each year and at providing guarantees to certain infrastructure projects. The latter was not realized and, after operations for secondary education and rural poverty were approved, Chile was not an active borrower between FY 1996 and FY 1998. However, Chile made use of Bank nonlending services, including the preparation of a poverty assessment, a study on tax reform and a study on catastrophic health insurance. In addition, technical assistance was provided under the reimbursable program in areas such as privatization, regulatory issues, and education. After the hiatus in borrowing from the Bank since FY96, three new operations, totaling US$160 million, were approved in FY99: Higher Education Reform Loan (US$145 million), Second Municipal Development Loan (US$10 million), and Millennium Science Initiative LIL (US$5 million). The undisbursed balance of the Chile portfolio totals US$143.2 million, as of March 31, 2001.

Lending for FY2001–FY03 is now expected to target water resources, public financial management and education. The World Bank will be preparing a new CAS in FY2002.

Chile: Financial Relations with the World Bank

(In millions of U.S. dollars)

	Commitments (Net of Cancellations)	Disbursements	Undisbursed
I. IBRD Operations (as of March 31, 2001)			
Fully disbursed loans	2,876.36	2,876.36	0.00
Loans in process of disbursement			
Agriculture	15.00	13.38	1.63
Education	173.62	53.26	120.36
Environment	0.00	0.00	0.00
Health	0.00	0.00	0.00
Municipal and urban	10.10	1.10	9.00
Public sector management	0.00	0.00	0.00
Transport	120.00	107.84	12.16
Water Supply	0.00	0.00	0.00
Total loans	3,195.08	3,051.93	143.15
Repaid 1/	2,229.24	0.00	0.00
Outstanding	965.84	0.00	0.00

II. IFC Operations (as of March 31, 2001)

	IFC			
	Loans	Equity	Quasi Equity	Participation
Held	52.53	59.02	14.93	74.46
Disbursed	22.78	59.02	14.93	19.21
Approvals pending commitment	0.00	0.00	0.00	0.00

III. IBRD Loan Transactions (calendar year)

	Actuals			
	1998	1999	2000	2001 2/
Disbursements	67.30	43.28	48.38	17.56
Repayments	105.03	110.67	115.05	46.00
Net lending	-37.73	-67.39	-66.67	-28.44

Source: World Bank.

1/ Includes repayment from third parties.
2/ As of May 29, 2001.

Chile: Statistical Issues

Monetary and real sectors

The central bank publishes comprehensive statistics on the real and monetary sectors on a bi-weekly basis. The recent STA mission identified a number of areas for improvement, but in general existing data practices in these areas do not pose major complications for surveillance purposes. The most significant current problem is that the national accounts data, being based on 1986 prices, have become outdated as the structure of the Chilean economy has evolved considerably in the last 15 years. New series, based on 1996 prices, are under development, and the authorities plan to publish these data in the first part of 2002.

Government finance

The Ministry of Finance publishes on a quarterly basis detailed data on the central government and a summary of the accounts of the nonfinancial public sector. The annual report on public finances presents comprehensive information on the central government, municipalities, and public enterprises. The use of the Copper Stabilization Fund is treated in the accounts of the government as an above-the-line item; withdrawals from the fund are registered as current revenues for the government, while deposits into the fund made by the state copper company (Codelco) do not appear in the government's accounts. The coverage of the government accounts is not complete, as it excludes the transfers made by Codelco to the armed forces, external financing obtained by the military (if any), and the military expenditure financed from these two sources. The accounts of certain publicly-owned military factories are also not included. Publication of fiscal data focuses on above-the line flows; it would be useful to present more detailed data on the sources of public sector financing, with a more transparent correspondence to data for the monetary and external accounts. Finally, it would be useful to publish central government operations data on a monthly basis, and central government debt data on a quarterly basis.

Balance of payments

The central bank publishes comprehensive statistics on the external sector on a bi-weekly basis. A number of areas for improvement remain. First, more complete International Investment Position data, including information on the foreign assets held by the private sector, would be useful in assessing external vulnerability. Second, as regards the differences between the Chilean and BIS short-term debt figures, the authorities have made substantial progress, but the Chilean data do not yet include direct short-term trade credits. Finally, coverage of the military sector in the external statistics is not necessarily complete. In particular, the accuracy of data on military imports is unclear, as those imports that do not pass through customs are estimated by the central bank. Also, if the military receives external credits, information on this may not be available to the central bank; therefore, such financing may not appear in the balance of payments or external debt statistics. Since the size of these omissions is unknown, their significance for surveillance purposes cannot be properly assessed.

Chile: Core Statistical Indicators

as of June 21, 2001

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance 1/	GDP/ GNP 2/	External Debt/ Debt Service 3/
Date of Latest Observation	6/20/2001	5/31/2001	5/2001	5/2001	4/2001	6/20/2001	5/2001	5/2001	Q1/2001	Q1/2001	Q1/2001	4/30/2001
Date Received	6/21/2001	6/4/2001	6/8/2001	6/16/2001	6/16/2001	6/21/2001	6/5/2001	6/18/2001	5/23/2001	5/19/2001	5/23/2001	6/7/2001
Frequency of Data 4/	D	M	M	M	M	D	M	M	Q	Q	Q	M
Frequency of Reporting 4/	D	O (twice monthly)	M	O (twice monthly)	O (twice monthly)	D	O (twice monthly)	O (twice monthly)	O (twice monthly)	Q	O (twice monthly)	M
Source of Update 5/	C	A	A	A	A	A	A	A	A	A	A	A
Mode of Reporting 6/	O (web site)	E	E	E	E	E	E	E	E	E	E	E
Confidentiality 7/	C	C	B	C	C	C	C	C	C	C	C	C
Frequency of Publication 4/	D	M	M	M	M	D	M	M	Q	Q	Q	M

1/ General government only (excluding municipal governments).

2/ Quarterly data at constant prices only.

3/ External debt only. General information on interest and amortization payments is available on a quarterly basis from the balance of payments. Detailed information on debt service payments is only available for missions.

4/ D-daily, M-Monthly, and Q-quarterly.

5/ A-direct reporting by central bank, ministry of finance, or other official agency; N-official publication or press release; P-commercial publication; and C-commercial electronic data provider.

6/ E-electronic transfer.

7/ A-for use by the staff only; B-for use of staff and the Executive Board, and C-for unrestricted use.

Statement by the IMF Staff Representative
July 16, 2001

This buff contains information which has become available since the staff report (SM/01/185) was issued. This information does not modify the thrust of the staff appraisal.

1. The monthly index of **economic activity** (IMACEC) increased in April by 2.6 percent (year-on-year), bringing the rate of growth in the first four months of the year to 3.1 percent (year-on-year). **Unemployment** has remained roughly unchanged, as data through May indicate a seasonally-adjusted rate of 9.7 percent. In the first five months of the year, exports increased by 1.6 percent (year-on-year) in U.S. dollar terms, while imports grew by only 0.4 percent. The **price of copper** has continued to drift downward, declining by 14 percent since end-2000. The 12-month **inflation** rate in June was 3.6 percent (2.7 percent for the underlying inflation index).

2. The **peso**, together with other currencies in the region, has been under some pressure in recent days, depreciating by 6 percent against the U.S. dollar in the first eleven days of July. (This follows a depreciation of about 10 percent in the first six months of the year.) The authorities and private analysts attribute the recent weakness in the peso to adverse developments in neighboring countries. Chile's **sovereign bond spread** continued to decline slowly to about 170 basis points in recent days, but increased to 182 basis points on July 11, amid generalized turbulence in international bond markets.

3. Forecasts of output growth in 2001 from a monthly survey of private analysts and institutions taken by the central bank have been revised downward, with the median forecast declining from 3.9 percent in the June survey to 3.6 percent in the July survey. On the basis of recent indicators, including developments in the external environment, the staff considers that the risks on the projection for output growth in the staff report, 4 percent, may now be more weighted on the downside. Also, although copper prices are very difficult to predict, recent prices suggest that their average for 2001 is likely to fall short of the 80 U.S. cents per pound envisaged earlier. If both output and copper prices were to turn out somewhat lower than projected in the staff report, the actual deficit of the central government would increase moderately, but the authorities' structural balance measure would not be affected. Regarding the external current account balance, lower export receipts would be broadly offset by smaller outflows of profit remittances by foreign-owned mining companies and by reduced import demand.

4. In terms of policy developments, the central bank announced in early July that during the rest of the year it will issue about US$1 billion of medium-term paper payable in domestic currency but indexed to the exchange rate with respect to the U.S. dollar. (Such instruments started to be issued during the 1998 episode of pressure against the peso.) The central bank estimates that the total amount of this type of paper outstanding at end-2001 would be around US$2.5 billion. The central bank explained that the new bond issue is intended to meet increased private demand for instruments to cover currency risk (resulting

from recent high volatility in the foreign exchange market), and not to target the level of the exchange rate. The central bank also said that the issuance of bonds indexed to the exchange rate will result in a better currency composition of its balance sheet, which currently includes a large share of assets denominated in foreign exchange and a large share of liabilities indexed to domestic inflation. Press reports indicate that some economic agents have interpreted the issuance of bonds indexed to the exchange rate as indirect intervention in the foreign exchange market aimed at influencing the level of the exchange rate.

5. On July 10 the government submitted to congress a proposal for a limited income tax reform intended to be revenue neutral. The reform would reduce personal income taxes (including by lowering the maximum rate from 45 percent to 40 percent and raising the level of income exempt from taxes), and would allow deduction of interest payments on mortgages in the determination of taxable income. The reduction in tax revenue resulting from these measures (estimated at 0.2 percent of GDP) would be offset by an increase in the corporate income tax rate from 15 percent to 17 percent. Some elements of the reform would be introduced gradually in the period through 2004.

6. The authorities recently indicated to the staff that they will establish a commission of independent experts charged with setting the reference price of copper that will be used to measure the structural balance of the central government. Full details about this initiative are not yet available, but the staff understands that the commission will produce forecasts of copper prices for each of the coming 10 years, the average of which will then be used as the reference price. The staff considers that establishing such a commission could enhance the transparency of the new fiscal policy framework, particularly if the commission's methods and analysis were to be published. Also, basing the reference price on a forecast over a specific horizon, rather than on an uncertain notion of a long-run price, will make the estimated structural balance a more reliable indicator of the underlying fiscal position. Although the horizon of 10 years is somewhat longer than suggested by the mission, the effect of this difference would not be substantial as long as the commission's forecasts take into account the considerable persistence of copper price fluctuations.

INTERNATIONAL MONETARY FUND
Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 01/73
FOR IMMEDIATE RELEASE
July 27, 2001

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

IMF Concludes 2001 Article IV Consultation with Chile

On July 16, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Chile.[1]

Background

Chile's economic performance was very strong during most of the 1990s, but the country suffered a recession in 1998–99. In early 1998, Chile faced a widening external current account deficit—resulting from surging domestic demand and a large drop in copper export prices—which together with turbulence in world financial markets weakened investor confidence and put downward pressure on the currency. In response and to prevent the loss of the nominal anchor, the authorities raised the policy interest rate markedly. The combination of an adverse terms of trade shock, diminished supply of external finance, and contractionary monetary policy led to a sharp fall in domestic demand, and a decline in economic activity. Monetary and fiscal policies were eased starting in late 1998, which together with higher copper prices helped reverse the recessionary trend.

Real GDP grew by 5.4 percent in 2000, despite a slowdown which began in the second half of the year. For 2000, the deficit of the combined public sector fell by 1 percent of GDP, reflecting an improvement in the central government accounts. The external current account deficit widened moderately, and international reserves were stable at comfortable levels. Inflation rose to 4.5 percent by end-2000, reflecting higher oil prices, but subsequently fell to levels within the target band of 2–4 percent that became effective this year. Despite the economic recovery, unemployment was at end-2000 considerably above its pre-recession level.

[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. 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. This PIN summarizes the views of the Executive Board as expressed during the July 16, 2001 Executive Board discussion based on the staff report.

For 2001, real GDP is expected to grow by 4 percent, assuming some pickup in activity later in the year owing to an easing of monetary policy that begun in August 2000 and intensified in 2001, and an envisaged improvement in external conditions. Inflation is projected at about 3 percent at the year's end, and the external current account deficit at around 2 percent of GDP. The combined public sector deficit is projected to narrow moderately, to about 2 percent of GDP. The authorities are addressing unemployment problems with temporary programs, including a scheme to support rescheduling of small- and medium-sized enterprises' debt.

Chile's economic policy regime has been enhanced in recent years, including by switching to a freely floating exchange rate, strengthening the inflation targeting framework, progressively removing capital account controls, and introducing measures to further develop domestic financial markets. On the side of fiscal policy, the new government has committed itself to a rule-oriented approach, defined in terms of a *structural* fiscal balance measure for the central government accounts. The target, a surplus of 1 percent of GDP, came into operation in 2001 and will be pursued on an ongoing basis. A new law on tax evasion and tax avoidance is aimed at increasing government revenue by 1 percent of GDP over the medium term.

Chile has maintained a very open trade regime and has continued with the unilateral phased reduction of its uniform external tariff rate, now down to 8 percent. At the same time, the new trade safeguards law has been applied to support a price-stabilization scheme for certain agricultural products which at time has generated import tariffs above Chile's WTO-agreed maximum tariff. The authorities recently intensified trade agreement negotiations with the United States and the European Union. Earlier this year Chile introduced a new system of unemployment insurance. A proposal for a reform of the labor market is currently in congress, but its outcome remains uncertain.

Executive Board Assessment

Executive Directors commended the Chilean authorities for their exemplary and long record of sound economic policies, which in the 1990s resulted in high and sustained economic growth and a gradual decline in inflation, along with an impressive record of poverty reduction. Directors noted that growth had been interrupted by the recession that began in 1998, but that a significant recovery of output has been underway since late 1999. The unemployment rate has, however, declined only slightly.

Directors observed that in 2000, the authorities restrained government expenditure to reverse a previous trend of a weakening of the public accounts, and early in the year firmed up monetary policy to contain inflationary pressures. They considered that the authorities acted appropriately by easing monetary policy starting in the second half of the year, as the slowdown in output growth reduced the inflation risk.

Directors endorsed the authorities' broad macroeconomic policy approach and stance for 2001. Monetary policy, with interest rates now at a historical low, seems under present circumstances appropriate for maintaining inflation within the target band of 2-4 percent. On fiscal policy, the actual balance is expected to hold steady in 2001, consistent with achieving the authorities' target for the structural balance of the central government, while the combined public sector deficit is expected to decline moderately. Directors considered that these policies should provide support to a pick-up of output growth and are likely to result in a small decline in underlying inflation and a moderate external current account deficit for the year. Directors noted that negative external developments, particularly in other emerging markets, could adversely affect the short-term outlook for economic activity. Nevertheless, Chile has not been affected significantly by contagion effects, and the country is well placed to deal with any such adversity.

Directors considered that the monetary and exchange rate policy regime are serving Chile well—including an exchange market that operates without intervention, except in extraordinary circumstances, and an inflation-targeting framework focused on a continuous inflation band. They thought that the floating of the peso provided sufficient flexibility to help the country deal with external shocks while allowing monetary policy to remain focused on achieving the inflation target. A number of Directors expressed some concern about the recent issue of foreign exchange indexed bonds, and recommended that the authorities be cautious in using this type of instrument.

Directors supported the new framework for formulating fiscal policy on the basis of an ongoing target for a structural balance measure. They noted that this approach allowed the authorities to commit to a precise fiscal target without suppressing the operation of automatic stabilizers. Looking ahead, Directors recognized the significance of achieving this target on an ongoing basis as a means to enhance credibility, and stressed that the determination of the copper reference price should be transparent. Some Directors, noting that the framework focuses only on the central government accounts, recommended that the authorities consider in due course adopting a more comprehensive measure of the structural balance, which includes also the central bank losses and the balance of state-owned enterprises. Directors welcomed the recent steps to enhance fiscal transparency, including the authorities' decision to participate in the fiscal transparency ROSC module.

Directors supported the authorities' continued steps to further develop domestic financial markets and to strengthen Chile's financial integration with the rest of the world. They considered that all these measures would contribute to deeper and more efficient capital markets and proper incentives for capital flows in the context of a sound banking system.

On the basis of available indicators, the banking system remains strong. Directors encouraged the authorities to continue to implement strict supervision practices and to advance in the introduction of supervision of financial conglomerates on a consolidated basis. They called for early progress in the capitalization of the central bank, which will add to fiscal transparency and strengthen public confidence in the bank's independence.

Directors commended Chile for its very open trade regime and welcomed the continued unilateral reduction of the country's uniform external tariff.

Directors observed that the high level of unemployment continues to be a problem, and noted the small decline in the unemployment rate so far from its 1999 peak. While agreeing that no easy solution to the unemployment problem is available, many Directors expressed concerns about the effect on incentives that could be generated by recent measures to facilitate rescheduling of debt of small and medium-sized enterprises. Directors considered that the authorities' initiatives to support employment would make a transitory contribution, but that it would be important to accompany them by caution in granting adjustments to the minimum wage and to keep labor markets flexible more generally. They encouraged the authorities to ensure that any new labor market reform measures do not introduce rigidities that would reduce the economy's ability to generate employment. Directors welcomed the new system of unemployment protection, which will enhance social safety net and reduce the distortions generated by severance payments.

Directors considered that the medium-term outlook for the Chilean economy is favorable. Growth will be supported by continued prudent monetary and fiscal policies and by recent structural reforms, including capital account liberalization and import tariff reduction. Directors thought that Chile's comfortable level of international reserves, strong banking system, credible policy framework, and exchange rate flexibility places the country in a good position to cope with changes in the external environment.

Directors noted the positive overall assessment of Chile's data dissemination practices and data quality found in the recent ROSC data module, and that Chile regularly provides the staff with timely data that are broadly adequate for surveillance purposes. They encouraged the authorities to continue improving Chile's statistical base, including by widening the coverage of fiscal and external statistics.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff report for the 2001 Article IV Consultation with Chile is also available.

Chile: Selected Economic Indicators

	1996	1997	1998	1999	Est. 2000	Proj. 2001
Real economy (annual percentage change) 1/						
Real GDP growth	7.4	7.4	3.9	-1.1	5.4	4.0
Unemployment (in percent)	6.5	6.1	6.2	9.7	9.2	...
Change in consumer prices (end of period)	6.6	6.0	4.7	2.3	4.5	3.2
Money and credit (year-end percentage change) 1/						
Broad money (M3)	22.0	13.0	8.5	5.1	5.1	7.9
Bank credit to the private sector	20.8	18.0	11.2	3.0	10.7	8.0
Three-month real interest rate 2/	7.3	6.8	9.6	6.0	5.4	...
External sector (in percent of GDP) 1/						
Trade balance	-1.6	-2.1	-3.4	2.5	2.1	1.6
Current account balance	-5.1	-5.0	-5.7	-0.1	-1.4	-2.2
Capital account balance 3/	6.8	9.2	2.8	-0.9	1.7	2.6
Overall balance of payments	1.7	4.3	-2.8	-1.0	0.3	0.4
Gross official reserves (in percent of short-term external debt 4/	347.6	496.4	385.2	367.8	215.9	195.8
External debt 5/	33.5	35.6	43.4	50.5	52.7	56.7
Real effective exchange rate (in percent change) 6/	4.0	9.7	-6.1	-6.3	2.4	...
Terms of trade (annual percentage change)	-15.5	2.6	-12.6	0.9	0.1	-1.7
Copper price (U.S. cents per pound)	103.2	103.2	75.0	71.3	82.3	80.0
Public finances (in percent of GDP)						
Combined public sector balance	1.4	-0.1	-2.3	-3.6	-2.6	-2.1
Central government balance	2.6	2.1	-0.1	-2.4	-1.0	-0.9
Public enterprise balance	-0.5	-1.1	-1.1	-0.1	-0.7	-0.3
Central bank balance	-0.7	-1.1	-1.1	-1.1	-0.9	-0.9
Memorandum item:						
Central government balance (official presentation) 7/	2.3	2.0	0.4	-1.5	0.1	-0.6
Structural balance (official presentation)	1.4	1.1	0.3	-0.8	0.2	0.9

Sources: Central Bank of Chile; ministry of finance and IMF staff estimates.

1/ Unless otherwise indicated.
2/ Yield on 90-day indexed central bank paper, in percent per annum (period average).
3/ Including errors and omissions.
4/ Based on the official figures on short-term debt (which include amortization of medium- and long-term debt falling due during the following year). These figures exclude trade credits.
5/ Figures do not include short-term trade credits.
6/ End of period, as reported by the IMF's Information Notice System. A decline indicates a depreciation of the Chilean peso.
7/ The staff's presentation differs from the official presentation in the treatment of the operations of the Copper Stabilization Fund and the capital gains from privatizations.

Statement by Guillermo Le Fort, Alternate Executive Director for Chile
July 16, 2001

Overview

1. My authorities are in general agreement with the thrust of the staff report and appraisal on recent economic developments in Chile; therefore, this Buff statement will mainly complement the report by expanding on some policy considerations and my authorities' views regarding the few points where some differences exist.

2. After a prolonged period of rapid economic growth, the Chilean economy faced in 1998 and 1999, the effects of the international financial crisis originated in Asia. The external contagion forced a severe reduction in domestic demand, and a strong real depreciation of the peso. These resulted in the first recession in 17 years that drove the unemployment rate above 10 percent, a level that had not been observed in Chile since 1988. Nevertheless, the severity of the adjustment contributed to consolidate price stability by completing the convergence of inflation to industrial countries rates, and to improve the external position by rapidly narrowing the current account deficit to almost balance.

3. The Chilean economy initiated a strong recovery from the recession in the last quarter of 1999, but has lost some momentum since then; real GDP growth reached 5.4 percent in 2000 and for 2001 is projected at around 4 percent. This is well below the rates prevailing in the 1990s, reflecting **mainly the effects of a cyclical downturn**. In recent trimesters, GDP and domestic demand growth in Chile, as well as in most developing and industrial countries, have consistently fallen below initial expectations. A significant output gap has developed over the last years opening the possibility for a period of accelerated-non-inflationary growth above the rate of expansion of potential output.

4. The recovery of employment has been much slower than that of output owing not only to the contraction of demand in labor intensive sectors, but also to a sharp increase in efficiency. The effect of the recession on firms' earnings brought into the open cost increases incurred in years of rapid GDP expansion. The **cost rationalization process** that followed, induced a huge reduction of employment. The rapid increase in labor productivity has been reflected in an extremely slow recovery of employment from the recession levels of 1999 and in an unemployment rate that, although falling from the peaks of 1999, has remained well above the levels of the last decade.

5. Three reasons could be advanced for the cyclical slowdown currently affecting the Chilean economy, namely the **worsening of external conditions**, the **domestic malaise** related to policy uncertainties and the high unemployment rate, and the initial effects on domestic demand of **changes in the macroeconomic policy mix**. First, given Chile's **external openness**, the sharp slowdown in world economic

First, given Chile's **external openness**, the sharp slowdown in world economic growth, and the aversion of international investors to confront additional emerging market risks, have negatively affected activity and demand through lower growth of export volume, terms of trade deterioration, and higher costs and reduced availability of foreign financing. Second, **local factors** have also played a role in the slowdown. These include a more muted political dialogue and the uncertainties associated with the delays in legislation related to important policy initiatives. Similarly, the high rate of unemployment has weakened consumer's confidence. Third, the correction of the fiscal deficit prevailing in 1999 and the progress towards the policy target of a structural surplus, have implied a tightening in the fiscal stance which exerted an almost immediate effect on domestic demand. Completing the **change in the policy mix**, the monetary policy stance was softened by a series of interest rate cuts beginning in August 2000. But given the lags with which monetary policy affects domestic demand, full offsetting of the effects of fiscal tightening may have not yet taken place. In addition, the oil price shock complicated the already difficult management of the inflation targeting regime and may explain a further delay in the expansionary effect of the monetary easing.

6. The initiatives to confront the slowdown should not be seen in isolation, but rather as part of a well-defined policy framework oriented to sustain strong economic growth. The rules-based framework to define policy commitments rests on three pillars namely stability, efficiency and equity. A strong commitment with **macroeconomic stability** is envisaged through well specified targets for fiscal policy -- a structural surplus for the central government of 1 percent of GDP--, and also for monetary policy, --the containment of the 12-month CPI inflation to within a 2 to 4 percent target range. The symmetric targeting of inflation is being implemented against the backdrop of a floating exchange rate. The second pillar is given by a system of supervision and market-friendly regulations (including in the financial system) directed at favoring **microeconomic efficiency**, through competition and market development. The system's objective is to set appropriate incentives and limitations to risk. Lastly, the third pillar consists of bold social policies targeted at **reducing poverty and promoting equal opportunities**. The framework that makes possible sustained growth also provides the resources for implementing far-reaching social policies that have allowed for a significant reduction in poverty levels. In 14 years, Chile's poverty rate has been cut by half to 20 percent, and in the period 1998-2000, despite the slowdown in growth, the incidence of poverty dropped by almost 2 percentage points. These impressive results, among the best ever in sustained poverty alleviation, attest to the adequacy of Chile's social policies and economic policy framework.

Demand Management Policies

7. A continuous **inflation target band centered on 3 percent,** replaced the succession of falling end-of-year inflation targets in use through 1999, during the period of

gradual disinflation. The 2-4 percent inflation target range is the anchor of monetary policy, and the authorities are ready to adjust the policy stance should new information suggest a deviation in the forecast of the 12-month CPI inflation rate from the center of the target band, **in a 12 to 24 month horizon**. Three Monetary Policy Reports per year, as well as monthly policy statements, are issued to present the authorities' views with respect to inflation prospects and the way they are being addressed. The reports are prepared on the basis of comprehensive forecasting models for inflation, whose contents will be made public, as well as judgment in the forecast of exogenous variables and the appraisal of risk.

8. Since last year's Article IV Consultation, inflation has remained **subdued and in full compliance with the target,** despite a transitory increase in the headline CPI inflation rate owing to the oil price shock. Headline inflation transitorily exceeded 4 percent in late 2000, but since February 2001 it has been below this level and is expected to converge toward 3 percent over the next 12 to 24 month period. Monetary policy is not geared towards offsetting the effect of supply shocks, but efforts are directed to ensure that these effects are not transmitted to the rest of the consumption basket. In this regard, core inflation (IPCX), a measure that excludes items with volatile prices like perishable foodstuff and oil derivatives, has remained not only within the target band, but close to 3 percent, the center of the target range, while the super core (IPCX1), which additionally excludes public transportation and a few other public services, has been around and, at times, even below 2 percent, i.e., the floor of the inflation target range.

9. Monetary response to the oil price shock of early 2000 was to increase the **policy interest rate**, the target for the interbank-overnight interest rate of inflation-adjusted financial instruments. The policy rate was increased by 50 basis points (bp), mainly in view of the risk of propagation of the shock considering the rapid recovery of domestic demand in late 1999, but in response to new information the monetary policy stance was later eased. In effect, contrasting with the central scenario in the Monetary Policy Report of May 2000, which was conditional on a constant policy rate of 5.5 percent, **the monetary policy rate was reduced by 200 bp in several steps** beginning in August 2000. The current rate of 3.5 percent plus the inflation rate is considered consistent with the continuous fulfillment of the inflation target over the planning horizon, and my authorities believe that the risks for inflation are over all symmetric.

10. The **floating of the currency** is considered an essential element of the policy framework, and my authorities have reiterated their willingness to let the value of the Chilean peso be determined by market forces, limiting intervention to exceptional circumstances. The recent volatility affecting international financial markets has prompted a depreciation of the peso and higher demand for hedging instruments. To facilitate this hedging process, and also to reduce, at favorable rates, **the central bank's large open position in foreign exchange,** the bank will issue US$ 1 billion in 3-year notes linked to the exchange rate (PRD). This will imply that the stock of PRD

will increase to US$ 2.5 billion towards the end of this year. The issue of PRD has implied an equivalent reduction in the programmed issue of peso denominated and inflation linked financial instruments. This sterilized intervention is expected to contribute to a more orderly hedging process, but not to affect significantly the value of the currency.

11. In my authorities' view, a fiscal adjustment was needed to revert the deterioration of the previous years which, if continued, risked an erosion in the hard-won market confidence in Chile's macroeconomic management. The authorities' commitment to the fiscal target was reinforced by a substantial advance towards a **structural surplus of 1 percent in the central government accounts.** In 2000, the government's structural balance presented a surplus of 0.2 percent of GDP from the deficit of 0.8 percent of GDP prevailing in 1999. Last year, the rapid expansion of public sector revenue contrasted with a very limited increase in government outlays, and, as a result, **in the official presentation a small fiscal surplus replaced the deficit of 1.5 percent of GDP registered in 1999.** The 2001 budget was built around the structural surplus target of 1 percent of GDP, but small deviations from the target may arise. In case that revised fiscal projections show significant deviations from the structural target remedial actions will be implemented, otherwise minor corrections would be considered in the definition of next year's budget. The implementation of the fiscal rule should allow for an increase of real public sector expenditure at an annual real rate in the order of 5 percent, and the development of a more stable and medium-term based strategy for social policies, that avoids the harmful stop and go characteristic of cyclical fiscal outlays.

12. Despite lower levels of private demand and employment than assumed in the budget, my authorities are fully committed to meeting the expenditure limits set in the 2001 budget. Automatic stabilizers in place are compensating the cyclical downturn, and a small actual deficit may arise as a result of the lower revenue. At the same time, **fiscal spending is being reallocated** to more labor intensive activities, employment subsidies and training for the unemployed. In addition, a program to support the recovery of small and medium sized enterprises (SME), severely affected by the downturn and that play a key role in the generation of employment, has also been implemented. My authorities consider that market imperfections limit SMEs access to credit, thus justifying government actions to reschedule bank loans and to defer tax payments and social security contributions so as to facilitate their recovery. The government provides a **partial guarantee** on rescheduled loans to allow for refinancing at market-based interest rates but at lower spreads. The operation is funded by bank deposits in general, including existing government deposits carrying market interest rates.

13. Fiscal policy is and will continue to be implemented through the budget, and by focusing on the central government structural balance, a **transparent measure of the fiscal policy stance is being targeted.** The central bank quasi fiscal deficit is not the object of fiscal policy actions, and its stable level was **taken into account in defining**

the 1 percent surplus rather than balance as the structural fiscal target. Eventually, when the central bank is recapitalized, the current quasi fiscal deficit will be fully included in the central government operations. It is important to note, however, that the quasi fiscal deficit not only results from the currency mismatch of asset and liabilities of the central bank, but also from the reduction in the bank's capital and negative net worth resulting from the measures taken to solve the external debt and financial crisis of the 1980s.

14. My authorities closely monitor the activities and policies of state-owned enterprises, but reiterate that they do not consider these enterprises as instruments of fiscal policy. The few remaining state-owned enterprises **are managed under rules similar to those that apply to private corporations,** with policies based on profitability criteria and oriented by market conditions. Reforms under way are transferring to the budget the marginal quasi-fiscal activities carried out through ENAMI, the national mining company, as well as reinforcing the market orientation of the incentive system for public enterprises. The ongoing privatization process involves the water companies, with the eight firms still in the public sector being transferred to private management through 20 to 30 year concessions. No other privatization programs are presently envisaged apart from concessions in infrastructure. It is worth noting that Chile has already privatized the electrical and telecommunication sectors, and, after the ongoing program is completed, will have also fully privatized the water and sewage sector.

15. While recognizing the difficulties involved in defining the reference price for copper in the structural fiscal balance, my authorities have taken the pragmatic approach of focusing on the **average expected price for the next ten years.** A constant reference representing a long-run price entails the risk of excessively delaying the recognition of permanent changes in the equilibrium price of copper, and may result in maintaining for a long period an excessively expansionary or contractionary fiscal policy stance. A reference copper price that follows too closely the current market price would, on the other hand, result in a variable fiscal policy stance that would amplify the effects of temporary price shocks on domestic demand. Beginning this year, a committee of independent experts will develop 10-year projections for the price of copper, thus defining the reference price to be used in the budget process.

Structural Policies

16. The policy response to confront the slowdown in economic growth and the increased risk aversion of international investors includes, in addition to changes in the stance of demand management policies, a program of structural reforms. A central element of this program involves **promoting the development of the local capital market,** which my authorities consider essential to sustain high growth rates. A comprehensive capital market reform has already passed the initial round of discussions in Congress. Its main objective is to increase liquidity and depth of the markets for equities and bonds, with a view to **improving the access to long-term financing by innovative SMEs.** A complementary objective is to increase the menu

of financial instruments, by widening the risk-return choices and providing additional incentives for household savings.

17. The reform envisages widening the eligible financial instruments for **tax exempt savings by households.** In addition to voluntary contributions to pension funds, voluntary savings would also be tax exempt when directed to mutual funds, housing savings funds, bank deposits, and life insurance policies among other instruments. Savings in these instruments are to be exempt from taxes, and withdrawals prior to retirement are authorized but carry a tax penalty. After retirement the withdrawals will be subject to the personal income tax, with the exception of up to 2 years of the retiree's average income of the last ten years, which can be withdrawn tax free.

18. The capital market reform also includes **important tax reduction measures** involving the capital gains tax, the stamp-tax on borrowing, the tax on interest receipts by foreign investors, and the tax on interest payments abroad. The **capital gains tax** is to be eliminated for transactions involving stocks with significant market presence, stocks of emerging companies and stocks used in operations of security lending and short-sales. The 0.1 percent **stamp-tax** paid monthly on borrowed resources sharply increases the cost of short-term financing and restricts the development of the market of commercial paper, despite a cap in place of up to 1.2 percent on the resources borrowed for more than a year. SMEs have very limited access to longer-term financing and do not benefit from this cap. To increase their financing alternatives, the tax on borrowed resources would be applied on the registered commercial paper issues of firms, at a rate of 1.2 percent paid once for the next 10 years. The **tax on interest receipts in local currency,** paid by foreign investors, would also be reduced from 35 percent to 4 percent, the same rate that applies to interest payments in foreign currency. Finally, the **tax on interest receipts in foreign currency** would be eliminated for financial intermediaries that channel the funds towards cross border loans.

19. A **segment for emerging companies** will be created in the stock market to foster the development of innovative SMEs. Firms without history, but with innovative projects and rapid growth potential will be listed in this segment. They will have to meet the disclosure requirements set by the exchange, and to facilitate this process a government agency will subsidize and monitor the work of specialized consultants. In addition, a market for private placements will be available only for institutional and other sophisticated investors that are qualified to bear higher risk. The **investment management industry will be deregulated** allowing for the development of multi-fund administrators in mutual funds, investment funds and pension funds. The limits on foreign investment by Pension Funds will be increased and Fund managers will be authorized to develop five alternative funds for workers to decide how best to invest their pension saving. Other initiatives include the deregulation of investment limits in mutual funds and the insurance sector. To preserve the stability of financial institutions in a less restrictive environment, **special emphasis is being given to transparency and self regulation,** with the Board of Directors and high level

managers of financial institutions having clear responsibilities in the design, disclosure and effective implementation of the investment policies.

20. The decision of the Central Bank to eliminate all outstanding restrictions on foreign exchange operations successfully **culminated a process of gradual deregulation of the forex market.** Foreign exchange operations are now free of restrictions, but since they had been gradually liberalized, this last step did not constitute a policy shock or have a noticeable effect on the price or volume of foreign exchange operations. Previous advances in the liberalization of foreign exchange operations included eliminating impediments for the issuance of external debt instruments denominated in domestic currency so as to favor the **hedging of medium-term foreign exchange risk.** The development of an external market for peso instruments has been difficult under the particularly dry conditions present in international financial markets over the last two years. Still, the World Bank and the government of Uruguay have already issued in the international market medium-term peso-indexed instruments, which have helped the benchmarking and to develop hedging instruments. The swapping back into dollars of the peso liabilities of the issuer, gives the opportunity to Chilean debtors to swap into pesos their medium-term foreign currency liabilities.

21. Regulations to capital inflows used in the 1990s were directed to preventing overspending and to modify the composition of foreign financing towards less volatile flows, reducing external vulnerabilities and supporting the crawling exchange rate band. After the sharp reduction in capital inflows in 1998, the floating of the peso in 1999, and the advances in adapting the financial system to foreign exchange volatility, this type of intervention was no longer needed. My authorities understand, however, that **external financing remains extremely pro-cyclical,** and that adequate instruments should be available to preserve macroeconomic and financial stability while facing external turbulences. They attach particular importance to **protecting banking institutions by limiting their exposure to market and credit risk.** In addition to the regular constraints on credit concentration and open foreign exchange positions, a system directed at preventing currency mismatches of corporations from becoming a source of vulnerability for the banking system was also put in place. Its objective is to improve the transparency and the timeliness of information provided by corporations to banks and to the financial market. Banks must now specifically consider **the exchange risk of their clients in pricing credit risk,** and when the Superintendency of Financial Institutions detects inappropriate pricing, additional loan provisions may be imposed.

22. My authorities are keen **on enhancing the efficiency and flexibility** with which the labor market operates. In particular, considering the exposure of the Chilean economy to external shocks, the primary objectives of the labor market reform are to foster competition and allow the market to operate efficiently so as to reduce the rate of long-term unemployment. The labor market reform has been under discussion for a long time, partly due to the importance given to labor market flexibility. The

government's bill eliminates restrictions against unionization following ILO guidelines. Flexible labor contracts are also contemplated, allowing, among others, for part-time, flexible time, work at home, temporary, and special training contracts. Collective bargaining continues to be held at the firm level, but it could be voluntarily extended to a group of firms, requiring the explicit agreement of all the employers and unions participating. The replacement of workers during strikes is maintained subject to a small payment for each replacement worker into a fund used to supplement the bonus paid when agreement is reached and the strike ends.

23. Congress recently approved an unemployment insurance scheme that allows workers to receive compensation in the event they become unemployed. The insurance is financed by contributions from workers, employers and the government, with the resources assigned to individual worker's accounts and a Solidarity Fund to be used in supplementing the insurance. The resources will be administered by a private fund manager, supervised by the Superintendency on Pension Funds.

24. The continuous reduction in the single external tariff rate, **to 6 percent by 2003,** and the ongoing efforts to finalize free trade agreements with all main trading partners, reflect my authorities' commitment with an open trade regime and efficient resource allocation. The long lasting practice of keeping the domestic prices for certain agricultural products within bands, should be viewed as a **compensatory action** to address the distortions generated by industrial country support policies in the international markets for these products. The bands apply to a small number of products, and the price support that they provide is kept under review considering current and prospective market developments.

25. The government has recently submitted to Congress a bill proposing a moderate and compensated reduction in personal income taxes, **that decreases the dispersion of income tax rates and enhances the efficiency of the tax system.** The fiscal impact is expected to be neutral, as the 0.2 percent of GDP reduction in personal taxes would be fully compensated by an increase in corporate taxes. The maximum personal tax rate would be reduced from 45 to 40 percent, the tax exempted income slightly increased and the deduction of mortgage interest payments authorized with a limit. In compensation, the corporate income tax rate would be raised from 15 to 17 percent.

Social Policies

26. Sustained economic growth provides the resources to finance **bold social policies** in education and training, housing, health and judiciary reform, where important initiatives to promote equal opportunities and improve income distribution over the medium-term are underway. In **education,** the government is trying to extend the average number of years of schooling by bringing forward the entrance age to the public education system, to improve the effectiveness of formal education in overcoming disadvantages of children of low-income families. To this end, the system is being expanded to include pre-school and nursery care. Other initiatives in education include the extension of the school day, the retention subsidies for high school students, and the enlargement of the access to new information technologies. In addition, more than half of the university students are eligible for scholarships and fiscal loan programs, which are being extended to professional and technical institutes. Since December 2000, a new and more effective **criminal justice system** is at work in two regions, and will be extended to other three later this year. The targeting of **public housing** expenditure on the population below the poverty line has also been improved through the introduction of new programs for basic housing that will be used to provide permanent housing to the 130,000 families that still live in shanty towns.

Other Issues

27. It should also be noted that my authorities are committed to **fostering transparency** and, as part of this process, a ROSC on Statistics is included among the staff reports for this consultation. Chile meets the SDDS specifications on all data categories and for the dissemination of advance release calendars. Measures are being implemented to overcome some limitations in the fiscal data, and my authorities have already requested a ROSC on fiscal policy transparency to be completed by the 2002 Article IV Consultation. In addition, ROSCs on the financial sector and a complete FSAP are planned for a latter stage, after the implementation of the capital market reform and some improvements in the payments system. Chile's efforts in fostering transparency have received international recognition. In the **opacity index** recently published by PricewaterhouseCoopers, Chile scored among the countries meeting the highest transparency standards worldwide.

28. In conclusion, I would like to convey to staff and management my authorities' appreciation and this chair's gratitude for the very useful policy and technical discussions held, the excellent set of papers, and in general, for the dedication and collaboration of staff during this Article IV Consultation.