September 2010
IMF Country Report No. 10/298

Chile: 2010 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Chile

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2010 Article IV consultation with Chile, the following documents have been released and are included in this package:

- The staff report for the 2010 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on July 30, 2010 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 August 25, 2010. 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 supplement of August 25, 2010, updating information on recent developments

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its September 13, 2010 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Chile.

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

Selected Issues Paper

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

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INTERNATIONAL MONETARY FUND

CHILE

Staff Report for the 2010 Article IV Consultation

Prepared by the Staff Representatives of the Western Hemisphere Department
(In consultation with other departments)

Approved by Miguel A. Savastano and Tamim Bayoumi

August 25, 2010

Executive Summary

Context. Since 2008, Chile's economy has successfully withstood two large adverse shocks—the global financial crisis and a devastating earthquake in February 2010. The economy's resilience has been underpinned by a strong policy framework, a well-capitalized banking system, and the absence of imbalances in the private sector. Real output growth is expected to recover strongly in 2010–11, driven by reconstruction spending and a rebuilding of inventories. In concluding the 2009 Article IV consultation, Directors strongly supported Chile's policy framework and highlighted its track record of exemplary policies, but encouraged the authorities to consider extending the horizon for fiscal policy formulation.

Policy discussions. Staff supported the authorities' intention to start withdrawing fiscal stimulus in 2011 even with higher spending on reconstruction and normalizing the stance of monetary policy. Staff agreed with the authorities' decision to review the fiscal rule, with a view to enhancing its effectiveness, and their plans to develop further domestic financial markets and strengthen the prudential framework. The discussions also covered options to better align the fiscal rule with international best practice, policy responses to a possible surge in capital inflows and steps to increase productivity growth.

Analytical Work. Background studies include options for strengthening Chile's fiscal framework, assessing the extent of "too-connected-to-fail" risk through network analysis, estimating potential output, and measuring the effects of terms of trade shocks on income distribution.

The 2010 Article IV consultation discussions were held in Santiago during July 19–30. The team comprised R. Rennhack (Head), D. Iakova, J. Chan-Lau, T. Daban, and N. Magud (all WHD). M. Ricaurte (OED) participated in the meetings. The mission met with Finance Minister Larraín, Governor of the Central Bank of Chile De Gregorio, other senior officials and representatives of the private sector.

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

OECD membership: Chile joined the OECD in May 2010.

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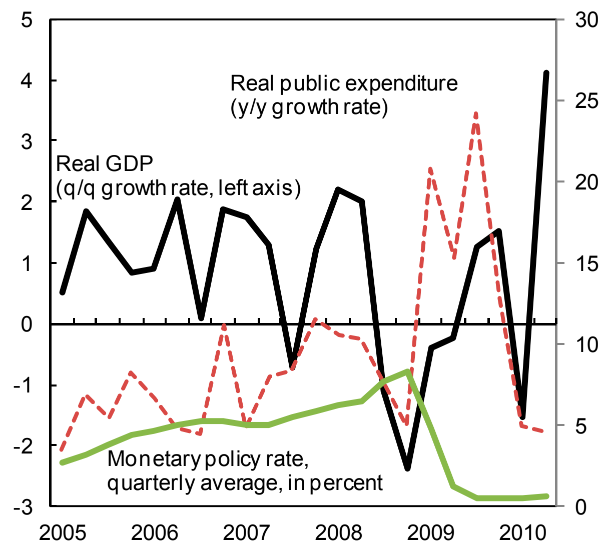
I. Context

1. **Since 2008, Chile's economy has successfully withstood two large adverse shocks—the global financial crisis and a devastating earthquake in February 2010**. Chile's resilience has been underpinned by a strong policy framework (a fiscal rule, inflation targeting and exchange rate flexibility), a well-capitalized banking system, and the absence of imbalances in the private sector. In response to the economic slowdown triggered by the global crisis, the previous government implemented a sizable fiscal stimulus, cut interest rates sharply, and put in place measures to improve liquidity in the banking system.[1] This response (large by regional standards) contributed to a strong recovery in real GDP growth in the second half of 2009 (text chart). After taking office in March 2010, the new administration put in place an ambitious earthquake reconstruction program, financed by a mix of temporary tax increases, reprioritization of spending, and some borrowing. With large fiscal savings accumulated over the past decade, and a proven track record of low inflation and prudent banking practices, these sizable policy responses have not compromised confidence in economic policies.



Source: Dipres and Haver.

II. Outlook for 2010

2. **A strong economic recovery is underway, and staff projects that real GDP will grow by 5 percent in 2010 (Figure 1 and Table 1).** After contracting sharply after the collapse of Lehman, real GDP grew at an annualized rate of 7 percent in the second half of 2009. Domestic demand led the recovery, supported by the substantial easing of fiscal and monetary policies. Consumer and business confidence strengthened as the global economy stabilized and Chile's terms of trade improved. Growth was temporarily disrupted by the end-February earthquake, but resumed in the second quarter of 2010. Strong private consumption and large private and public investment, including on inventories, are expected to sustain domestic demand growth.

[1] As discussed in last year's Article IV report, the government announced a sizable fiscal stimulus in January 2009, followed by the adoption of measures to facilitate credit in March 2009, and the expansion of subsidies in May 2009. The central bank started to provide liquidity to the financial system in October 2008 and in January 2009 started lowering the policy interest rate (from 8.25 percent to 0.5 percent by July 2009).

3. **With diminishing spare capacity in the economy, inflation is expected to rise to 3.7 percent by end-2010.** The rapid growth of domestic demand has contributed to strong real import growth and to a rise in domestic inflation (consumer prices increased by 2.2 percent y/y in July, after falling by 1.4 percent during 2009, Figure 2). At the same time, the earthquake is likely to have caused a transitory decline in the level of potential output. Staff's estimates suggest that Chile's output gap would average about 2 percent of GDP in 2010, and would close in 2011 (Box 1).

4. **The rebound in growth, together with higher copper prices, will help narrow the fiscal deficit in 2010**. The central government deficit is projected to decline to 1¾ percent of GDP in 2010 (from 4.4 percent of GDP in 2009), reflecting a recovery in tax revenues from both the mining and non-mining sectors and lower current expenditure (Figure 3 and Table 2). The revenue gains are being supported by efforts to restore tax compliance, which declined during 2009, as well as temporary tax increases. On the expenditure side, the end of several of the temporary stimulus measures adopted in 2009 and the government's efforts to improve expenditure efficiency are expected to lower real expenditure growth to 9 percent (from almost 20 percent the year before). Staff estimates that the reconstruction spending would raise the structural deficit (the balance with revenues measured at potential output and the long-term trend copper price) to about4.1 percent of GDP in 2010, from 3.1 percent of GDP in 2009.[2] The net financial asset position of the central government is projected to decline to 14 percent of GDP by the end of 2010, from a peak of 20 percent of GDP in 2008 (Table 3).

5. **Financing conditions have eased and credit growth is picking up.** After tightening significantly in late 2008 and early 2009, credit conditions for both corporations and households have eased, and credit growth resumed (Figure 4). Lending rates have declined in the course of 2009, in line with the reduction of the policy rate. Corporate bond spreads have also declined to their pre-crisis levels. The normalization of liquidity conditions allowed the central bank to terminate in June 2010 the temporary short-term bank liquidity facility set up during the crisis.

6. **The central bank started raising the policy rate in June 2010 to help moderate the pace of demand growth.** After three consecutive monthly increases, the policy rate stands at 2 percent in August 2010. Inflation expectations for end-2010 are above the 3 percent target, but remain anchored at target at the end of the 24-month policy horizon.

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[2] Staff calculations of the structural balance in 2009-10 rely on staff estimates of the output gap, which are smaller than the authorities' estimates used to calculate the structural balance. Based on the interim findings of the fiscal rule commission, the authorities revised their estimates of the structural deficit to 3.1 percent of GDP in 2009 and 3.2 percent of GDP in 2010, from 1.2 percent of GDP and 1.6 percent of GDP, respectively.

7. **Chile's external position remains strong.** The net international investment position has improved by about US$30 billion since mid-2009, largely due to valuation gains on the assets held abroad by institutional investors (Figure 6). The external current account is projected to shift from a surplus of 2½ percent of GDP in 2009 to a deficit of about 1 percent of GDP in 2010, as real import growth strengthens and profit repatriations accelerate (Table 4 and Figure 5). Staff estimates, based on CGER methodologies, suggest that the real effective exchange rate is broadly line with its long term fundamentals as of June 2010.

Chile: CGER-based Equillibrium REER Assessment

	REER Misalignment 1/
Macroeconomic Balance	-9
External Sustainability	-5
Equilibrium Real Exchange Rate	0

Source: IMF Staff estimates, June 2010.

1/ Undervaluation = "-".

8. **The financial system weathered the crisis well, with only a moderate cyclical deterioration in credit quality.** Non-performing loans remain relatively low, at 3 percent of all loans. Banks are well capitalized and have a relatively stable funding base (Figure 7). Provisioning levels have strengthened, in part due to stricter provisioning requirements in place since January 2010. Annual bank credit growth to the private sector has recovered to 7.5 percent in mid-2010.

Chile: Financial Soundness Indicators

(In percent, unless otherwise indicated)

	2006	2007	2008	2009	2010 1/
Bank regulatory capital to risk-weighted assets	12.5	12.2	12.5	14.3	13.7
Bank capital to assets	6.8	6.7	6.9	7.4	7.1
Bank nonpeforming loans to total loans 2/	0.8	0.8	1	1.4 / **2.9**	**3.0**
Bank provisions to nonperforming loans 2/	199	210	179	178 / **81**	**83**
Bank return on assets	1.3	1.1	1.2	1.3	1.6
Bank return on equity	18.6	16.2	15.2	18	20

Source: SBIF.

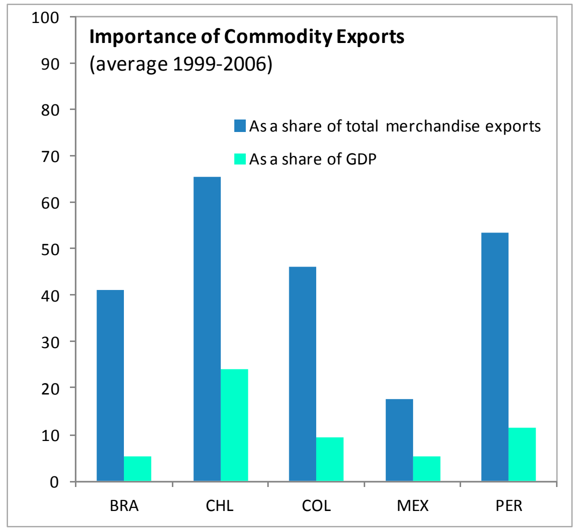
1/ As of March 2010.

2/ Nonperforming loans are based on IFRS accounting rules starting in 2009 (data in bold).

III. Medium term Outlook and Risks

9. **Real GDP growth is expected to accelerate to about 6 percent in 2011, and thereafter converge to the potential output growth rate of about 4½ percent (Table 4).** The staff baseline scenario assumes that the overall position of the central government will return to virtual balance by 2014, and its net financial assets will remain close to 15 percent of GDP. The current account deficit is expected to stabilize at around 2¼ percent of GDP, financed mainly by continued net foreign direct investment. Net international reserves are projected to remain stable, given central bank commitment to exchange rate flexibility.

10. **While near term risks are broadly balanced, Chile remains vulnerable to global economic shocks over the medium term.** In the near term, strong consumer and business confidence, underpinned by large reconstruction spending and still easy financing conditions, could translate into a greater-than-expected boost to demand and a faster than envisaged narrowing of the output gap. However, as a highly open and financially integrated economy, heavily dependent on copper exports and oil imports, Chile remains vulnerable to volatility in world commodity prices, global growth, and capital markets (see chart).



IV. Policy Discussions

11. **The authorities are committed to preserving macroeconomic stability, strengthening further the policy framework, and creating incentives to boost productivity**. They noted that the fiscal rule in place since 2001 had been critical in helping the government effectively manage the effects of the global financial crisis and the 2010 earthquake. However, recent experience with implementation of the rule showed that certain aspects of it could be improved, and for that purpose the government convened a high-level commission with the task of recommending reforms to the fiscal rule. The authorities also stressed that a key priority of the new government is to create conditions to accelerate productivity growth. Key initiatives in this area include increasing the efficiency of the public sector, and securing legislative approval for comprehensive capital market reforms.

Fiscal Policy

12. **The authorities emphasized that expenditure restraint would anchor fiscal policy over the medium term.** They noted that, even with the additional spending on reconstruction in 2010–12, they aimed to reduce the structural deficit to 1 percent of GDP by 2014, which would require a cautious expenditure policy. Staff and the authorities agreed that to ensure a consistent policy mix and moderate exchange rate appreciation pressures, a gradual withdrawal of fiscal stimulus should start in 2011, while still allowing room for reconstruction expenditure. Detailed fiscal plans for 2011 and for the medium term will be released in September, when the draft 2011 budget is sent to Congress. The authorities estimated that the government's share of the estimated total reconstruction costs of about US$30 billion would be on the order of US$8.4 billion (4 percent of GDP) over 2010–13, which would be financed through insurance reimbursements, improved efficiency and reallocation of spending, temporary tax increases, and debt issuance. The authorities noted that the temporary tax increases would help avoid a compression of spending in the near term, and would be combined with a productivity-enhancing extension of the reduction in the

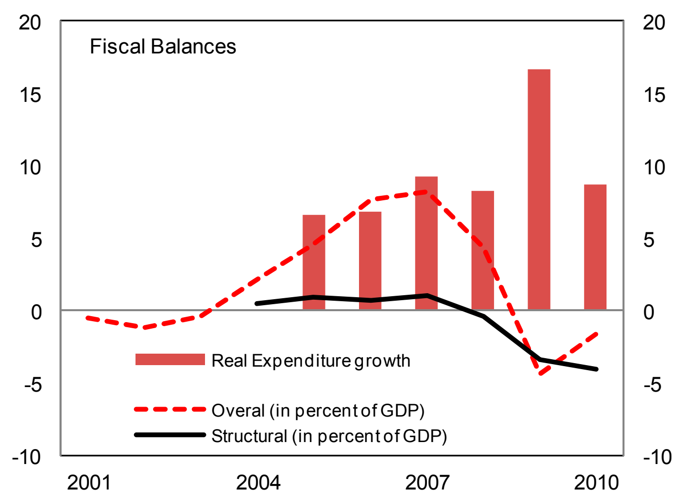
stamp tax on financial transactions and some tax breaks for small and medium sized enterprises (text table). In July the government placed a US$1 billion 10-year bond at a spread of 90 basis points, and sold a US$500 million peso-linked bond to international investors at an interest rate of 5.5 percent.

Government Net Reconstruction Costs, 2010–13

	In millions of U.S. dollars	In percent of GDP
Reconstruction Cost	8,431	4.2
Gross	10,600	5.3
Insurance	-1,300	(0.7)
Efficiency Gains	-869	(0.4)

Sources: Ministry of Finance and staff calculations.

13. **Staff supported the authorities' goal of narrowing the structural deficit to 1 percent of GDP by 2014.** It noted that attaining this goal would entail keeping the growth of government spending below the growth rate of output for most of this administration (assuming broadly an unchanged tax burden and stable long-term copper prices). Staff discussed a scenario where the headline central government deficit declines from 1.7 percent of GDP in 2010 to 0.5 percent of GDP in 2011, and real government expenditure grows by 9 percent and 5 percent, respectively. The central government's headline position would gradually move to virtual balance by 2014, as expenditure would decline to about 22 percent of GDP—near its level prior to the global financial crisis. (Table 5). In this scenario, the structural deficit would remain about 3 percent of GDP in 2011, and gradually fall to a deficit of 1 percent of GDP by 2014. This fiscal profile would result in a gradual withdrawal of the 2009 fiscal stimulus between 2011 and 2014, which would help avoid undue compression of expenditure at the end of the period. While staff supported the fiscal target for 2014, it stressed that it would be prudent to return the structural position to balance over a longer horizon, say by 2016, to signal the intention to keep fiscal policy neutral over the long term and preserve the net financial position of the government on a sustained basis. To this end, staff suggested that any rise in the structural revenues caused by upward revisions in the long-term copper price could be used to reduce the structural deficit faster than currently planned. The authorities noted that the current institutional framework required the government to formulate goals for fiscal policy only during its term.



14. **Staff welcomed the government's decision to establish a commission to review the fiscal rule**. In late August 2010, the commission published its interim report and recommended revisions to the methodology for calculating the structural balance. The final report (due by November 2010) will consider the scope for broader reforms to the rule, possibly including proposals to modify its countercyclical role and strengthen its institutional basis. Staff noted that the rule in place since 2001 has helped stabilize spending growth and accumulate sizable net financial assets during the copper price boom, but could be improved in several aspects. Staff analysis, drawing on best international practices (Annex 1), suggests the following points to consider in reviewing the design of the rule:[3]

- Make the calculation of the structural balance more transparent and easy to replicate.
- Introduce an explicit escape clause to allow for discretionary countercyclical policy in the case of large shocks.
- Complement the rule with a medium-term policy framework that would extend beyond the 4-year presidential term to provide a clear path for returning to the fiscal target after temporary deviations.
- Minimize unintended procyclicality. An expenditure growth ceiling could help prevent procyclical increases in public spending in the event of a significant increase in the long-term copper price.
- Expand the role of the expert committees to include an ex-post assessment of the implementation of the rule and consider the adoption of a full "fiscal council" system to increase further fiscal transparency and accountability.
- Complement the rule with an indicative target for the government's long-term net financial assets, taking into account contingent liabilities.

The authorities agreed with the recommendations in the interim report but wanted to carefully review the final report before offering any views on possible reforms to the rule.

15. **Staff encouraged the fiscal authorities to continue the recapitalization of the central bank.** Between 2006 and 2008, the government reduced the estimated capital shortfall of the central bank to ½ percent of GDP, but these transfers were suspended in 2009.[4] Completing the recapitalization of the central bank would help strengthen further its credibility, without affecting the overall asset position of the general government. The

[3] See "Strengthening Chile's Rule-Based Fiscal Framework" in the Selected Issues Papers.

[4] The 2006 Fiscal Responsibility Law established a mechanism for the central government to gradually recapitalize the central bank in years of fiscal surplus. In line with the law, these transfers stopped in 2009 when the countercyclical fiscal stimulus moved the central government's overall balance into deficit.

authorities replied that they would review a report on the capital position of the central bank before deciding on the next steps.

Monetary Policy

16. **Monetary policy has appropriately moved to a tightening stance since June.** The strengthening economic outlook calls for further tightening in the coming months, as envisaged in the latest Monetary Policy Report. Market expectations suggest that the policy rate will increase to 5.5 percent by early 2012.

17. **Staff noted that the widening of interest rate and growth differentials with major advanced economies could trigger capital inflows.** Staff and the authorities agreed that in the event of a surge of capital inflows, the first line of defense should be to allow nominal exchange rate appreciation, possibly accompanied by macroprudential policies to limit excessive growth in credit. Staff suggested that possible prudential measures could include higher bank reserve requirements, countercyclical provisioning or capital requirements, and limits on loan-to-value and loan-to-deposit ratios. Limits and/or higher capital requirements on banks' forward foreign exchange positions could also be considered in the case of excessive exchange rate volatility. The authorities noted that there were a wide range of macroprudential measures that could be considered, and the choice would be tailored to the specific situation and coordinated with the supervisory agencies. In some cases, these measures would require legislative approval. Staff agreed with the central bank's view that intervention in the foreign exchange market would be warranted only in the case of extreme exchange rate misalignments, accompanied by the risk of disruptions in domestic financial markets, in line with the framework for sterilized interventions in place since 2000.[5]

Strengthening the Financial System

18. **Staff and the authorities agreed that domestic credit risks would diminish further as the recovery firms up.** The earthquake could have a limited temporary impact on credit risk in the affected zones, as indicated in the latest financial stability report of the central bank. However, for the banking system as a whole, this effect is expected to be offset by the rebound of economic activity and lower unemployment. Stress tests conducted by the central bank suggest that banks' capital ratios will remain above minima, even if economic conditions deteriorate and the cost of financing increases relative to the baseline projections. Staff and the authorities also agreed that the risk of financial contagion from Europe appeared to be contained, as the large domestic banks that are subsidiaries of Spanish and U.S. banks have a stable domestic funding base (Figure 8 and Box 2).[6] As of April 2010, external funding was only 9 percent of total liabilities and most of it was long-term debt.

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[5] The central bank has intervened only on three occasions since 2000.

[6] A more detailed analysis is presented in "Too-Connected-to-Fail (TCTF) Risk in the Chilean Banking System" in the Selected Issues Papers.

19. **The authorities remain committed to continue financial sector reforms.** These reforms are intended to further strengthen the prudential framework and deepen domestic capital markets, which should be beneficial for productivity growth. The third capital market reforms law (MKIII), approved by Congress in May 2010, broadens the universe of authorized financial instruments, including exchange-traded funds and mortgage bonds; facilitates the process of securitization; and extends tax exemptions on selected fixed income instruments to foreign institutional investors. In addition, the government is developing another set of reforms (the bicentennial capital market reform or MKB) to improve further the liquidity of financial markets and update the institutional framework, especially in the areas of consolidated supervision and corporate governance of the financial supervisors (Box 3).

20. **The staff fully supported these initiatives, and suggested possible additional measures to strengthen further the regulatory and supervisory framework.**[7] These included: (i) adopting a functional approach to regulation and supervision to limit regulatory arbitrage and facilitate systemic risk assessment; (ii) formalizing cooperative supervisory arrangements among the three supervisory agencies, including by setting up a systemic risk council; (iii) strengthening cross-border coordination with international counterparts; (iv) addressing information gaps to help identify vulnerabilities and price misalignments; and (v) using a regulatory benchmark model and common assumptions to assess the adequacy of dynamic loan loss provisions. The authorities agreed with the staff's view that a functional approach, similar to the one currently applied to investment funds and mortgage financing, would broaden the perimeter of regulation to currently unregulated entities and improve the uniformity of regulatory standards. They added that the three main supervisory agencies—the SBIF (banking), the SVS (securities and insurance), and SP (pensions)—are currently implementing a pilot exercise on consolidated supervision of financial conglomerates, with a view to setting up a formal framework for cooperation. They also agreed that addressing information gaps is important and noted that they are expanding the set of data collected from financial conglomerates. Staff supported the planned adoption of dynamic provisioning, and suggested that it could be complemented by the introduction of countercyclical capital buffers to reduce macroprudential risks associated with procyclical credit expansion.

Enhancing Productivity Growth

21. **Staff also supported the government's other initiatives to enhance productivity growth.** In 2010, Chile ranked 49th in the World Bank's Doing Business Indicators, reflecting relatively high costs for starting a business, inefficient bankruptcy procedures, and labor market regulations that favor short-term subcontracting. The government is planning reforms aimed at increasing competition, facilitating the entry of new firms, making credit more accessible to small and medium-enterprises, and improving bankruptcy regulations. It

[7] See Annex 2 for a concise description of the financial system and the supervisory framework.

also plans to establish a specialized stock market to facilitate initial public offerings for start-ups and increase the availability of venture capital. Staff agreed with the authorities that replacing the current high severance payment system with a more comprehensive unemployment insurance scheme could help increase labor market mobility and encourage greater investment in education and on-the-job training. Increasing the share of skilled workers in the labor force could also help reduce income inequality.[8] Staff also noted that relatively high minimum wages in Chile—45 percent of the average wage compared to the OECD average of 40 percent—could increase youth unemployment and contribute to the growth of the informal sector.

V. Staff Appraisal

22. **Chile's economy has shown remarkable resilience in the past two years.** The economic recovery is fully underway, helped by appropriate policy responses to the two large adverse shocks. The recent success in tapping international capital markets on very favorable terms attests to the strong market confidence that macroeconomic stability will be preserved.

23. **Fiscal policy played a critical countercyclical role, drawing on the public savings accumulated prior to the global crisis.** The 2009 fiscal stimulus helped support an early recovery of economic activity. The planned withdrawal of the fiscal stimulus was delayed by the demands on government spending placed by the devastating earthquake of February 2010. The government has adopted a prudent approach to financing the emergency spending through reprioritization of other expenditure, temporary tax increases, efficiency gains, and some debt issuance. The government's commitment to firm expenditure restraint starting in 2011 is important to ensure that fiscal policy helps reduce the risk of overheating and limit exchange rate appreciation pressures.

24. **Staff supports the authorities' goal of reducing the structural deficit of the central government to 1 percent of GDP by 2014.** The target is challenging, as it implies firm expenditure restraint over a number of years. However, over a longer horizon, it would be advisable to return the structural position of the central government to balance in order to keep the government's discretionary fiscal policy neutral while preserving its net financial assets. Thus, any increase in the long-term copper price could be used to reduce the structural deficit even faster. Staff encourages the government to renew its commitment to fully recapitalize the central bank.

25. **The government's decision to review the fiscal rule is welcome.** While the rule has worked well and is one of the main pillars of Chile's policy framework, its design can be refined to make the rule even more effective. Areas for improvement include making the rule more transparent and easier to replicate; introducing an explicit escape clause and features to limit unintended procyclicality in spending; complementing the rule with an explicit

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[8] See "A Note on Terms of Trade Shocks and the Wage Gap" in the Selected Issues Papers.

medium-term policy framework that extends beyond the term of each government; and strengthening accountability through ex-post assessment of compliance. Once the commission has issued its final report, the government could limit any uncertainty by outlining a clear timetable for adopting any revisions to the rule.

26. **Staff supports the recent shift of monetary policy to a tightening stance.** Diminishing spare capacity in the economy calls for continuing withdrawal of monetary stimulus to bring inflation in line with the target by the end of the 24-month policy horizon. The implementation of monetary policy could become challenging, however, if the widening interest rate and growth differentials with major advanced economies lead to a surge in capital inflows. Staff supports the central bank's intention to rely on exchange rate flexibility as the first line on defense to mitigate the risk of excessive inflows, and notes that the central bank has intervened in the foreign exchange market only on three occasions since 2000 under exceptional conditions. It also supports the central bank's willingness to consider macroprudential measures to help prevent excessive growth in credit.

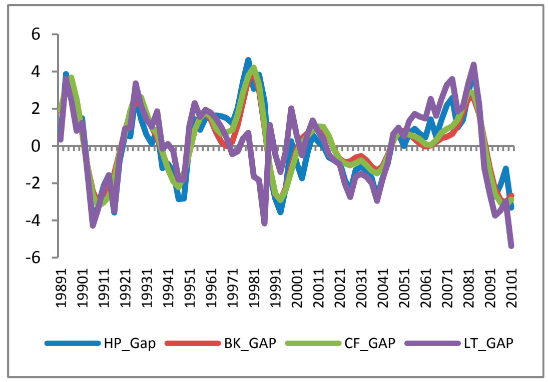
27. **The financial system has weathered the crisis well, but a further strengthening of the prudential framework would be beneficial**. The planned introduction of consolidated supervision of financial conglomerates will allow a more comprehensive assessment of risks. In addition, it would be important to adopt a functional approach to regulation and supervision, which would facilitate a broadening of the perimeter of supervision to include nonbank credit providers. Other important reforms that could enhance systemic risk surveillance include formalizing cooperation arrangements among the supervisory agencies, strengthening cross-border coordination with international counterparts, and addressing information gaps to help identify potential vulnerabilities. The cooperation arrangements should also include the consumer protection agency, once it becomes operational.

28. **Staff supports the authorities' focus on fostering faster productivity growth.** Government initiatives to reduce the cost of doing business by increasing competition, facilitating the entry of new firms, making credit more accessible to small and medium-enterprises, and reforming the corporate bankruptcy procedure are welcome. Increasing labor market efficiency should be another key objective. Replacing the current high severance payment system with a more comprehensive unemployment insurance scheme, for example, would increase labor mobility and encourage greater investment in education and on-the-job training.

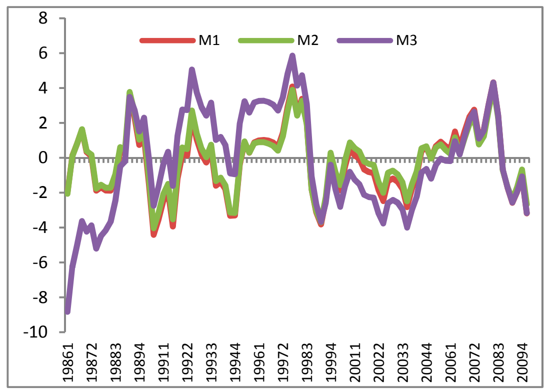
29. **Staff proposes that the next Article IV consultation be held on the standard 12-month cycle.**

Box 1. Measuring Chile's Output Gap 1/

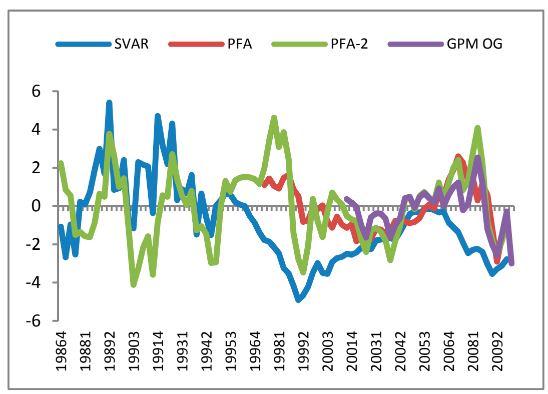
Staff estimates suggest that Chile's output gap was about 2–3 percent as of end-2009. The results, obtained using several different estimation methods, suggest that the ongoing recovery should close the output gap by mid-2011.



Using linear filters, the output gap is estimated about 2–3 percent in Q1-2010. The top chart shows the results from a piece-wise linear trend, the Hodrick-Prescott filter (HP), the Baxter and King band-pass filter (BK), and the Christiano-Fitzgerald (CF) method. The results are similar to those obtained using a linear trend model (LT).



Kalman filter estimates give a similar range. The three lines in the second chart correspond to estimates from a backward-looking Phillips curve (M1), with inflation deviations positively linked to the output gap, a backward-looking IS curve model (M2), and an Okun's law approach (M3) relating the output gap and deviations of the unemployment rate from NAIRU.



The results are similar when using econometric methods. Applying the production function approach, a structural vector-auto-regression procedure (SVAR), and IMF's Global projection model give a similar range of estimates of the output gap (third chart). Two production function aproaches (PFA-1 and PFA-2) yield similar results.

1/ See Selected Issues Paper "Revisiting the Estimation of the Chilean Output Gap," by N. Magud and L. Medina.

Box 2. Too-Connected-to-Fail (TCTF) Risk in the Chilean Banking System 2/

Proper systemic surveillance requires the assessment of too-connected-to-fail risk in the banking system. Any banking system is vulnerable to negative spillovers from the failure of individual institutions. The spillovers could be transmitted through direct exposures (such as losses incurred from claims on the defaulted institution or the sudden withdrawal of funding from a creditor), indirect exposures (such as mark-to-market losses due to declining asset prices from asset fire sales prompted by the default), or a combination of both.

Balance sheet network analysis suggests that, within Chile's banking system, TCTF risk from direct exposures is small. Balance sheet data from the banking supervisory agency (SBIF) suggests that interbank exposure, relative to banks' capital, is relatively small. This suggests that Chilean banks are relatively insulated from credit shocks (losses on claims on a defaulted bank) and funding shocks (sudden withdrawal of funds by a creditor). In the worst case, some banks would experience an average loss of 6-10 percent of their capital.

The main source of TCTF risk in Chile is associated with funding from domestic non-bank financial institutions and foreign banks. A sudden withdrawal of funding from foreign banks could induce an average capital loss of 17 percent, and up to 22 percent if combined with a credit shock. If domestic non-bank financial institutions were to withdraw their funding, the average capital loss would exceed 40 percent of the capital of the banking system. The likelihood of such event, however, is very small.

2/ See selected issues paper by J. Chan-Lau for details.

Box 3. Bicentennial Capital Markets Reform (MKB)

The new financial markets reform initiative, announced on May 5, 2010, rests on the following seven pillars:

Updating the institutional framework, including implementing consolidated supervision of financial conglomerates; strengthening of the corporate governance of the securities and insurance supervisory agency; increasing the autonomy of the banking supervisory agency, and updating the bankruptcy law for non-financial corporations.

Reducing credit procyclicality and upgrading the solvency and liquidity requirements for financial institutions.

Enhancing information and transparency in the financial system through further integration of securities exchanges, improved price information in exchange markets, minimum professional certification requirements for financial sector employees, and the use of "Chinese walls" to prevent the misuse of inside information.

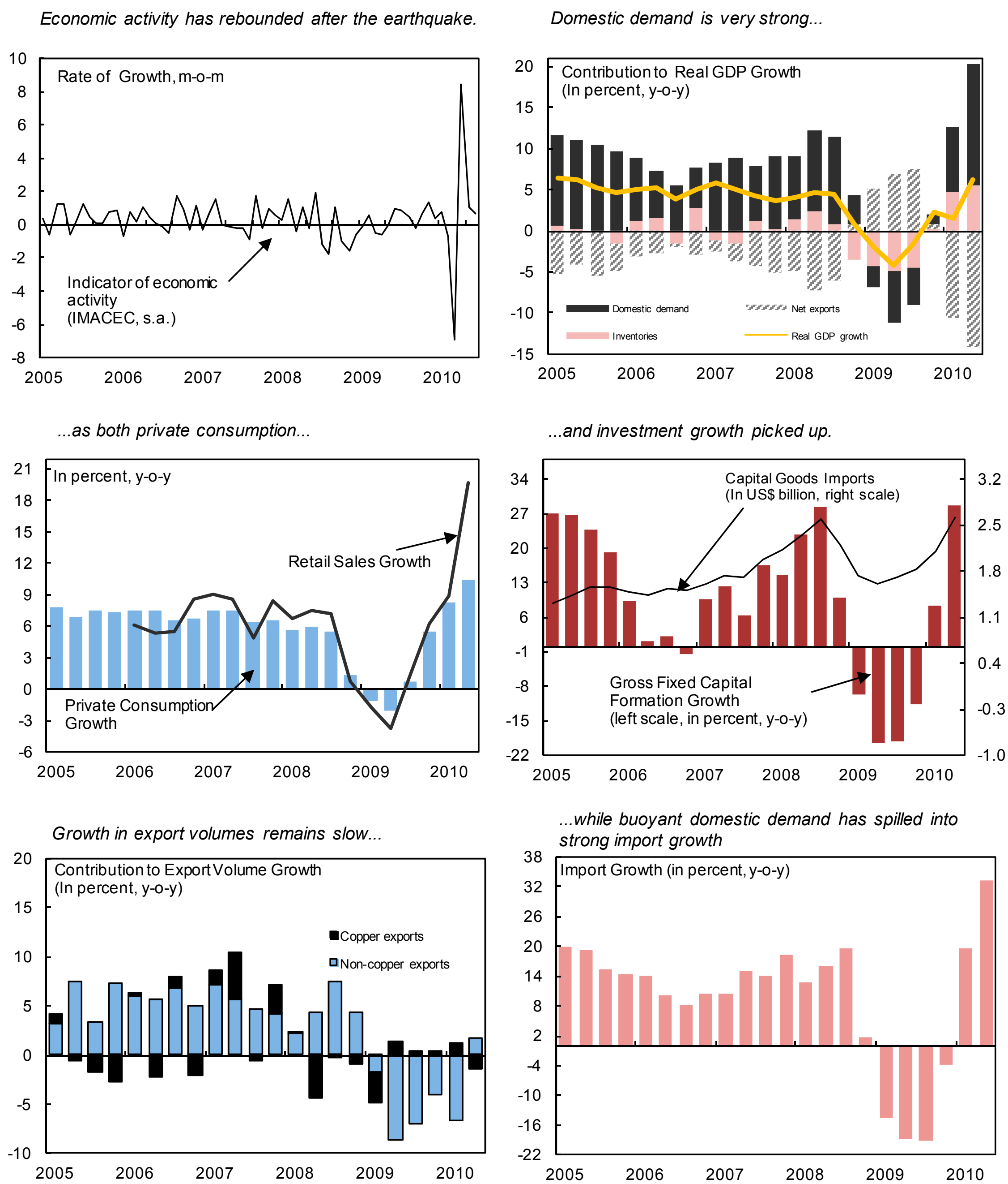
Reforming the taxation framework to simply the value added tax on investment funds and the tax treatment of fixed income instruments and derivatives products.

Creating a financial consumer protection agency.

Improving market access for middle class households and small and medium enterprises through increased banking services to households, reduction of initial public offering costs, and further incentives for venture capital.

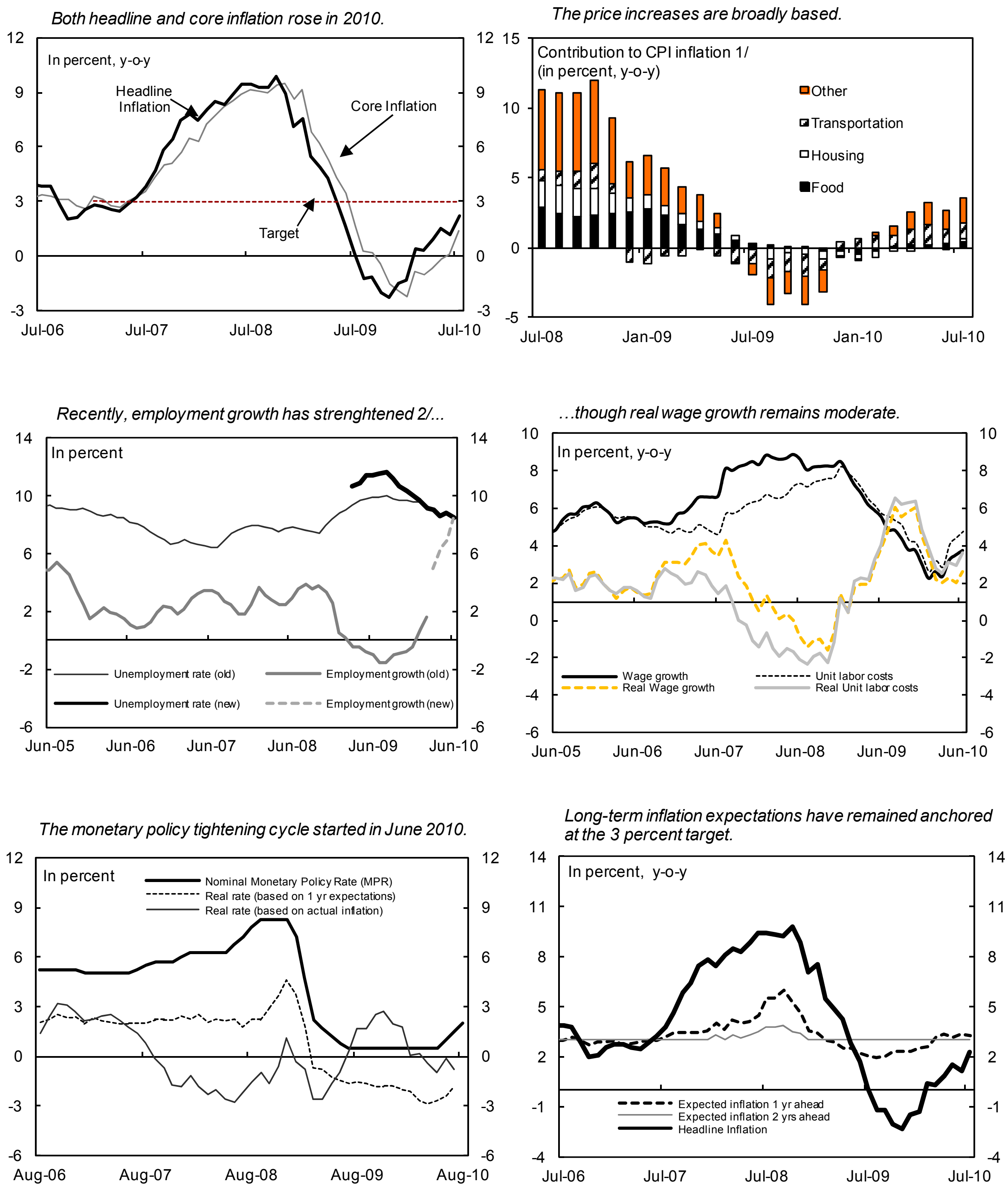
Developing new markets and financial products to reduce financing costs, including the development of a high yield bond market, better access to foreign exchange hedging by small firms, and the provision of a sound legal framework governing microfinance institutions.

Figure 1. Domestic Demand and Net Exports
(January 2005 – June 2010)



Sources: Haver Analytics Inc, Chilean Authorities and Fund Staff estimates.

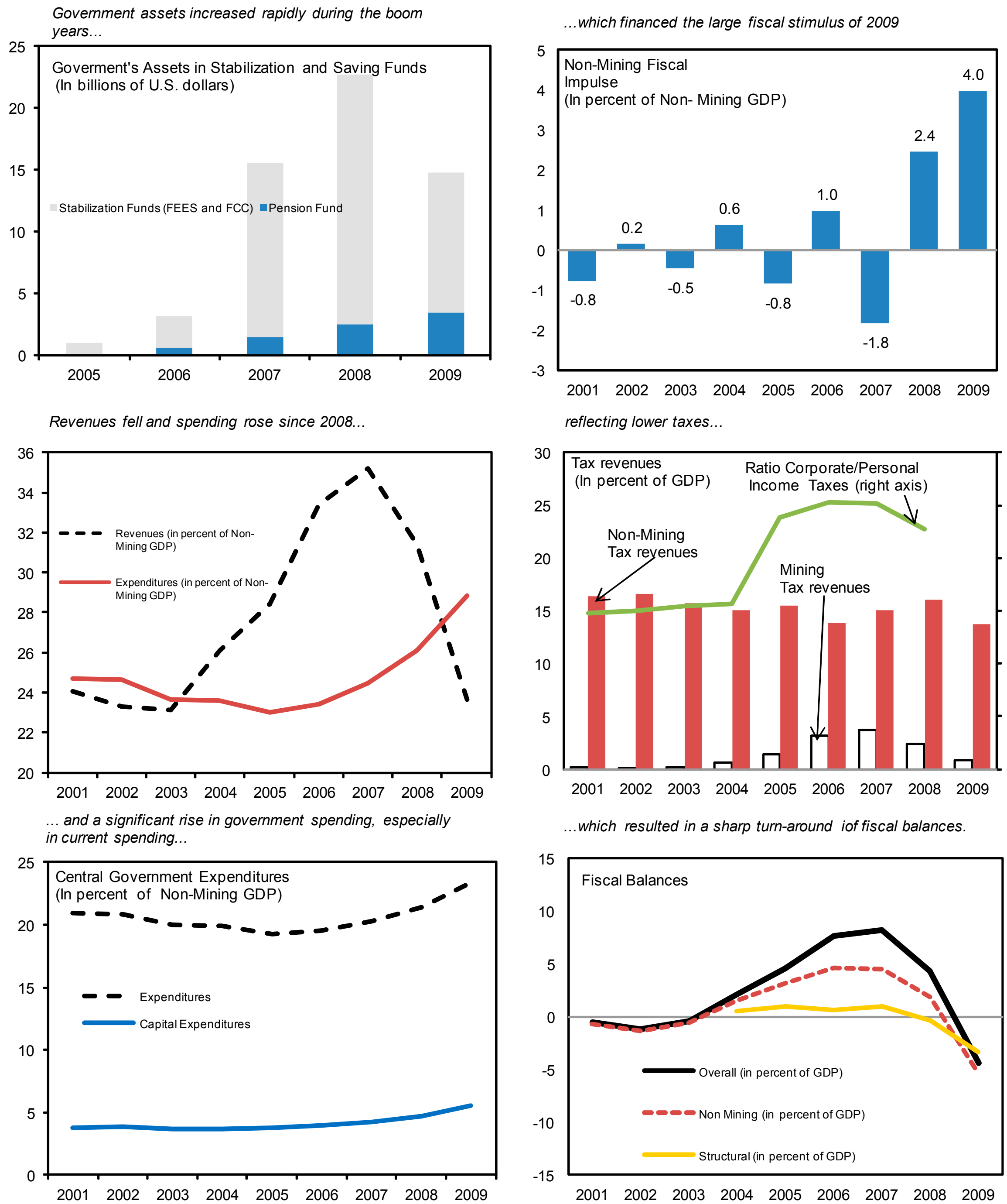
Figure 2. Inflation, Labor Markets and Monetary Policy
(Through June-July 2010)



Sources: Central Bank of Chile and Haver Analytics Inc.

1/ CPI weights and basket changed in December 2008.
2/ The methodology for compiling labor market statistics changed in March 2010.

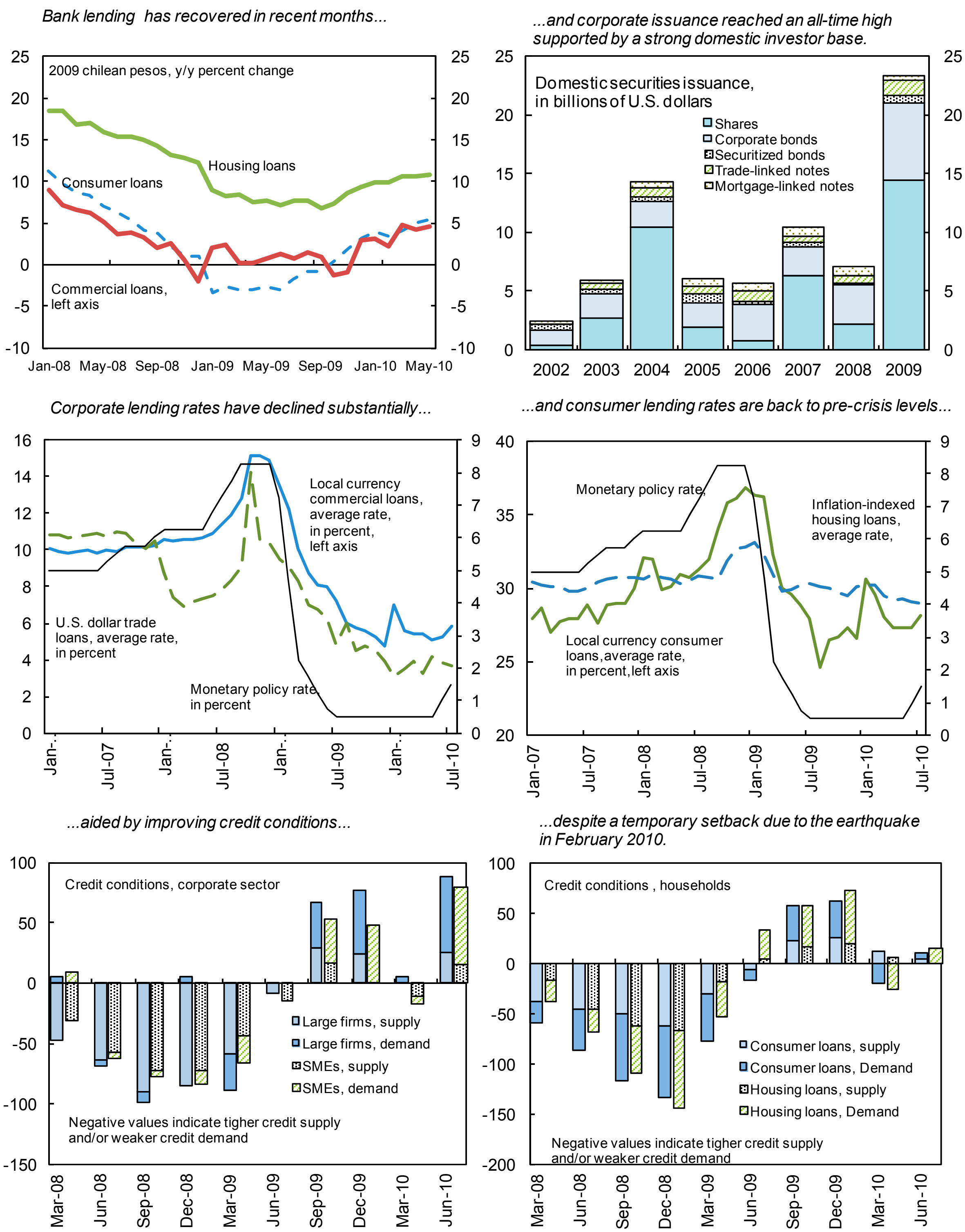
Figure 3. Fiscal Policy
(2001–09)



Sources: Ministry of Finance and Fund staff calculations.

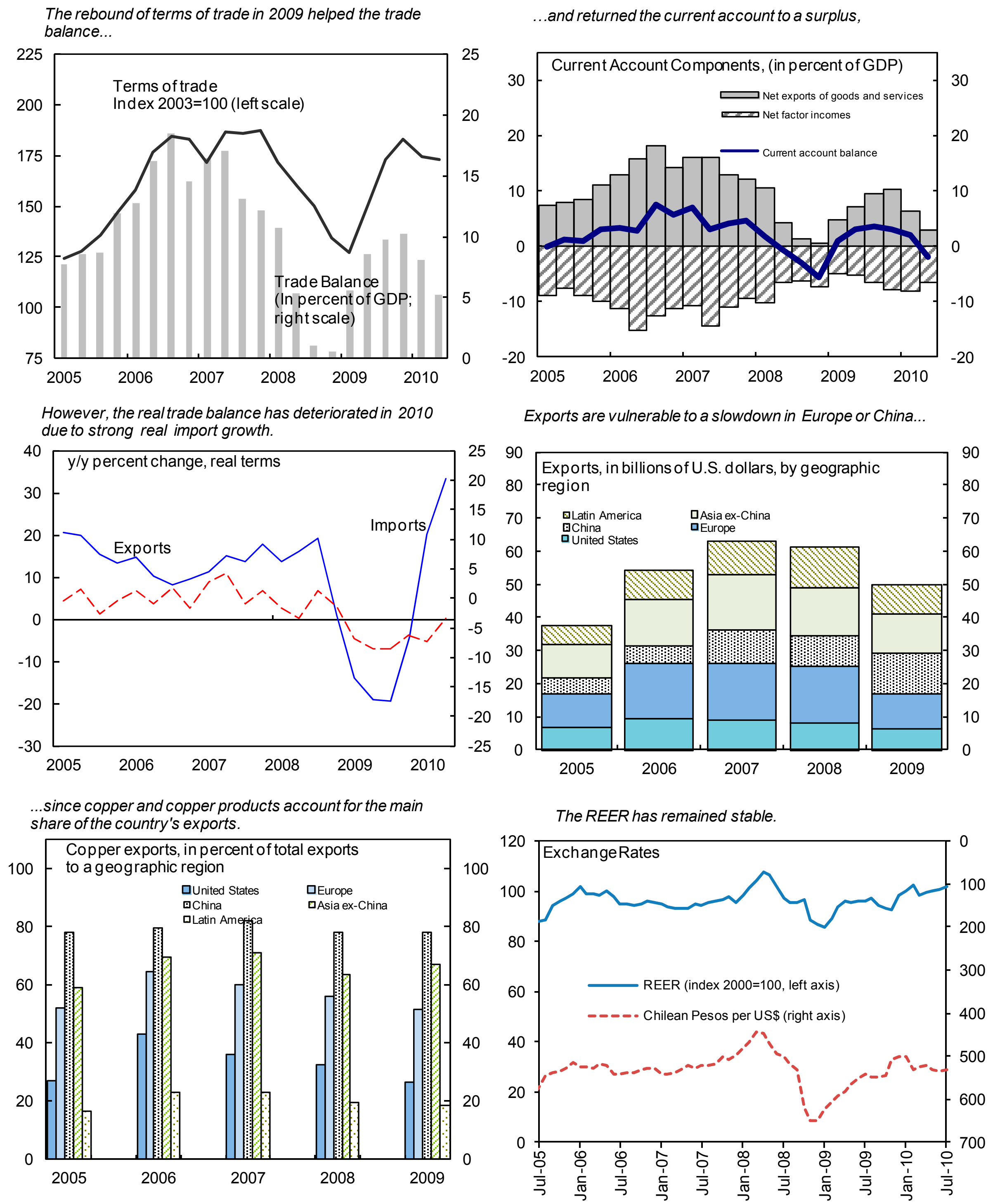
Figure 4. Financial Markets

(January 2007 – May 2010)



Source: Central Bank of Chile, SVS, and staff calculations.

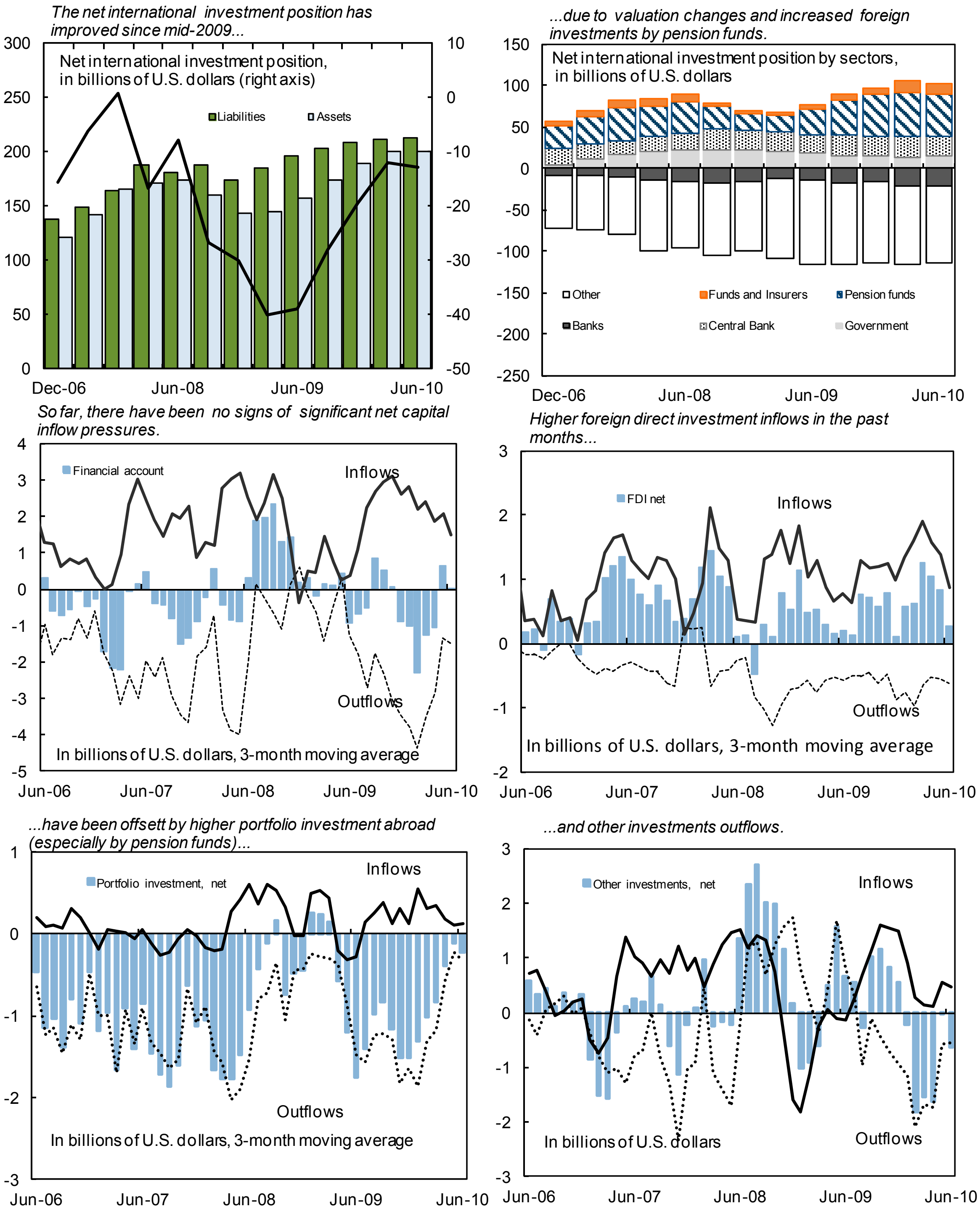
Figure 5. External Current Account
(2005Q1 – 2010Q1)



Sources: Central Bank of Chile and Fund staff calculations.

Figure 6. Net IIP and Capital Flows

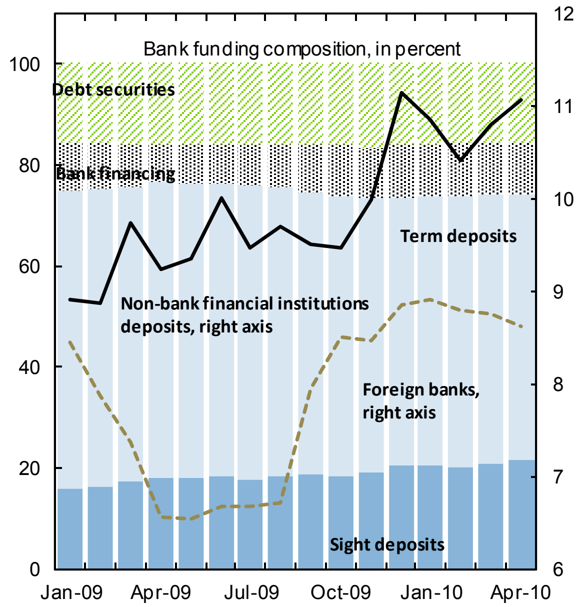
(2006Q2–2010Q2)



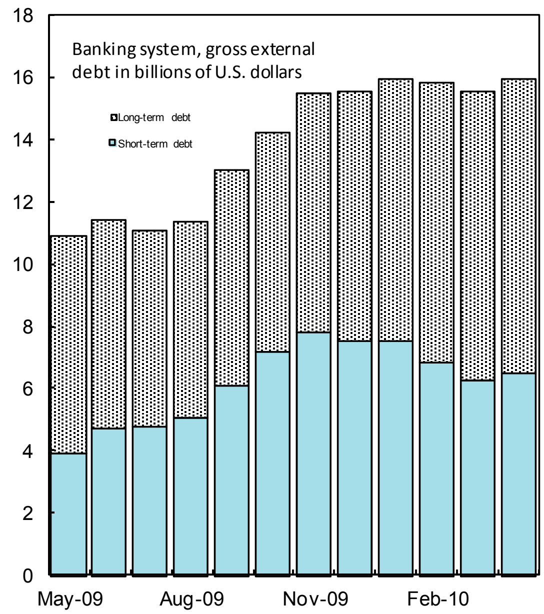
Sources: Central Bank of Chile and Fund staff calculations.

Figure 7. Banking System Developments
(January 2009 – April 2010)

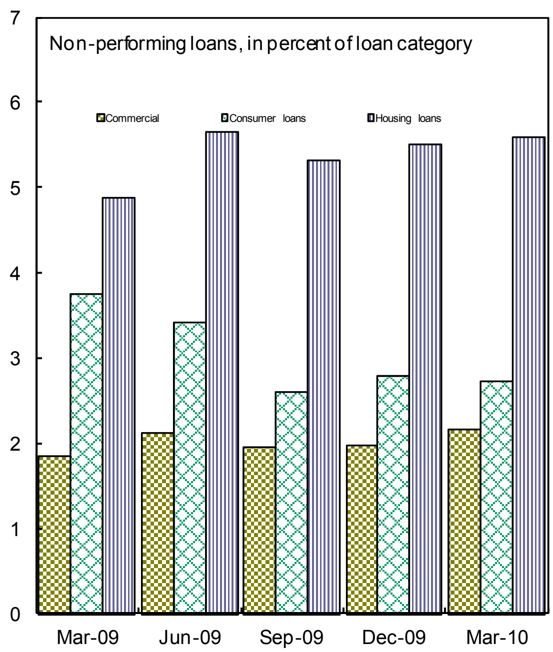
Foreign bank financing has resumed and wholesale domestic funding has risen.



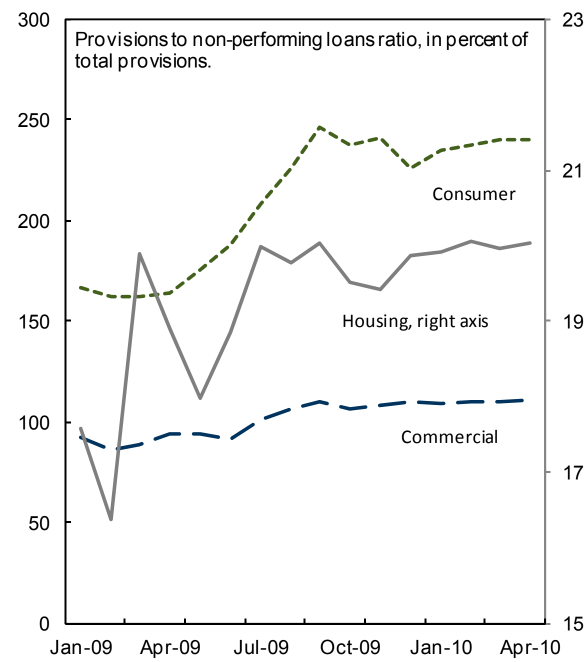
Banks' external debt has increased.



Non-performing loans from corporates remain low...

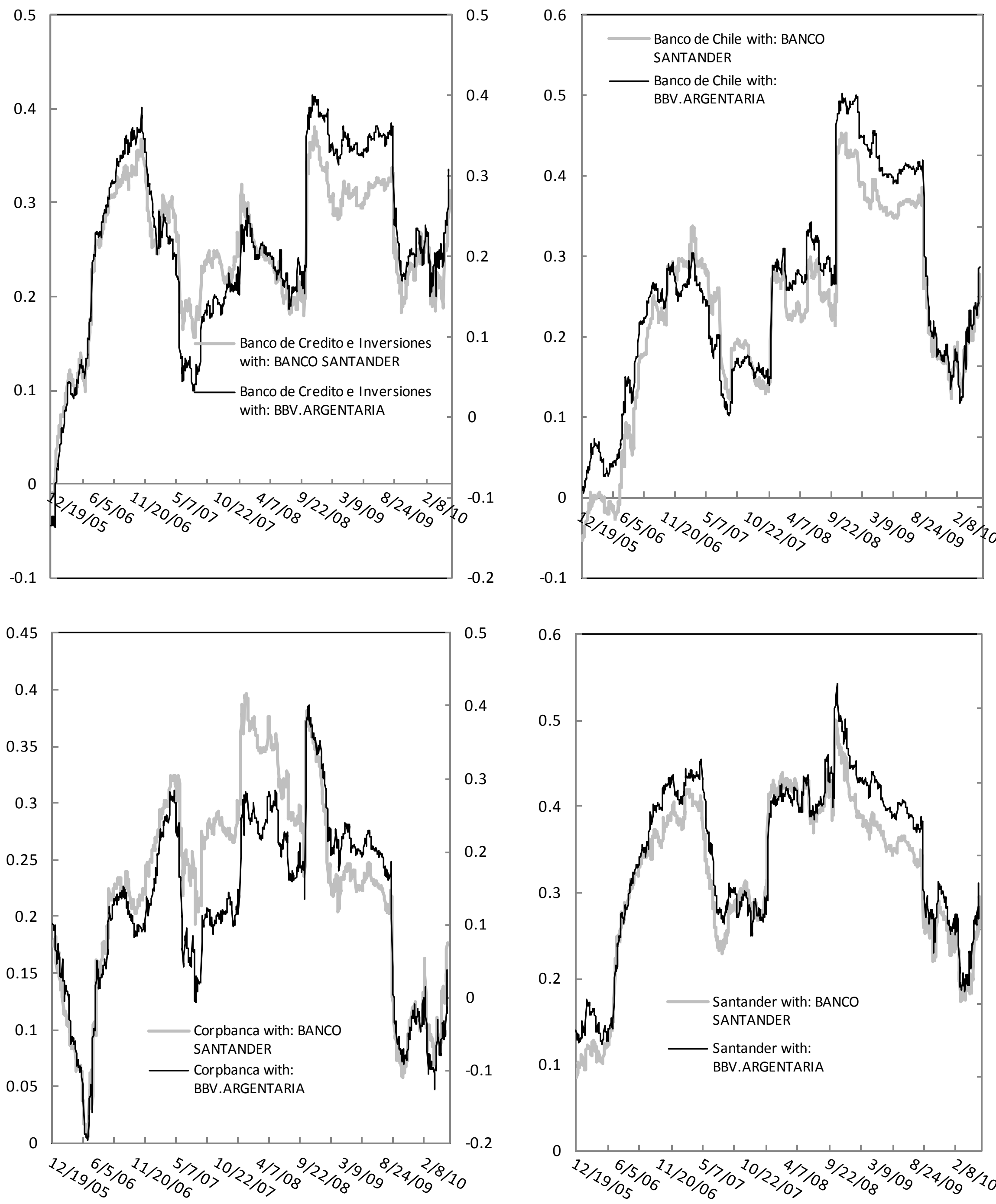


...while banks' provision ratios have improved.



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

Figure 8. Equity Return Pairwise Correlation, Spanish and Chilean Banks
(2005–2010)



Sources: Primark Datastream LLC and Fund staff calculations.

Table 1. Chile: Selected Social and Economic Indicators

I. Social and Demographic Indicators

GDP (2009)	91,518	**Poverty rate (2009)**	15.1
U.S. dollars (billions)	164.3	Indigent	3.7
Per capita (U.S. dollars)	9,809	Poor, not indigent	11.4
Population characteristics (2008)		**Income distribution (2009)**	
Total (in millions)	16.7	Richest 10% of households	40.2
Urban population (percent of total)	87.9	Poorest 20% of households	3.6
Life expectancy at birth (years)	78.3	Gini coefficient	0.55

II. Economic Indicators

					Est.	Staff Projections	
	2005	2006	2007	2008	2009	2010	2011
	(Annual percentage change, unless otherwise specified)						
National accounts and employment							
Real GDP	5.5	4.6	4.6	3.7	-1.5	5.0	6.0
Total domestic demand	10.3	6.8	7.5	7.6	-5.9	13.4	6.9
Consumption	7.1	7.0	7.0	4.0	1.7	6.4	4.7
Private	7.3	7.1	7.0	4.6	0.8	7.4	6.4
Public	5.8	6.4	7.2	0.5	6.8	1.2	-5.2
Investment	21.4	6.3	9.2	18.7	-25.9	38.9	13.0
Private	25.3	1.4	9.5	20.7	-21.2	18.6	13.0
Public	10.8	12.0	24.7	4.0	35.5	4.3	33.8
Fixed	23.6	2.5	11.2	18.7	-15.2	16.1	16.2
Inventories 1/	-0.3	1.0	-0.3	0.2	-3.4	4.8	-0.6
Net exports 1/	-4.4	-2.3	-3.2	-4.4	5.0	-9.1	-1.8
Exports	4.3	5.1	7.5	3.2	-5.6	6.3	6.4
Imports	16.9	10.6	14.5	12.3	-14.3	26.3	8.2
Consumer prices							
End of period	3.7	2.6	7.8	7.1	-1.4	3.7	3.0
Average	3.1	3.4	4.4	8.7	1.7	1.7	3.0
Unemployment rate (annual average)	9.3	8.0	7.0	7.7	9.6	...	...
Money and credit							
Broad money	11.9	11.4	14.7	19.1	2.3	...	...
Credit to the private sector (end of period)	19.9	17.7	20.8	12.6	-3.8	...	...
External Debt and Balance of Payments	(In percent of GDP, unless otherwise specified)						
Current account	1.2	4.9	4.5	-1.5	2.6	-0.7	-2.0
Trade Balance (in billions of U.S. dollars)	10.8	22.8	23.9	8.8	14.0	14.5	18.6
Exports of goods (in billions of U.S. dollars)	41.3	58.7	68.0	66.5	53.7	68.6	78.5
Imports of goods (in billions of U.S. dollars)	30.5	35.9	44.0	57.6	39.8	54.0	59.8
Gross external debt	38.0	32.4	33.9	37.6	45.8	38.6	35.1
Public	8.1	7.3	7.8	7.2	8.5	8.2	7.2
Private	29.9	25.1	26.2	30.5	37.3	30.4	27.8
Gross International Reserves (in billions of U.S. dollars)	17.0	19.4	16.9	23.2	25.4	25.4	25.4
	(Annual percentage change)						
Terms of Trade	10.8	31.1	4.3	-15.9	2.9	12.6	4.6
Real Effective Exchange Rate	11.9	-5.3	8.2	-12.0	17.1	...	...
Savings and investment	(In percent of GDP)						
Gross domestic investment	22.1	20.0	20.4	25.0	19.1	23.2	24.3
Public	2.1	2.0	2.4	2.6	2.9	3.2	4.0
Private	20.1	18.0	18.1	22.4	16.1	20.0	20.3
National saving	23.4	24.9	25.0	23.5	21.7	22.5	22.3
Public 2/	5.7	10.6	10.2	10.9	-0.9	2.4	6.1
Private	17.7	14.2	14.7	12.6	22.6	20.1	16.2
Public sector finance							
Net Debt	11.8	-1.5	-11.4	-17.5	-11.2	-9.9	-9.7
Excluding public enterprises	2.5	-6.1	-13.5	-23.7	-17.4	-15.6	-15.1
Public sector gross debt 3/	34.9	25.7	28.8	27.3	27.7	26.2	24.5
Central government gross debt	7.3	5.3	4.1	5.2	6.2	7.6	6.9
Central government balance	4.6	7.7	8.2	4.3	-4.4	-1.7	-0.6

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

1/ Contribution to growth.
2/ Gross saving of the general government sector, including the deficit of the central bank.
3/ Gross consolidated debt of the public sector (central bank, non-financial public enterprises, and general government).

Table 2. Chile: Summary Operations of the Central Government

(In percent of GDP)

	2005	2006	2007	2008	Est. 2009	Staff Projections 1/ 2010	2011
Overall balance	4.6	7.7	8.2	4.3	-4.4	-1.7	-0.6
Non-Mining Balance	-0.6	-1.1	-0.4	-1.7	-7.0	-6.1	-4.9
Total revenue	23.8	25.8	26.9	25.5	20.1	21.9	22.5
Taxes	16.9	17.0	18.8	18.5	14.6	16.3	16.8
Nonmining	15.5	13.9	15.1	16.0	13.7	14.6	15.2
Mining-related	1.4	3.1	3.8	2.4	0.9	1.7	1.6
Codelco revenues	3.7	5.7	4.8	3.6	1.7	2.8	2.7
Income on assets	0.3	0.5	0.8	0.9	0.7	0.4	0.4
Social contributions	1.4	1.3	1.3	1.4	1.5	1.4	1.4
Grants	0.2	0.2	0.2	0.2	0.1	0.4	0.3
Other	1.3	1.1	1.0	1.0	1.4	0.6	0.9
Total expenditure	19.3	18.1	18.7	21.2	24.5	23.5	23.1
Consumption	5.6	5.3	5.6	5.9	6.8	5.9	5.3
Social benefits	4.6	4.3	4.2	4.6	5.0	4.3	4.9
Subsidies and grants	5.0	4.7	5.1	6.4	7.4	7.8	6.7
Interest payments	0.8	0.7	0.6	0.5	0.5	0.4	0.3
Gross investment	1.8	1.8	2.1	2.3	2.7	2.9	3.7
Defense	1.3	1.2	1.2	...	...	...	...
Non-defense	0.5	0.6	0.9	...	...	...	...
Net capital transfers	1.3	1.3	1.2	1.6	2.0	2.3	2.2
Net Assets	0.1	7.0	13.7	20.3	15.9	14.3	13.7
Gross Debt	7.3	5.3	4.1	5.2	6.2	7.6	6.9
Peso-denominated Assets	5.8	5.1	5.5	6.0	6.4	5.5	5.1
Foreign currency-denominated Assets	1.5	7.1	12.3	19.5	11.4	9.9	9.3
Memorandum Items:							
Structural Balance	0.9	0.7	1.0	-0.4	-3.3	-4.1	-3.0
Real Expenditure Growth	6.6	6.9	8.7	7.7	17.7	8.7	5.0
Nonmining Structural Balance 2/	-0.8	-1.8	0.1	-2.4	-6.3	-8.1	-6.2
Nonmining Structural Primary Balance 2/	-0.2	-1.5	-0.1	-2.8	-6.6	-8.2	-6.3
Fiscal Impulse	-0.8	1.3	-1.3	2.7	3.8	1.6	-1.8
Net Assets of the Public Sector	-11.8	1.5	11.4	17.5	11.2	9.9	9.7
Excluding public enterprises 3/	-2.5	6.1	13.5	23.7	17.4	15.6	15.1
Nominal GDP (trillions of pesos)	66.2	77.8	85.8	89.3	91.5	105.3	115.8
Output Gap	0.5	1.5	1.1	1.4	-3.3	-1.8	0.0

Sources: Ministry of Finance (DIPRES) and staff estimates.

1/ Based on the 2009 Budget, mid-2010 budget revision, staff estimates.

2/ As a share of non-mining GDP.

3/ General government and Central Bank only.

Table 3. Chile: Summary Operations of the Public Sector 1/

	2005	2006	2007	2008	Est. 2009	Staff Projections 2010	2011
Central government							
Balance	4.6	7.7	8.2	4.3	-4.4	-1.7	-0.6
Total revenue	23.8	25.8	26.9	25.5	20.1	21.9	22.5
Of which: Intragovernmental receipts	1.0	0.9	0.9	0.9	0.9	0.9	0.9
Total expenditures 2/	19.3	18.1	18.7	21.2	24.5	23.5	23.1
Of which: Intragovernmental transfers	0.9	0.8	0.8	0.8	0.8	0.8	0.8
Current	16.1	15.1	15.5	17.4	19.8	18.6	17.5
Capital	3.1	3.0	3.2	3.8	4.7	4.9	5.7
Net Assets	0.1	7.0	13.7	20.3	15.9	14.3	13.7
Municipalities 3/							
Balance	0.1	0.1	0.1	0.0	0.1	0.0	0.0
Total revenue	2.9	2.6	2.7	2.9	2.7	3.0	3.0
Of which: Intragovernmental receipts	0.9	0.8	0.8	0.8	0.8	0.8	0.8
Total expenditures	2.8	2.5	2.6	2.8	2.6	3.0	2.9
Of which: Intragovernmental transfers	1.0	0.9	0.9	0.9	0.9	0.9	0.9
Current	2.5	2.2	2.2	2.5	2.3	2.7	2.6
Capital	0.3	0.3	0.3	0.3	0.2	0.3	0.3
Central bank							
Balance	-2.1	-0.2	-0.5	2.9	-0.2	-0.2	-0.2
Net Operating Balance 2/	-1.8	-0.1	-0.5	2.6	-0.3	-0.2	-0.2
Net Administrative Expenses	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1
Net Assets	-2.6	-0.9	-0.2	3.5	1.6	1.3	1.4
State-owned non-financial enterprises							
Balance	2.2	3.5	1.9	0.6	0.9	1.1	0.9
Total revenue	15.0	18.8	16.8	21.3	12.4	11.2	10.9
Of which: Intragovernmental receipts	0.1	0.2	0.2	0.3	0.8	0.1	0.1
Total expenditures	12.7	15.3	14.9	20.7	11.5	10.2	10.0
Current	10.7	13.1	12.1	18.3	9.6	8.7	8.5
Capital 4/	2.0	2.2	2.8	2.4	1.9	1.5	1.4
Net Assets	-5.3	-4.5	-3.6	-6.3	-6.0	-5.7	-5.4
Consolidated Public Sector							
Balance	4.8	11.2	9.8	7.8	-3.6	-0.7	0.1
Net Assets	-7.8	1.6	9.9	17.4	11.4	9.9	9.7

Sources: Ministry of Finance (DIPRES), Central Bank of Chile, and staff estimates.

1/ This table reflects the authorities' revisions to historical official data to bring the fiscal accounts in line with GFSM 2001. For further details see: http://www.dipres.cl/572/articles-63318_doc_pdf.pdf.

2/ Includes the effects of valuation changes (inflation) to the stock of UF debt and accrued interest on Treasury debt; excludes administrative expenses and provisions.

3/ On a cash basis. Municipalities hold neither sizeable financial assets nor debt.

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

Table 4. Chile: Balance of Payments

				Projections					
	2007	2008	2009	2010	2011	2012	2013	2014	2015
				(In percent of GDP)					
Current account	4.5	-1.5	2.6	-0.7	-2.0	-2.1	-2.3	-2.3	-2.3
Trade balance	14.6	5.2	8.7	7.3	8.4	7.8	6.3	5.0	3.7
Exports	41.4	38.9	33.2	34.4	35.2	36.1	35.0	33.4	31.7
Copper	23.0	19.3	17.0	18.5	18.7	18.1	16.1	14.2	12.1
Non-copper	18.4	19.6	16.3	15.9	16.5	18.1	18.9	19.3	19.6
Imports	-26.8	-33.7	-24.6	-27.1	-26.9	-28.3	-28.7	-28.4	-28.0
Net services	-0.6	-0.5	-0.7	-1.2	-1.7	-1.5	-1.3	-1.1	-0.9
Net income	-11.3	-7.9	-6.4	-8.9	-10.3	-10.1	-8.9	-7.7	-6.5
Net transfers	1.9	1.7	1.0	2.1	1.7	1.7	1.6	1.5	1.4
Finacial Account Balance	-6.2	4.3	-1.5	-1.4	2.0	2.1	2.3	2.3	2.3
Foreign direct investment (net)	6.1	4.2	2.9	4.0	6.0	4.9	5.0	4.5	3.7
Abroad	-1.6	-4.7	-4.9	-3.8	-2.4	-2.0	-1.8	-1.6	-1.4
In Chile	7.6	8.9	7.7	7.8	8.4	6.9	6.8	6.1	5.1
Portfolio investment (net)	-10.0	-5.2	-7.2	-8.5	-6.1	-4.8	-3.8	-3.9	-3.2
Abroad	-9.7	-6.8	-8.5	-10.2	-8.6	-7.9	-6.7	-6.1	-5.4
In Chile	-0.3	1.6	1.2	1.7	2.5	3.1	2.9	2.1	2.3
Financial Derivatives	0.3	-0.6	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Other Investments	-2.6	5.8	3.0	3.2	2.2	2.1	1.2	1.7	1.8
Abroad	-6.8	2.1	-1.1	-0.8	-2.1	-2.0	-2.2	-2.0	-1.9
In Chile	4.2	3.7	4.1	4.1	4.3	4.0	3.5	3.7	3.7
Change in Reserves Assets	2.0	-3.8	-1.0	0.0	0.0	0.0	0.0	0.0	0.0
Errors and Omissions	-0.3	1.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Change in official reserves ($ billion)	-2.5	6.3	2.2	0.0	0.0	0.0	0.0	0.0	0.0
Central bank operations with commercial bank:	0.0	6.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other 1/	-2.5	0.0	2.2	0.0	0.0	0.0	0.0	0.0	0.0
Gross official international reserves	2.9	5.6	4.6	4.1	3.5	3.3	3.1	3.0	3.0
(In months of imports of goods and services)									
				(Annual change in percent)					
Total export volume	7.1	-0.8	-4.8	6.1	6.5	4.6	4.4	3.5	3.3
Copper export volume	7.5	-2.2	-1.5	5.5	8.4	5.0	4.6	3.6	3.0
Agricultural exports volume	3.3	10.6	3.8	3.7	12.9	5.0	5.0	3.8	3.0
Industrial exports volume	6.2	2.2	-10.0	5.5	4.6	5.0	5.0	4.0	4.0
Total import volume	16.0	10.9	-15.4	24.2	8.2	7.3	5.5	4.1	3.9
Terms of trade	4.3	-15.9	2.9	12.6	4.6	-2.4	-4.1	-4.2	-3.6
Total export prices	9.1	-3.7	-14.5	21.0	7.3	7.5	-1.3	-2.0	-2.3
Copper export prices	7.2	-11.0	-34.4	34.3	3.8	0.9	-9.1	-10.0	-11.4
Total import price	4.5	14.1	-16.5	7.4	2.7	9.9	2.9	2.3	1.4
				(In percent of GDP)					
Total external debt (end of period)	33.9	37.6	45.8	38.6	35.1	32.6	30.9	29.1	27.4
Memorandum items:									
Copper price (LME; U.S. cents per pound) 2/	324	316	234	315	327	330	299	270	234
Volume of copper exports (2004=100)	101	99	97	102	111	117	122	126	130

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

1/ "Other" variations in reserves largely reflect changes in deposits by commercial banks and the government with the central bank, as well as the repayment of foreign currency bonds, completed in 2006.

2/ Updated staff forecasts, average.

Table 5. Chile: Medium-Term Framework

	2008	2009	2010	2011	2012	2013	2014	2015
	(Annual percentage change, unless otherwise specified)							
National accounts and employment								
Real GDP 1/	3.7	-1.5	5.0	6.0	4.6	4.5	4.5	4.5
Total domestic demand	7.6	-5.9	13.4	6.9	5.9	5.0	4.7	4.6
Consumption	4.0	1.7	6.4	4.7	5.2	5.3	4.4	4.2
Investment	18.7	-25.9	38.9	13.0	7.4	4.3	5.2	5.6
Net exports 2/	-4.4	5.0	-9.1	-1.8	-2.1	-1.3	-0.9	-0.9
Consumer prices								
End of period	7.1	-1.4	3.7	3.0	3.0	3.0	3.0	3.0
Average	8.7	1.7	1.7	3.0	3.0	3.0	3.0	3.0
	(In percent of GDP)							
Balance of Payments								
Current account	-1.5	2.6	-0.7	-2.0	-2.1	-2.3	-2.3	-2.3
Trade Balance	5.2	8.7	7.3	8.4	7.8	6.3	5.0	3.7
Exports of goods	38.9	33.2	34.4	35.2	36.1	35.0	33.4	31.7
Imports of goods	33.7	24.6	27.1	26.9	28.3	28.7	28.4	28.0
Financial Account Balance	4.3	-1.5	-1.4	2.0	2.1	2.3	2.3	2.3
Foreign direct investment (net)	4.2	2.9	4.0	6.0	4.9	5.0	4.5	3.7
Portfolio investment (net)	-5.2	-7.2	-8.5	-6.1	-4.8	-3.8	-3.9	-3.2
Financial Derivatives	-0.6	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Other Investments	5.8	3.0	3.2	2.2	2.1	1.2	1.8	1.8
Change in Reserves Assets	-3.8	-1.0	0.0	0.0	0.0	0.0	0.0	0.0
Errors and Omissions	1.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
	(Annual percentage change)							
Total export volume	-0.8	-4.8	6.1	6.5	4.6	4.4	3.5	3.3
Copper export volume	-2.2	-1.5	5.5	8.4	5.0	4.6	3.6	3.0
Agricultural exports volume	10.6	3.8	3.7	12.9	5.0	5.0	3.8	3.0
Industrial exports volume	2.2	-10.0	5.5	4.6	5.0	5.0	4.0	4.0
Total import volume	10.9	-15.4	24.2	8.2	7.3	5.5	4.1	3.9
Terms of Trade	-15.9	2.9	12.6	4.6	-2.4	-4.1	-4.2	-3.6
Total export prices	-3.7	-14.5	21.0	7.3	7.5	-1.3	-2.0	-2.3
Copper export prices	-11.0	-34.4	34.3	3.8	0.9	-9.1	-10.0	-11.4
Total import price	14.1	-16.5	7.4	2.7	9.9	2.9	2.3	1.4
External Debt	(In percent of GDP)							
Gross external debt	37.6	45.8	38.6	35.1	32.6	30.9	29.1	27.4
Public	7.2	8.5	8.2	7.2	6.6	6.2	5.8	5.5
Private	30.5	37.3	30.4	27.8	26.1	24.7	23.2	21.9
Gross int. reserves (in billions of U.S. dollars)	23.2	25.4	25.4	25.4	25.4	25.4	25.4	25.4
Savings and investment								
Gross domestic investment	25.0	19.1	23.2	24.3	24.9	24.8	25.1	25.6
Public	2.6	2.9	3.2	4.0	3.2	2.6	2.6	2.7
Private	22.4	16.1	20.0	20.3	21.7	22.1	22.5	22.9
National saving	23.5	21.7	22.5	22.3	22.8	22.5	22.8	23.3
Public 3/	10.9	-0.9	2.4	6.1	6.6	7.0	7.1	7.3
Private	12.6	22.6	20.1	16.2	16.2	15.5	15.7	16.0
Public sector finance								
Net Debt	-17.5	-11.2	-9.9	-9.7	-9.8	-9.7	-9.7	-9.3
Excluding public enterprises	-23.7	-17.4	-15.6	-15.1	-14.7	-14.5	-14.4	-14.0
Public sector gross debt 4/	27.3	27.7	27.2	25.4	24.0	22.6	21.3	20.2
Central government gross debt	5.2	6.2	7.6	6.9	6.4	6.0	5.6	5.3
Central government balance	4.3	-4.4	-1.7	-0.6	-0.5	-0.4	-0.2	-0.5
Total Revenue	25.5	20.1	21.9	22.5	22.1	22.2	22.3	22.4
Total Expenditure	21.2	24.5	23.5	23.1	22.6	22.6	22.5	22.9
Memorandum Items:								
Copper prices (LME; U.S. cents per pound) 5/	316	234	315	327	330	299	270	234
Volume of copper exports (2004=100)	98	96	102	110	116	121	125	129

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

1/ Medium term projections are consistent with potential growth of 4.5 percent for 2013-2015.
2/ Contribution to growth.
3/ Gross saving of the general government sector, including the deficit of the central bank.
4/ Gross consolidated debt of the public sector (central bank, non-financial public enterprises, and general government).
5/ IMF staff forecasts, average.

Table 6. Chile: Indicators of External Vulnerability

(In percent; unless otherwise indicated)

	2005	2006	2007	2008	2009
Financial indicators					
M3 (percent change)	11.9	11.4	14.7	19.1	-1.4
Less pension funds' deposits (annual percentage change)	10.8	27.9	14.7	19.1	1.0
Private Sector Credit to GDP	62.9	62.5	68.6	78.3	68.2
90-day central bank promissory note (nominal) interest rate (avg.)	3.5	4.8	5.2	7.2	1.7
Share of foreign currency deposits in total deposits	5.5	5.8	5.8	7.8	6.4
Share of foreign currency loans in total credit	10.0	10.3	10.2	13.9	10.3
External indicators					
Exports, U.S. dollars (annual percentage change)	26.9	42.2	15.8	-2.2	-19.2
Imports, U.S. dollars (annual percentage change)	33.0	17.7	22.6	30.9	-31.0
Terms of trade (annual percentage change)	10.8	31.1	4.3	-15.9	2.9
REER (annual percent change, period average)	5.7	5.2	-1.5	2.3	-2.2
Exchange rate (pesos per U.S. dollar, period average)	560	530	522	522	566
Current account Balance (percent of GDP)	1.2	4.9	4.5	-1.5	2.6
Financial account less reserves accumulation (percent of GDP)	0.2	-3.5	-6.5	5.2	-1.6
Gross official reserves (in billions of U.S. dollars) 1/	17.0	19.4	16.9	23.2	25.4
Gross official reserves, months of imports of goods and services	4.6	4.3	2.9	5.6	4.6
Gross official reserves to broad money	16.5	16.0	12.0	13.8	16.6
Gross official reserves to short-term external debt 2/	104.8	111.2	75.5	80.5	92.8
Total external debt (percent of GDP)	39.1	33.7	33.9	37.6	45.8
Of which: External public sector debt	8.3	7.8	7.8	7.2	8.5
Total external debt to exports of goods and services	95.5	74.4	72.4	83.3	119.0
External interest payments to exports of goods and services	2.9	2.3	2.0	1.9	2.6
External amortization payments to exports of goods and services	17.0	20.6	12.8	17.5	21.3
Financial market indicators					
Stock market index (in U.S. dollars; period average) 3/	1105	1278	1776	1630	2052
Sovereign long-term foreign-currency debt rating (end of period)					
Moody's	Baa1	A2	A2	A2	A1
S&P	A	A+	A+	A+	A+
Fitch Ratings	A	A	A	A	A

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

1/ Gold valued at end-period market prices.

2/ Includes amortization of medium/long-term debt due during the following year but not trade credits.

3/ Morgan-Stanley Capital International index (Dec/1987=100).

Table 7. Chile: External Debt and Debt Service

					Est.	Staff Projections	
	2005	2006	2007	2008	2009	2010	2011
	(In billions of U.S. dollars, end of period)						
Total debt outstanding 1/	**46.2**	**49.5**	**55.7**	**64.3**	**74.0**	**76.9**	**78.1**
Of which: External private debt	36.4	38.1	43.0	52.0	60.3	60.6	62.0
External public debt	9.8	11.4	12.8	12.3	13.8	16.3	16.1
Medium- and long-term debt	39.1	40.2	44.8	49.7	56.6	58.8	58.7
Public sector	9.0	10.1	10.3	9.4	11.3	13.9	13.7
Of which: Central government	4.1	4.2	3.6	2.9	2.6	5.1	4.9
Private sector	30.1	30.1	34.4	40.3	45.2	45.0	44.9
Financial sector	6.1	5.6	9.0	9.9	8.0	7.7	7.7
Non-financial sector	24.0	24.5	25.4	30.4	37.2	37.2	37.2
Short-term debt 1/	7.1	9.3	11.0	14.6	11.4	18.0	19.5
Residual maturity basis	16.2	17.5	22.4	28.8	27.3	23.7	25.6
Total medium- and long-term debt service	**8.2**	**13.7**	**9.8**	**14.2**	**11.5**	**10.6**	**7.5**
Amortization	6.8	12.1	8.2	12.8	9.9	9.1	6.0
Interest	1.4	1.5	1.6	1.4	1.6	1.5	1.5
	(In percent of GDP)						
Total external debt, end-period 1/	**39.1**	**33.7**	**33.9**	**37.6**	**45.8**	**38.6**	**35.1**
Of which: External private debt	30.8	25.9	26.2	30.5	37.3	30.4	27.8
External public debt	8.3	7.8	7.8	7.2	8.5	8.2	7.2
Gross change (in percent)	-6.4	-5.4	0.2	3.7	8.2	3.5	-3.5
Gross change of nominal stock (in percent)	3.3	7.1	17.1	15.4	15.1	3.8	1.6
Interest payments on external debt	1.2	1.1	1.0	0.8	1.0	0.8	0.7
	(In percent of exports of goods and services)						
Debt-service payments	17.0	20.6	12.8	18.4	18.5	13.6	8.5
Of which: Interest	2.9	2.3	2.0	1.9	2.6	2.0	1.7
Total external debt outstanding 1/	95.5	74.4	72.4	83.3	119.0	98.4	87.9
	(In billions of U.S. dollars)						
Memorandum items:							
Gross international reserves	17.0	19.4	16.9	23.2	25.4	25.4	25.4
GDP 2/	118.2	146.8	164.2	170.9	161.6	199.2	222.8

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

1/ Original maturity basis; end of period basis.
2/ At current prices and exchange rates.

Table 8. Social and Demographic Indicators

GDP (2009)		**Poverty rate (2009)**	**15.1**
Chilean pesos (billions)	91,518	Indigent	3.7
U.S. dollars (billions)	164	Poor, not indigent	11.4
Per capita (U.S. dollars)	9,809		
Population and Country Information (2008)		**Health**	
Total (in millions)	16.6	Population per physician (2003)	917
Urban population (in percent of total)	87.9	Population per hospital bed (2002)	385
Area (thousand sq. km.)	756.1		
Density (per sq. km)	21.9		
Annual rate of growth, 1997-2007	1.3		
Population characteristics (2005)		**Access to electricity (2003)**	
Life expectancy at birth (years)	78.2	Percent of population	98.9
Crude birth rate (per thousand)	15.3	Urban (2003)	99.7
Crude death rate (per thousand)	5.2	Rural (2003)	74.6
Infant mortality rate (per 1000 births)	8.4		
Mortality rate (ages 1-4, per 1000)	9.5		
Income distribution (2009)		**Access to safe water (2004)**	
Percent of total income received:		Percent of population	n.a.
By richest 10 percent of households	40.2	Urban	n.a.
By poorest 20 percent of households	3.6	Rural	n.a.
Gini coefficient	0.6		
Distribution of labor force, in percent of total (2008)		**Education**	
Agriculture and fishing	10.6	Adult literacy rate (2006)	n.a.
Mining	1.4	Gross enrollment rates, percent of the age group	
Industry	12.0	Primary education (2005)	104
Construction	8.1	Secondary education (2005)	91
Services, Public Utilities, and Trade	67.9	Tertiary education (2005)	48

Sources: Haver Analytics, INE, World Bank, Encuesta CASEN, and staff estimates.

ANNEX 1. CHILE'S FISCAL RULE FROM AN OECD PERSPECTIVE

Compared to practices in other OECD economies, Chile's fiscal rule presents several strengths, but also some shortcomings. The differences between Chile's fiscal rule, and the practices in the other 27 OECD economies that have a fiscal rule could be usefully grouped in the seven categories listed below:

	OECD Practices	Chile's Fiscal Rule
Clear statutory basis	In most OECD countries fiscal rules are supported by special legislation (e.g. national law, guidelines or supranational agreements) that usually includes stringent procedural rules on accountability, transparency and fiscal stability, as well as key budget principles.	Chile's Fiscal Responsibility Law (FRL) of 2006 does not provide much guidance on the design and practical implementation of the fiscal. The FRL only mandates (i) that the President of the Republic enacts, within the 90 days of entering office, a decree indicating how the fiscal policy planned for his/her administration will affect the structural balance; and (ii) that the Budget Directorate calculates the structural balance. The nature, rationale, and methodology for the calculation of the structural balance rule have been usually explained in policy papers issued by the Budget Directorate.
Clear targets	The legislation on fiscal rules in most OECD countries typically includes clear methodological principles and definitions for the fiscal covered by the rule; normally, these comprise targets on gross or net public debt, on several definitions of deficit (overall, structural balance, primary balance, non-oil primary balance), on tax ratios, and on the growth rate of government expenditure.	Chile's FRL defines the structural balance, as the difference between the central government revenues and expenditures that would have been obtained if, in any given year, the economy was operating at potential and the copper price was at its (estimated) long-term level. The initial methodology outlined by the Budget Directorate to calculate the structural balance was easy to understand and replicate. However, the computation of the structural balance has became increasingly complex and difficult to replicate over the years owing to the expansion of the private mining sector, the introduction of new taxes on mining, the coming into stream of output of non-copper minerals (e.g. molybdenum), and non-transparent changes in the elasticities of tax collections with respect to the output gap.
Clear objectives	The rationale for fiscal rules is usually spelled out clearly in special legislation or guidelines. The objectives of fiscal rules in OECD countries typically include ensuring public debt sustainability, addressing common pool problems in highly decentralized countries or within	A 2001 policy paper of the Budget Directorate spelled out the objectives of Chile's fiscal rule. The paper noted that the structural surplus targeted with the rule (1 percent of GDP at the time) was to be used to recapitalize the central bank, pre-finance contingent liabilities, and create a buffer of net

	OECD Practices	Chile's Fiscal Rule
	international arrangements, avoiding domestic demand pressures, and tackling ageing-related issues.	financial assets to allow the central government to absorb external shocks. The 2006 FRL, however, did not refer to these objectives, and only stipulated the creation of two separate sovereign funds for the allocation of overall surpluses.
Clear link between targets and objectives	Fiscal rules in OECD countries usually set targets/benchmarks on several fiscal indicators covering both sustainability and cyclicality aspects of fiscal policy. The most common are (i) an upper limit on gross or net public debt and ceilings on one or several definitions of deficit (e.g. Maastricht Treaty and the Stability and Growth Pact); and (ii) ceilings for the overall balance and the growth rate of expenditures, either in nominal or real terms (e.g. Sweden, Finland, Netherlands).	Chile's structural balance rule does not establish a clear link with medium-term fiscal goals. The rule is not formulated within a full-fledged medium-term framework nor is it used to assess how current policies would affect the government's net financial wealth. Moreover, the upward revision of the long-term copper price in recent years has imparted an unintended procyclicality to government expenditures.
Flexibility	Fiscal rules in most OECD countries include provisions to deal with unexpected shocks. These provisions allow temporary deviations from the targets and provide guidance for a gradual adjustment to those targets, while avoiding procyclicatlity and preserving credibility. The most common provisions include: (i) "exceptional circumstances clauses" that allow for temporary deviations in the face of major shocks; (ii) "notional accounts" to store small ex-post deviations, which would be corrected overtime (e.g. Germany and Switzerland); and (iii) clear procedures to undertake periodic and rolling adjustments of the numerical targets.	Chile's rule is, in principle, quite flexible, as it does not constrain the government's capacity to modify the structural balance target. In fact the target has been changed over time for several reasons, and the changes have been usually justified by analytical work. However, Chile's fiscal framework does not provide much guidance on how to introduce changes to the target or how to implement a discretionary response to a shock. In terms of ex-post compliance, Chile's FRL does not contain mechanisms to assess small ex-post deviations or eliminate them over time.
Transparency provisions	OECD legislation on fiscal rules usually contains provisions to promote full transparency of fiscal policy plans and ex-post fiscal performance. Through these provisions the public is generally well informed of deviations and of plans to correct them over time.	Chile's FRL does not include provisions to promote full transparency (either of the ex-ante calculation of the structural balance or ex-post performance). The only requirement is that the Budget Directorate computes the structural balance every year. The government monitors fiscal performance on an ongoing basis and has showed a strong responsiveness to new informational demands, even though not required by law. Because of those actions, understanding of Chile's rule by the public is quite high, in spite of its complexity.

	OECD Practices	Chile's Fiscal Rule
Accountability.	A large number of OECD countries have created independent fiscal councils to provide independent fiscal policy analysis and recommendations. The councils usually provide: (i) objective analysis of current fiscal policy; (ii) independent projections and forecasts of key macrofiscal variables; and (iii) an assessment on the application of the rule, and the quality of the fiscal adjustment to comply. Typically, the councils only have an advisory role, and are accountable to the legislative branch.	Chile fiscal framework delegates to two independent panels of experts the determination of critical inputs for the calculation of the structural balance (the long-term copper price, and the rates of growth of the labor force, capital accumulation, and total factor productivity). The composition of the panels and their main recommendations are published by the Budget Directorate on a regular basis. However, the recommendations of the panels are not binding, and the law does not assign to any third party the task of assessing compliance with the rule.

ANNEX 2. CHILE—FINANCIAL SYSTEM DEVELOPMENTS

A. The Financial System

30. **The financial system is large and well diversified**. The financial system comprises mainly commercial banks, pension funds, insurance companies and securities market intermediaries. Three of the largest locally incorporated banks (accounting for 44 percent of bank assets) are partly owned by foreign banks (Santander, Banco de Chile, BBVA).

	Number of institutions	Assets under management, in billions of Chilean pesos	Assets under management, as percent of 2009 GDP
Banks 1/	25	104,401	114
Commercial	21	103,609	113
Foreign bank branches	4	792	1
Pension fund administrators 1/	5	62,162	68
Insurance companies 1/	51	20,458	22
Property and Casualty	20	1,487	2
Life	31	18,971	21
Fund administrators 2/	43	20,172	22

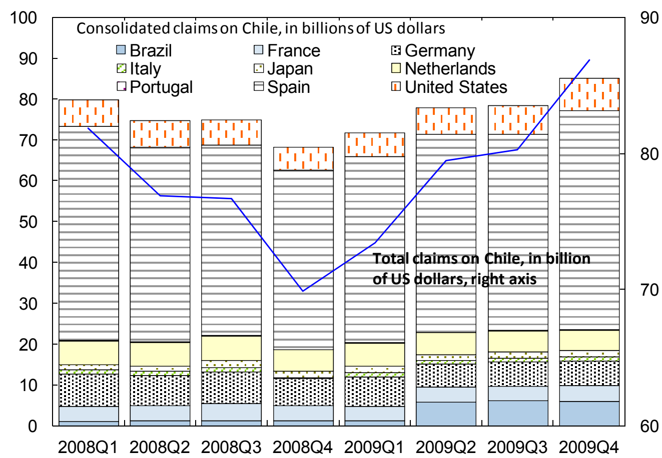
Source: SBIF, SVS, SP and staff calculations.

1/ As of June 2010.

2/ As of December 2009

31. **Non-banks play an important role in credit provision.** Non-banks, including department stores, cooperatives, and others, account for about 45 percent of total consumer debt and about 15 percent of mortgage debt.

32. **The country is highly integrated within the global financial system**. Consolidated banking statistics from the BIS indicate that in 2009Q4, claims on Chile by BIS reporting banks amounted to $86 billion (52 percent of GDP), slightly above their pre-crisis levels and 25 percent above their lows in 2008Q4. Spanish banks claims on Chile, at $53¾ billion, were back to the pre-global financial crisis levels. Claims by Brazilian banks increased five-fold to $5¾ billion during 2009.



Source: BIS and staff calculations.

B. The Regulatory and Surveillance Framework

33. **Financial supervision is performed by three separate institutions.** The institutions are the banking supervisory agency (SBIF), the securities and insurance supervisory agency (SVS), and the pension fund supervisory agency (SP). Supervisory coordination takes place through the Committee of Superintendents, in which the central bank has an observer role. The Committee also includes a technical secretariat which coordinates technical work related to risk-based supervision and the analysis of domestic financial markets, and liaises with foreign counterparts and other international bodies. The OECD has recommended adopting formal cooperation arrangements such as information sharing protocols. Domestic banks and branches of international banks, insurance companies, and exchanges are under the direct supervision of one of the three main supervisory agencies. These agencies are currently cooperating in a pilot exercise on consolidated supervision of financial conglomerates with a view to setting up a formal supervisory framework. A consolidated supervision law to be finalized by end-2010 or early 2011 would provide the required legal framework.

34. . **Addressing information gaps with respect to transactions and positions involving foreign exchange was considered adequate** given the high level of disclosure and information collection by the authorities, and the relatively simple instruments, investment and trading strategies used by financial institutions. Less detailed information, however, is available on disaggregated fixed income securities and related derivatives positions. Finally, lack of information sharing on credit histories between department stores and banks prevents a full assessment of the creditworthiness of individuals.

35. **Supervisors are currently assessing private sector dynamic loan loss provision models**. The SBIF has started a joint study with banks to assess their dynamic provisioning practices and/or proposals. The assessment could be further strengthened by using a regulatory benchmark model and common regulatory scenarios.

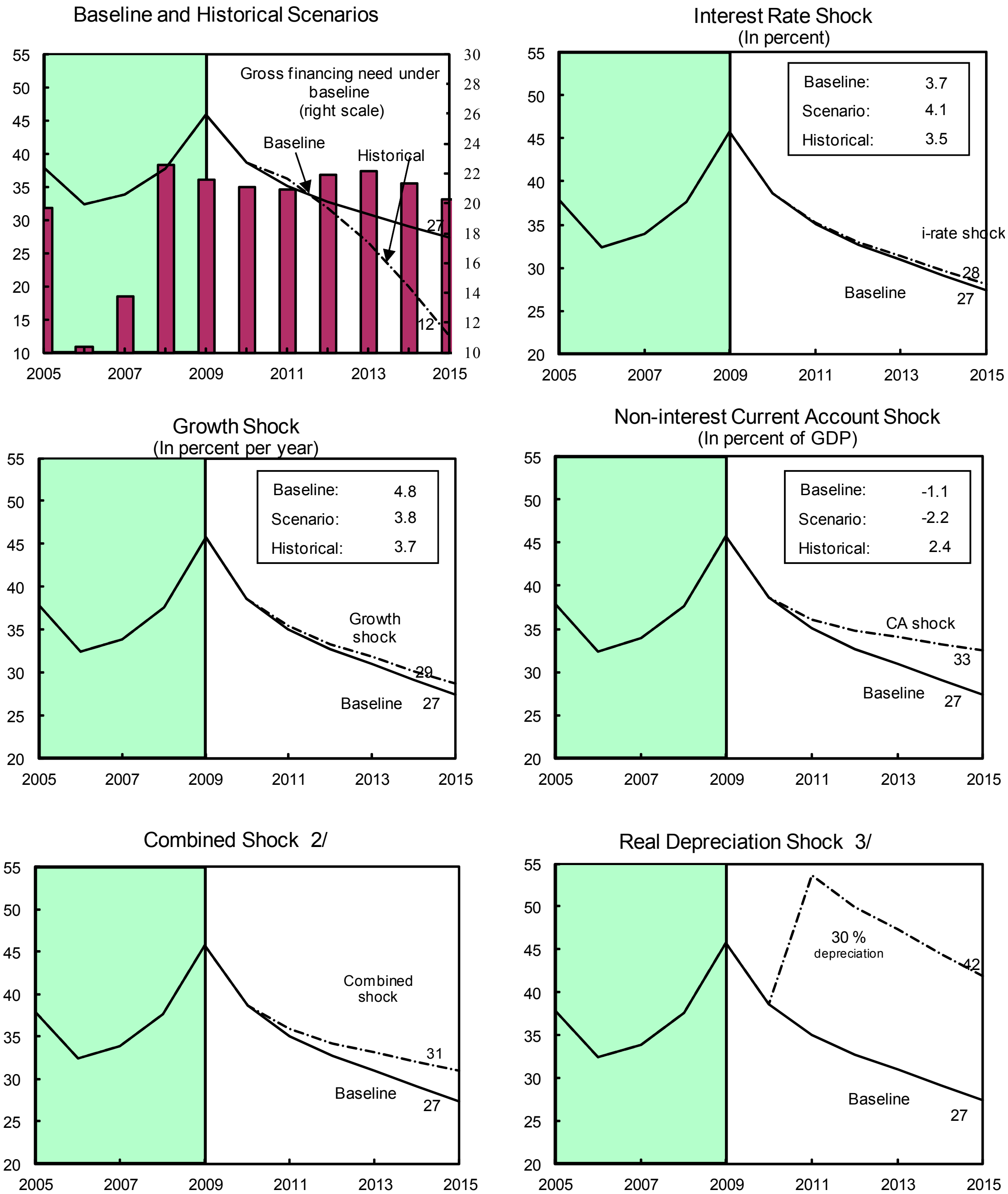
36. **The new proposed capital markets reform law MKB aims to further strengthen the prudential and supervisory framework.** MKB contemplates the adoption of best supervisory practices including policies to reduce credit procyclicality and limit the risks of individual institutions. MKB also contemplates a substantial update of the institutional supervisory framework to broaden the autonomy of the supervisory agencies and facilitate the resolution mechanism for failed institutions. The update includes changing the structure of the SVS to a securities and insurance commission (CVS) composed by two independent bodies, one on charge of regulation and supervision and the second one of enforcement, in order to ensure independence and accountability. The senior officers in the commission would be designated by the President from a roster proposed by the Council of Public Administration. The authorities are also exploring changes to the corporate governance structure of the SBIF geared towards enhancing its autonomy and independence.

ANNEX 3. CHILE—DEBT SUSTAINABILITY ANALYSIS

Chile's external debt is relatively low (Figure A1). Total external debt increased to 45 percent in 2009 from 38 percent in 2008. Debt levels are not very sensitive to growth or interest-rate shocks, but are somewhat sensitive to a depreciation of the peso, as nearly all of Chile's external debt is denominated in foreign currency.

Chile remained a net public creditor in 2009. Net public sector assets decreased to 11.2 percent of GDP in 2009, and gross central government debt remained low at 9 percent of GDP (Figure A2).

Figure A1. Chile: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



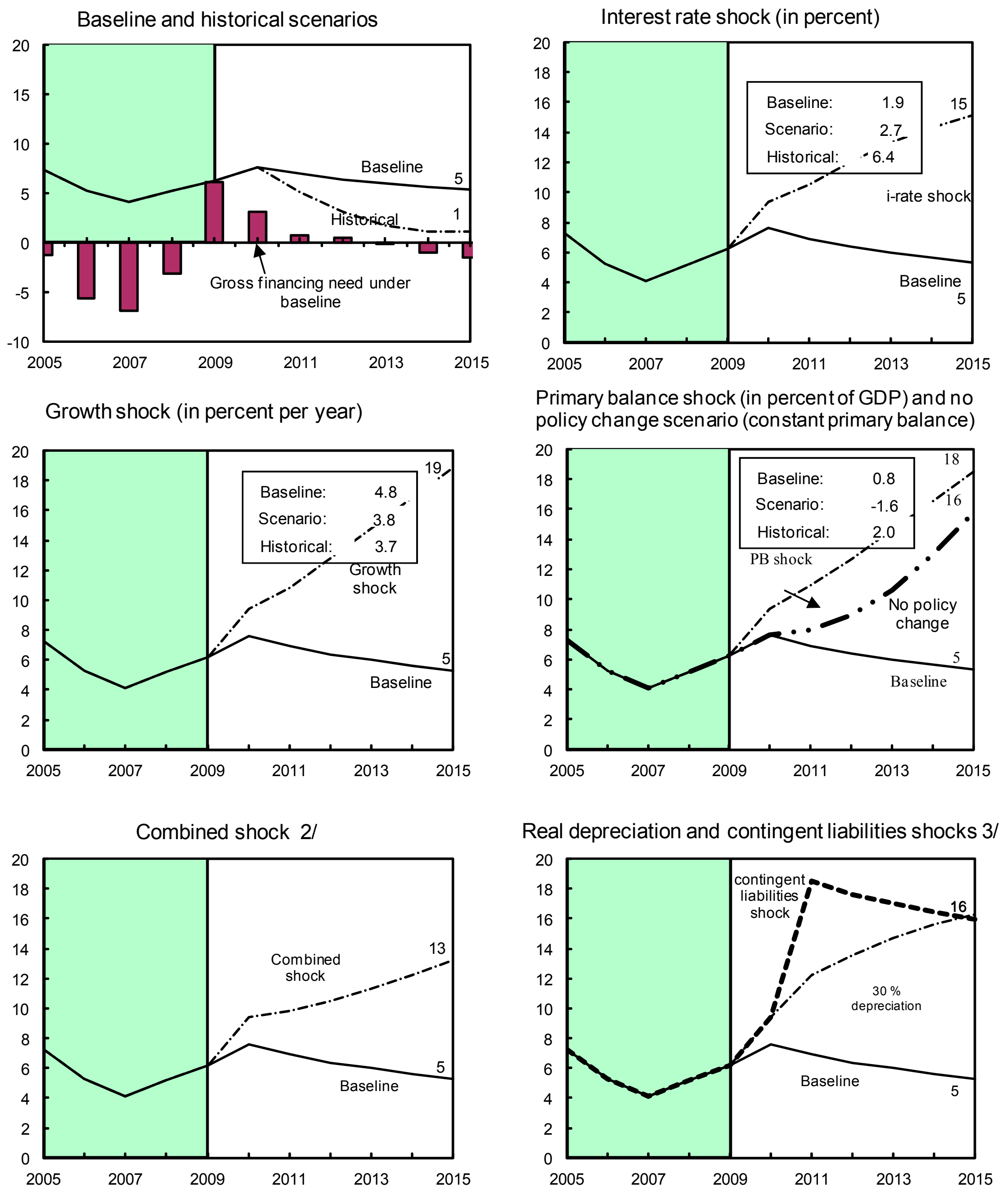
Sources: International Monetary Fund, Country desk data, and staff estimates.

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

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

3/ One-time real depreciation of 30 percent occurs in 2010.

Figure A2. Chile: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.

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

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table A1. Chile: External Debt Sustainability Framework, 2005–2015
(In percent of GDP, unless otherwise indicated)

	Actual				Projections						
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	32.4	33.9	37.6	45.8	**38.6**	**35.1**	**32.6**	**30.9**	**29.1**	**27.4**	**-5.5**
Change in external debt	-5.5	1.5	3.7	8.2	-7.2	-3.5	-2.4	-1.7	-1.9	-1.7	
Identified external debt-creating flows (4+8+9)	-17.1	-15.8	-9.9	-8.4	-11.6	-10.0	-7.1	-6.8	-5.1	-4.0	
Current account deficit, excluding interest payments	-5.9	-5.5	0.6	-3.6	-0.1	1.3	1.6	0.8	0.9	1.0	
Deficit in balance of goods and services	-75.6	-79.6	-85.8	-69.0	-72.3	-73.2	-76.5	-76.2	-74.4	-72.3	
Exports	45.3	46.8	45.2	38.5	39.2	39.9	41.4	40.6	39.2	37.5	
Imports	-30.2	-32.8	-40.5	-30.5	-33.1	-33.3	-35.1	-35.6	-35.3	-34.8	
Net non-debt creating capital inflows (negative)	-4.9	-7.9	-10.0	-7.9	-10.4	-9.9	-7.8	-7.7	-6.1	-5.1	
Automatic debt dynamics 1/	-6.3	-2.5	-0.5	3.2	-1.1	-1.4	-0.9	0.1	0.1	0.1	
Contribution from nominal interest rate	1.1	1.0	0.8	1.0	0.8	0.7	0.5	1.5	1.4	1.3	
Contribution from real GDP growth	-1.4	-1.3	-1.2	0.6	-1.9	-2.1	-1.5	-1.4	-1.3	-1.2	
Contribution from price and exchange rate changes 2/	-6.0	-2.1	-0.1	1.5	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	11.7	17.3	13.6	16.6	4.4	6.4	4.7	5.1	3.2	2.3	
External debt-to-exports ratio (in percent)	71.6	72.4	83.3	119.0	98.4	87.9	78.9	76.2	74.3	73.0	
Gross external financing need (in billions of US dollars) 4/	15.2	22.6	38.6	34.9	41.9	46.6	53.5	57.6	59.0	59.4	
in percent of GDP	10.4	13.7	22.6	21.6	21.1	20.9	21.9	22.2	21.4	20.2	
Scenario with key variables at their historical averages 5/					**38.6**	**36.2**	**31.7**	**26.7**	**19.9**	**12.5**	**-7.4**
Key Macroeconomic Assumptions Underlying Baseline											
Real GDP growth (in percent)	4.6	4.6	3.7	-1.5	5.0	6.0	4.6	4.5	4.5	4.5	
GDP deflator in US dollars (change in percent)	18.7	7.0	0.3	-3.9	17.3	5.5	4.9	1.6	1.8	1.8	
Nominal external interest rate (in percent)	3.4	3.3	2.6	2.5	2.1	2.0	1.7	5.0	4.9	4.9	
Growth of exports (US dollar terms, in percent)	37.4	15.7	0.4	-19.4	25.5	13.8	13.8	4.1	2.7	2.0	
Growth of imports (US dollar terms, in percent)	16.0	21.7	28.3	-28.8	33.6	12.4	15.9	7.5	5.5	4.9	
Current account balance, excluding interest payments	5.9	5.5	-0.6	3.6	0.1	-1.3	-1.6	-0.8	-0.9	-1.0	
Net non-debt creating capital inflows	4.9	7.9	10.0	7.9	10.4	9.9	7.8	7.7	6.1	5.1	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

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

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

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

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

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

Table A2. Chile: Central Government Debt Sustainability Framework, 2005-2015
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	**Debt-stabilizing primary balance 9/**
Baseline: Central Government debt 1/	7.3	5.3	4.1	5.2	6.2	**7.6**	**6.9**	**6.4**	**6.0**	**5.6**	**5.3**	**-0.1**
o/w foreign-currency denominated	5.2	3.6	2.1	2.1	1.5	2.8	2.5	2.3	2.2	2.0	1.9	
Change in central government debt	-3.4	-2.0	-1.2	1.1	1.0	1.4	-0.7	-0.5	-0.4	-0.4	-0.3	
Identified debt-creating flows (4+7+12)	-6.1	-8.0	-9.5	-5.1	4.0	1.3	0.0	-0.4	-0.9	-1.5	-2.0	
Primary deficit	-5.4	-8.4	-9.4	-5.7	3.9	1.3	0.3	-0.2	-0.7	-1.4	-1.9	
Revenue and grants	23.8	25.8	27.4	26.2	20.1	21.9	22.5	22.1	22.2	22.3	22.4	
Primary (noninterest) expenditure	18.4	17.4	18.0	20.5	24.0	23.2	22.8	21.9	21.5	21.0	20.5	
Automatic debt dynamics 2/	-0.7	0.4	-0.1	0.6	0.1	0.0	-0.3	-0.2	-0.2	-0.1	-0.1	
Contribution from interest rate/growth differential 3/	0.0	0.2	0.2	0.0	0.5	0.0	-0.3	-0.2	-0.2	-0.1	-0.1	
Of which contribution from real interest rate	0.6	0.5	0.4	0.1	0.4	0.3	0.1	0.1	0.1	0.1	0.1	
Of which contribution from real GDP growth	-0.5	-0.3	-0.2	-0.1	0.1	-0.3	-0.4	-0.3	-0.3	-0.3	-0.2	
Contribution from exchange rate depreciation 4/	-0.7	0.2	-0.3	0.6	-0.4	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	2.7	5.9	8.4	6.2	-3.0	0.1	-0.7	-0.1	0.5	1.1	1.7	
Central Government debt-to-revenue ratio 1/	30.6	20.4	14.9	19.7	30.9	34.7	30.7	28.8	27.0	25.2	23.6	
Gross financing need 6/	-1.3	-5.6	-6.9	-3.2	6.1	3.1	0.7	0.5	-0.1	-1.0	-1.6	
in billions of U.S. dollars	-1.6	-8.3	-11.4	-5.4	9.9	6.2	1.5	1.2	-0.2	-2.9	-4.6	
Scenario with key variables at their historical averages 7/						**7.6**	**5.1**	**3.1**	**1.8**	**1.1**	**1.1**	**0.0**
Scenario with no policy change (constant primary balance) in 2010-2015						**7.6**	**7.9**	**9.0**	**10.6**	**13.0**	**15.8**	**-0.3**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	5.5	4.6	4.6	3.7	-1.5	5.0	6.0	4.6	4.5	4.5	4.5	
Average nominal interest rate on public debt (in percent) 8/	8.9	11.2	12.7	12.5	10.3	7.0	4.5	4.7	4.9	5.1	5.3	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	5.9	7.8	8.3	3.8	8.6	5.3	1.5	1.7	1.9	2.1	2.3	
Nominal appreciation (increase in US dollar value of local currency, in percent)	8.9	-3.8	7.8	-21.2	18.7	...	...	...	...	...	...	
Inflation rate (CPI, in percent)	3.1	3.4	4.4	8.7	1.7	1.8	3.0	3.0	3.0	3.0	3.0	
Growth of real primary spending (deflated by CPI deflator, in percent)	-2.6	7.5	9.3	8.7	18.0	9.2	5.3	1.2	1.1	1.0	1.0	
Primary deficit	-5.4	-8.4	-9.4	-5.7	3.9	1.3	0.3	-0.2	-0.7	-1.4	-1.9	

1/ Indicate coverage of central government.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

6/ Defined as central government deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

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

INTERNATIONAL MONETARY FUND

CHILE

Staff Report for the 2010 Article IV Consultation—Informational Annex

Prepared by the Western Hemisphere Department

August 25, 2010

Contents Page

APPENDIX 1. CHILE: FUND RELATIONS
(As of July 31, 2010)

I. Membership Status: Joined: December 31, 1945; Article VIII

II. General Resources Account:	**SDR Million**	**Percent Quota**
Quota	856.10	100.00
Fund holdings of currency	672.99	78.61
Reserve Position	183.11	21.39
Holdings Exchange Rate		

III. SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	816.89	100.00
Holdings	789.78	96.68

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements:

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

VI. Projected Payments to Fund (in SDR Million)

			Forthcoming		
	2010	2011	2012	2013	2014
Principal					
Charges/Interest	0.04	0.09	0.09	0.09	0.09
Total	0.04	0.09	0.09	0.09	0.09

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

VII. Implementation of HIPC Initiative: Not Applicable.

VIII. Implementation of Multilateral Debt Relief Initiative (MDRI): Not Applicable.

APPENDIX 2. CHILE—STATISTICAL ISSUES APPENDIX

As of August 17, 2010

I. Assessment of Data Adequacy for Surveillance	
General: Data provision is adequate for surveillance. The National Institute of Statistics (INE) regularly publishes a full range of economic and financial data. The Central Bank of Chile also publishes comprehensive macroeconomic and financial data. The Ministry of Finance publishes fiscal data. Key publicly accessible websites for macroeconomic data and analysis are: National Institute of Statistics: http://www.ine.cl/canales/chile_estadistico/home.php Central Bank of Chile: http://www.bcentral.cl/ Ministry of Finance: http://www.minhda.cl/	
II. Data Standards and Quality	
Subscriber to the Fund's Special Data Dissemination Standard (SDDS) since May 17, 1996.	A data ROSC was published September 17, 2007.

Chile: Table of Common Indicators Required for Surveillance

As of August 17, 2010

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memo items[7]: Data Quality – Methodological Soundness[8]	Memo items[7]: Data Quality Accuracy and reliability[9]
Exchange Rates	July 30, 2010	August 2, 2010	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	July 30, 2010	August 2, 2010	W	W	W		
Reserve/Base Money	July 2010	August 9, 2010	M	M	M	O, O, LO, O	O, O, O, LO, O
Broad Money	July 2010	August 9, 2010	M	M	M		
Central Bank Balance Sheet	June 2010	July 7, 2010	M	M	M		
Consolidated Balance Sheet of the Banking System	June 2010	July 28, 2010	M	M	M		
Interest Rates[2]	August 12,2010	August 12, 2010	D	D	D		
Consumer Price Index	July 2010	August 6, 2010	M	M	M	LO, LNO, LNO, LO	LO, LO, LO, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q2 2010	July 30, 2010	Q	Q	Q	O, LO, LNO, LO	LO, O, O, LO, O
Revenue, Expenditure, Balance and Composition of Financing3– Central Government	June 2010	July 30, 2010	M	M	M		
Stocks of Central Government and Central Government –Guaranteed Debt[5]	Q1 2010	June 29, 2010	A	Q	Q		
External Current Account Balance	July 30, 2010	August 2 , 2010	W	W	W	O, O, LO, LO	O, O, O, O, O
Exports and Imports of Goods and Services	July 30, 2010	August 2 , 2010	W	W	W		
GDP/GNP	Q2 2010	August 18, 2010	Q	Q	Q	O, LO, LO, LO	LO, LO, LO, LO, O
Gross External Debt	March 2010	July 29, 2010	M	M	M		
International Investment position[10]	Q1 2010	June 29, 2010	Q	Q	Q		

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[7] Reflects the assessment provided in the data ROSC, (published September 17, 2007 and based on the findings of the mission that took place during April 18-May2, 2007) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[8] Same as footnote 7, except referring to international standards concerning source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.
[9] Same as footnote 8, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.
[10] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

APPENDIX 3. CHILE: WORLD BANK—FUND COUNTRY-LEVEL WORK PROGRAM UNDER JMAP

Title	Products	Provisional timing of Missions	Expected delivery date*
1. Bank work program	**A. ESW** 1. Social Protection Study (Andean countries) (P106406)		October 2010
	B. Technical Assistance 1.Support for the Development of a National Energy Efficiency Program (P112532) 2. Support to the Delivery Unit of Secretaria de la Presidencia 3. Support to Water Resource Management 4. Chile Decentralization		October 2010 December 2010 December 2010/11 December 2011
2. Fund work program	Staff visit 2011 Article IV Consultation	March 2011 June 2011	Staff report August 2011
3. Joint work program	FSAP Update	March 2011	June 2011

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

Public Information Notice (PIN) No. 10/136
FOR IMMEDIATE RELEASE
September 29, 2010

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

IMF Executive Board Concludes 2010 Article IV Consultation with Chile

On September 13, 2010 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Chile.[1]

Background

Chile's economy has withstood successfully two consecutive large negative shocks—the global financial crisis and the February 2010 earthquake. Its resilience has been underpinned by substantial macroeconomic easing, a well-capitalized banking system, and absence of imbalances in the private sector. Strong growth has resumed since the second half of 2009, and the earthquake caused only a temporary disruption in economic activity. The unemployment rate has declined and annual Consumer Price Index (CPI) inflation increased to 2.2 percent in July.

The financial system has weathered the crisis well and the cyclical deterioration of credit quality has been moderate. Non-performing loans remain relatively low at 3 percent of all loans. Banks are well capitalized and have a relatively stable domestic funding base. Financing conditions have eased since the second half of 2010 and credit growth has resumed. As liquidity conditions normalized, the central bank has unwound unconventional

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

policy measures implemented during the crisis. The temporary short-term bank liquidity facility was terminated in mid-June 2010, and the policy rate has been raised to 2 percent by August.

Large fiscal savings accumulated over the past decade allowed the authorities to put in place a substantial fiscal stimulus in 2009, followed by an ambitious earthquake reconstruction program, while preserving trust in the soundness of public finances. The overall fiscal balance shifted to a deficit of 4.4 percent of Gross Domestic Product (GDP) in 2009. The structural fiscal deficit is expected to remain high in 2010 due to reconstruction spending. Nonetheless, fiscal credibility remains strong. Moody's raised Chile's government debt rating to Aa3 in June, and the recent turbulence in Europe has had little impact on risk premia.

Looking ahead, the economic recovery is expected to continue. GDP is expected to grow by 5 percent in 2010, accelerating to 6 percent in 2011. Large scale private and public reconstruction spending should continue to boost growth. At the same time, net exports are likely to weaken further, as some of the domestic demand growth spills over to imports. CPI inflation is expected to exceed the 3-percent target by the end of 2010, before coming down gradually in 2011, as the effect of interest rate increases filters through.

Executive Board Assessment

Executive Directors commended the authorities' skillful responses to the global financial crisis and to the devastating earthquake of last February, capitalizing on Chile's robust policy framework. As a result, the economy is back on track for a sustainable recovery. Directors viewed the authorities' decision to accommodate relief and reconstruction spending through a combination of tax and expenditure measures, and some debt issuance, as timely and prudent. Looking ahead, the government's commitment to firm expenditure restraint starting in 2011 will anchor expectations, help reduce the risk of overheating and limit appreciation pressures.

Directors supported the authorities' target of lowering the structural deficit of the central government to 1 percent of GDP by 2014. Returning to a zero structural balance over a longer horizon would be desirable. Directors also encouraged the government to renew its commitment to fully recapitalize the central bank.

Directors welcomed the government's decision to review the fiscal rule. While Chile's fiscal rule has served the country well in the last decade, it could be made even more effective by making it more transparent; introducing an explicit escape clause and features to limit spending procyclicality; and complementing it with an explicit medium-term policy framework that extends beyond the government's term. Directors encouraged the government to outline a clear timetable for adopting any revisions to the rule, once the fiscal rule commission has issued its final report.

Directors supported the gradual tightening of the monetary policy currently underway. They recognized the risk that widening interest rate and growth differentials with major advanced economies could result in a surge in capital inflows, and agreed with the central bank's approach to let exchange rate flexibility be the first line of defense. In addition, macroprudential measures could be useful to protect domestic balance sheets and prevent excessive growth in credit.

Directors noted that Chile's financial sector is sound and has weathered the crisis well. They welcomed the authorities' intentions to enhance the supervision of the financial sector, including the planned move towards consolidated supervision of financial conglomerates. They recommended continued strengthening of the prudential framework by adopting a functional approach to regulation and supervision; formalizing cooperation arrangements among the supervisory agencies; and strengthening cross-border coordination with international counterparts.

Directors supported the government's initiatives to reduce the cost of doing business by facilitating the entry of new firms, making credit more accessible to small and medium enterprises, and reforming the corporate bankruptcy procedures. Increasing labor market efficiency should be another key objective.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2010 Article IV Consultation with Chile is also available.

Chile: Selected Social and Economic Indicators

I. Social and Demographic Indicators

GDP (2009)	91,518	**Poverty rate (2009)**	15.1
U.S. dollars (billions)	164.3	Indigent	3.7
Per capita (U.S. dollars)	9,809	Poor, not indigent	11.4
Population characteristics (2008)		**Income distribution (2009)**	
Total (in millions)	16.7	Richest 10% of households	40.2
Urban population (percent of total)	87.9	Poorest 20% of households	3.6
Life expectancy at birth (years)	78.3	Gini coefficient	0.55

II. Economic Indicators

					Est.	Staff Projections	
	2005	2006	2007	2008	2009	2010	2011
	(Annual percentage change, unless otherwise specified)						
National accounts and employment							
Real GDP	5.5	4.6	4.6	3.7	-1.5	5.0	6.0
Total domestic demand	10.3	6.8	7.5	7.6	-5.9	13.4	6.9
Consumption	7.1	7.0	7.0	4.0	1.7	6.4	4.7
Private	7.3	7.1	7.0	4.6	0.8	7.4	6.4
Public	5.8	6.4	7.2	0.5	6.8	1.2	-5.2
Investment	21.4	6.3	9.2	18.7	-25.9	38.9	13.0
Private	25.3	1.4	9.5	20.7	-21.2	18.6	13.0
Public	10.8	12.0	24.7	4.0	35.5	4.3	33.8
Fixed	23.6	2.5	11.2	18.7	-15.2	16.1	16.2
Inventories [1]	-0.3	1.0	-0.3	0.2	-3.4	4.8	-0.6
Net exports [1]	-4.4	-2.3	-3.2	-4.4	5.0	-9.1	-1.8
Exports	4.3	5.1	7.5	3.2	-5.6	6.3	6.4
Imports	16.9	10.6	14.5	12.3	-14.3	26.3	8.2
Consumer prices							
End of period	3.7	2.6	7.8	7.1	-1.4	3.7	3.0
Average	3.1	3.4	4.4	8.7	1.7	1.7	3.0
Unemployment rate (annual average)	9.3	8.0	7.0	7.7	9.6	...	...
Money and credit							
Broad money	11.9	11.4	14.7	19.1	2.3	...	...
Credit to the private sector (end of period)	19.9	17.7	20.8	12.6	-3.8	...	...
External Debt and Balance of Payments	(In percent of GDP, unless otherwise specified)						
Current account	1.2	4.9	4.5	-1.5	2.6	-0.7	-2.0
Trade Balance (in billions of U.S. dollars)	10.8	22.8	23.9	8.8	14.0	14.5	18.6
Exports of goods (in billions of U.S. dollars)	41.3	58.7	68.0	66.5	53.7	68.6	78.5
Imports of goods (in billions of U.S. dollars)	30.5	35.9	44.0	57.6	39.8	54.0	59.8
Gross external debt	38.0	32.4	33.9	37.6	45.8	38.6	35.1
Public	8.1	7.3	7.8	7.2	8.5	8.2	7.2
Private	29.9	25.1	26.2	30.5	37.3	30.4	27.8
Gross International Reserves (in billions of U.S. dollars)	17.0	19.4	16.9	23.2	25.4	25.4	25.4
	(Annual percentage change)						
Terms of Trade	10.8	31.1	4.3	-15.9	2.9	12.6	4.6
Real Effective Exchange Rate	11.9	-5.3	8.2	-12.0	17.1	...	...
Savings and investment	(In percent of GDP)						
Gross domestic investment	22.1	20.0	20.4	25.0	19.1	23.2	24.3
Public	2.1	2.0	2.4	2.6	2.9	3.2	4.0
Private	20.1	18.0	18.1	22.4	16.1	20.0	20.3
National saving	23.4	24.9	25.0	23.5	21.7	22.5	22.3
Public [2]	5.7	10.6	10.2	10.9	-0.9	2.4	6.1
Private	17.7	14.2	14.7	12.6	22.6	20.1	16.2
Public sector finance							
Net Debt	11.8	-1.5	-10.4	-17.5	-11.3	-9.9	-9.7
Excluding public enterprises	2.5	-6.1	-13.5	-23.7	-17.4	-15.6	-15.1
Public sector gross debt [3]	34.9	25.7	28.8	27.3	27.7	26.2	24.5
Central government gross debt	7.3	5.3	4.1	5.2	6.2	7.6	6.9
Central government balance	4.6	7.7	8.2	4.3	-4.4	-1.7	-0.6

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

[1] Contribution to growth.

[2] Gross saving of the general government sector, including the deficit of the central bank.

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

Mr. Alfredo Mac Laughlin, Executive Director and
Mr. Miguel Ricaurte, Advisor to the Executive Director
September 13, 2010

1. Our authorities would like to thank the staff for the Staff Report and Selected Issues papers and for the thorough discussions on the recovery process from the international crisis and the earthquake which occurred on February 27 of this year, as well as on the policy responses implemented to deal with these events. Such discussions reflect the permanent dialogue between the Chilean authorities and the Fund staff on policy issues which has characterized the relationship between Chile and the Fund. In early 2010, more dynamic activity and receding unemployment meant the Chilean economy was on a recovery path from the global downturn of the last quarter of 2008. This was achieved thanks to the significant policy stimulus, made possible by the credible fiscal and monetary frameworks, and incipient world recovery. However, a significant earthquake that destroyed infrastructure and disrupted productive activities altered short term prospects. The new administration acted decisively and assumed a leadership role in the reconstruction process. The costs associated with this unexpected natural disaster meant that envisaged fiscal structural balance goals had to be revised. Our authorities are committed to taking advantage of these challenges to push for pro-efficiency reforms in terms of government management and labor and financial market functioning, as well as improving the structural balance rule seeking to achieve more transparency. The final goal is to attain higher potential output growth, keeping price and financial stability always in sight.

The Global Crisis and the Earthquake

2. The degree of financial and commercial integration of Chile meant the global crisis took a large toll on the economy. Starting in the fourth quarter of 2008, output growth slowed and became negative. For eleven months following December 2008, economic activity contracted, reaching its worst point in April 2009, when the 12-month growth rate of the economic activity index was -4.9 percent. Accordingly, unemployment, measured by the new employment survey, rose to a maximum of 11.6 percent in the June-August quarter, while employment contracted 1.9 percent between the January-March and May-July quarters. Moreover, inflation rapidly decelerated during 2009, showing negative y-o-y growth during the last five months of the year, with the largest drop of 2.3 percent registered in November. In response to the impact of the global crisis, our authorities undertook significant monetary, fiscal, and pro-credit policies in order to mitigate the impact of the global downturn as much as possible.

3. As a result of these policies, as well as the incipient improvement in international conditions towards the end of 2009, the economy began to recover, with output growing at 2.1 percent in the last quarter of 2009, as well as receding unemployment. In 2009, GDP dropped by 1.5 percent (1.4, SA), compared to the 3.7 percent growth of 2008 (3.4, SA). An

inventory drawdown process and falling investment played important roles in the faltering of the economy. Moreover, the prospects for recovery in 2010 looked promising as the indicator of economic activity grew at an annual rate of 3.9 percent in January and unemployment stood slightly above 9 percent, although prices continued to fall that month (headline inflation was -1.3 and core inflation, -2.2 percent).

4. Yet, on February 27, Chile was hit by an 8.8 Richter-scale earthquake and a subsequent tsunami. With considerable damage to the south-center regions of the country - important to the paper and pulp, oil refining, fishing, and iron and steel product industries - private and public infrastructure destruction, and lives lost, short-term prospects took a heavy blow. Production fell 2.3 percent in March and employment was affected, especially in the regions most hardly hit by the earthquake. The Banco Central de Chile (BCC) estimated that the earthquake destroyed 3 percent of the country's capital stock, narrowing the output gap generated during the global crisis. Our authorities took this challenge as an opportunity to strengthen the country and its economy. The government's share of the estimated US$30 billion cost of the reconstruction is anticipated to be US$8.4 billion (4 percent of GDP), which will be implemented between 2010 and 2013. The reconstruction plan will be funded by a temporary rise in taxes, improved expenditure efficiency and debt issuance. For this purpose, Chile placed two bonds in international markets in very favorable conditions at the end of last July. Since the earthquake, recovery has been stronger than expected. In the first quarter of 2010, output grew 1.5 percent (1.4, SA), while the second quarter saw a 6.5 percent growth rate (6.5, SA); and the unemployment rate for the May-July quarter was 8.3 percent. In light of these developments, market expectations for output growth for 2010 have increased, in line with the BCC's current forecast of 5.0 to 5.5 percent.

5. Consumer price inflation has begun to pick up after the rapid and steady decline of 2009 and the first half of 2010, in part due to mounting international pressures and the closing of the output gap triggered by the earthquake. Headline inflation reached 2.6 percent in August, whereas core inflation was 1.9 percent. Currently, CPI inflation is expected to reach over 3 percent by the end of 2010, and to converge to 3 percent in 2011. In line with these developments, the BCC revised upward its y-o-y inflation forecast to 3.9 percent for December 2010.

6. In the midst of these changing economic conditions, a new administration took office in March, facing extraordinary challenges in terms of economic policy. Our authorities acknowledge that the responses in terms of monetary, fiscal, and credit policies started by the previous administration were possible thanks to sound policy frameworks that allowed the government to save resources needed not only to fund the fiscal stimulus and reconstruction packages, but to add credibility to the incoming government programs. Nevertheless, the new administration is aware that more needs to be done and, therefore, is working to introduce significant reforms seeking to improve government, regulatory, and productive efficiency and restore fiscal balance lost during the global crisis.

Monetary Policy

7. Following the unraveling of the global crisis, the BCC aggressively decreased the monetary policy rate 775 basis points in seven months, bringing it down to 0.5 percent in July 2009. This was consistent with the view that a massive monetary stimulus was necessary to attain the inflation target in the policy horizon. The BCC indicated that 0.5 was the lower bound rate and complementary funding measures were adopted in order for the market to incorporate the BCC's stance into their expectations. Once the economy showed signals of recovery, the BCC board announced in the November 2009 Monetary Policy Meeting communiqué that the term funding facility would be phased-out by May 2010, and that the policy rate would be kept at its minimum at least up to the second quarter of 2010.

8. The policy rate was left unchanged at 0.5 percent until May. The BCC considered that the short-term impact of the earthquake was larger than initially assessed and inflation remained subdued. However, new information showed that the earthquake had a very transient impact on the economy, which began to recover rapidly. Since June, the monetary policy rate has been hiked by 50 basis points each time, currently standing at 2.0 percent. Although headline inflation rose in July, the BCC authorities highlight transitory shocks as the sources behind this surge, while underlying measures remain contained. Although there is higher uncertainty regarding the international environment as recovery of developed economies has not materialized in a definite manner, the outlook for Chile remains favorable. Therefore, the BCC authorities informed in the September monetary policy report that the monetary stimulus would continue to be withdrawn at a pace that depends on the evolution of internal and external macroeconomic conditions. Private sector expectations are consistent with this stance.

9. While the nominal exchange rate has fluctuated due to market developments, the real exchange rate broadly remains aligned with its long-term fundamentals. Our authorities are committed to maintaining the flexible exchange rate regime in place since late 1999. Nevertheless, this framework does not preclude intervention during extraordinary circumstances.

Fiscal Policy and Productivity-Oriented Reforms

10. The government's fiscal position deteriorated as the country faced the global crisis and the earthquake. The new administration is not only committed to improving fiscal accounts, but has the goal of increasing the efficiency of the government apparatus which, alongside other labor market and financial reforms, will contribute to enhancing Chile's potential growth rate over the next four years.

11. The structural budget rule and the Fiscal Responsibility Law resulted in the Chilean government saving the windfall gains in the copper price surpluses during the commodity price boom into the two Sovereign Wealth Funds: the Pension Reserve Fund and the Economic and Social Stabilization Fund (ESSF), the latter of which had accumulated US$

20.2 billion as of December 2008. The ESSF served the country well when resources were needed during the global crisis to fund the countercyclical policy responses involving a Fiscal Stimulus Plan to support economic activity and employment; a Pro-Credit Plan to secure the flow of credit to businesses and individuals in the lower phase of the economic cycle; and the Pro-employment Employment Accord to mitigate the impact of the cycle on employment. The Fiscal Stimulus Plan was announced in early January 2009, with a size equivalent to 2.4 percent of GDP (US$4 billion). As additional resources were needed, withdrawals from the ESSF continued to be made amounting to a total of US$9.3 billion in 2009. By the end of the year, public expenditure had grown 18.2 percent in real terms, surpassing initial estimates.

12. In 2010 the real growth rate of government expenditure is expected to decrease to 9 percent. To finance government expenditure, our authorities sent a comprehensive funding package to Congress which included temporary tax increases, redirecting the share of government-owned Codelco revenues intended for the armed forces towards the central government's budget, and a proposed increase in the mining royalty regime to take advantage of currently high commodity prices. All measures, except the royalty to the mining sector, were approved by Congress and the authorities had to look for alternative sources of funding, including an alternative royalty scheme reform recently sent to Congress. In late July, Chile issued two bonds, one denominated in US dollars and another linked to pesos in the international markets. Both were heavily overwritten, reflecting the positive position Chile has in international markets in spite of the tough conditions it has faced in the last two years. The US$1 billion dollar bond paid a 90 basis points premium, the best conditions an emerging market has been able to achieve under similar circumstances. The peso-linked bond of US$500 million was issued at a 5.5 percent interest rate.

13. One of our authorities' main goals is to return to structural balance once the fiscal stimulus package and reconstruction spending are phased out. This requires resetting a clear structural balance goal. Our authorities acknowledge the fact that the fiscal rule applied in Chile between 2001 and 2008 proved to be a fundamental pillar of the existing macroeconomic framework to secure domestic and external stability. However, the rule did not allow for the type and magnitude of counter-cyclical policies needed in 2009 to deal with the global crisis. The authorities' plan originally contemplated a reduction, on a temporary basis, in the structural surplus target from 0.5 to 0 percent of GDP, which finally became a 1.2 structural deficit as the conditions warranted a larger fiscal stimulus. In response to this event, the current administration is seeking to perfect the rule in order to deal with exceptional situations, keeping in mind it is a key instrument for macroeconomic stability. For this purpose, a Committee of Advisors on the Structural Balance Rule was assembled.

14. The Committee will give a final report containing specific recommendations on the structure of the rule, as well as its governing legal framework later in the year. However, in mid-August, it presented a preliminary report, which evaluates the current stance and provides guidance for the 2011 budget. In general terms, the Committee recommended using

the rule as it currently stands for next year's budget, but suggested: (1) reversing the correction for transitory tax measures; reversing the cyclical adjustment of (2) the "other income" account and (3) the interest earned on the treasury's financial assets; and (4) re-estimating the elasticity of health insurance contributions. Applying the revised methodology to historical data results in larger structural deficits as percentage of GDP for 2008 (-0.6 vs. 0.0) and 2009 (-3.1 vs. -1.2). Since the authorities have adopted the Committee's preliminary methodology for the 2011 budget, they have revised the outlook to a 3.2 percent deficit for 2010 and to a 1 percent structural deficit target (instead of structural balance) for 2014. Our authorities want to stress the fact that underlying conditions have not changed, but rather, these modifications clarify what constitutes expenditures and income under a neutral stance of GDP with the goal of improving transparency on the structural balance situation of Chile.

15. Beyond mere expenditure control measures, the authorities are seeking to gain efficiency in the state apparatus by improving institutional governance, as well optimizing expenditure. Currently, government programs are being audited in order to identify their social returns so that resources can be aimed at those from which society benefits the most. Additional gains are sought from labor legislation reforms aimed at making the labor market more flexible, favoring indefinite versus fix-term contracts, as well as labor force participation. Our authorities expect to favor training and human capital accumulation under indefinite contracts, once large firing costs are substituted by a more comprehensive unemployment insurance scheme. Moreover, pro-investment policies seeking to favor small- and medium-size enterprises, along with the above mentioned reforms, are expected to yield an additional 1 percentage point to potential GDP growth rate. All in all, it is this administration's goal to attain a 6 percent potential growth rate for Chile.

Financial Sector

16. Chile’s sound regulatory framework has proven to be fundamental in securing the stability of the financial system, and therefore insulating the domestic market from the global turmoil. The financial sector performed well during the crisis, with banks capitalization remaining well above minimum regulatory requirements. The financial sector has also proven resilient to the earthquake and the recent period of financial turmoil triggered by events in Europe. The most recent bank lending conditions survey shows that banks are easing credit conditions – which is consistent with the recent recovery in credit growth.

17. Our authorities are committed to further enhancing the financial regulatory framework. The most recent financial market reform approved, the MKIII, broadens the range of authorized financial instruments, facilitates securitization, improves conditions for foreign institutional investors and expands the set of long-term financing alternatives for banks. Moreover, the current administration is working on a comprehensive reform agenda, denominated the Bicentennial Capital Markets reform, or MKB, which would further improve market liquidity, update corporate governance of supervisors, improve information sharing and, ultimately, move towards a comprehensive reform of the supervision scheme.

Progress has also been made in strengthening the supervision of financial conglomerates. The first steps were taken in June 2009 when a Memorandum of Understanding (MoU) was signed by the members of the Committee of Superintendents (which includes the banking, pensions and securities supervisors), in order to formalize the cooperation and coordination channels between them. This committee is currently conducting a pilot oversight project for conglomerates, under a lead supervisor model. Additionally, the strengthening of the consumer protection agency's role in financial products is under discussion in Congress. Finally, concrete steps have been taken to strengthen securities clearing and settlement infrastructure.

Conclusion

18. Following the effect of global crisis on Chile's economy, a comprehensive stimulus package was put forward to minimize its adverse effect, financed with resources saved during the commodity price boom. Chile's economy had begun to recover when the February 27 earthquake hit the country. Nevertheless, the new administration took a decisive stance to use these challenges as opportunities to push for significant reforms aimed at reconstructing lost infrastructure, restoring fiscal balance and, ultimately, attaining higher potential output growth for Chile. Funding for reconstruction will come from, among other sources, temporary increases in taxes and borrowing. Moreover, learning from the last crisis, the authorities are seeking to enhance the fiscal balance rule to cope with extreme situations as the one lived in 2009 as well as improving the transparency of fiscal balance goals. Chile is currently on a solid recovery path, with output growing at healthy rates and decreasing unemployment. Our country's strong institutions and policy frameworks have been instrumental in the process of becoming a member of the OECD, which culminated in May of 2010 with the accession to the organization as an official member.