INTERNATIONAL MONETARY FUND

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CHILE

September 2012

2012 ARTICLE IV CONSULTATION

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 2012 Article IV consultation with Chile, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 29, 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 6. 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.
- **Informational Annex** prepared by the IMF.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its September 5, 2012 discussion of the staff report that concluded the Article IV consultation.
- **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 2012 ARTICLE IV CONSULTATION

August 6, 2012

KEY ISSUES

Context: After two years of robust expansion driven by strong domestic demand, output growth is expected to moderate towards potential in 2012. The output gap is closed and labor markets remain tight, although inflation pressures have eased and inflation expectations remain anchored at the official target. The key downside risks are spillovers from a sharp escalation of financial tensions in the euro area, and the possibility of a significant growth slowdown in China, resulting in a sharp fall in copper prices.

Fiscal policy: The withdrawal of fiscal stimulus continued in 2011, but some easing of the fiscal stance is projected for 2012. It would be desirable to keep tight control on expenditure in the remainder of the year to avoid adding fuel to a strong economy. Staff recommended aiming for a positive structural balance over the medium term, and frontloading the consolidation if economic conditions remain favorable.

Monetary policy: The authorities have appropriately maintained a neutral stance in recent months. In the event of an intensification of financial tensions in the euro area, decisive actions should be taken to maintain confidence. With inflation below the target, there is ample space to ease monetary policy if needed. Exchange rate flexibility will remain an important buffer against terms of trade shocks and volatile capital flows.

Mitigating risks to financial stability: To minimize risks of negative spillover effects and guard against excessive risk-taking in the current favorable economic environment, banks should maintain high levels of liquidity and capital, and continue to diversify external funding sources. Continued monitoring of the rise in corporate leverage is warranted. Staff supports the authorities' efforts to strengthen further the prudential framework of the financial system.

Raising productivity growth: The government's recent initiatives to foster female labor participation, streamline the business incorporation process, and strengthen the protection of intellectual rights are welcome. Increasing labor market flexibility and enhancing energy supply should remain on the structural reform agenda.

Approved By
Miguel Savastano and Tam Bayoumi

Discussions were held in Santiago during June 18–29, 2012. The staff team comprised Dora Iakova (Head), Jiri Podpiera, Daniel Rodriguez-Delgado, Sebastian Sosa, and Yi Wu (all WHD). Pablo Garcia-Silva (OED) participated in the discussions. The mission met with senior government and central bank officials, and representatives from the business community.

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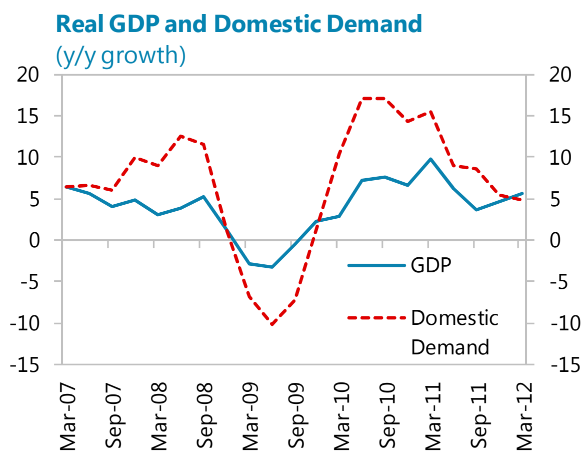
BACKDROP: SUSTAINED STRONG GROWTH

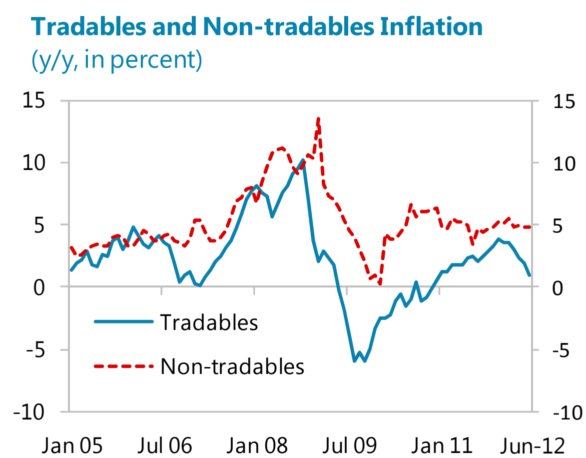
1. Chile's economy has expanded at a robust pace. The economy recovered rapidly from the global financial crisis, supported by a solid policy framework, sound banking system, and favorable commodity price developments. Real GDP grew by about 6 percent during 2010–11 on the back of exceptionally dynamic domestic demand, and strong growth has continued in early 2012 (Figure 1).



2. The output gap has closed and some pressures on capacity constraints have emerged. The unemployment rate has declined to a historically low level, labor shortages have been reported in some sectors, and real wage growth has been strong (Figure 2). Both labor force participation and employment increased rapidly in the last two years, although their growth rates have moderated in recent months. The surge in domestic demand fueled import growth, and the external current account balance turned negative in 2011, despite record high copper prices (Figure 3).

3. Inflation pressures have moderated and inflation expectations remain anchored. Core and headline inflation increased rapidly in 2011, driven by rising import prices and wages. More recently, price pressures have eased as food and energy prices declined. Year-on-year headline inflation fell to 2.6 percent in June, and core inflation has moderated as well. Inflation expectations remain close to the 3-percent official target.

4. Bank credit growth has been strong. Although credit standards have tightened in recent months, loan demand remains robust. Bank credit in real terms is growing by more than 10 percent, with particularly strong growth in corporate and consumer loans (Figure 4). In contrast, non-bank consumer credit, which accounts for about 30 percent of consumer credit, has declined since mid-2011.



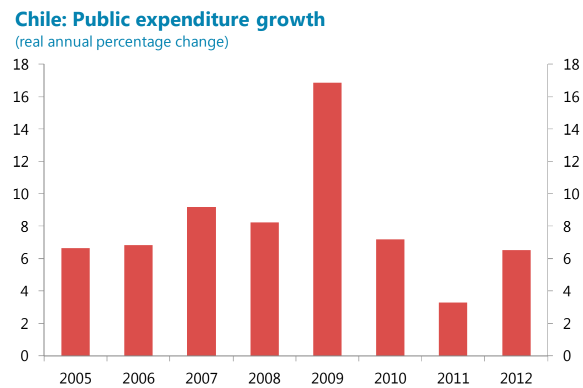
5. The real exchange rate is broadly in line with fundamentals. The real effective exchange rate has appreciated substantially over the past ten years. The appreciation has been driven by fundamentals, particularly by improving terms of trade. In recent months, the exchange rate has been close to its long-term average level. Staff estimates using IMF's EBA and CGER methodologies suggest that the real effective exchange rate is broadly in line with fundamentals. This assessment is supported by the fact that Chile's world market share of agricultural and industrial exports has remained broadly stable since 2003.

6. **Net private capital inflows turned positive in 2011.** The main contributing factor was a switch in private pension funds' portfolio allocation from foreign to domestic assets. FDI inflows were also strong, especially in the mining sector. At end 2011, the balance of payments recorded a surplus of US$14 billion (6 percent of GDP). Chile's net external liabilities, at 10 percent of GDP as of end-2011 (Figure 6), are relatively modest compared with other emerging market countries. Overall, Chile's external position is broadly consistent with underlying fundamentals (Box 1).

7. **The monetary policy stance is broadly neutral.** The central bank raised the policy rate by 475 basis points to 5¼ percent from mid-2010 to June 2011. Since a one-off easing in January 2012, amid uncertain global financial conditions, the policy rate has been kept at 5 percent. The central bank completed the pre-announced US$12 billion foreign exchange purchases program in December 2011, strengthening reserve adequacy measures.

8. **Spillovers from volatility in global financial markets have been limited thus far.** Stock market prices have moved broadly in line with prices in other emerging markets. Despite some increase since mid-2011, bank funding costs remain well below their levels after the Lehman crisis. A rise in liquidity pressures in domestic money markets in December 2011 was successfully contained with temporary liquidity measures.

9. **The withdrawal of fiscal stimulus continued in 2011, but some easing of the policy stance is projected for 2012**. The structural fiscal deficit (which adjusts for the economic and copper price cycles, see Annex I) narrowed by about 1½ percentage points of GDP in 2011, as expenditure growth slowed down and a temporary corporate tax increase gave a boost to revenue. The non-mining structural primary balance in percent of non-mining GDP (a metric which captures better the economic effects of fiscal policy in commodity-producing countries) also showed significant fiscal withdrawal (Table 2).[1] However, an increase in education and other social spending in 2012 will result in some easing of the fiscal policy stance in 2012. Real government expenditure is projected to grow at 6½ percent, more than real GDP growth, and the non-mining primary structural deficit is projected to widen.



Sources: Ministry of Finance, and Fund staff estimates and projections.

10. **A tax reform, expected to yield about 0.3 percent of GDP in additional revenue, has been recently proposed by the government.** The reform will make permanent the increase in the corporate tax rate from 17

[1] In principle, changes in the overall and the non-mining structural balances should be similar. Notable differences would arise when there is a significant change in the long-term copper price set by the expert committee, since that affects structural copper revenues.

to 20 percent.[2] There would be offsetting reductions in taxes on personal income and financial transactions. The net increase in revenues relies in part on the elimination of tax loopholes and improvements in tax collection (see Annex II for details). The bill was submitted to Congress in August; if approved, it will take effect in late 2012.

11. The authorities' macroeconomic policies over the past year have been broadly in line with Fund advice. As recommend by staff, an ambitious fiscal withdrawal in 2011 helped reduce domestic demand pressures and build up fiscal assets. However, the authorities chose to leave their medium-term structural deficit target unchanged at 1 percent of GDP, instead of aiming for continued gradual fiscal consolidation. Progress has been made in strengthening the regulatory and supervisory framework of the financial sector and reducing information gaps.

OUTLOOK AND RISKS

12. Looking forward, growth is expected to moderate. Staff's central scenario assumes no escalation of tensions in the euro area and moderate global growth (in line with the July 2012 WEO projections). In this context, real GDP growth for 2012 is expected to be around 4¾ percent, broadly in line with staff's estimate of Chile's potential growth. Private consumption growth is projected to slow down as employment growth moderates. Demand for durable goods has already slowed from high post-earthquake levels. Machinery and equipment investment growth would also moderate, although construction and engineering works investment would remain robust, supported by large mining and energy projects. Net exports should have a smaller negative contribution to growth compared to 2011, as real import growth converges to the rate of growth of domestic demand. In spite of this, the external current account deficit is projected to widen further (to about 3 percent of GDP), due in part to less favorable terms of trade. Both core and headline inflation rates are expected to remain close to the target as domestic demand growth moderates and import prices remain subdued.

13. Large risks surround the baseline scenario. On the upside, domestic demand may grow faster than expected, supported by strong wage growth and positive consumer and business confidence. With the output gap already closed, additional pressures on capacity constraints would put upward pressure on inflation and on the external current account deficit. Further widening of the current account deficit would increase Chile's exposure to external shocks. There are two key downside risks:

- *Renewed escalation of financial tensions in the euro area.* Although direct bank funding exposure to the euro area is small, an intensification of tensions in Europe could have negative effects on confidence, affecting the availability and cost of funds for Chilean banks and corporations.[3]

[2] The corporate tax rate was increased from 17 percent in 2010 to 20 percent in 2011, and 18.5 percent in 2012, to help finance reconstruction from the February 2010 earthquake.

- *Sharp growth deceleration in China*. Copper accounts for more than half of all exports and China is Chile's main trading partner. A significant slowdown in China's economic growth, accompanied by a decline in world commodities demand, could prompt a sharp fall in copper prices, affecting Chile's current account and growth prospects.

Heightened volatility of capital flows is another risk. In the near term, bouts of increased global investors' risk aversion may trigger capital outflows. Over the medium term, the prospect of a prolonged period of low interest rates in advanced economies may induce new waves of capital flows to fast-growing emerging markets like Chile, fueling credit growth and raising the risk of asset price bubbles.[4]

14. The authorities broadly agreed with the outlook and the characterization of the key risks. They noted that, historically, domestic pension funds have provided a natural hedge against capital outflows, increasing their purchases of domestic assets in times of rising global risk aversion. They also emphasized that the flexible exchange rate is an effective shock absorber, and would help mitigate the effect of external shocks on the current account deficit. They also noted that the recent deterioration in the current account balance had been driven in part by higher foreign investment in the mining sector, which would help support future exports.

POLICY DISCUSSIONS

Discussions focused on policies to preserve macroeconomic stability and reduce vulnerability to external shocks. In particular, discussions centered on the appropriate policy mix under the baseline and various risk scenarios; the importance of maintaining strong fiscal buffers; measures to preserve financial sector stability; and the challenge of raising productivity growth.

A. Near-Term Policy Mix

15. Staff argued that it would be desirable to maintain tight control of fiscal expenditure in the remainder of 2012. The withdrawal of fiscal stimulus in 2011 helped reduce overheating pressures, contain the rise in consumer prices, and increase net public assets. However, there is some easing of the fiscal stance in 2012, despite a favorable cyclical position. Staff suggested keeping tight control on expenditure in the remainder of the year and allocating any savings to improve the fiscal balance, as was done in 2011. Fiscal restraint also would help contain the deterioration of the external current account. The authorities responded that there is limited flexibility to deviate from the expenditure level approved in the Budget.

16. There was agreement that monetary policy should remain responsive to global

[3] Analysis presented in a selected issues paper finds that the investment and sales of firms with higher dependence on external financing were more negatively affected during the 2008/09 crisis.

[4] See the Risk Assessment Matrix in Annex III for a more detailed discussion of risk to the outlook.

and domestic shocks. Staff saw the current neutral stance as appropriate, given the prospect of a slowdown in output growth towards potential and volatile global financial conditions. With domestic risks mostly on the upside, staff and central bank officials agreed that wage developments, credit growth, and other indicators of capacity constraints pressures had to be monitored carefully. The authorities reiterated their commitment to respond quickly if any of the downside risk scenarios were to materialize.

B. Coping with Risks

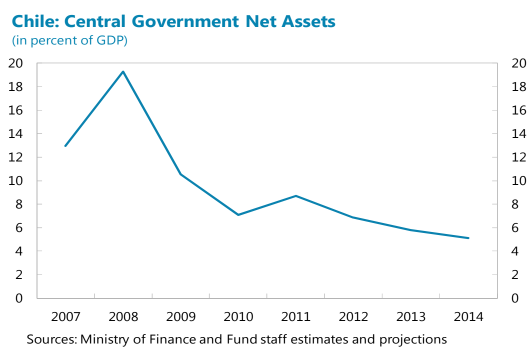
17. A sharp deterioration of external financing conditions should trigger resolute actions to maintain confidence and ensure orderly functioning of domestic markets. There was agreement that the authorities should be prepared to use measures similar to those deployed in Chile after the Lehman crisis to contain liquidity pressures, including expanding repo operations, broadening the range of accepted collateral, and setting up dollar swap auctions. Staff emphasized that a good communication strategy would also be important to preserve confidence. With inflation near the target and well-anchored inflation expectations, there is ample space to ease monetary policy, if necessary. Automatic fiscal stabilizers would also provide support. Staff indicated that temporary fiscal stimulus should be considered only as a last resort, if there is evidence of a sharp decline in activity. The authorities agreed and noted that they have prepared a crisis contingency plan, including measures to maintain employment and temporary fiscal stimulus, but that it will be put in action only in case of a large negative shock to output.

18. There was agreement that exchange rate flexibility would help mitigate the economic impact of a sharp decline in the external terms of trade. Depending on the size of the shock, temporary easing of macroeconomic policies could also be appropriate to help smooth the adjustment. It would be important, however, to avoid a large permanent decline in government net assets.

19. Staff and the authorities concurred that exchange rate flexibility would also remain the first line of defense if capital flows volatility were to increase. Staff noted that the flexible exchange rate has helped contain speculative investment in the past by reducing one-sided bets on the currency, and should remain the main tool to limit capital flow pressures. If strong inflows resume, raising the risk of credit and asset price bubbles, macroeconomic policies may need to be adjusted accordingly. There was broad agreement that macroprudential policies could also be considered, if necessary. The choice of measures would depend on the specific issues that arise. Staff suggested including the option of setting time-varying capital buffers in the revised General Banking Law to increase the range of available macroprudential instruments. The authorities noted that Chilean banks typically keep capital buffers well above the required minimum, so using countercyclical capital buffers as a macroprudential tool may be difficult.

C. Medium-Term Fiscal Policy

20. Staff emphasized that maintaining strong fiscal buffers should remain a key priority. Chile's high dependence on volatile commodity income and vulnerability to adverse global financial developments and natural disasters make large fiscal buffers particularly important. The 2009 financial crisis illustrated the sensitivity of Chile's net asset position to large external shocks. Central government net assets stood at 8.7 percent of GDP at the end of 2011 (compared to almost 20 percent in 2008), and are projected to decline as a share of GDP in the medium term.



21. Staff recommended targeting a structural balance by 2015, and weighing the benefits of targeting a small structural surplus thereafter. A structural surplus target would help maintain significant fiscal buffers, which would increase policymakers' flexibility to respond to adverse shocks in the future and would prepare the country better to meet longer-term fiscal challenges related to population aging. The authorities agreed that maintaining strong fiscal buffers is important, and that it would be desirable to aim for structural surpluses further out, but noted that the planning horizon of the current administration ends in 2014. They reiterated their commitment to attain a structural fiscal deficit of 1 percent of GDP by 2014, and to keep the growth rate of public expenditure below GDP growth on average over the term of the administration. Staff supported the commitment, but argued that a faster pace of consolidation would be desirable if economic conditions remain favorable.[5]

22. The authorities agreed with staff that new permanent spending commitments should be matched with permanent revenue increases. The tax reform proposed by the government aims to finance the increase in education spending envisaged in the budget. Staff noted that to achieve the targeted increase in tax collection, further improvements in tax administration may be necessary. The authorities pointed out that tax collection has already improved in the last two years.

23. Staff suggested that work to strengthen further the medium-term fiscal framework should continue. Staff welcomed recent improvements in the medium-term fiscal expenditure forecasting framework, implemented with the help of Fund experts. Drawing on the recommendations of the advisory commission of the fiscal rule set up by the government in 2010, staff supported the establishment of an independent Fiscal Council. The authorities responded that they expect to set up a Fiscal Council in the coming months. In addition, staff suggested

[5] Based on the latest fiscal projections (in the 2012 Budget), the structural fiscal deficit in 2013 would be 1.3 percent of GDP. If the proposed tax reform is adopted, the structural balance will be around 1 percent in 2013 (unchanged from 2012), in the absence of changes in expenditure plans.

incorporating long-term fiscal projections and an assessment of key fiscal risks in the regular budget discussions to inform policymaking and help anchor medium-term fiscal targets. These long-term projections should take into account expenditure changes related to demographic developments, as well as potential pressures on the revenue side (including the rise in copper extraction costs). The authorities noted that they plan to extend the annual report on long-term fiscal trends to include projections of health care and education spending.

D. Maintaining Financial Stability

24. Chile's banks remain well capitalized and profitable. Both regulatory and Tier 1 capital levels are high (above 14 percent and 10 percent respectively). Bank liquidity ratios are also relatively high. Returns on assets and equity are comfortable (see text table), and non-performing loans are low, at about 2½ percent of total loans. The share of external financing in total bank financing remains below 10 percent. Moreover, since late 2010, banks have diversified geographically their external funding sources (Figure 7).

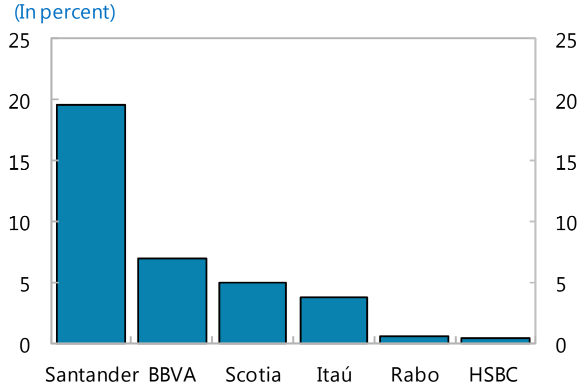
Financial soundness indicators 1/	2008	2009	2010	2011	Jan-12
Regulatory Capital to Risk-Weighted Assets	12.5	14.3	14.1	13.9	...
Reg. Tier 1 Capital to Risk-Weighted Assets	9.9	10.9	10.1	10.1	...
Non-performing Loans to Total Gross Loans	1.0	2.9	2.7	2.3	2.5
Return on Assets	1.0	1.2	1.5	1.4	1.3
Return on Equity	12.4	15.1	18.6	17.4	17.3
Liquid Assets to Total Assets	12.5	16.3	14.4	15.2	14.2

Source: SBIF

1/ Introduction of IFRS in 2009; pre-2009 figures not comparable

25. So far, bank deleveraging in Europe and strains in the Spanish banking system have had limited effect on Chile's banks. Subsidiaries of Spanish banks have substantial presence in Chile (see chart). In November 2011, Santander Spain sold 7.8 percent of its shares in Santander Chile. The sale caused a temporary drop in the stock price, but had no notable effect on system-wide credit.

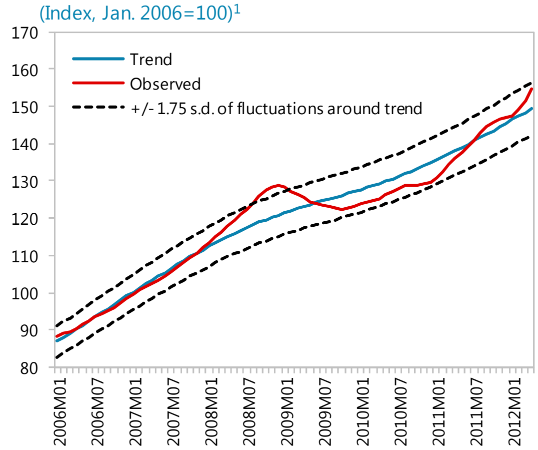
Market shares of foreign banks (loans)
(In percent)



26. Household leverage has remained broadly stable and house price growth has been moderate (Figure 9). Household debt has grown broadly in line with disposable income since 2008, and debt service as a share of income also has remained broadly stable. A recently released index of house prices suggests that real annual price increases have been fairly modest since 2004. Loan-to-value ratios for new mortgage loans average about 80 percent. A potential area of concern is the rate of growth of bank consumer loans, which remains high despite some deceleration in recent months.

27. Corporate debt as share of GDP has increased somewhat since 2010. The pace of growth of credit to corporates has been above trend since mid-2011, although it remains below thresholds that have been associated with a credit boom in the literature. The rise in leverage is concentrated in certain sectors, including construction and retail, which could increase their vulnerability to a slowdown in economic activity. New data on commercial real estate show that price growth has been broadly in line with fundamentals, despite some acceleration in 2011. The share of external debt has remained broadly unchanged, at about 30 percent of total corporate debt. Central bank data suggest that there are no large currency mismatches in the corporate sector.

Chile: Real Bank Corporate Credit
(Index, Jan. 2006=100)[1]



Sources: Datastream; and Fund staff calculations.
[1] Threshold based on Mendoza and Terrones (2008)

28. Despite its strength, Chile's financial system remains exposed to sudden changes in global financial conditions. An escalation of tensions in the euro area is likely to affect financial conditions in Chile. Staff analysis suggests that the cost of bank funding in Chile is positively related to measures of global financial stress, and that both real and financial external shocks affect Chile's economic performance (Box 2). Some small and medium-sized banks, which rely more heavily on foreign financing or wholesale funding, could be particularly affected. Nonetheless, staff agreed with the authorities that spillovers to European bank subsidiaries should be contained if depositor confidence is preserved. Foreign bank subsidiaries rely mostly on domestic deposits for funding, and financial links with parent banks are strictly limited by local regulations.[6] European bank subsidiaries in Chile currently have higher ratings than their parent banks, reflecting the strength of their balance sheets.

29. Staff also noted that negative output shocks could lead to a cyclical deterioration of credit quality. Staff argued that a sharp global slowdown, accompanied by sustained declines in commodity prices, will affect Chile's output and employment and could push up non-performing loans. Non-bank credit card lenders also would see a rise in defaults since they typically focus on higher-risk low-income borrowers, who are more vulnerable to an economic slowdown.

30. In light of these risks, staff argued that the focus of prudential policy should be to reduce vulnerabilities. The authorities agreed with staff that banks should continue to maintain high levels of liquidity and capital to minimize the risk of contagion from an intensification of financial tensions in the euro area. Banks should also continue to diversify external funding sources to reduce reliance on a few large global financial institutions. On the asset side, banks and non-bank creditors may need to tighten lending standards further to limit risk taking in the current favorable economic environment. Staff also suggested that supervisors should continue to monitor carefully the rise in corporate indebtedness and the growth of consumer loans.

31. The authorities agreed with staff's characterization of financial sector risks and

[6] European bank subsidiaries do not borrow from the parent banks, and total lending to foreign related parties (including parents) are limited by law to 25 percent of capital (secured) or 5 percent of capital (unsecured).

with the need for continued vigilance. They discussed similar risks in the central bank's Financial Stability Report (FSR) in June. At the same time, they pointed out that banks' strong capital buffers should help limit potential vulnerabilities. Stress test results, presented in the Central Bank's FSR suggest that capital adequacy ratios will remain above regulatory requirements for the large majority of banks under a risk scenario of negative output growth in the second half of 2012, temporary peso depreciation, and higher short-term interest rates.

E. Strengthening the Prudential Framework

32. The mission welcomed the strengthening of the institutional set up for monitoring and managing systemic risks. In 2011, the government created a Financial Stability Council (FSC), with a mandate to monitor and manage systemic risks and facilitate coordination among the supervisory agencies, including in the area of the supervision of financial conglomerates. The FSC comprises the Minister of Finance and the heads of the three financial supervisory agencies (overseeing banks, insurance and securities, and pensions). The central bank Governor is not a formal member of the FSC (because of the legal independence of the central bank), but he attends all meetings and participates actively in the Council's deliberations. The Council has initiated work on developing methodologies to assess stability risks related to financial conglomerates. In addition, the authorities have enhanced the powers of the National Consumer Service (Sernac) in the area of financial services, which should help strengthen consumer protection in that area. Finally, staff noted that the recent publication of housing and commercial real estate price data would allow better monitoring and identification of risks.

33. The authorities and staff concurred that several legislative initiatives, currently before Congress, would make an important contribution to enhancing prudential oversight. The proposed law on risk-based supervision of insurance companies would enhance significantly the assessment and management of insurers' risk and increase the enforcement powers of supervisors. Proposed legislation to expand the existing credit registry to include comprehensive credit history information from banks and non-banks would help improve the evaluation and pricing of credit risk. The corporate bankruptcy law under discussion will streamline the bankruptcy process and facilitate business restructuring.

34. Staff emphasized that efforts to strengthen the financial regulatory and supervisory framework should continue, as recommended by the 2011 FSAP. Staff welcomed the authorities' plans to update the General Banking Law and review the legal framework for bank resolution. Given the large presence of conglomerates in Chile's financial system, it will be important to establish a legal framework for consolidated supervision. The authorities agreed in principle, and noted that they are making progress in this area under the direction of the FSC. Staff noted that strengthening the corporate governance structure of the financial supervisory agencies would enhance their operational independence and improve accountability (see

Annex IV for progress on other FSAP recommendations).

F. Raising Productivity Growth

35. There was agreement that raising productivity growth remains an important challenge. Staff noted that over the last decade rising employment has been a key driver of Chile's rapid growth, however, labor productivity growth has slowed down (see Box 3). While there is room to increase further female and youth labor force participation rates (which are below OECD averages), future growth would have to rely increasingly on productivity increases. Staff welcomed the approval of the new poverty-reduction program Ingreso Etico Familiar, which aims to foster female labor participation and reward academic achievement of children from low-income families. Staff also commended recent initiatives to reduce the time it takes to incorporate a business, improve intellectual rights protection laws, and strengthen competition.

36. Staff urged the authorities to persist in their efforts to achieve consensus on measures to increase labor market flexibility and efficiency. In line with OECD recommendations, staff suggested that labor market efficiency could be enhanced by moving away from the system of high severance payments for workers, increasing the flexibility of working hours, and improving the efficiency of training programs. The authorities agreed that it is desirable to improve labor market efficiency, although building consensus on specific measures has been difficult. They are now in the process of evaluating training programs and discussing options to improve their effectiveness. Staff noted that the ratio of minimum-to-average and minimum-to-median wages is higher in Chile than in most OECD countries, which could hinder formal employment growth and increase the informal sector. In addition, Chile faces higher energy prices than most OECD economies and neighboring countries. Staff and the authorities agreed that high energy prices have a negative effect on potential output and could reduce competitiveness. Measures to facilitate private investment in the generation and transmission of electricity would help increase supply and reduce prices.

STAFF APPRAISAL

37. After two years of robust expansion, output growth is expected to moderate to trend levels. Real GDP is projected to grow at 4¾ percent in 2012. Private consumption growth is moderating in line with employment growth. Private investment is also expected to decelerate, and import growth would converge to the lower growth rate of domestic demand. The external current account deficit is projected to widen further largely due to deteriorating terms of trade. Core and headline inflation are expected to remain close to the target.

38. Chile's key near-term challenge is to preserve macroeconomic and financial stability. There are substantial risks to the outlook, stemming from heightened global uncertainty. The key downside risks are a sharp intensification of financial tensions in the euro area and the possibility of a significant slowdown of economic activity in China resulting in a sharp drop in commodity prices.

39. Monetary policy should remain responsive to changing economic conditions. The current neutral stance is appropriate, given the prospects of a gradual convergence of domestic output growth towards potential and anchored inflation expectations. With the output gap closed and tight labor markets, wage developments, credit growth, and asset prices should be monitored carefully.

40. In case of a sharp deterioration of financing conditions, decisive actions should be taken to ensure orderly market functioning. Efforts should focus on containing liquidity pressures. A good communication strategy would also be important to maintain market confidence. With anchored inflation expectations and inflation near the target, there is ample space to ease monetary policy, if needed. Automatic fiscal stabilizers would also provide support, however, discretionary fiscal stimulus should be considered only in the case of a sharp decline in economic activity.

41. Exchange rate flexibility remains an important buffer against volatile capital flows and terms of trade shocks. It has played an important role in limiting speculative capital inflows and in facilitating adjustment to large terms of trade changes. In case of renewed capital inflow pressures, macroeconomic policies may need to be adjusted to limit the risk of credit and asset price bubbles. Macroprudential policies could also be considered to help maintain stability.

42. Public expenditure restraint in the remainder of 2012 would be desirable. The withdrawal of fiscal stimulus in 2011 helped contain overheating pressures, but the fiscal stance was eased somewhat in 2012. Despite the favorable cyclical conjuncture, public expenditure growth is likely to exceed GDP growth. It would be advisable to maintain a tight control on fiscal spending in the remainder of the year and allocate the savings to increase net fiscal assets, as was done in 2011. Staff welcomes the authorities' intention to increase tax revenue to match the permanent increase in education expenditure.

43. Staff urges the authorities to achieve structural fiscal balance by 2015, and consider targeting a small surplus thereafter. Maintaining strong fiscal buffers will enhance Chile's resilience to external shocks, and would allow the government to cope better with long-term fiscal challenges related to population aging. Staff supports the authorities' commitment to meet their 1 percent structural fiscal deficit target by 2014. If economic conditions remain favorable, more ambitious frontloaded deficit reduction would be desirable.

44. Efforts to continue strengthening Chile's fiscal framework are welcome. The planed creation of a Fiscal Council would help strengthen policy assessment and accountability. Plans to extend the long-term fiscal projections to include health care and education spending also are welcome. Discussion of other fiscal risks, including potential pressures on the revenue side, would also help inform policy decisions.

45. Although financial soundness indicators remain strong, continued vigilance is warranted. An escalation of financial tensions in the euro area is likely to affect financing conditions for Chilean banks and corporations. To protect against this risk, banks should maintain high levels of liquidity and capital, and continue to diversify external funding sources. A negative output shock could lead to a deterioration of credit quality. Bank and non-bank creditors may need to tighten lending standards further to limit risk taking in the current favorable economic environment. The rise in debt in certain business sectors warrants close monitoring.

46. Staff supports the authorities' efforts to strengthen further the prudential framework of the financial system. The recently established Financial Stability Council would strengthen the monitoring and management of systemic risk, and facilitate coordination in times of crisis. Several current legislative initiatives, including the law on risk-based supervision of insurance companies, the corporate bankruptcy law, and the proposal to expand the credit registry, would also make an important contribution to enhancing prudential oversight. Plans to update the General Banking Law and review the legal framework for bank resolution are also welcome. As recommended by the 2011 FSAP Update, it will be important to establish a legal framework for consolidated supervision of financial conglomerates.

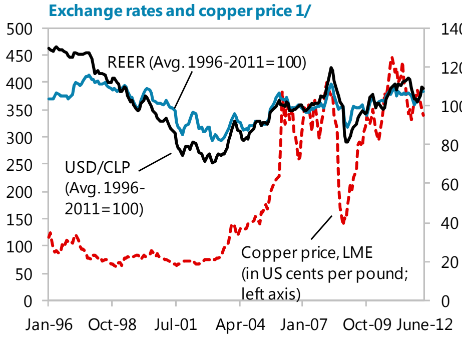
47. Increasing productivity growth remains Chile's key medium-term challenge. Staff welcomes recent government initiatives to foster female labor participation, streamline business incorporation and bankruptcy process, and strengthen competition. Labor market flexibility could be further enhanced by reforming high severance pay for employees, increasing the flexibility of working hours and the efficiency of training programs. Chile's relatively high ratio of minimum-to-average wages could hinder employment growth and contribute to growth of the informal sector. To contain this risk, minimum wage increases should be consistent with productivity growth. Measures to facilitate investment in the energy sector would help improve the competitiveness of Chilean firms.

48. Staff recommends that the next Article IV consultation takes place on the standard 12-month cycle.

Box 1. Assessment of Chile's External Position

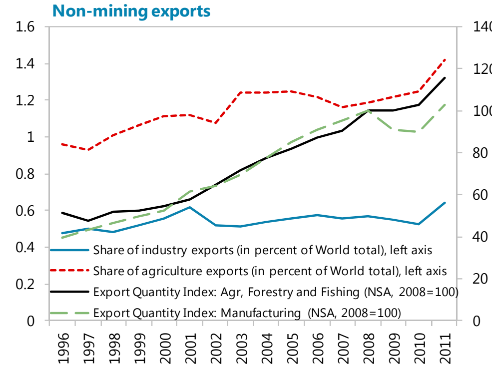
Chile's real effective exchange rate (REER) has fluctuated around its long-term average in recent years. The REER strengthened in the mid-2000s alongside a copper price boom. In the last two years, it has hovered around its average value of the previous 15 years. Despite the appreciation, Chile's non-mining export growth over the last decade has been relatively robust. In addition, Chile's world market share of agricultural and industrial exports has remained broadly stable since 2004.

Exchange rates and copper price 1/



1/ An increase in the exchange rates indicates an appreciation.

Non-mining exports



Chile's ability to maintain robust non-mining exports is attributable to a number of factors. The structure of Chile's industrial exports played a role: resources-based exports such as food and wood products account for two thirds of Chile's industrial exports. Chile was therefore able to avoid competing with manufacturing powerhouses such as China. In addition, since 2003, Chile has ratified free trade agreement (FTA) with all of its major trading partners.

CGER estimates suggest that the real effective exchange rate is broadly in line with fundamentals (see table). However, the new External Balances Assessment's current account approach (explained in IMF's Pilot External Sector Report, July 2012) suggests that the current account balance is about 2 percentage points below the estimated norm under desirable policies, implying a small overvaluation of the real exchange rate (about 7 percent). The current account deficit is driven in part by imports related to higher investment in mining and energy, which should support future exports. More ambitious fiscal consolidation, consistent with staff advice, would also help reduce the current account deficit.

REER Gaps Based on CGER Methodologies 1/

	MB	ERER	ES
Exchange rate gap	0.0%	-2.3%	2.1%

1/ Positive values indicate overvaluation.

The macroeconomic balance (MB) approach calculates the difference between the medium term CA balance and a CA "norm", which is a function of fundamentals (fiscal balance, old-age dependency, NFA, oil balance, real GDP per capita, and real GDP growth). The ERER is a function of fundamentals (NFA, relative productivity differentials, the TOT, and trade restrictions). The ES approach calculates the difference between the actual and NFA-stabilizing CA balances. The real exchange rate adjustment will bring the CA in line with its NFA-stabilizing level.

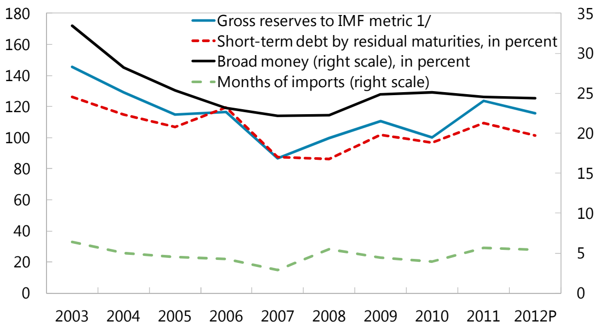
For more detail on the CGER methodology, see Lee et al., "Exchange Rate Assessments: CGER Methodologies," IMF Occasional Paper No. 261, April 2008.

Looking at the financing side, the external current account deficit is financed mostly by FDI. FDI inflows are much larger and more stable than portfolio and other investment inflows. FDI inflows are expected to remain strong in the medium term, especially in the mining sector. Net external liabilities stood at 10 percent of GDP in 2011, relatively low compared to other emerging markets.

Box 1. Assessment of Chile's External Position (Concluded)

Chile's international reserve position is adequate based on various reserve metrics. International reserve stood at US$40.3 billion at end-June 2012, which is close to 100 percent of short-term debt at residual maturity. The reserve level is also considered adequate when measured relative to imports, broad money, or using the new IMF metric.

Chile: International Reserve Adequacy

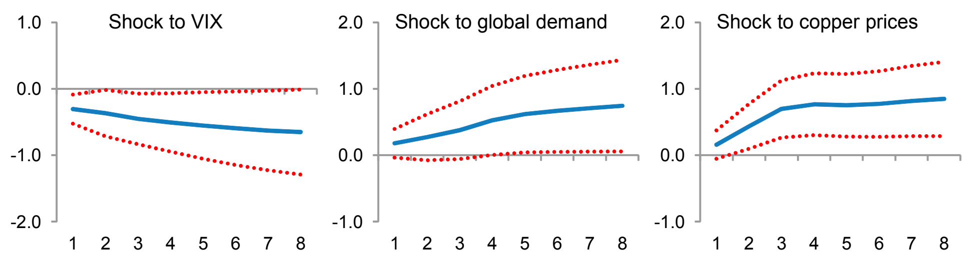


Sources: Central Bank of Chile and IMF staff estimates.
1/Metric proposed in "Assessing Reserve Adequacy" (SM/11/31); the suggested adequacy range is 100-150 percent.

Box 2. Financial and Real Spillovers to Chile

As a small open economy, Chile is exposed to external shocks. Chile's trade openness and international financial integration are significant. Chilean banks and corporations are net borrowers in world markets, so the cost and availability of domestic financing are affected by global factors. In addition, subsidiaries of foreign banks account for a large share of bank assets. Staff analysis based on a vector autoregression suggests that global financial and demand shocks, and shocks to copper prices have an important impact on Chile's output.

Chile: Cumulative Response of Output to External Shocks[1]

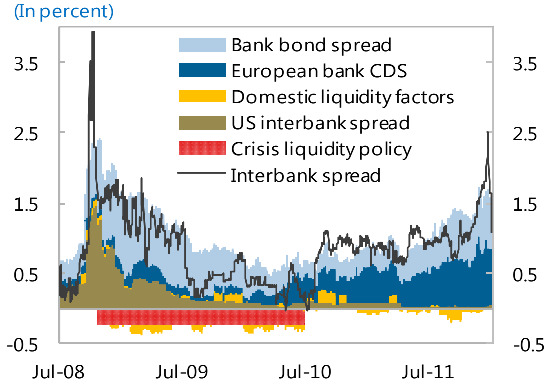


Source: Selected Issues Paper

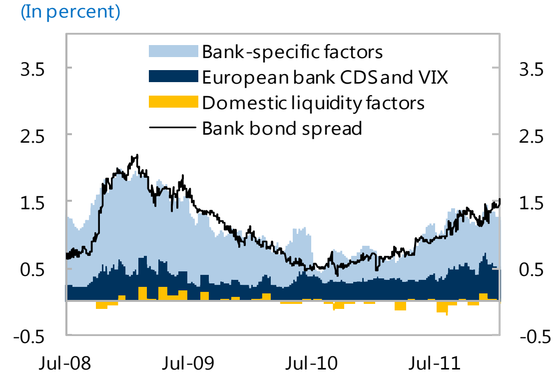
[1] Cumulative response of Chile's GDP to one standard deviation shock. Time horizon in quarters.

More detailed analysis shows that global financial shocks affect bank funding costs in Chile. The analysis presented in the selected issues paper finds that interbank and bank bond spreads are highly correlated with measures of global financial stress. Independent variables include global variables such as the composite CDS spread of the largest European banks, VIX, foreign interbank spreads, and domestic liquidity variables. During the Lehman crisis, the US interbank market spread explained the bulk of the movement in the Chilean interbank spread; while the last two years, domestic bank funding costs have been positively correlated with European bank CDS spreads and the VIX. Despite these links, spillovers from global financial stress have been limited. In the last two years, average funding spreads have been low, at around one percent, and bank credit growth has been very strong.

Interbank Spread
(In percent)



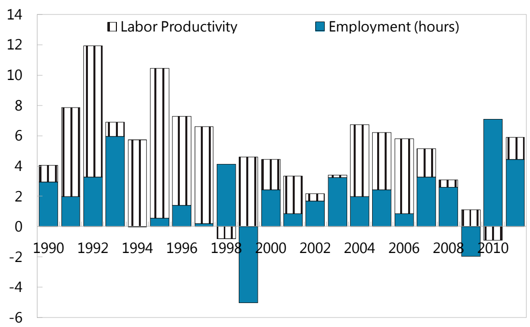
Bank Bond Spread
(In percent)



Box 3. Labor Productivity

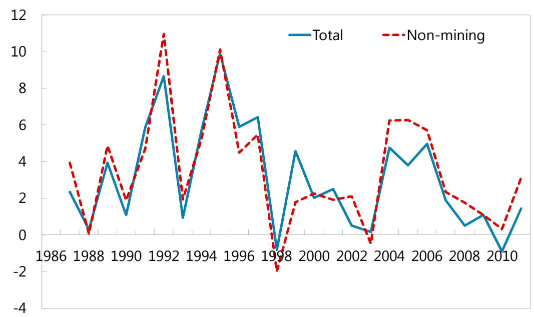
Labor productivity gains in Chile moderated over the last decade. Average annual labor productivity growth declined from 4.8 percent in the 1990s to 1.5 percent in 2006–2011. Some of the decline is explained by lower productivity in the mining sector related to declining ore grade. However, non-mining labor productivity gains also declined (from 4.5 percent per year in the 1990s to 2.4 percent in the last five years).

Chile: Growth Decomposition
(percentage points)



Sources: National authorities and Fund Staff estimates

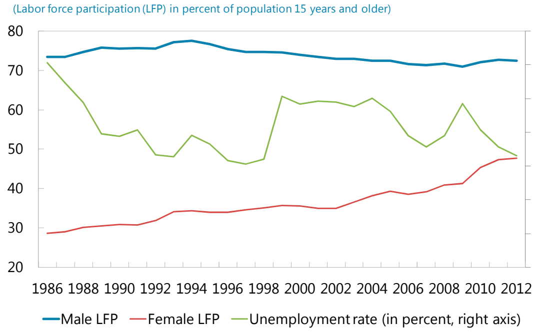
Chile: Labor Productivity
(annual percentage change)



Sources: National authorities and Fund staff estimates

Following the 2009 crisis, output growth has been underpinned by strong employment growth. Labor force participation increased 4 percent per year driven by rising female participation, while employment growth averaged 6 percent per year. After declining in 2010, labor productivity grew 1½ percent in 2011. Although there is still room to raise female and youth participation rates which are below the OECD average, output growth going forward will depend increasingly on productivity gains.

Chile: Labor market trends
(Labor force participation (LFP) in percent of population 15 years and older)



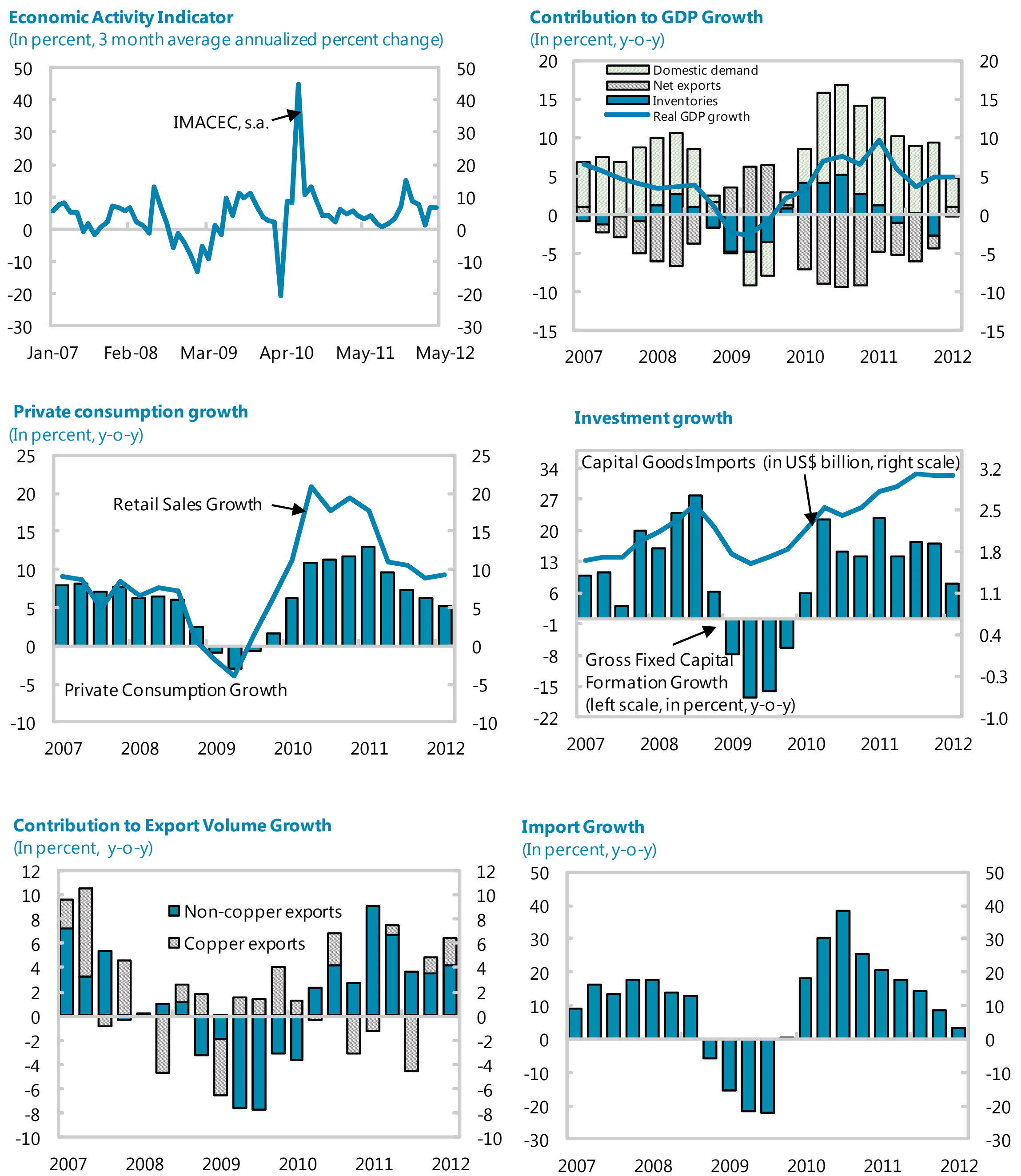
Sources: Chile's National Statistics Institute.
Data starting in March 2010 correspond to the new employment survey. March for 2012.

Chile: Youth and Female Labor Participation
(youth in percent of 15-24 population; female in percent of 15-64 population)

Sources: OECD, Labour Force Statistics Database

Raising productivity growth has been at the center of the authorities' reform agenda. The conditional cash transfer program for low-income families, Ingreso Ético Familiar, includes transfers conditional on educational achievement of children as well as work-subsidies for women. In addition to increasing female labor participation, the program would also help reduce poverty and income inequality further (recently released data show that income inequality has declined in 2011, although it remains at a high level, with a Gini coefficient of 0.52), The recent education reform has emphasized improved access to tertiary and pre-school education. The authorities are also pressing ahead with reforms to improve intellectual property rights and streamline procedures for business incorporation and bankruptcy. As noted by recent OECD reports, however, there is a need to further enhance the flexibility of Chile's labor market and improve the quality of human capital.

Figure 1. Chile: Domestic Demand and Net Exports (Through May 2012)

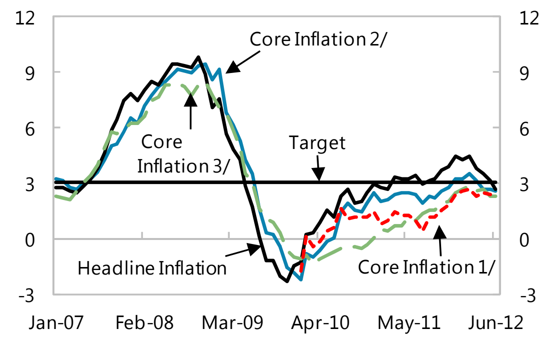


Sources: Haver Analytics Inc, Chilean authorities, and Fund staff estimates.

Figure 2. Chile: Inflation, Labor Markets and Monetary Policy (Through July 2012)

Inflationary pressures have moderated...

(In percent, y-o-y)

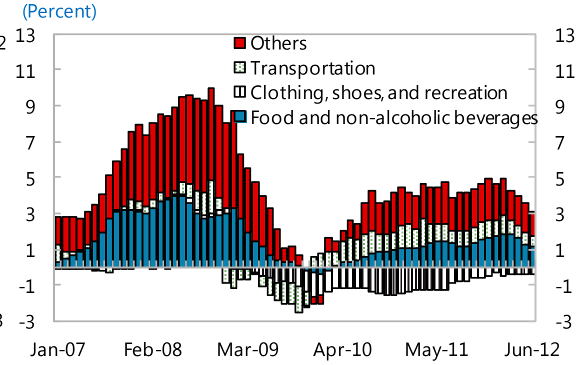


1/ CPI less food and energy
2/ CPI excluding fuels and fresh fruit and vegetables (IPCX).
3/ CPI less energy, perishables and administered prices.

...as food and energy price growth has eased.

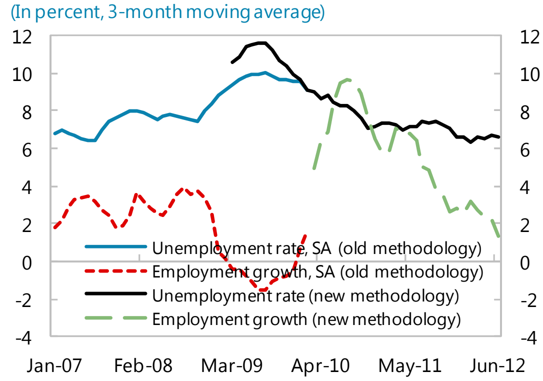
Inflation Components

(Percent)



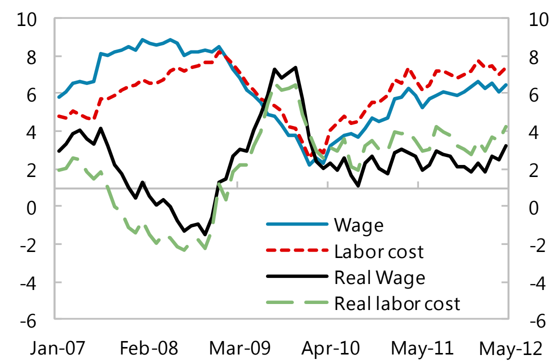
Unemployment is near historical lows...

(In percent, 3-month moving average)



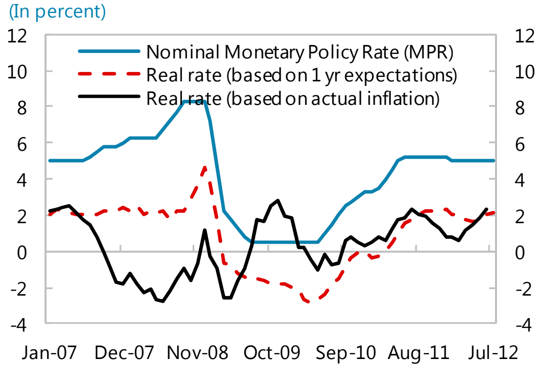
...fueling wage pressures

(In percent, y-o-y)



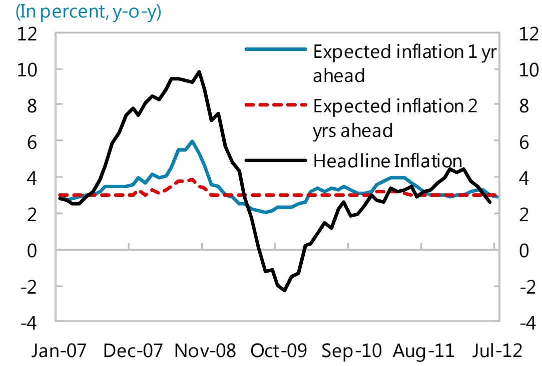
The policy rate was lowered to 5 percent in January 2012.

(In percent)



Inflation expectations remain well anchored.

(In percent, y-o-y)

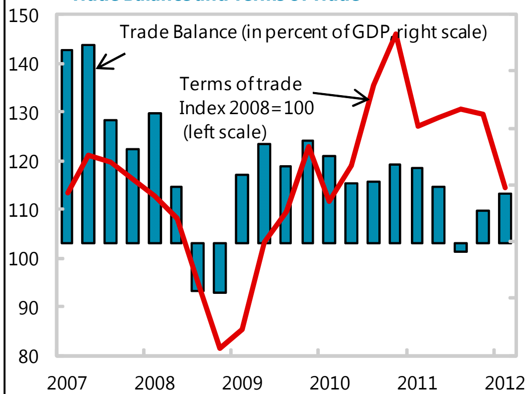


Sources: Central Bank of Chile and Fund staff calculations.

Figure 3. Chile: External Current Account Balance (Through June 2012)

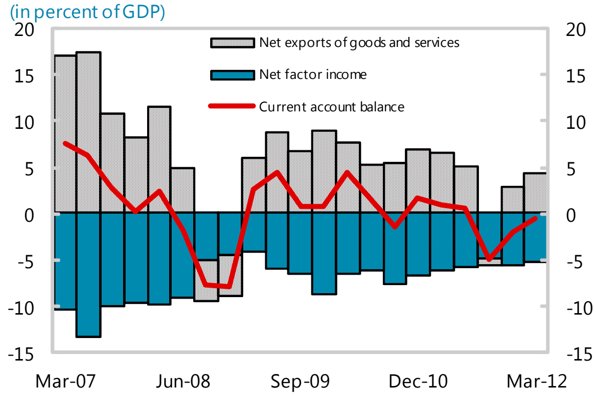
In 2011, the surplus in the trade balance declined...

Trade Balance and Terms of Trade



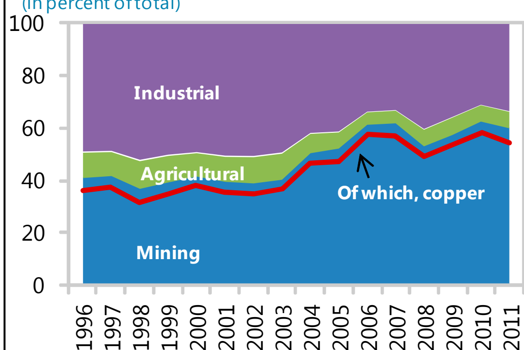
...and the current account turned into a deficit.

Current Account Components
(in percent of GDP)



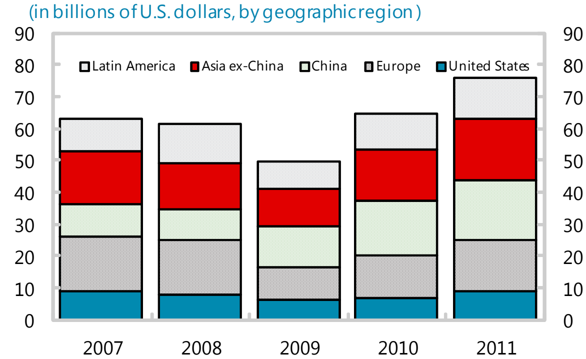
Mining products continue to dominate exports...

Export shares
(in percent of total)



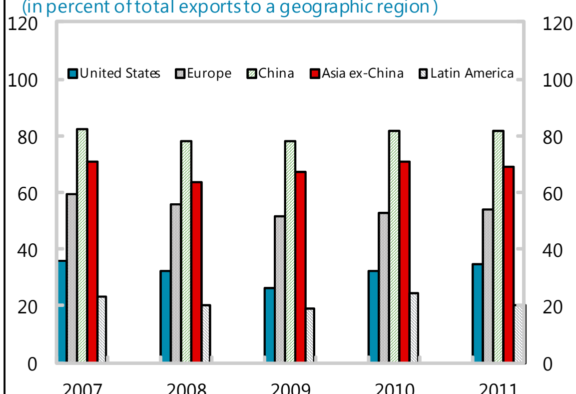
...making exports particularly vulnerable to a slowdown in Asia...

Exports
(in billions of U.S. dollars, by geographic region)



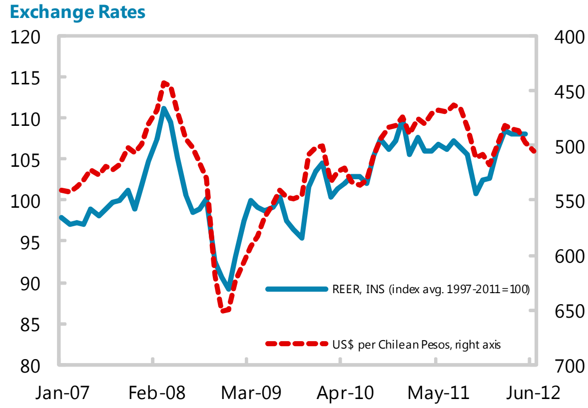
Copper and copper products account for the main share of exports to Asia.

Copper exports
(in percent of total exports to a geographic region)



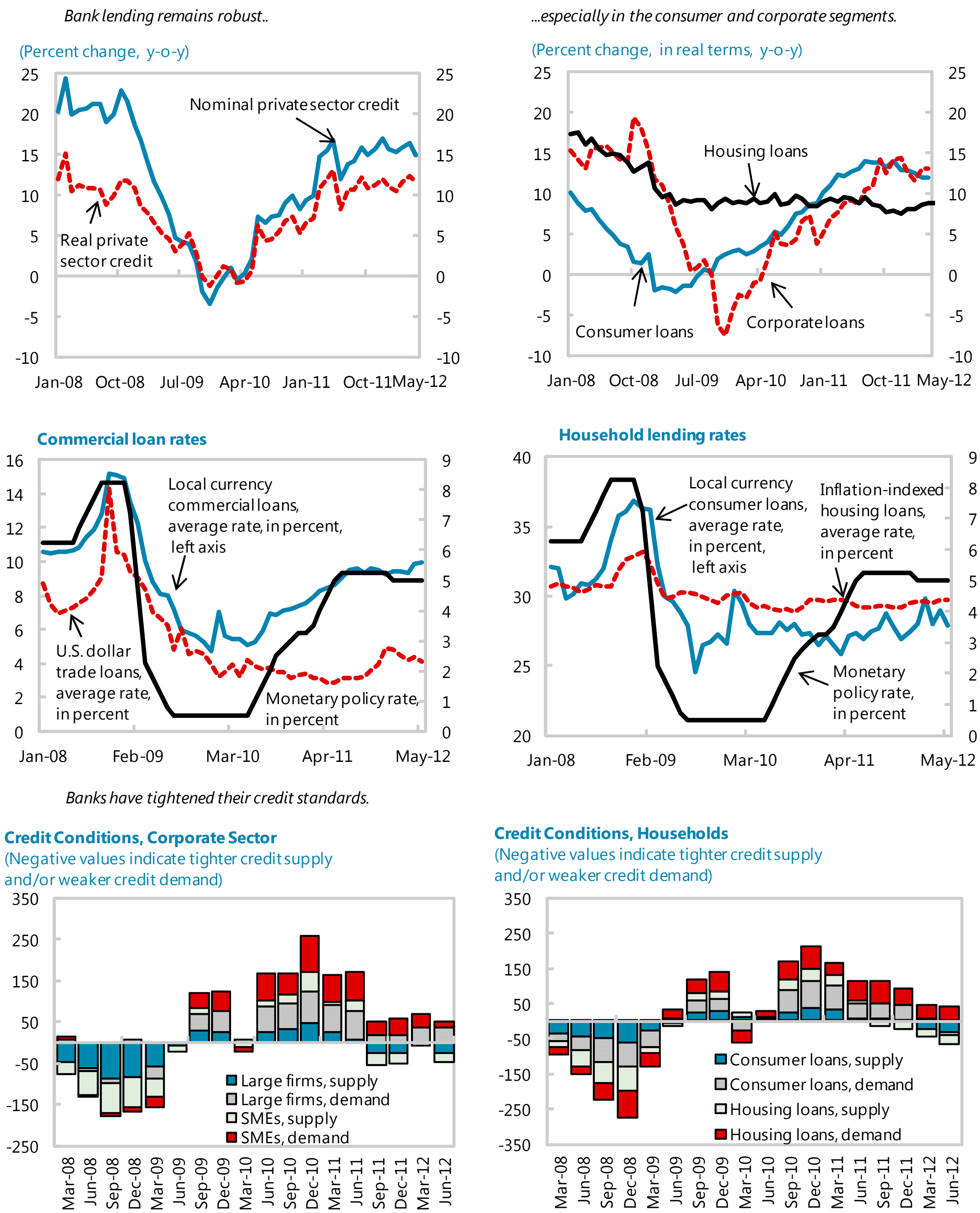
Real effective exchange rate is hovering around its historical average.

Exchange Rates



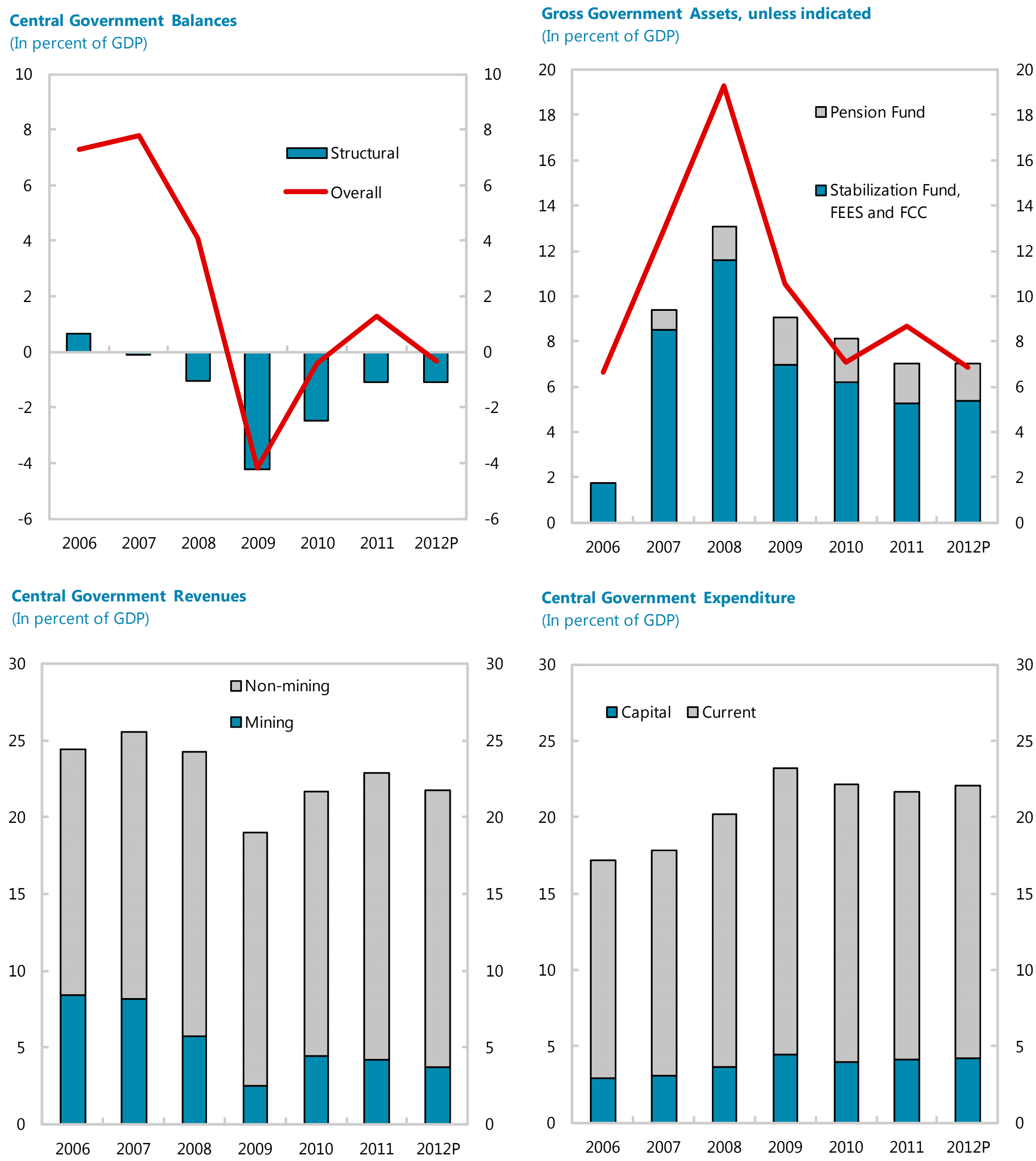
Sources: Central Bank of Chile and Fund staff calculations.

Figure 4. Chile: Financial Markets
(Through June 2012)



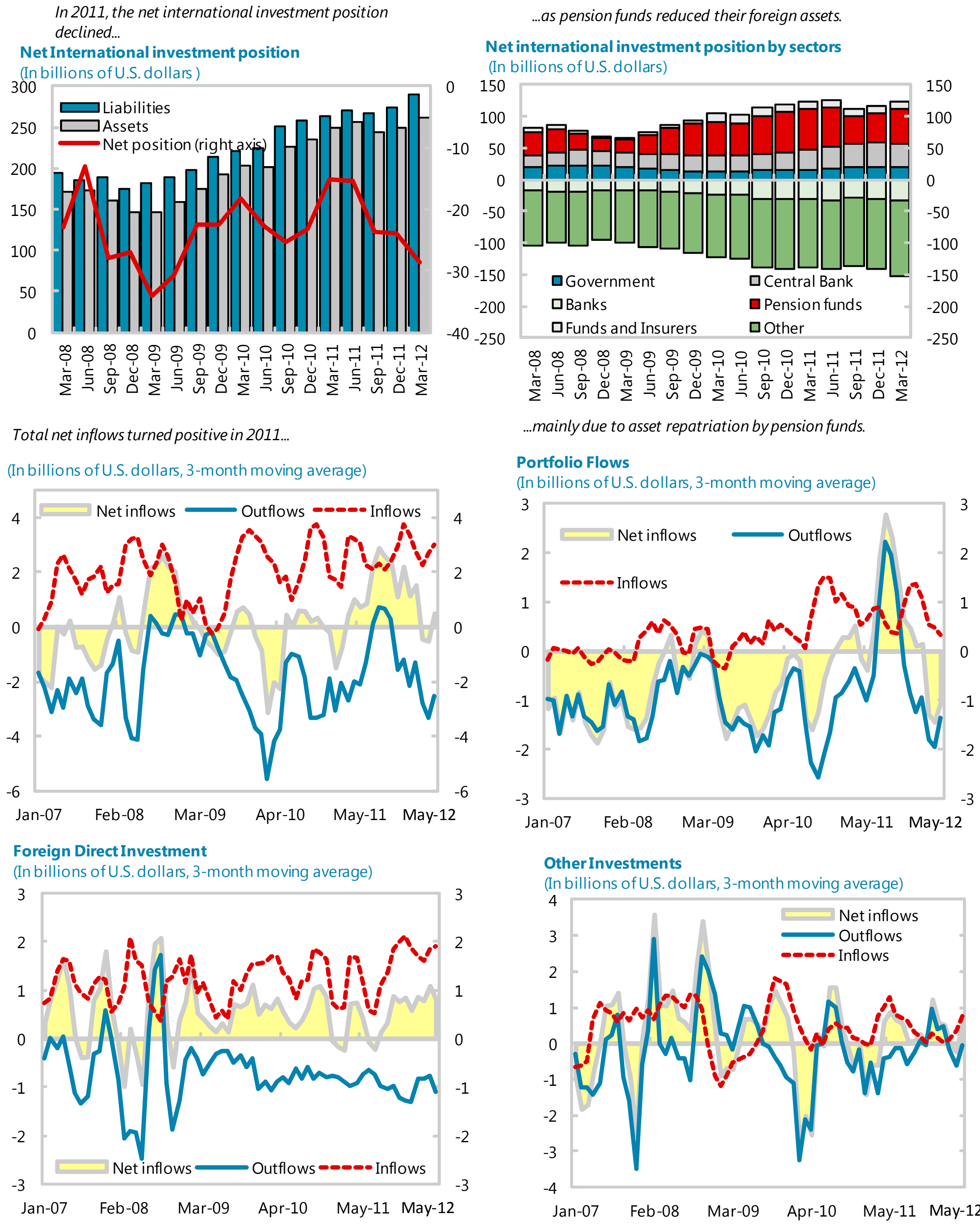
Sources: Central Bank of Chile, Superintendency of Banking and Financial Institutions (SBIF), and staff calculations.

Figure 5. Chile: Fiscal Policy (2006-12)



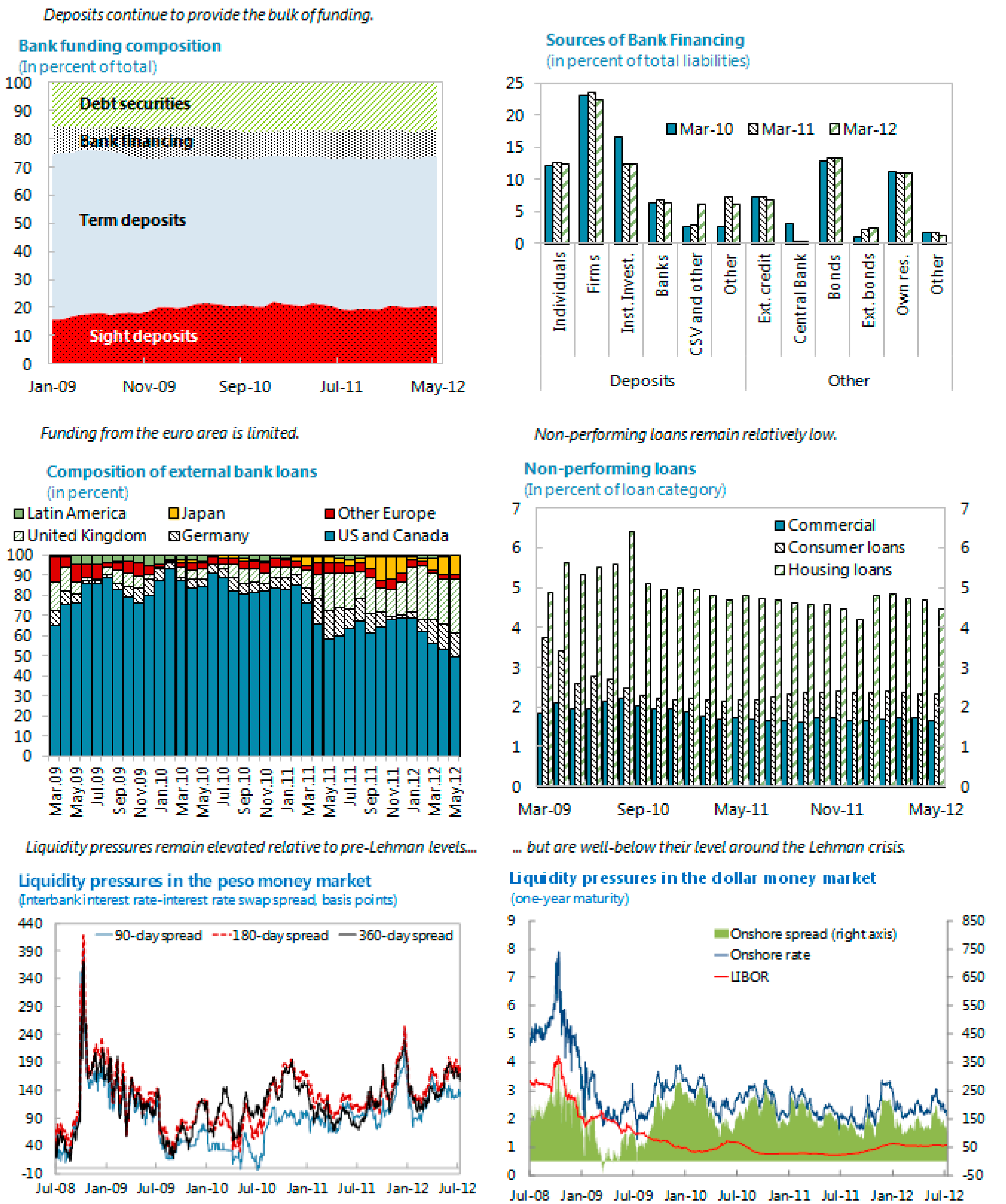
Sources: Ministry of Finance and Fund staff calculations.

Figure 6. Chile: Net IIP and Capital Flows
(Through May 2012)



Sources: Central Bank of Chile and Fund staff calculations.
Note: Negative sign for outflows means residents increasing their overseas investments.

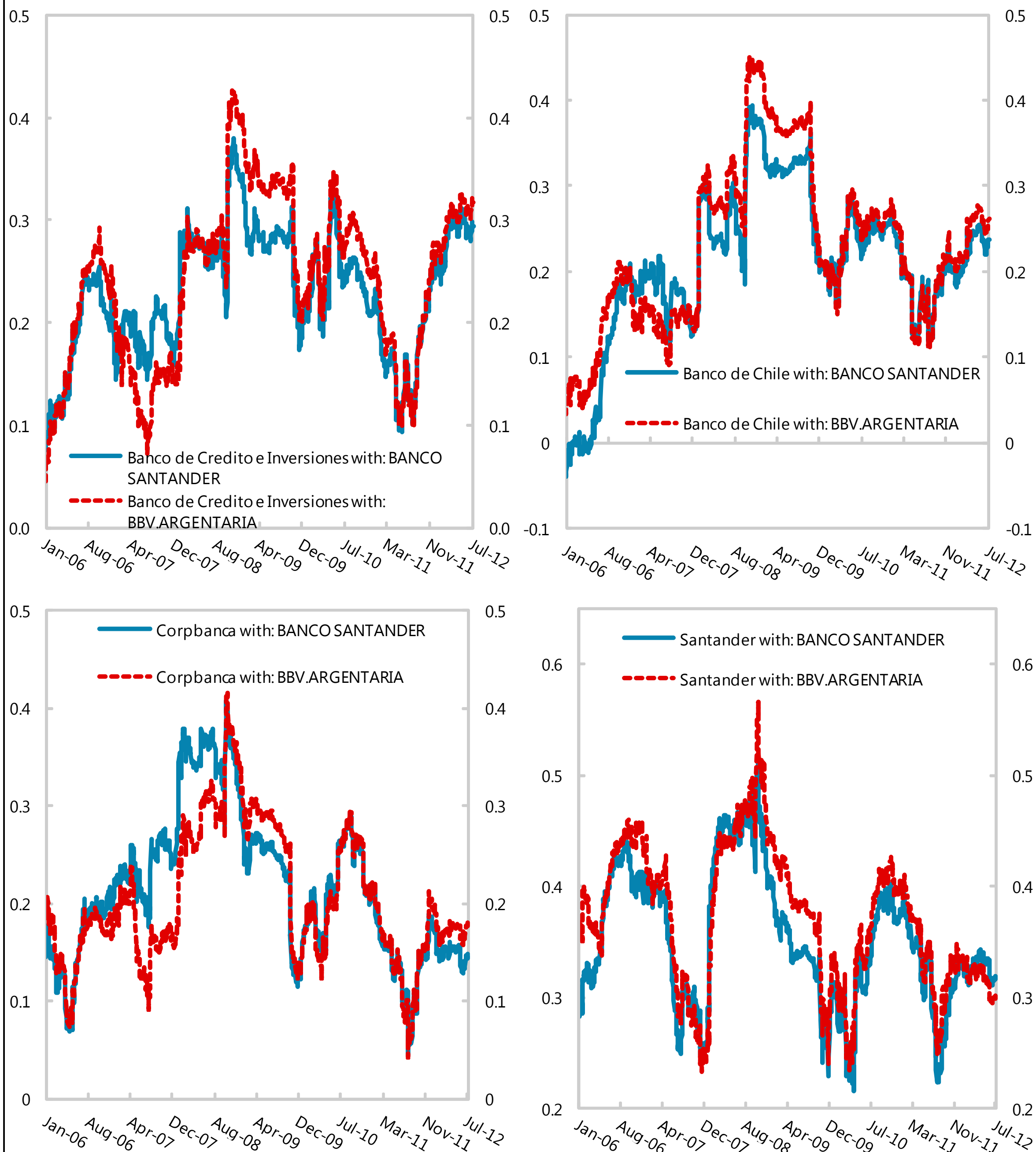
Figure 7. Chile: Banking System
(Through July 2012)



Sources: Central Bank of Chile, SBIF, SVS, SuSeSo, SP, and Bloomberg, Inc.

1/ Institutional Investors (Inst. Invest) include mutual funds and pension funds. Own resources (Own res.) include tier 1 capital, provisions, net value of derivative instruments and earnings. Bonds include mortgage, senior and subordinated bonds.

Figure 8. Chile: Equity Return Pairwise Correlation, Chilean and Spanish Banks 1/ (January 2006–July 2012)



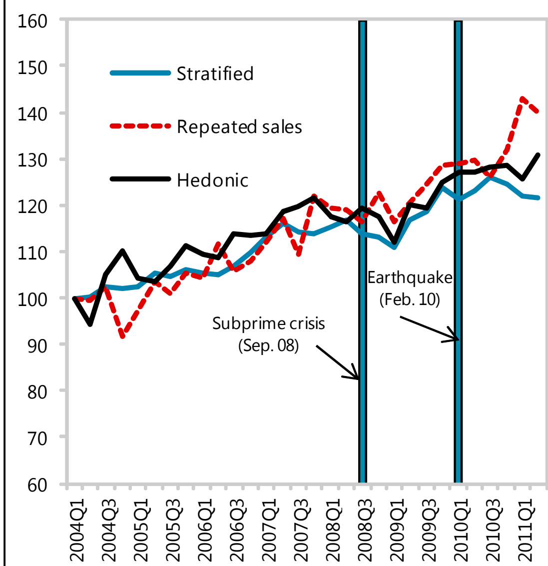
Sources: Datastream, LLC and Fund staff calculations.

1/ Corresponds to the correlation between the daily equity return (in annual terms) of Chilean and Spanish banks, calculated in Chilean pesos. An increase indicates a rise in the correlation.

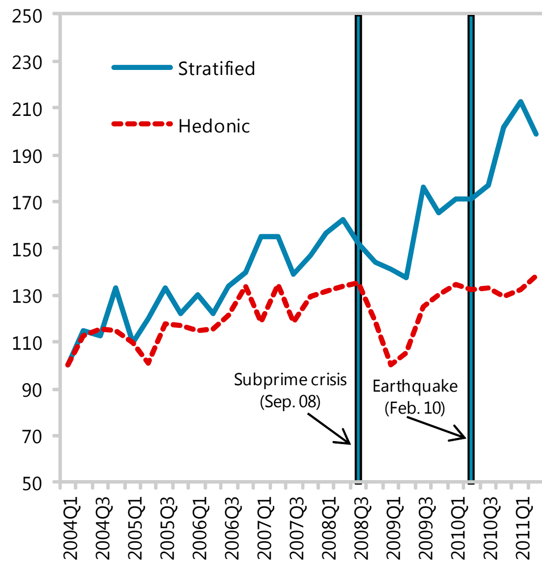
Figure 9. Chile Real Estate Prices, Household and Nonfinancial Firm Leverage (Through March 2012)

Growth of house prices has been modest.

Real House Price Index
(Baseline index Mar. 04 = 100)

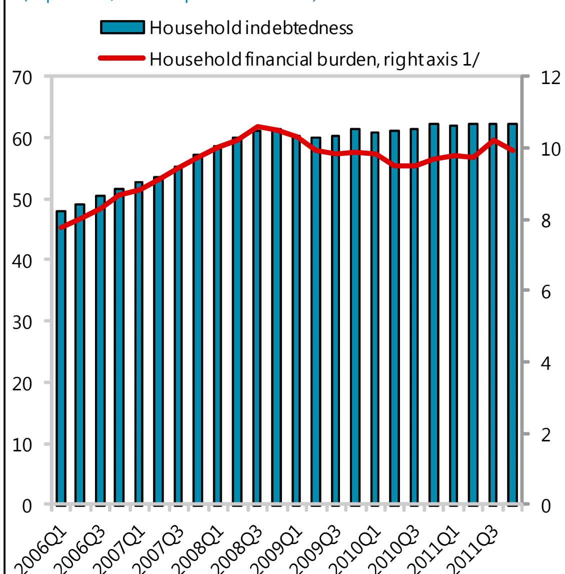


Real Office Price Index
(Baseline index Mar. 04 = 100)



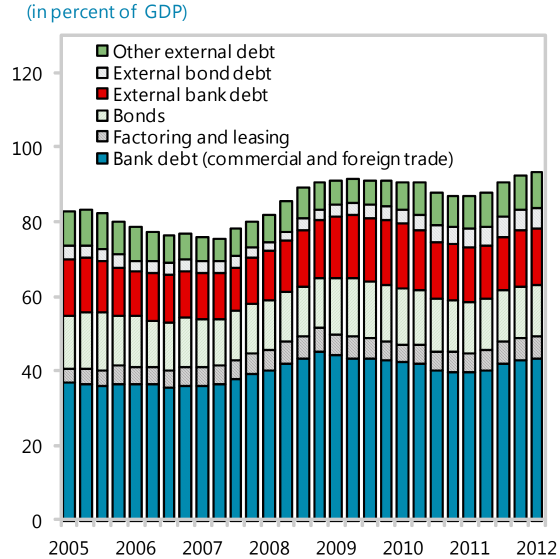
Household leverage...

Household financial burden and Household indebtedness
(in percent; over disposable income)



...and corporate leverage are relatively high but stable.

Total debt of nonfinancial firms
(in percent of GDP)



Sources: Central Bank of Chile, SBIF, SVS, SuSeSo, and SP.

1/ Household financial burden measures the payments that households must make to fulfill their consumer and mortgage loan commitments, as a percentage of their available income.

Table 1. Chile: Selected Social and Economic Indicators

GDP (2011), in billions of pesos	120,158	Quota	
GDP (2011), in billions of U.S. dollars	248.4	in millions of SDRs	856
Per capita (U.S. dollars)	14,403	in % of total	0.36%
Population (2009), in millions	16.9	Poverty rate (2011)	14.4
Main products and exports	Copper	Gini coefficient (2011)	0.52
Key export markets	China, U.S., Japan	Literacy rate (2011)	98.9

	2007	2008	2009	2010	2011	Proj. 2012	Proj. 2013
	(Annual percentage change, unless otherwise specified)						
Output							
Real GDP	5.2	3.1	-0.9	6.1	5.9	4.7	4.5
Total domestic demand	7.0	7.4	-5.0	14.8	9.7	5.7	4.6
Consumption	7.5	4.5	0.8	8.9	8.1	5.4	4.4
Private	7.7	5.2	-0.8	10.0	8.9	5.7	4.8
Public	6.7	0.4	9.2	3.7	4.0	3.5	1.7
Investment	6.3	21.0	-23.5	35.6	13.7	9.3	3.7
Fixed	10.7	18.1	-12.2	14.2	17.7	8.0	5.6
Private	9.1	20.0	-17.7	20.5	18.4	7.3	5.8
Public	24.5	3.5	37.9	-19.6	11.6	14.0	3.5
Inventories 1/	-0.8	0.7	-3.1	4.0	-0.6	0.4	-0.4
Net exports 1/	-1.8	-3.7	4.1	-8.7	-4.2	-0.3	-0.3
Exports	7.1	-0.7	-4.5	1.4	4.7	4.7	4.7
Imports	14.0	9.3	-15.4	27.7	14.8	4.8	4.7
Employment							
Unemployment rate (annual average) 2/	7.0	7.8	10.8	8.2	7.1	6.6	6.9
Consumer prices							
End of period	7.8	7.1	-1.5	3.0	4.4	2.6	3.0
Average	4.4	8.7	1.5	1.4	3.3	3.2	3.0
	(In percent of GDP, unless otherwise specified)						
Public sector finance							
Central government revenue	25.6	24.2	19.0	21.7	22.9	21.7	21.0
Central government expenditure	17.8	20.2	23.2	22.1	21.6	22.0	21.7
Central government fiscal balance	7.8	4.1	-4.2	-0.4	1.3	-0.3	-0.7
Structural fiscal balance 3/	-0.1	-1.1	-4.2	-2.5	-1.1	-1.1	-1.3
Public sector net debt	-9.5	-16.8	-6.5	-2.2	-5.0	-1.1	0.1
Public sector gross debt	18.9	24.7	27.4	26.1	35.2	34.2	34.2
Central government gross debt	3.9	4.9	5.8	8.6	11.3	11.5	12.4
Of which, share of FX-denominated debt (in percent)	51.5	40.0	22.8	17.3	17.2	12.3	8.2
Money and credit							
Broad money (% change)	20.5	18.6	-5.3	9.3	18.5	...	...
Credit to the private sector (end of period, % change)	21.0	18.7	-1.4	8.3	17.0	...	...
3-month central bank bill rate (%)	5.2	7.4	1.1	2.1	5.1	...	...
Balance of payments							
Current account	4.1	-3.2	2.0	1.5	-1.3	-2.9	-2.7
Current account (in billions of U.S. dollars)	7.1	-5.8	3.5	3.3	-3.2	-7.8	-8.0
Foreign direct investment inflows	7.3	8.6	7.5	7.1	7.0	6.9	6.7
Gross international reserves (in billions of U.S. dollars)	16.9	23.2	25.4	27.9	42.0	42.0	42.0
In months of next year's imports of goods and services	2.9	5.5	4.5	3.9	5.6	5.4	5.2
Gross external debt	30.9	35.5	41.6	38.9	39.7	39.3	36.9
Public	6.8	6.5	7.7	7.9	8.3	8.4	7.7
Private	24.1	29.0	34.0	31.0	31.4	30.9	29.2
	(Annual percentage change)						
Exchange rate							
Real effective exchange rate (real appreciation +)	-2.1	1.8	-2.2	5.9	0.9	...	...
Terms of trade	3.9	-15.4	6.0	21.5	0.7	-7.7	-1.1

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

1/ Contribution to growth.

2/ The methodology to compute the unemployment rate changed in 2009.

3/ The estimate of the structural balance is based on staff estimates of the output gap, and may differ from the authorities' estimate.

Table 2. Chile: Summary Operations of the Central Government
(In percent of GDP; unless otherwise indicated)

				Projections 1/			
	2009	2010	2011	2012	2013	2014	2015
Revenues	**18.9**	**21.7**	**22.9**	**21.7**	**21.0**	**20.6**	**20.2**
Taxes	13.8	15.9	17.6	17.2	16.1	16.1	16.1
Private mining companies	0.8	1.7	1.9	1.9	1.5	1.3	1.2
Other tax revenues, non-mining	13.0	14.2	15.7	15.3	14.6	14.8	14.9
Social contributions	1.4	1.4	1.4	1.4	1.3	1.4	1.4
Grants	0.1	0.1	0.1	0.1	0.0	0.0	0.0
Other revenue	3.7	4.3	3.9	3.1	3.6	3.2	2.7
Codelco revenues	1.6	2.8	2.3	1.8	2.1	1.9	1.4
Income on assets	0.7	0.4	0.5	0.7	0.7	0.7	0.7
Operating income	0.6	0.5	0.5	0.5	0.4	0.4	0.4
Other income	0.8	0.6	0.7	0.1	0.3	0.2	0.2
Expenditures	**23.1**	**22.1**	**21.6**	**22.0**	**21.7**	**21.0**	**20.4**
Expense	20.6	20.0	19.5	19.7	19.4	18.7	18.3
Compensation of employees	4.4	4.2	4.1	4.5	4.4	4.3	4.3
Purchases of goods and services	2.1	2.1	2.2	1.7	1.7	1.5	1.4
Interest payments	0.5	0.5	0.6	0.8	0.8	0.9	0.9
Subsidies and grants	7.0	6.8	6.3	6.7	6.6	6.3	6.1
Social benefits	4.8	4.5	4.3	4.1	4.0	3.9	3.8
Other expense	1.9	1.9	2.0	1.9	1.9	1.8	1.8
Capital transfers	1.9	1.8	2.0	1.9	1.9	1.8	1.8
Net acquistion of nonfinancial assets	2.5	2.1	2.1	2.3	2.3	2.2	2.2
Investment	2.6	2.1	2.2	2.3	2.3	2.2	2.2
Sale of physical assets	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Gross operating balance	**-1.7**	**1.7**	**3.4**	**2.0**	**1.6**	**1.9**	**1.9**
Net lending/borrowing (overall balance)	**-4.2**	**-0.4**	**1.3**	**-0.3**	**-0.7**	**-0.3**	**-0.3**
Non-mining overall balance	-6.7	-4.9	-2.9	-3.9	-4.3	-3.5	-2.9
Net financial transactions	**-4.2**	**-0.4**	**1.3**	**-0.3**	**-0.7**	**-0.3**	**-0.3**
Net acquisition of financial assets	-3.9	2.1	3.1	0.9	1.0	1.0	1.0
Currency and deposits	0.1	-0.1	-0.2	0.0	0.0	0.0	0.0
Securities other than shares	-4.1	2.2	3.4	0.9	1.0	1.0	1.0
Loans	0.1	0.0	-0.1	0.1	0.0	0.0	0.0
Net incurrence of liabilities	0.3	2.5	1.8	1.2	1.7	1.3	1.3
Domestic	1.5	2.5	2.0	2.0	2.8	2.1	1.9
Securities other than shares	1.7	2.8	2.4	2.0	2.8	2.4	2.6
Amortization	0.3	0.3	0.4	0.0	0.0	0.3	0.7
External	-0.4	0.7	0.5	-0.2	-0.3	0.0	0.0
Securities other than shares	0.0	0.7	0.5	0.1	0.0	0.0	0.0
Amortization	0.4	0.1	0.1	0.3	0.3	0.0	0.0
Recognizion bonds	-0.8	-0.7	-0.7	-0.6	-0.8	-0.7	-0.6
Memorandum items							
Structural balance 2/	-4.2	-2.5	-1.1	-1.1	-1.3	-1.0	-0.8
Nonmining structural primary balance 3/	-7.0	-5.5	-3.4	-4.5	-4.7	-3.7	-3.0
Fiscal impulse	4.5	-1.5	-2.1	1.1	0.2	-1.0	-0.8
Expenditure growth (in real terms)	16.9	7.2	3.3	6.5	3.1	1.0	2.1
Expense	15.2	8.7	1.9	6.4	3.1	1.0	2.1
Net acquisition of nonfinancial assets	21.1	-6.6	7.5	12.4	3.1	1.0	2.1
Net assets of the central government	10.5	7.1	8.7	6.9	5.8	5.1	4.6
Gross debt	5.8	8.6	11.3	11.5	12.4	12.8	13.2
Peso-denominated assets	6.1	6.2	7.8	7.1	7.4	7.7	8.0
Foreign currency-denominated assets	10.3	9.5	12.1	11.3	10.7	10.2	9.8
Nominal GDP (trillions of pesos)	96.7	110.3	120.2	129.2	139.2	149.9	161.5
Long term price of copper, USD per pound	1.99	2.13	2.59	3.02	3.02	3.02	3.02
Copper price, USD per pound (WEO)	2.34	3.42	4.00	3.54	3.39	3.38	3.38

Sources: Ministry of Finance (DIPRES) and Fund staff estimates and projections.
1/ Based on the authorities' medium-term fiscal projections in the 2012 Budget Law, adjusted for staff's GDP and copper price projections. Effects of the authorities's tax reform proposal are not included.
2/ Based on staff' s output gap estimates and WEO copper prices.
3/ In percent of non-mining GDP.

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

				Projections			
	2009	2010	2011	2012	2013	2014	2015
Central Government							
Balance	-4.2	-0.4	1.3	-0.3	-0.7	-0.3	-0.3
Total revenue	19.0	21.7	22.9	21.7	21.0	20.7	20.2
Of which: Intragovernmental receipts	1.3	0.9	0.9	0.9	0.9	0.9	0.9
Total expenditures	23.2	22.1	21.6	22.0	21.7	21.0	20.5
Of which: Intragovernmental transfers	0.9	0.8	0.8	0.8	0.8	0.8	0.8
Current	18.8	18.1	17.5	17.8	17.5	16.9	16.5
Capital	4.4	4.0	4.1	4.2	4.2	4.0	3.9
Net assets	10.5	7.1	8.7	6.9	5.8	5.1	4.6
Municipalities 2/							
Balance	0.1	0.1	0.1	-0.1	0.0	0.1	0.0
Total revenue	3.0	2.5	2.7	2.7	2.7	2.7	2.7
Of which: Intragovernmental receipts	0.9	0.8	0.8	0.8	0.8	0.8	0.8
Total expenditures	2.9	2.4	2.6	2.8	2.7	2.7	2.6
Of which: Intragovernmental transfers	1.3	0.9	0.9	0.9	0.9	0.9	0.9
Current	2.6	2.2	2.3	2.5	2.5	2.4	2.4
Capital	0.3	0.2	0.2	0.3	0.3	0.3	0.2
Central Bank							
Balance 3/	-2.9	-1.4	0.9	-0.3	-0.2	-0.2	-0.2
Net assets	1.5	0.7	2.0	0.2	0.1	-0.1	-0.1
State-Owned Non-Financial Enterprises							
Balance	1.6	1.3	1.1	1.0	0.8	0.8	1.0
Total revenue	12.5	10.9	10.7	10.5	10.0	9.7	9.5
Of which: Intragovernmental receipts	0.7	0.2	0.2	0.2	0.2	0.2	0.2
Total expenditures	10.9	9.7	9.6	9.6	9.3	8.9	8.5
Current	9.1	8.3	8.2	8.2	8.0	7.6	7.3
Capital 4/	1.8	1.4	1.4	1.4	1.3	1.3	1.2
Net Assets	-5.7	-5.6	-5.7	-6.0	-6.0	-6.0	-6.0
Consolidated Public Sector							
Balance	-5.3	-0.4	2.2	0.2	-0.2	0.3	0.6
Net Assets	6.3	2.2	5.0	1.1	-0.1	-1.0	-1.5

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

1/ This table reflects the authorities' revisions to historical official data to bring the fiscal accounts in line with GFSM 2001.
2/ On a cash basis. Municipalities hold neither sizable financial assets nor debt.
3/ Includes the effects of valuation changes (exchange rate).
4/ The data reported here does not include depreciation as an expense.

Table 4. Chile: Balance of Payments

	2009	2010	2011	2012	2013	2014	2015	2016	2017
				Projections					
				(In millions of U.S. dollars)					
Current account	3,517	3,268	-3,222	-7,760	-7,979	-8,766	-9,109	-9,766	-10,497
Trade balance	15,361	15,324	10,792	4,602	3,531	2,864	2,645	2,166	1,584
Exports	55,463	70,897	81,411	79,552	80,660	83,534	86,953	90,429	94,320
Copper	29,695	41,170	44,438	42,045	41,889	43,094	44,310	45,510	46,674
Non-copper	25,768	29,727	36,973	37,507	38,771	40,439	42,643	44,919	47,647
Imports	-40,102	-55,573	-70,619	-74,949	-77,129	-80,669	-84,308	-88,264	-92,737
Net services	-2,011	-1,806	-2,416	-2,348	-2,245	-2,257	-2,044	-2,064	-2,013
Net income	-11,396	-14,765	-14,015	-12,485	-11,620	-11,907	-12,253	-12,629	-13,319
Net transfers	1,563	4,515	2,417	2,470	2,354	2,535	2,544	2,761	3,251
Capital account balance 1/	14	6,240	13	0	0	0	0	0	0
Financial account balance	-2532	-5926	18118	7760	7979	8766	9109	9767	10497
Foreign direct investment (net)	5,654	6,142	5,477	6,183	6,678	7,209	7,778	8,389	8,991
Abroad	-7,233	-9,231	-11,822	-12,414	-13,034	-13,686	-14,370	-15,089	-15,843
In Chile	12,887	15,373	17,299	18,596	19,712	20,895	22,149	23,478	24,834
Portfolio investment (net)	-12,399	-6,081	11,108	-3,867	-4,060	-4,263	-4,477	-4,700	-4,935
Abroad	-14,269	-15,380	665	-14,713	-15,448	-16,221	-17,032	-17,883	-18,778
In Chile	1,870	9,299	10,443	10,846	11,388	11,957	12,555	13,183	13,842
Financial derivatives	-1,049	-934	-2,418	-482	-692	-733	-772	-824	-879
Other investments	5,261	-5,054	3,951	5,926	6,054	6,553	6,579	6,902	7,321
Abroad	-612	-6,694	-2,498	-1,140	-1,224	-943	-1,143	-1,051	-871
In Chile	5,873	1,640	6,449	7,066	7,278	7,497	7,722	7,953	8,192
Change in reserves assets (increase -)	-1,648	-3,024	-14,190	0	0	0	0	0	0
Errors and omissions	646	-558	-721	0	0	0	0	0	0
Change in official reserves ($ billion)	2.2	2.5	14.1	0.0	0.0	0.0	0.0	0.0	0.0
Central bank operations with commercial banks	0.0	0.0	12.0	0.0	0.0	0.0	0.0	0.0	0.0
Other 2/	2.2	2.5	2.1	0.0	0.0	0.0	0.0	0.0	0.0
Gross official international reserves	4.5	3.9	5.6	5.4	5.2	5.0	4.7	4.5	4.2
(In months of imports of goods and services)									
				(In percent of GDP)					
Current account	2.0	1.5	-1.3	-2.9	-2.7	-2.8	-2.7	-2.7	-2.7
Trade balance	8.9	7.1	4.3	1.7	1.2	0.9	0.8	0.6	0.4
Exports	32.1	32.8	32.8	29.7	27.6	26.7	26.2	25.3	24.5
Copper	17.2	19.1	17.9	15.7	14.3	13.8	13.4	12.7	12.1
Non-copper	14.9	13.8	14.9	14.0	13.3	12.9	12.9	12.6	12.4
Imports	-23.2	-25.7	-28.4	-28.0	-26.4	-25.8	-25.4	-24.7	-24.1
Net services	-1.2	-0.8	-1.0	-0.9	-0.8	-0.7	-0.6	-0.6	-0.5
Net income	-6.6	-6.8	-5.6	-4.7	-4.0	-3.8	-3.7	-3.5	-3.5
Net transfers	0.9	2.1	1.0	0.9	0.8	0.8	0.8	0.8	0.8
Financial account balance	-1.5	-2.7	7.3	2.9	2.7	2.8	2.7	2.7	2.7
				(Annual change in percent)					
Total export volume	-3.1	-0.1	4.0	5.0	4.7	4.2	4.4	4.4	4.4
Copper export volume	1.3	0.1	-2.3	5.9	5.0	3.0	3.0	3.0	3.0
Agricultural exports volume	0.1	2.4	12.5	6.4	5.0	5.0	5.0	5.0	5.0
Industrial exports volume	-8.8	-1.2	13.7	4.3	4.5	4.7	5.0	5.0	5.0
Total import volume	-19.0	32.0	15.1	6.0	4.7	4.7	4.7	5.0	4.7
Terms of trade	6.0	21.5	0.7	-7.7	-1.1	-0.3	0.2	0.0	-0.3
Total export prices	-11.0	27.9	10.5	-6.9	-3.2	-0.6	-0.3	-0.4	-0.1
Copper export prices	-8.6	39.9	10.9	-10.4	-5.5	-0.1	-0.2	-0.3	-0.4
Total import price	-15.8	5.5	9.6	1.0	-2.2	-0.3	-0.4	-0.4	0.2
Memorandum items:									
Copper price (LME; U.S. cents per pound) 3/	234	342	400	354	339	338	338	337	335
Volume of copper exports (2004=100)	99	99	97	102	108	111	114	118	121

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

1/ In 2010 reflects insurance payment associated with the earthquake.

2/ "Other" variations in reserves largely reflect changes in deposits by commercial banks and the government with the central bank.

3/ Updated staff forecasts, average.

Table 5. Chile: Monetary Survey
(In billions of pesos; unless otherwise indicated)

	2007	2008	2009	2010	2011
Central Bank					
Net foreign assets	8,423	14,630	12,254	12,508	21,307
Net international reserves	8,384	14,572	12,849	13,051	21,891
Net international reserves (In millions of US dollars)	16,909	23,163	25,372	27,865	41,980
Other foreign assets (net)	39	58	-595	-543	-584
Net domestic assets	-4,751	-10,400	-7,672	-6,983	-14,456
Net credit to general government	634	738	580	559	143
Net claims on banks and financial corporations	-1,228	-1,659	-2,854	-2,964	-4,593
Credit to the private sector	946	957	904	861	805
Other items (net)	-5,103	-10,436	-6,302	-5,439	-10,811
Monetary base	3,672	4,230	4,582	5,525	6,851
Currency	2,429	2,676	2,935	3,423	3,892
Required reserves	1,243	1,554	1,647	2,102	2,959
Other depository institutions					
Net foreign assets	-1,929	-3,395	-4,014	-4,767	-6,995
Net foreign assets (In millions of US dollars)	-3,891	-5,397	-7,926	-10,178	-13,414
Net domestic assets	54,178	63,777	64,965	66,513	81,620
Net credit to general government	-3,599	-3,923	-2,269	-2,240	-1,709
Credit to the private sector	58,849	69,870	68,879	74,628	87,301
Other items (net)	-1,072	-2,170	-1,645	-5,875	-3,972
Liabilities to the private sector	52,249	60,382	60,951	61,746	74,625
Demand deposits	8,368	8,417	11,150	13,465	14,749
Quasi-money	43,881	51,965	49,801	48,281	59,876
Banking system					
Net foreign assets	6,494	11,235	8,240	7,741	14,313
Net domestic assets	52,098	57,936	61,147	61,579	72,887
Net credit to general government	-2,965	-3,185	-1,689	-1,681	-1,566
Credit to the private sector	59,795	70,827	69,783	75,489	88,106
Other items (net)	-4,732	-9,705	-6,710	-12,229	-13,653
Liabilities to the private sector	58,592	69,171	69,387	69,320	87,200
Money	10,797	11,093	14,086	16,888	18,641
Quasi-money	47,795	58,078	55,301	52,432	68,559
Memorandum items					
			(Percent changes)		
Monetary base	7.8	15.2	8.3	20.6	24.0
Liabilities to the private sector 1/	13.6	18.1	0.3	-0.1	25.8
Credit to the private sector 1/	20.6	18.4	-1.5	8.2	16.7
			(In percent of GDP)		
Monetary base	4.1	4.5	4.7	5.0	5.7
Liabilities to the private sector 1/	64.9	73.8	71.8	62.9	72.6
Credit to the private sector 1/	66.2	75.5	72.2	68.5	73.3

Sources: Central Bank of Chile and Haver Analytics.

1/ Banking system.

Table 6. Chile: Medium-Term Framework

	2009	2010	2011	2012	2013	2014	2015	2016	2017
				Projections					
National accounts	(Annual percentage change, unless otherwise specified)								
Real GDP	-0.9	6.1	5.9	4.7	4.5	4.6	4.6	4.6	4.6
Total domestic demand	-5.0	14.8	9.7	5.7	4.6	4.8	4.7	4.8	4.7
Consumption	0.8	8.9	8.1	5.4	4.4	4.4	4.4	4.8	4.6
Private	-0.8	10.0	8.9	5.7	4.8	5.2	4.9	5.1	5.0
Public	9.2	3.7	4.0	3.5	1.7	-0.1	1.1	3.2	2.4
Investment	-23.5	35.6	13.7	9.3	3.7	5.7	5.6	4.8	5.0
Construction and other works	-7.3	1.9	12.7	9.8	5.6	6.0	5.8	5.0	5.2
Machinery and equipment	-20.9	40.0	26.2	5.4	5.6	6.0	5.8	5.0	5.2
Inventories 1/	-3.1	4.0	-0.6	0.4	-0.4	0.0	0.0	0.0	0.0
Net exports 1/	4.1	-8.7	-4.2	-0.3	-0.3	-0.4	-0.4	-0.5	-0.4
Consumer prices (average)	1.5	1.4	3.3	3.2	3.0	3.0	3.0	3.0	3.0
Balance of payments	(In percent of GDP)								
Current account	2.0	1.5	-1.3	-2.9	-2.7	-2.8	-2.7	-2.7	-2.7
Trade balance	8.9	7.1	4.3	1.7	1.2	0.9	0.8	0.6	0.4
Financial account balance	-1.5	-2.7	7.3	2.9	2.7	2.8	2.7	2.7	2.7
Foreign direct investment (net)	3.3	2.8	2.2	2.3	2.3	2.3	2.3	2.3	2.3
Portfolio investment (net)	-7.2	-2.8	4.5	-1.4	-1.4	-1.4	-1.4	-1.3	-1.3
Financial derivatives	-0.6	-0.4	-1.0	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Other investments	3.0	-2.3	1.6	2.2	2.1	2.1	2.0	1.9	1.9
Change in reserves assets	-1.0	-1.4	-5.7	0.0	0.0	0.0	0.0	0.0	0.0
	(Annual percentage change)								
Total export volume	-3.1	-0.1	4.0	5.0	4.7	4.2	4.4	4.4	4.4
Copper export volume	1.3	0.1	-2.3	5.9	5.0	3.0	3.0	3.0	3.0
Agricultural exports volume	0.1	2.4	12.5	6.4	5.0	5.0	5.0	5.0	5.0
Industrial exports volume	-8.8	-1.2	13.7	4.3	4.5	4.7	5.0	5.0	5.0
Total import volume	-19.0	32.0	15.1	6.0	4.7	4.7	4.7	5.0	4.7
Terms of trade	6.0	21.5	0.7	-7.7	-1.1	-0.3	0.2	0.0	-0.3
Total export prices	-11.0	27.9	10.5	-6.9	-3.2	-0.6	-0.3	-0.4	-0.1
Copper export prices	-8.6	39.9	10.9	-10.4	-5.5	-0.1	-0.2	-0.3	-0.4
Total import price	-15.8	5.5	9.6	1.0	-2.2	-0.3	-0.4	-0.4	0.2
External Debt	(In percent of GDP)								
Gross external debt	41.6	38.9	39.7	39.3	36.9	36.1	35.7	34.7	33.8
Public	7.7	7.9	8.3	8.4	7.7	7.5	7.4	7.2	7.0
Private	34.0	31.0	31.4	30.9	29.2	28.6	28.3	27.5	26.8
Gross int. reserves (in billions of U.S. dollars)	25.4	27.9	42.0	42.0	42.0	42.0	42.0	42.0	42.0
Savings and investment									
Gross domestic investment	20.2	23.5	24.6	25.8	25.6	25.9	26.0	26.0	26.0
Public	2.8	2.3	2.4	2.6	2.6	2.5	2.4	2.4	2.4
Private	17.4	21.2	22.2	23.2	23.1	23.4	23.6	23.6	23.6
National saving	22.3	25.1	23.4	22.9	22.9	23.1	23.2	23.2	23.3
Public	-1.3	2.0	3.7	2.1	1.8	2.1	2.1	2.2	2.2
Private	23.6	23.1	19.6	20.8	21.1	21.0	21.1	21.1	21.1
Public sector finance									
Net debt	-6.5	-2.2	-5.0	-1.1	0.1	1.0	1.5	2.2	2.8
Excluding public enterprises	-12.0	-7.8	-10.7	-7.1	-5.9	-5.0	-4.5	-3.8	-3.1
Public sector gross debt 2/	27.4	26.1	35.2	34.2	34.2	33.8	33.4	32.9	32.4
Central government gross debt	5.8	8.6	11.3	11.5	12.4	12.8	13.2	13.5	13.8
Central government balance	-4.2	-0.4	1.3	-0.3	-0.7	-0.3	-0.3	-0.2	-0.2
Total revenue	19.0	21.7	22.9	21.7	21.0	20.7	20.2	20.2	20.2
Total expenditure	23.2	22.1	21.6	22.0	21.7	21.0	20.5	20.5	20.4
Central government structural balance	-4.2	-2.5	-1.1	-1.1	-1.3	-1.0	-0.8	-0.7	-0.7
Employment	(Annual percentage change, unless otherwise specified)								
Working age population	1.7	1.6	1.5	1.5	1.4	1.3	1.3	1.2	1.1
Labor force	1.3	4.2	3.8	1.9	1.8	1.3	1.3	1.2	1.1
Employment	-0.7	7.4	5.0	2.4	1.5	1.3	1.3	1.2	1.1
Unemployment rate (in percent)	10.8	8.2	7.1	6.6	6.9	6.9	6.9	6.9	6.9
Memorandum items:									
Copper prices (LME; U.S. cents per pound)	234	342	400	354	339	338	338	337	335
Volume of copper exports (2004=100)	99	99	97	102	108	111	114	118	121

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

1/ Contribution to growth.

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

Table 7. Chile: Indicators of External Vulnerability
(In percent; unless otherwise indicated)

	2007	2008	2009	2010	2011	Proj. 2012
Financial indicators						
M3 (percent change)	14.7	19.1	-1.4	11.2	18.9	...
Less pension funds' deposits (annual percentage change)	13.5	23.3	4.8	13.2	18.3	...
Private sector credit to GDP	65.1	74.5	71.3	67.7	72.7	...
90-day central bank promissory note (nominal) interest rate (avg.)	5.2	7.4	1.1	2.1	5.1	...
Share of foreign currency deposits in total deposits	10.1	14.5	13.2	15.4	12.8	...
Share of foreign currency loans in total credit	10.7	11.8	10.9	10.1	12.2	...
External indicators						
Exports, U.S. dollars (annual percentage change)	15.5	-5.9	-14.0	27.8	14.8	-2.3
Imports, U.S. dollars (annual percentage change)	21.9	31.5	-31.4	38.6	27.1	6.1
Terms of trade (annual percentage change)	3.9	-15.4	6.0	21.5	0.7	-7.7
REER (annual percent change, period average)	-2.1	1.8	-2.2	5.9	0.9	...
Exchange rate (pesos per U.S. dollar, period average)	522	522	560	510	484	...
Current account Balance (percent of GDP)	4.1	-3.2	2.0	1.5	-1.3	-2.9
Financial account less reserves accumulation (percent of GDP)	-6.0	6.8	-1.1	-3.0	7.0	2.9
Gross official reserves (in billions of U.S. dollars) 1/	16.9	23.2	25.4	27.9	42.0	42.0
Gross official reserves, months of imports of goods and services	2.9	5.5	4.5	3.9	5.6	5.4
Gross official reserves to M3	11.9	13.7	16.3	14.7	17.7	...
Gross official reserves to short-term external debt 2/	87.3	86.2	101.8	96.7	109.5	101.5
Total external debt (percent of GDP)	30.9	35.5	41.6	38.9	39.7	39.3
Of which: External public sector debt	6.8	6.5	7.7	7.9	8.3	8.4
Total external debt to exports of goods and services	68.8	84.7	112.5	103.0	105.1	114.4
External interest payments to exports of goods and services	2.2	2.1	2.4	2.3	2.3	2.4
External amortization payments to exports of goods and services	25.1	32.6	48.8	35.2	33.5	41.7
Financial market indicators						
Stock market index (in U.S. dollars; period average) 3/	1757	1629	1601	2362	2564	...
Sovereign long-term foreign-currency debt rating (end of period)						
Moody's	A2	A2	A1	Aa3	Aa3	...
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.
3/ Morgan-Stanley Capital International index (Dec/1987=100).

Table 8. Chile: External Debt and Debt Service

	2007	2008	2009	2010	2011	Proj. 2012
	(In billions of U.S. dollars, end of period)					
Total debt outstanding	**53.4**	**63.7**	**71.9**	**84.1**	**98.6**	**105.2**
Of which: External private debt	41.7	52.1	58.7	67.1	77.9	82.7
External public debt	11.7	11.7	13.2	17.1	20.6	22.5
Medium- and long-term debt	44.4	49.7	56.1	67.7	79.1	82.7
Public sector	10.3	9.5	11.4	16.0	18.7	20.2
Of which: Central government	3.6	3.0	2.6	4.2	5.5	5.0
Private sector	34.1	40.2	44.7	51.7	60.4	62.5
Financial sector	9.0	9.8	8.2	11.5	14.8	15.7
Non-financial sector	25.0	30.4	36.5	40.3	45.6	46.8
Short-term debt	9.0	14.0	15.8	16.5	19.4	22.4
Total medium and long-term debt service	**13.1**	**17.1**	**18.7**	**14.8**	**17.2**	**21.1**
Amortization	11.4	15.5	17.1	12.9	15.0	18.9
Interest	1.7	1.6	1.5	1.9	2.2	2.2
	(In percent of GDP)					
Total external debt, end-period	**30.9**	**35.5**	**41.6**	**38.9**	**39.7**	**39.3**
Of which : External private debt	24.1	29.0	34.0	31.0	31.4	30.9
External public debt	6.8	6.5	7.7	7.9	8.3	8.4
Gross change (in percent)	-0.5	4.6	6.1	-2.7	0.7	-0.4
Gross change of nominal stock (in percent)	9.9	19.3	12.9	17.0	17.2	6.7
Interest payments on external debt	1.0	0.9	0.9	0.9	0.9	0.8
	(In percent of exports of goods and services)					
Total medium- and long-term debt service	**16.9**	**22.8**	**29.2**	**18.1**	**18.3**	**23.0**
Of which : Interest	2.2	2.1	2.4	2.3	2.3	2.4
Total external debt outstanding	68.8	84.7	112.5	103.0	105.1	114.4
	(In billions of U.S. dollars)					
Memorandum items:						
Short-term debt: residual maturity basis	19.4	26.9	24.9	28.8	38.4	41.4
Gross international reserves	16.9	23.2	25.4	27.9	42.0	42.0
GDP	172.9	179.5	172.7	216.1	248.4	267.8

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

ANNEX I. CHILE'S FISCAL RULE: A SHORT DESCRIPTION

Chile produces about one-third of the world's copper. Copper exports represented 55 percent of its goods exports (or 18 percent of GDP) in 2011, and copper revenues accounted for close to 19 percent of fiscal revenues (4¼ percent of GDP). About half of these revenues come from profits of the state-owned mining company Codelco, and the other half comes from taxes on private mining companies (most of which are foreign-owned).

The current structural balance rule was adopted in 2001. Its main objective is to contribute to macroeconomic stability and fiscal sustainability by protecting public spending from the effects of cyclical variations in copper prices and economic activity. Since there are large copper reserves (of at least 60 years), copper is not considered an exhaustible resource; therefore concerns related to exhaustibility have not played a role in the rule. The medium-term structural fiscal balance target is set at the beginning of each administration, and annual targets are set in the budget every year. The medium-term target of the current administration is 1 percent structural deficit by 2014.

The structural balance is defined as the difference between structural revenues (consistent with trend estimates for output and the price of copper) and public expenditure. Potential output and the long-term copper prices, used in the calculation of non-mining and copper structural revenues respectively, are set by independent expert committees every year.

Changes in structural fiscal copper revenues from year to year would be affected by three factors: changes in the long-term copper price (50 cents/pound increase in the long-term price increases structural revenues by up to 1 percentage point of GDP), changes in quantity produced, and changes in profits (which would be affected by cost of extraction and other factors). Thus, a significant increase in the long-term copper price could allow an increase in expenditure, while keeping the structural balance unchanged. For example, in 2012, the structural balance is expected to be unchanged relative to 2011, although there has been an increase in fiscal spending of ½ percent of GDP, and a ¼ percent of GDP decline in non-mining revenue due to a change in the corporate tax rate (these are offset by an increase in structural mining revenues due to a rise in the long-term copper price). For that reason, the change in the non-mining structural balance is a better indicator of the direction of fiscal policy and its economic effects (the fiscal impulse) than the change in the overall structural balance.

For a more detailed description of the rule, see Larraín et al, 2011, "Una política fiscal de balance estructural de segunda generación para Chile" and Daban, 2010, "Strengthening Chile's Rule-Based Fiscal Framework", Chile: Selected Issues Paper, IMF Country Report No. 10/299.

ANNEX II. PROPOSED TAX REFORM

The reform presented to Congress by the government aims to raise tax revenue by about 0.3 percent of GDP on a permanent basis to finance higher education spending (see table). The reform would also improve incentives to invest and provide some tax relief to low and middle-income people. In addition, it would eliminate some loopholes and exemptions.

Specifically, the proposed reform would make permanent the marginal rate of 20 percent on corporate income. Further, the tax regime for excessive costs would be the same for joint-stock companies (*sociedades anóminas*) and other types of business organizations. The tax regime regarding transfer pricing would also be strengthened in line with international best practices.

The reform also contemplates reducing marginal personal income tax rate by 10 percent for middle and high-income taxpayers —except for those in the highest income bracket— and by 15 percent for those in the lowest taxable income bracket. Additional tax relief would be provided through an education tax credit. The rate of the financial transaction tax (stamp tax) would also be reduced.

Chile: Proposed Tax Reform

(in percent of GDP)

	Projections					
	2012	2013	2014	2015	2016	2017
Tax increases	0.07	0.63	0.38	0.40	0.40	0.40
Revenue reduction	0.00	-0.24	-0.29	-0.30	-0.30	-0.30
Elimination of loopholes	0.00	0.05	0.15	0.16	0.16	0.16
Net effect	0.07	0.43	0.24	0.26	0.26	0.25

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

ANNEX III. CHILE—RISK ASSESSMENT MATRIX[1]

Source of Risk	Relative Likelihood[2]	Impact if Realized
Escalation of financial tensions in the euro area	*Staff assessment: MEDIUM* Further intensification of the financial turmoil in the euro area will affect Chile through deterioration in financial conditions, lower export demand, and potentially lower commodity prices.	*Staff assessment: MEDIUM* A sharp escalation of the crisis would affect the funding cost and availability of external financing for Chilean banks and corporations, the peso would depreciate, and domestic activity could decelerate. However, the impact should be moderate since trade and bank funding dependence on Europe is limited. In addition, Chile has substantial policy levers to limit spillovers and mitigate the effects on the economy.
Sharp growth deceleration in China	*Staff assessment: LOW* A sharp growth deceleration in China would have negative effect on world commodity prices and on demand for Chilean exports. The probability of this event in the near term is low, given the large room for policy support in China.	*Staff assessment: HIGH* China is Chile's main trading partner, and copper accounts for more than half of Chile's exports and about 20 percent of government revenue. A sharp slowdown in China's investment growth would lead to a drop in copper demand and prices, affecting Chile's growth.
Heightened volatility of capital flows	*Staff assessment: MEDIUM* In the near term, an intensification of tensions in the euro area may increase global risk aversion and result in capital outflows. Moreover, the prospect of a prolonged period of low interest rates in advanced economies could encourage renewed bouts of capital flows.	*Staff assessment: LOW to MEDIUM* A sudden stop or reversal of capital flows could worsen domestic financial conditions. Conversely, a surge in private capital inflows could fuel credit growth, put upward pressure on the exchange rate, and increase the risk of asset price bubbles. As in the past, Chile's flexible exchange rate should help limit the effects of speculative flows.

[1] The RAM shows relatively low probability events that could materially alter the baseline path, which is the scenario most likely to materialize in the view of staff. Staff's subjective assessment of the relative likelihood among those low probability events as noted in the matrix (ranging from "low" to "high") is consistent across different country reports prepared in a given period. The RAM reflects staff's views on the source of risks and overall level of concerns as of the time of discussions with the authorities.

[2] In case the baseline does not materialize.

ANNEX IV. 2011 FSAP UPDATE—STATUS OF MAIN RECOMMENDATIONS

Recommendation (priority H/M, time frame S/M)	**Update**
Reduce information gaps, including through a consolidated credit registry and standardized residential and commercial property price indices (M, M)	A bill was submitted to Congress in August 2011 to create a public credit bureau, which would consolidate data provided by financial institutions (banks, retailers, insurance companies, and others). It will include both positive and negative information for individuals and companies. It will be managed by the Superintendency of Banking and Financial Institutions (SBIF). The Central Bank published residential housing price data (for 2001-11) in December 2011, and commercial real estate data in June 2012. The data compose three indices: hedonic prices, mixed adjustment, and total sales.
Develop a strategy to ensure adequate replacement rate for retirees (H, M)	The 2008 Pension Reform contained several measures to address the issue of low pension and replacement rates, including the introduction of a new solidarity pillar to prevent old-age poverty and measures to reduce the gender gap in old-age income (e.g. division of balance in case of divorce). To increase coverage, subsidies for young workers and a gradual mandatory participation of independent workers were introduced. These measures are relatively recent, and an evaluation of their impact is not yet available. More recently, the Superintendency of Pensions (SP) has developed two new methodologies to measure and forecast replacement rates. One model uses administrative and survey data at the individual level. The other is a pension risk model, which is used in a public web-based pension simulator that allows users to estimate their pension under different return assumptions. There is also ongoing joint work with the OECD on computing replacement rates. These efforts should lead to an updated assessment of replacement rates, based on which further reforms will be considered.
Strengthen the independence and legal protection of regulatory agencies (H, M)	The Government has prepared a draft law to be submitted to Congress in 2012, which envisages improving governance of the Superintendency for Securities and Insurance (SVS) by converting it to a Commission managed by a five-member council, which are protected from dismissal for political reasons. It also proposes improvements to the enforcement process and transparency (an annual report will be published and regulatory impact assessment will be made prior issuing new regulations). The revised General Banking Law would include amendments to enhance independence of the SBIF.
Strengthen the enforcement powers of securities regulators (H, S)	Enhancement of enforcement powers of the SVS is envisaged in the draft law mentioned above. The law would establish Securities and Insurance Prosecutor – an autonomous body in charge of investigation and enforcement proceedings. Sanctions will be applied by the Commission, upon conclusion of the investigation by the Prosecutor.

Recommendation (priority H/M, time frame S/M)	Update
Complete the incorporation of Basel bank capital standards (H, M), and strengthen the legal framework for bank resolution (H, M)	The Government is working on changes to the General Banking Law to fully adopt Basel bank capital standards, reinforce the legal framework for bank resolution, and introduce amendments to enhance independence of the banking supervisor, in line with FSAP recommendations. The SBIF and the Central Bank are also working on improvements in liquidity regulation and reporting, taking into consideration recent proposals of the Basel Committee on Banking Supervision.
Establish legal framework to enable the consolidated oversight of financial conglomerates (H, M)	The Committee of Financial Superintendents (CSSF) is developing a methodology for supervision of financial conglomerates, including assessment of overall risks and identification of lead supervisors. The CSSF has established formal rules for sharing information relevant for supervision and regulation. The new Financial Stability Council builds up on the work of the CSSF. The Council is supported by three working groups: Risk Analysis, Regulation and Legislation, and Financial Conglomerates, the latter is working on identifying key indicators of financial health for conglomerates.
Enhance uniformity in business conduct regulation for asset management services and investment advice (H, M)	A comprehensive Funds Law that standardizes regulation in the fund industry was submitted to Congress in September 2011. In December 2011, the SVS issued regulation on internal control and risk management for securities intermediaries, which sets minimum requirements for control and risk management. Securities intermediaries will be required to have an Internal Audit Unit, and an internal risk management system consistent with the complexity of operations. The senior executives will be accountable for the implementation of the internal control and risk management. A staff's code of conduct will also be required.
Introduce comparable transparency standards for fixed income securities traded outside exchanges (H, M)	There has been no progress to date. Nonetheless, the SVS is arranging a tailor-made staff training program with the Toronto Centre for capacity-building.
Adopt a comprehensive approach to custodial, clearing, and settlement infrastructure (M, M)	There has been no progress to date. The SVS is arranging a tailor-made staff training program with the Toronto Centre for capacity-building.

Recommendation (priority H/M, time frame S/M)	**Update**
Further enhance the AML/CFT framework (M, M)	In April 2011, the Financial Analysis Unit (UAF), SVS, SBIF, and the SP issued regulations against corruption of senior government officials. They established criteria to define Politically Exposed Persons (PEP), and procedures for financial intermediaries to determine the source and destination of funds of such persons. In addition, all entities supervised by the UAF are required to register all transactions of PEP and inform of any suspicious operations. Progress has been made on GAFISUD recommendation to require foreign subsidiaries to inform about activities carried out in countries that are not in compliance with the set standards. In 2010-11, the UAF has issued 324 sanctions for noncompliance with AML/CFT obligations.
Consider introduction of a premium-based limited deposit insurance system (M, M)	There have been no changes to date.
Examine options to establish a framework for dealing with a systemic crisis and with the potential failure of a financial conglomerate (M, M)	The Finance Ministry, Central Bank, and the SBIF conducted a joint crisis exercise in 2011, coordinated by Crisis Management Analytics. The Financial Stability Council is currently reviewing lessons from the exercise, and plans to prepare a cooperation protocol based on those lessons. In addition, there has been progress in enhancing the supervision of conglomerates.

ANNEX V. CHILE—DEBT SUSTAINABILITY ANALYSIS

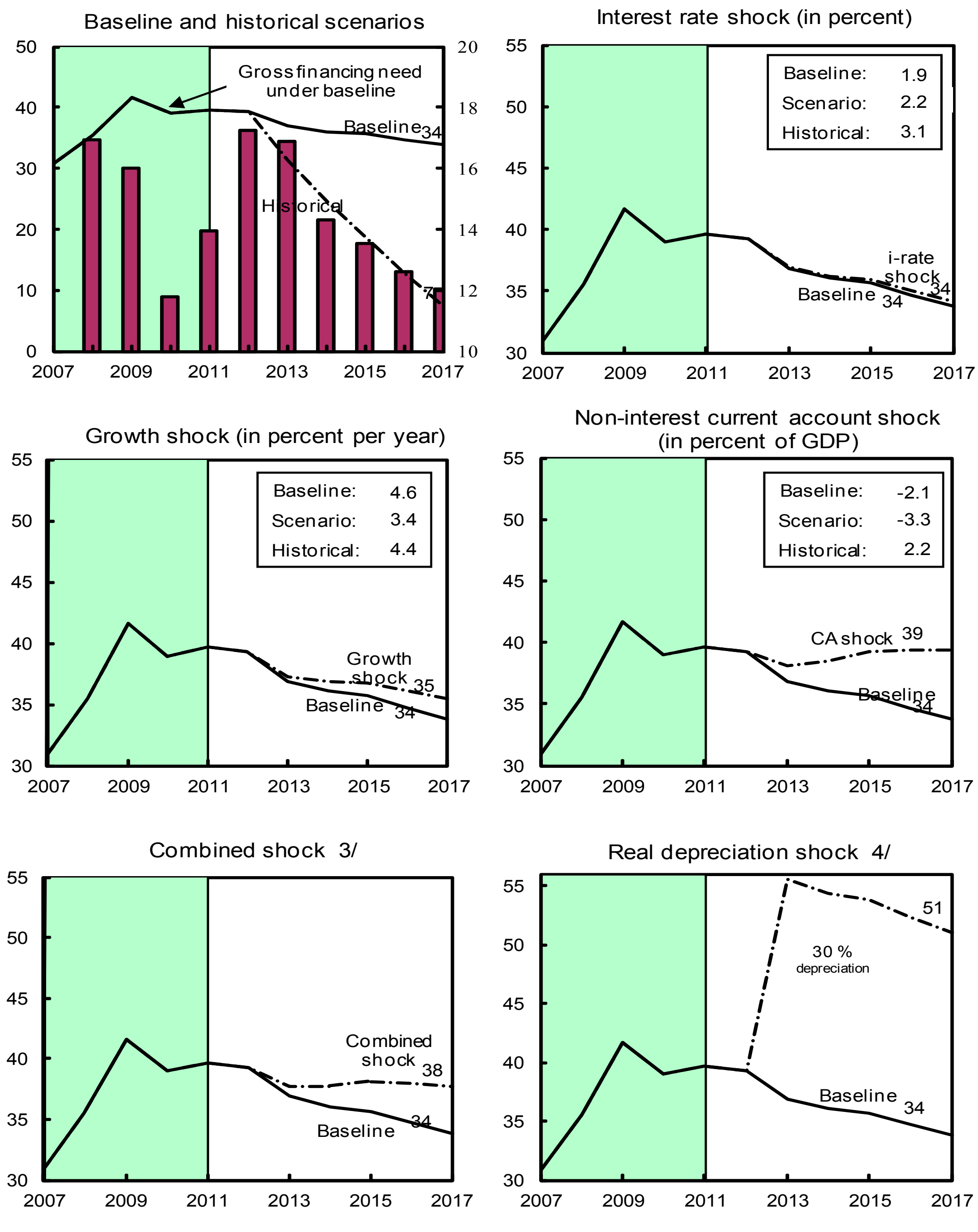
Chile's external debt has risen in recent years but relatively low at 40 percent of GDP (Figure A1). Most of it is private debt, held by non-financial companies. External debt levels are not very sensitive to growth or interest-rate shocks, but are somewhat sensitive to a depreciation of the peso, as nearly all of Chile's external debt is denominated in foreign currency.

Chile remained a net public creditor in 2011. Relative to GDP, net central government assets improved from 7 percent in 2010 to 8¾ percent in 2011. Going forward, lower projected copper revenues and the convergence of growth toward potential would result in 5 percentage points decline in net government assets by 2017.

Under the baseline scenario gross public debt would remain relatively stable. Chile's gross debt-to-GDP ratio has increased steadily since 2007, albeit from a low base. The rise has been driven by issuance of peso-denominated instruments, while foreign currency-denominated debt has remained stable. The public debt sustainability analysis suggests that debt levels would remain comfortable under various shocks.

The government's report on contingent liabilities suggests that they are relatively small. According to the 2011 report, the net present value of contingent liabilities amount to 3¼ percent of 2011 GDP (or 0.03 percent of GDP on an annual flow basis), of which deposit guarantees and guarantees on the debt of state enterprises jointly account for 2¼ percentage points. This analysis, however, does not include as contingent liabilities long-term projections of government expenditure on health care or education.

Figure A.1. Chile: External Debt Sustainability: Bound Tests 1/ 2/
(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/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2013.

Table A.1. Chile: External Debt Sustainability Framework, 2007-2017
(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Debt-stabilizing non-interest current account 6/
1	**Baseline: External debt**	30.9	35.5	41.6	38.9	39.7	**39.3**	**36.9**	**36.1**	**35.7**	**34.7**	**33.8**	**-5.7**
2	Change in external debt	-0.3	4.6	6.1	-2.7	0.7	-0.4	-2.4	-0.8	-0.4	-0.9	-0.9	
3	Identified external debt-creating flows (4+8+9)	-12.1	-2.5	-4.1	-13.5	-7.8	-2.9	-2.9	-2.7	-2.8	-2.7	-2.6	
4	Current account deficit, excluding interest payments	-5.1	2.3	-2.9	-2.4	0.4	2.1	2.1	2.3	2.0	2.0	2.1	
5	Deficit in balance of goods and services	-76.6	-81.1	-66.3	-69.4	-72.2	-67.8	-63.8	-62.4	-61.5	-59.7	-58.0	
6	Exports	44.9	41.9	37.0	37.8	37.8	34.3	32.1	31.3	30.9	29.8	29.0	
7	Imports	-31.7	-39.2	-29.3	-31.6	-34.4	-33.5	-31.7	-31.1	-30.7	-29.8	-29.1	
8	Net non-debt creating capital inflows (negative)	-4.7	-4.6	-3.5	-3.7	-4.0	-4.1	-4.0	-4.0	-4.0	-3.9	-3.9	
9	Automatic debt dynamics 1/	-2.3	-0.2	2.3	-7.5	-4.2	-0.9	-1.0	-1.1	-0.8	-0.8	-0.8	
10	Contribution from nominal interest rate	1.0	0.9	0.9	0.9	0.9	0.8	0.6	0.5	0.8	0.7	0.7	
11	Contribution from real GDP growth	-1.5	-0.9	0.3	-2.0	-2.0	-1.7	-1.6	-1.6	-1.6	-1.5	-1.5	
12	Contribution from price and exchange rate changes 2/	-1.8	-0.2	1.1	-6.3	-3.1	...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 3/	11.7	7.1	10.3	10.8	8.5	2.5	0.5	1.9	2.4	1.8	1.7	
	External debt-to-exports ratio (in percent)	68.8	84.7	112.5	103.0	105.1	114.4	114.9	115.3	115.5	116.3	116.7	
	Gross external financing need (in billions of US dollars) 4/	12.4	30.4	27.7	25.5	34.7	46.1	47.6	36.8	39.8	41.0	42.3	
	in percent of GDP	7.2	16.9	16.0	11.8	14.0	17.2	16.3	11.8	12.0	11.5	11.0	
	Scenario with key variables at their historical averages 5/						**39.3**	**31.4**	**24.7**	**18.6**	**12.8**	**7.5**	**-4.8**
	Key Macroeconomic Assumptions Underlying Baseline												
	Real GDP growth (in percent)	5.2	3.1	-0.9	6.1	5.9	4.7	4.5	4.6	4.6	4.6	4.6	
	GDP deflator in US dollars (change in percent)	6.3	0.7	-2.9	17.9	8.5	3.0	4.5	2.3	1.3	3.0	3.1	
	Nominal external interest rate (in percent)	3.6	3.0	2.4	2.6	2.6	2.3	1.7	1.5	2.3	2.2	2.1	
	Growth of exports (US dollar terms, in percent)	15.4	-3.0	-15.0	27.8	14.8	-2.0	2.1	4.3	4.5	4.2	4.6	
	Growth of imports (US dollar terms, in percent)	21.3	28.5	-28.1	34.8	25.3	5.0	3.2	5.1	4.5	4.7	5.1	
	Current account balance, excluding interest payments	5.1	-2.3	2.9	2.4	-0.4	-2.1	-2.1	-2.3	-2.0	-2.0	-2.1	
	Net non-debt creating capital inflows	4.7	4.6	3.5	3.7	4.0	4.1	4.0	4.0	4.0	3.9	3.9	

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).

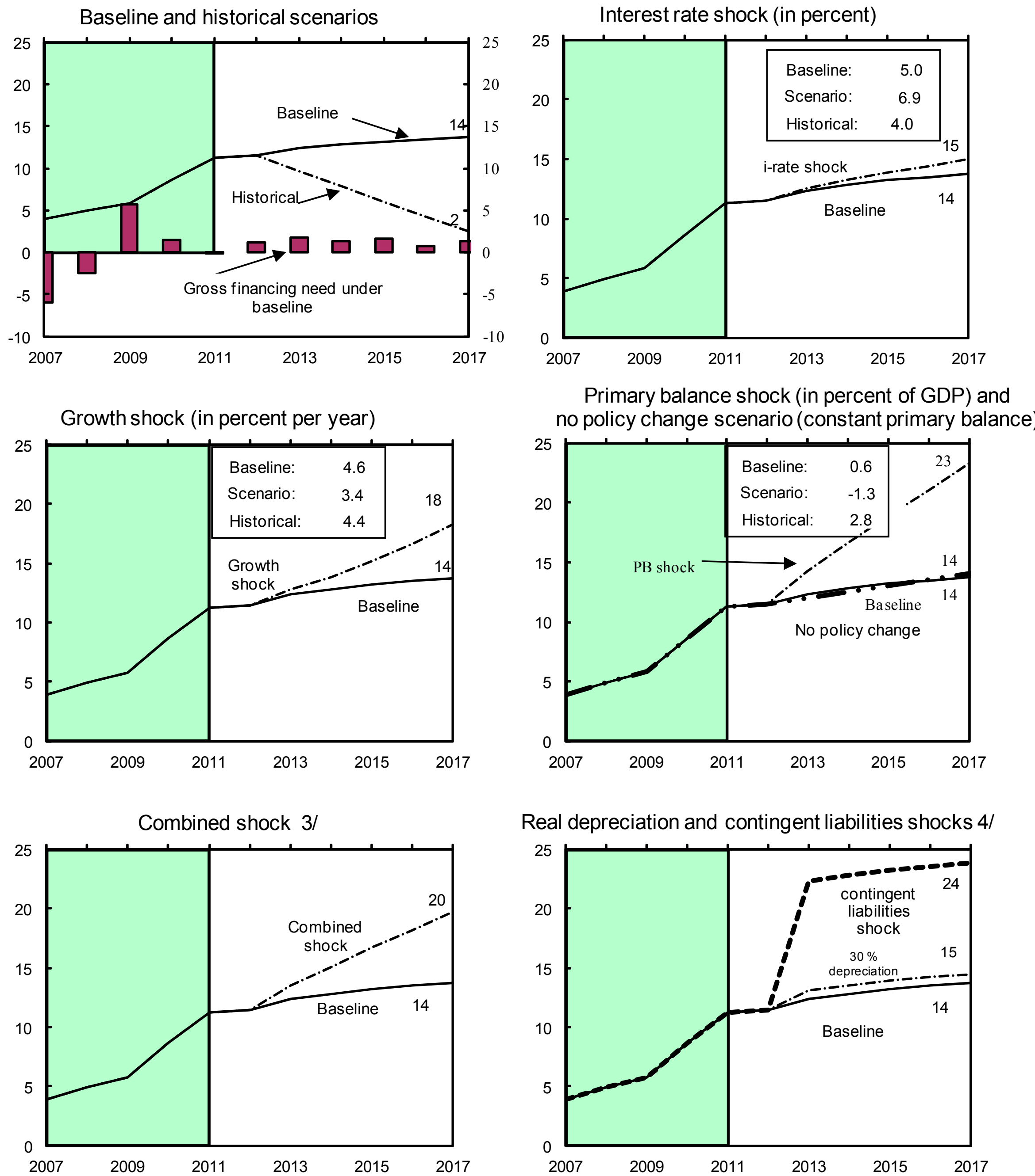
3/ For projection, line includes the impact of price and exchange rate changes.

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.

Figure A.2. Chile: Public Debt Sustainability: Bound Tests 1/ 2/
(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/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2013, 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 A.2. Chile: Public Sector Debt Sustainability Framework, 2007-2017
(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Debt-stabilizing primary balance 9/
1	**Baseline: Public sector debt 1/**	3.9	4.9	5.8	8.6	11.3	**11.5**	**12.4**	**12.8**	**13.2**	**13.5**	**13.8**	**0.02**
	o/w foreign-currency denominated	2.0	2.0	1.3	1.5	1.9	1.4	1.0	0.9	0.8	0.7	0.7	
2	Change in public sector debt	-1.1	1.0	0.9	2.8	2.6	0.2	0.9	0.5	0.4	0.3	0.3	
3	Identified debt-creating flows (4+7+12)	-8.5	-3.7	3.6	-0.4	-1.8	-0.5	-0.2	-0.6	-0.6	-0.7	-0.7	
4	Primary deficit	-8.4	-4.6	3.7	-0.1	-1.9	-0.5	-0.2	-0.6	-0.7	-0.8	-0.8	
5	Revenue and grants	25.6	24.2	19.0	21.7	22.9	21.7	21.0	20.7	20.2	20.2	20.2	
6	Primary (noninterest) expenditure	17.2	19.7	22.7	21.6	21.1	21.2	20.9	20.1	19.5	19.5	19.4	
7	Automatic debt dynamics 2/	-0.1	0.9	-0.1	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
8	Contribution from interest rate/growth differential 3/	0.1	0.3	0.3	-0.2	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	
9	Of which contribution from real interest rate	0.4	0.4	0.3	0.1	0.3	0.5	0.5	0.6	0.6	0.6	0.6	
10	Of which contribution from real GDP growth	-0.2	-0.1	0.0	-0.3	-0.5	-0.5	-0.5	-0.5	-0.5	-0.6	-0.6	
11	Contribution from exchange rate depreciation 4/	-0.3	0.6	-0.4	-0.1	0.2	...	...	...	...	...	...	
12	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	
13	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	
14	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	
15	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	
16	Residual, including asset changes (2-3) 5/	7.4	4.7	-2.7	3.2	4.4	0.7	1.0	1.0	1.0	1.0	1.0	
	Public sector debt-to-revenue ratio 1/	15.2	20.3	30.6	39.9	49.1	52.8	58.7	62.0	65.4	66.7	68.2	
	Gross financing need 6/	-6.0	-2.4	5.7	1.5	-0.1	1.2	1.8	1.4	1.6	0.7	1.3	
	in billions of U.S. dollars	-10.4	-4.3	9.8	3.3	-0.3	3.3	5.4	4.3	5.3	2.7	5.2	
	Scenario with key variables at their historical averages 7/						**11.5**	**9.7**	**7.8**	**6.0**	**4.2**	**2.5**	**-0.01**
	Scenario with no policy change (constant primary balance) in 2012-2017						**11.5**	**12.0**	**12.5**	**13.1**	**13.6**	**14.1**	**0.02**
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
	Real GDP growth (in percent)	5.2	3.1	-0.9	6.1	5.9	4.7	4.5	4.6	4.6	4.6	4.6	
	Average nominal interest rate on public debt (in percent) 8/	12.7	12.5	10.3	9.6	7.1	8.0	8.0	8.0	8.0	8.0	8.0	
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	8.0	11.8	6.3	2.1	4.2	5.2	4.9	5.0	5.0	5.0	4.9	
	Nominal appreciation (increase in US dollar value of local currency, in percent)	7.8	-21.2	24.2	8.1	-10.2	...	...	...	...	...	...	
	Inflation rate (GDP deflator, in percent)	4.7	0.7	4.0	7.5	2.9	2.7	3.1	2.9	3.0	3.0	3.1	
	Growth of real primary spending (deflated by GDP deflator, in percent)	9.6	17.9	14.3	1.0	3.3	5.3	2.9	0.5	1.8	4.4	4.4	
	Primary deficit	-8.4	-4.6	3.7	-0.1	-1.9	-0.5	-0.2	-0.6	-0.7	-0.8	-0.8	

1/ Central government debt
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 public sector 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

August 6, 2012

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By | Western Hemisphere Department

CONTENTS

I. CHILE—FUND RELATIONS

(As of June 30, 2012)

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	558.07	65.19
Reserve Position	298.03	34.81
Holdings Exchange Rate		
Lending to the Fund		
New Arrangements to Borrow	138.8	

III. SDR Department:	**SDR Million**	**Percent Allocations**
Net cumulative allocation	816.89	100.00
Holdings	791.01	96.83

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		
	2012	2013	2014	2015	2016
Principal					
Charges/Interest	0.02	0.05	0.05	0.05	0.05
Total	0.02	0.05	0.05	0.05	0.05

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. 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. Chile has a floating exchange rate system.

II. CHILE—STATISTICAL ISSUES APPENDIX

As of July 10, 2012

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 July 10, 2012

	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 6, 2012	July 10, 2012	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	June 30, 2012	July 10, 2012	W	W	W		
Reserve/Base Money	June 2012	July 10, 2012	M	M	M	O, O, LO, O	O, O, O, LO, O
Broad Money	June 2012	July 10, 2012	M	M	M		
Central Bank Balance Sheet	June 2012	July 10, 2012	M	M	M		
Consolidated Balance Sheet of the Banking System	May 2012	July 10, 2012	M	M	M		
Interest Rates[2]	July 6,2012	July 10, 2012	D	D	D		
Consumer Price Index	June 2012	July 6, 2012	M	M	M	LO, LNO, LNO, LO	LO, LO, LO, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	December 2011	July 9, 2012	Q	Q	Q	O, LO, LNO, LO	LO, O, O, LO, O
Revenue, Expenditure, Balance and Composition of Financing3– Central Government	May 2012	July 9, 2012	M	M	M		
Stocks of Central Government and Central Government – Guaranteed Debt[5]	March 2012	July 9, 2012	A	Q	Q		
External Current Account Balance	Q1 2012	May 18 , 2012	W	W	W	O, O, LO, LO	O, O, O, O, O
Exports and Imports of Goods and Services	June 2012	July 10 , 2012	W	W	W		
GDP/GNP	Q1 2012	May 18, 2012	Q	Q	Q	O, LO, LO, LO	LO, LO, LO, LO, O
Gross External Debt	May 2012	July 10, 2012	M	M	M		
International Investment position[10]	Q1 2012	July 10, 2012	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.

III. CHILE—WORLD BANK—FUND COUNTRY-LEVEL WORK PROGRAM UNDER JMAP

Title	Products	Provisional Timing of Missions	Expected delivery date*
1. Bank work program	**A. Investment Loans**		
	1. Additional Financing for the Social Protection Technical Assistance Project (P114774)		December 2003
	2. Second Public Expenditure Management Project (P1035441)		August 2007
	3. Ministry of Public Works Institutional Strengthening TAL (P102931)		June 2007
	4. Tertiary Education Finance for Results Project III (P111661)		March 2012
	B. Technical Assistance		
	1. Technical Assistance for Tertiary Education in Chile (new)		June 2013
	2. Concession Study Phase II (new)		June 2013
	3. Water Management Study (new)		June 2013
	4. Urban Transport (new)		June 2013
	5. Implementation of a System for Consumer Protection against Fuel Price Volatility (new)		June 2013
2. Fund work program	Staff visit	January 2013	
	2013 Article IV Consultation	June 2013	Staff report August 2013

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

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 12/107
FOR IMMEDIATE RELEASE
September 11, 2012

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

IMF Executive Board Concludes 2012 Article IV Consultation with Chile

On September 5, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Chile.[1]

Background

Chile's economy has expanded at a robust pace over the past two years. The economy recovered rapidly from the global financial crisis and the February 2010 earthquake, supported by a strong policy framework, favorable copper prices and strong consumer and business confidence. Real GDP increased by about 6 percent during 2010–11 on the back of exceptionally dynamic domestic demand.

The output gap is closed and some pressures on capacity constraints have emerged. The unemployment rate is at a historically low level, leading to strong wage growth. Labor force participation and employment have increased rapidly in 2010–11, although there has been some deceleration in recent months. The surge in domestic demand has fueled import growth, turning the external current account into deficit in 2011, despite record high copper prices. Core and headline inflation increased rapidly in 2011 driven by rising import prices and wages. Price pressures have eased in recent months as food and energy prices declined, and inflation expectations remain well anchored.

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[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.

Bank credit growth has been strong, despite some tightening in credit standards since late 2011. Bank credit in real terms has been growing at around 11 percent year-on-year, with particularly strong growth in the corporate and consumer loans segments. In contrast, non-bank consumer credit, which accounts for about 30 percent of consumer credit, has declined since mid-2011.

The central bank raised the policy rate by 475 basis points from mid-2010 to June 2011 (to 5¼ percent) to withdraw policy stimulus and contain inflation. After a one-off easing in January 2012, amid uncertain global financial conditions, the policy rate has been maintained at 5 percent. The central bank completed the pre-announced US$12 billion foreign exchange purchases program in December 2011, strengthening the reserve position.

Spillovers to Chile from volatility in global financial markets have been limited. Stock market prices have moved broadly in line with prices in other emerging markets. Despite some increase since mid-2011, bank funding costs remain well below their levels after the Lehman crisis. The temporary liquidity measures implemented by the authorities in December 2011 were successful in containing a rise in liquidity pressures in domestic money markets. Net capital inflows have remained strong, especially in the mining sector. The real effective exchange rate is close to its long-term historical average.

The withdrawal of fiscal stimulus continued in 2011. Public expenditure growth slowed down and a temporary corporate income tax hike boosted revenue. However, an increase in education and other social spending will result in some easing of the fiscal policy stance in 2012. A tax reform has been proposed by the government to help finance the increase in education spending.

Looking ahead, real GDP is expected to grow 4¾ percent in 2012, broadly in line with potential growth. The current account deficit is expected to widen further in 2012 due to less favorable terms of trade. Core and headline inflation are expected to remain close to the target as domestic demand growth moderates and import prices remain subdued.

Executive Board Assessment

Executive Directors commended the authorities' skillful economic management anchored on sound policy frameworks, which has contributed to robust economic growth with low inflation, unemployment, and public debt. Directors underscored, however, that downside risks remain, stemming from global uncertainties and Chile's vulnerability to commodity price shocks. They called for continued vigilance and maintenance of strong and flexible policy frameworks. They were encouraged that the authorities have space for counter-cyclical policies if needed, particularly on the monetary side.

Directors supported the authorities' plans to reduce the structural budget deficit to one percent of GDP by 2014, with a number of Directors observing that the aim eventually should be structural balance or a small surplus. Near-term flexibility should be retained, however, and a more front-loaded reduction would be desirable if conditions remain favorable. Directors encouraged the authorities to build up fiscal buffers and strengthen the medium-term fiscal framework further. Expenditure restraint and higher revenue collection will be essential. New spending commitments, including higher social spending, should be matched by permanent revenue increases. In this context, the tax reform to finance education expenditure is welcome. Directors welcomed plans to create a Fiscal Council and broaden the expenditure forecasting framework to include health care and education spending.

Directors observed that the inflation targeting and flexible exchange rate regimes have served Chile well. They agreed that the current neutral stance of monetary policy is appropriate but should remain responsive to changing economic conditions. Exchange rate flexibility, buttressed by macro-prudential measures as needed and a good communication strategy to maintain market confidence, remains an important buffer and first line of defense against volatile capital flows and terms of trade shocks.

Directors welcomed the soundness and resilience of Chile's financial sector, noting that banks are well-capitalized, liquid, and profitable, a testimony to the authorities' strong financial oversight. Given global uncertainties, banks should maintain adequate liquidity and capital and continue to diversify external funding sources. Directors encouraged the authorities to implement the remaining reforms recommended in the 2011 FSAP report to enhance financial regulation and supervision. In this connection, they welcomed the establishment of a Financial Stability Council and various legislative initiatives being pursued, and recommended the creation of a legal framework for consolidated supervision of financial conglomerates.

Directors saw productivity growth as key to sustaining high economic growth rates in the future. They welcomed recent initiatives to foster female labor participation, and pressed for reforms to enhance labor market efficiency and flexibility, boost investment in the energy sector, and improve the business environment.

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 2012 Article IV Consultation with Chile is also available.

Chile: Selected Social and Economic Indicators

GDP (2011), in billions of pesos	120,158	Quota	
GDP (2011), in billions of U.S. dollars	248.4	In millions of SDRs	856
Per capita (U.S. dollars)	14,403	In percent of total	0.36%
Population (2009), in millions	16.9	Poverty rate (2011)	14.4
Main products and exports	Copper	Gini coefficient (2011)	0.52
Key export markets	China, U.S., Japan	Literacy rate (2011)	98.9

						Proj.	
	2007	2008	2009	2010	2011	2012	2013
(Annual percentage change, unless otherwise specified)							
Output							
Real GDP	5.2	3.1	-0.9	6.1	5.9	4.7	4.5
Total domestic demand	7.0	7.4	-5.0	14.8	9.7	5.7	4.6
Consumption	7.5	4.5	0.8	8.9	8.1	5.4	4.4
Private	7.7	5.2	-0.8	10.0	8.9	5.7	4.8
Public	6.7	0.4	9.2	3.7	4.0	3.5	1.7
Investment	6.3	21.0	-23.5	35.6	13.7	9.3	3.7
Fixed	10.7	18.1	-12.2	14.2	17.7	8.0	5.6
Private	9.1	20.0	-17.7	20.5	18.4	7.3	5.8
Public	24.5	3.5	37.9	-19.6	11.6	14.0	3.5
Inventories 1/	-0.8	0.7	-3.1	4.0	-0.6	0.4	-0.4
Net exports 1/	-1.8	-3.7	4.1	-8.7	-4.2	-0.3	-0.3
Exports	7.1	-0.7	-4.5	1.4	4.7	4.7	4.7
Imports	14.0	9.3	-15.4	27.7	14.8	4.8	4.7
Employment							
Unemployment rate (annual average) 2/	7.0	7.8	10.8	8.2	7.1	6.6	6.9
Consumer prices							
End of period	7.8	7.1	-1.5	3.0	4.4	2.6	3.0
Average	4.4	8.7	1.5	1.4	3.3	3.2	3.0
(In percent of GDP, unless otherwise specified)							
Public sector finance							
Central government revenue	25.6	24.2	19.0	21.7	22.9	21.7	21.0
Central government expenditure	17.8	20.2	23.2	22.1	21.6	22.0	21.7
Central government fiscal balance	7.8	4.1	-4.2	-0.4	1.3	-0.3	-0.7
Structural fiscal balance 3/	-0.1	-1.1	-4.2	-2.5	-1.1	-1.1	-1.3
Public sector net debt	-9.5	-16.8	-6.5	-2.2	-5.0	-1.1	0.1
Public sector gross debt	18.9	24.7	27.4	26.1	35.2	34.2	34.2
Central government gross debt	3.9	4.9	5.8	8.6	11.3	11.5	12.4
Of which, share of FX-denominated debt (in percent)	51.5	40.0	22.8	17.3	17.2	12.3	8.2
Money and credit							
Broad money (% change)	20.5	18.6	-5.3	9.3	18.5	...	...
Credit to the private sector (end of period, percent change)	21.0	18.7	-1.4	8.3	17.0	...	...
3-month central bank bill rate (percent)	5.2	7.4	1.1	2.1	5.1	...	...
Balance of payments							
Current account	4.1	-3.2	2.0	1.5	-1.3	-2.9	-2.7
Current account (in billions of U.S. dollars)	7.1	-5.8	3.5	3.3	-3.2	-7.8	-8.0
Foreign direct investment inflows	7.3	8.6	7.5	7.1	7.0	6.9	6.7
Gross international reserves (in billions of U.S. dollars)	16.9	23.2	25.4	27.9	42.0	42.0	42.0
In months of next year's imports of goods and services	2.9	5.5	4.5	3.9	5.6	5.4	5.2
Gross external debt	30.9	35.5	41.6	38.9	39.7	39.3	36.9
Public	6.8	6.5	7.7	7.9	8.3	8.4	7.7
Private	24.1	29.0	34.0	31.0	31.4	30.9	29.2
(Annual percentage change)							
Exchange rate							
Real effective exchange rate (real appreciation +)	-2.1	1.8	-2.2	5.9	0.9	...	...
Terms of trade	3.9	-15.4	6.0	21.5	0.7	-7.7	-1.1

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

1/ Contribution to growth.

2/ The methodology to compute the unemployment rate changed in 2009.

3/ The estimate of the structural balance is based on staff estimates of the output gap, and may differ from the authorities' estimate

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Statement by Pablo Garcia-Silva, Executive Director for Chile
September 5, 2012

On behalf of my Chilean authorities, I would like to thank the staff for a well-written set of papers on the Chilean economy. The Article IV report adequately presents the constructive tone of the dialogue between my authorities and the staff during the consultation process, and is a good reflection of the collaborative relationship between Chile and the Fund. As a small and highly integrated economy, Chile has significant stakes on an environment that promotes a well-functioning global economy. My authorities see their productive engagement with the Fund as part of their contribution to that environment.

Background

The Chilean economy quickly recovered from the 2009 recession and February 2010 earthquake, posting above-trend growth of 6.1 percent over 2010 and 2011. Thus, the output gap has closed, whilst the unemployment rate has fallen below pre-crisis levels. The significant monetary and fiscal stimulus put in place in 2009 was timely withdrawn as the economy picked up speed, forestalling the emergence of domestic imbalances or financial tensions. Thus, the economy is in a healthy position to face the lingering risks from a still uncertain global environment.

The financial turbulences associated with sovereign tensions in the Eurozone over the second half of 2011 had a limited impact on the Chilean economy. A slight dip in household and business confidence, as well as a limited impact on equities, did not manage to significantly dent the growth in domestic demand and output. In 2012, the economy has continued to expand robustly, at 5.4 percent in the first half of the year. In spite of this dynamism, there are signs of a deceleration towards trend-like rates of expansion for the whole of 2012. Underlying these domestic factors, the softening of global conditions in 2012, due to the international financial situation, is expected to exert a moderating influence on Chile's economy. This is consistent with commodity prices having shifted back from their early-year highs, and the expected reduction in Chile's terms of trade in 2012.

The overall normalization of the business cycle, and the appropriate policy responses by the authorities, has prevented a significant resurgence of inflationary pressures. The high headline inflation by the end of 2011, close to 4 percent, was mostly driven by external factors, namely the depreciation of the exchange rate in response to international turbulences, as well as high food and energy prices. However, core inflation remained subdued. More recently, the reduction in international fuel prices, as well as the strength of the peso, has contributed to modest inflation prints. The private sector, as well as the authorities, now expects that headline inflation will fall below 3 percent by the end of this year.

Although labor productivity growth decelerated over the last ten years, it has recently picked up, in the first half of this year to over 3 percent, which is similar to pre-2008 prints. This gives confidence that expected trend growth should remain around 5 percent. The recent results of the independent committee of experts for the design of fiscal policy are also consistent with these figures for trend growth.

Monetary Policy

The Banco Central de Chile (BCC) conducts its monetary policy under an Inflation-Targeting scheme and a flexible exchange rate regime. This framework has served the economy well, both to confront the disinflationary and negative output implications of the 2009 recession, and to properly forestall the emergence of imbalances in the subsequent vigorous recovery. After reaching the zero lower bound and the implementation of non-conventional monetary policy stimulus in 2009, the BCC's policy rate currently stands at 5 percent, broadly considered a neutral stance.

The BCC continues to perceive that two main risks dominate the Chilean outlook going forward. On the one hand, the external backdrop remains a significant concern to the authorities. A disorderly and costly resolution of the sovereign tensions in the Eurozone, excessive fiscal retrenchment in the US, or a significant slowdown in China, all could have severe financial and real effects on Chile. On the other hand, the resilience of the domestic drivers of growth has not generated imbalances and tensions so far, but over the medium term, the inflationary risks of a buoyant demand-driven growth process remain present, in the context of easy global monetary conditions and high commodity prices. The authorities have been clear to point out that even though current developments have shown a limited impact of external tensions, and low headline inflation prints, monetary policy will remain vigilant to confront risks, were they to materialize, so as to prevent the unhinging of the inflationary process.

Fiscal Policy

In the context of the fiscal rule in place since 2001, public spending is set so as to achieve the authorities' target for a given structural balance. At the beginning of the current administration, in 2010, and in accordance with the Fiscal Sustainability Act, the authorities defined their fiscal policy in order to achieve a structural deficit of 1 percent of GDP by 2014, balancing the needs for a sound fiscal stance with the social priorities and policy challenges Chile faces on the path to economic development. Moreover, this fiscal objective was consistent with a significant withdrawal of the large fiscal stimulus program of 2009, which widened the structural deficit to 3 percent of GDP that year. Fiscal policy restraint, in the context of increasing structural revenues, allowed the authorities to already reach the target in 2011, with a structural deficit of 1.1 percent instead of the 1.5 foreseen one year earlier, thus implementing a structural improvement in the fiscal balance of close to 2 percent of GDP in two years. The overall fiscal balance posted a significant surplus in 2011, has shown so far in 2012 a surplus of 2 percent of GDP, and is expected to remain close to balance for the year as a whole. Moreover, public spending has grown in 2012 close to overall GDP. The authorities see this as consistent with their policy commitments and the low level of gross public debt, whereas the lingering risks from abroad make a rapid slowdown in public spending unadvisable.

The authorities are aware of the significant risks stemming from the global environment, and thus appropriately value the importance of sound fiscal policy design and implementation. Although the current policy framework in place in Chile tasks monetary policy with the first line of defense in the case of a significant deterioration of the outlook, fiscal policy is also ready to act should the risks of a marked downgrade in output and employment prospects materialize. The authorities have put in place contingencies to face such an occurrence, and recognize that the existing fiscal buffers provide room for maneuver in such a circumstance. So far, however, the authorities have not activated the contingency plan, as the spillovers from the sovereign crisis in the Eurozone have been limited.

Total assets held in cash and the sovereign wealth funds by the Treasury reach close to USD34 billion as of mid 2012, and the public sector remains a net creditor, with net debt below minus 8 percent of GDP. This aspect suggests that the external and public debt sustainability analysis should result in even more comfortable assessments than those presented in the staff papers. Going forward, the authorities consider that it would be appropriate to include in sustainability analyses not only gross measures, but also net levels of public debt, particularly when assets are liquid and are held for macrofinancial stabilization purposes.

Financial Sector Issues

The authorities view a sound macroeconomic policy framework as necessary but not sufficient to forestall financial instability. Firm financial regulation and supervision are also critical. The current regulatory infrastructure helped limit the financial damage from the 2008-2009 global financial crisis and recession, and thus households and corporates, both financial and non-financial, were well placed to benefit from the stimulative policies put in place in 2009.

The subsequent expansion of credit has been moderate, and driven most recently by banks. Household leverage, as measured by, for instance, debt-to-income ratios, has also remained within stable levels. In any case, non-performing loans have edged up somewhat higher from the low levels observed in 2010, which is consistent with the more cautious approach taken by credit originators noted earlier, as well as with a moderate increase in credit spreads for smaller-sized loans. Overall, the authorities view these developments as an adequate adjustment of the credit market to an environment that is less conducive to high rates of growth, such as the ones observed in 2010 and 2011.

Corporate debt also continues to expand at a moderate pace, with only a third through external indebtedness. Moreover, the issuance of external debt has been geared towards longer tenors and mostly for the financing of foreign direct investment. It should be noted that given the structure of the corporate sector in Chile, a significant part of corporate external debt has been issued either by exporting firms, or by foreign-owned large companies in the utility sector and is held by the parent company abroad. The balance sheets of smaller companies, which depend on local banking sources for their funding, have remained healthy.

The presence of foreign-owned banks in Chile, under a subsidiary model with mostly local funding, has been a positive development on a number of fronts. The strong capital and liquidity buffers of the banking sector are also particularly seen in the foreign-owned segment of the market, and the deleveraging efforts of the parent companies have not had a material impact locally.

A number of initiatives are, in any case, in place to bolster the regulatory and supervisory infrastructure. The overall financial stability oversight has been entrusted to the Financial Stability Council (FSC), composed of the Minister of Finance, the three supervisory agencies (banks, securities exchange and insurance, pensions) and the BCC governor. The FSC has undertaken work to identify sources of systemic risk and lay out the groundwork for consolidated supervision, among other tasks. Although the authorities recognize that the current legal framework for supervision allows a significant degree of cooperation and information sharing, some legal changes would be required, and they appreciate the FSAP recommendations on this area.

The External Accounts and the Policy Framework

The improvement of the external environment by the middle of last decade resulted in a rapid and significant increase in commodity prices. A particular feature has been the sharp increase in the share of China in world copper demand. However, given the high volatility and mean reverting properties of copper prices, it was appropriate for these income surges to be perceived as transitory by both the public sector and the private export companies. The natural implication of the higher mineral prices was therefore an increase in national savings, without an equivalent increase in domestic investment, and thus a significant shift in the current account balance towards a surplus during the second half of the last decade.

However, after the resilience displayed by commodity prices in general (and copper prices in particular) during the 2009 global recession, perceptions have shifted, and a significant part of the higher commodity prices is now perceived as persistent. On the investment side, we have seen a significant surge in copper mining investment, both on the private and public side, whilst the operation of the expert's assessment within the fiscal rule on long-run copper price trends has resulted in a relevant increase in the public sector's structural income. The Chilean authorities still see that commodity prices are an important determinant of the external vulnerability of the Chilean economy, and thus should be monitored closely along with their implications for the balance of payments. The appearance of a current account deficit, after several years of surpluses, is however part of an adjustment process to a new scenario of high commodity prices and the subsequent higher investment in mining. Moreover, the bulk of the financing of the current account deficit has occurred through FDI. Proper consideration of these country-specific circumstances is difficult to include in the cross-country assessment of external balances, such as the CGER and EBA. The staff should strive, nevertheless, to include adequate qualifications where needed.

The shift towards a neutral monetary policy stance, after several years of low interest rates, and the lower interest rates in some large emerging economies, has reduced the attractiveness of the Chilean peso as a funding currency for carry trade operations. This, coupled with the positive domestic growth prospects going forward, may enhance the attractiveness of Chile as a recipient of capital inflows, either by residents or non-residents. Proper note should be given to some of the implications of the high degree of financial integration of the Chilean economy, particularly the large holdings of foreign assets by local institutional investors. These have helped smooth the fluctuations of local financial markets, as investment decisions have resulted in stabilizing capital inflows in times of international turmoil.

The authorities recognize the challenges the current external conditions could pose for Chile's macrofinancial stability. They consider that the current policy framework, based on a set of rules for the conduct of monetary and fiscal policy, along with a flexible exchange rate and strong financial supervision and regulation, provide an appropriate set of tools to successfully deal with emerging risks. The authorities welcome the staff's advice on such issues, and look forward to a continued fruitful engagement with the Fund.