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Chile: Staff Report for the 2000 Article IV Consultation

As required under Article IV of its Articles of Agreement, the International Monetary Fund conducts periodic consultations with its member countries. In the context of the 2000 Article IV consultation with Chile, the following documents have been released and are included in this package:

- the staff report for the 2000 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **April 19, 2000,** with the officials of Chile on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on June 14, 2000.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;.

- a staff statement **of July 7, 2000**, updating information on recent economic developments.

- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during the July 7, 2000, Executive Board discussion** of the staff report that concluded the Article IV consultation.

- a statement by the authorities of Chile.

Further background documentation prepared by IMF staff for the consultation may be published separately at a later date. The policy of publication of Article IV staff reports and PINS allows for the deletion of market-sensitive information.

The Article IV staff report is published—both in hard copy and on the IMF's website (http://www.imf.org)—as part of a pilot project. To assist the IMF in evaluating the pilot project for release of Article IV staff reports, reader comments are invited prior to October 5, 2000, and may be sent by e-mail to Pilotproject@imf.org.

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CHILE

Staff Report for the 2000 Article IV Consultation

Prepared by the Staff Representatives for
the 2000 Consultation with Chile

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June 13, 2000

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EXECUTIVE SUMMARY

Recent developments

During most of the 1990s Chile had a very strong economic performance, including high growth and a gradual decline in inflation. In early 1998, surging domestic demand and a drop in the terms of trade led to a widening of the external current account deficit, which together with turbulence in international financial markets caused recurrent pressures on the peso. The authorities scaled back expenditure plans, and tightened monetary policy sharply to prevent a large depreciation of the peso. In the event, domestic demand fell significantly; by end-1998 the current account deficit had started to narrow, but economic activity was declining and unemployment was rising rapidly.

In 1999 monetary and fiscal policy took an expansionary stance, which together with improving terms of trade, succeeded in reversing the recessionary trend. Recovery began in the final quarter of the year and is now firmly on track. For 1999 as a whole, real GDP fell by 1 percent, while inflation declined to 2.3 percent, and the external current account deficit was virtually eliminated. International reserves fell somewhat, but indicators of external vulnerability remained at comfortable levels. The banking system continued to be strong.

In September 1999 the authorities abandoned the sliding exchange rate band system in favor of a freely floating exchange rate. They also announced their decision to move from targeting a year-end inflation level to targeting a continuous inflation range of 2–4 percent starting in 2001.

Policy discussions

For 2000, the authorities plan to strengthen the fiscal position through expenditure restraint, and to continue implementing monetary policy on the basis of their inflation target, with a freely floating exchange rate. The staff supports the authorities' broad policy intentions and shares their view on the outlook for the economy. Real GDP is expected to grow by about 6 percent, inflation would be around 4 percent at year's end, and the current account deficit would widen moderately.

The authorities have recently launched a set of important initiatives. In addition to floating the exchange rate and enhancing their inflation targeting framework, they further liberalized capital flows, and indicated their intention to achieve a "structural" fiscal surplus of 1 percent of GDP in 2001. Other proposals, submitted to congress, include a revision of the scheme for administering domestic fuel prices to prevent persistent subsidies, regulations on bank concentration to limit the risks of moral hazard and of market control by a single bank, regulations on corporate governance, and a new unemployment protection system. They are also working on other labor market reforms. The thrust of these initiatives is appropriate, but caution is needed in finalizing some of the proposals and in their actual implementation (for example, calculating the structural fiscal balance to include central bank losses and on the basis of conservative assumptions for copper prices, and crafting the labor reforms so as to safeguard labor market flexibility).

Chile has a very open trade regime, it has continued with the unilateral gradual reduction of its uniform external tariff, and the authorities indicated that the planned move toward full membership in Mercosur would not involve an increase in the country's tariffs. Chile's price band scheme for some agricultural goods has generated very high tariffs, on the basis of a new law on safeguards.

The medium-term outlook for the economy is favorable. There are risks arising primarily from a less favorable external environment, but Chile's increased exchange rate flexibility, strong banking system, and comfortable level of reserves should help the country deal with these risks.

I. Introduction

1. The 2000 Article IV consultation discussions with Chile were held in Santiago during April 7–19, 2000.[1, 2] A new administration from the coalition that has held government since 1990 took office last March for a six-year term. The staff team met with the ministers of finance, education, labor, economy, mining and energy, the president of the central bank, senior officials in the government and the central bank, academics, and private sector representatives.

2. At the conclusion of the last consultation on January 25, 1999 (EBM/99/10), Directors noted Chile's long record of sound economic policies, and commended the authorities for their prompt response to the challenges posed by the deterioration in the external environment and by surging domestic demand in the second half of 1997 and in early 1998. They supported the authorities' objectives for 1999, which included further progress in reducing inflation and a narrowing of the external current account deficit, while maintaining positive growth. They considered that under prevailing fiscal policies there was room for further reductions in interest rates without compromising the objective for the external current account, and welcomed the authorities' decision to continue the gradual widening of the exchange rate band. A number of Directors considered that Chile's one-year unremunerated reserve requirement on capital inflows had contributed to reducing the country's vulnerability to sudden changes in capital flows, while a few Directors observed that the effectiveness of this instrument tended to diminish over time. Directors praised the authorities' decision to continue with Chile's unilateral gradual reduction in its uniform external tariff, but noted a proposal to introduce safeguard clauses and urged the authorities to be cautious in their use.

II. Background and Recent Developments

3. **Chile's overall economic performance in the period 1990–97 was very strong.** Real GDP grew at an annual average rate of 7.7 percent while inflation declined gradually from 26 percent to 6 percent (Table 1).[3] While income distribution remained roughly

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[1] The staff team comprised Messrs. Lizondo (Head), Kaufman, Nadal-De Simone (all WHD), Phillips (PDR), and Zettelmeyer (RES). Ms. Jul, Executive Director for Chile, participated in the discussions.

[2] Chile accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund Articles of Agreement on July 27, 1977. Relations with the Fund are presented in Appendix I.

[3] This strong performance was achieved despite the complications arising from large changes in the terms of trade, mainly reflecting variations in world copper prices. Copper accounts for almost 40 percent of Chile's exports. Since about 35 percent of copper output is produced by the state-owned company Codelco, changes in copper prices also have important effects on the fiscal accounts.

unchanged, social indicators improved significantly, and the proportion of the population living under the poverty line approximately halved. During this period, the authorities targeted a declining year-end inflation rate, and adjusted short-term interest rates to achieve that objective, with the support of strong fiscal policies.[4] The authorities also managed the exchange rate within a sliding band, and maintained a set of controls on capital flows.

4. **Performance weakened following the worsening of the external environment brought about by the Asian crisis**. In early 1998 the authorities were facing a widening external current account deficit, which resulted from a large drop in copper prices and very strong domestic demand (Figures 1 and 2). At the same time, the turbulence in international financial markets, as well as concerns about the growing current account deficit, weakened investor confidence. To contain domestic demand, the authorities scaled down their expenditure plans to make fiscal policy less expansionary, and raised the benchmark interest rate markedly. In addition, in response to recurrent attacks on the peso, they allowed overnight interest rates to increase to unprecedented levels on three occasions during 1998 (Figure 3).[5] The authorities also issued medium-term debt instruments indexed to the U.S. dollar, intervened in the foreign exchange market, reduced the width of the exchange rate band to signal their commitment to defend the peso, and relaxed controls on capital inflows (Figure 4). This strong defense of the peso reflected the authorities' concern that a large depreciation of the currency could have jeopardized their inflation target, and could have had adverse consequences for the banking system in view of the foreign currency exposure of bank borrowers. With higher real lending rates, growth of credit to the private sector slowed substantially (Table 2).

5. **The combination of the adverse terms of trade shock, the diminished supply of external finance, and a contractionary monetary policy, led to a sharp fall in domestic demand and to a decline in economic activity**. By the fourth quarter of 1998, real GDP growth had turned negative (year-on-year) for the first time since the early 1980s, and unemployment was rising rapidly (Figure 5). Also, the external current account deficit started to narrow, and by year-end inflation had declined to 4.7 percent (close to the target of 4.5 percent).

6. **In response to the weakness in economic activity, reduced price pressures, and fading concerns about the current account deficit, monetary and fiscal policies were eased starting in late 1998**. The authorities reduced in several steps the benchmark real

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[4] The authorities signaled their monetary stance by setting a benchmark interest rate and controlled liquidity to bring the overnight market interest rate close to the benchmark rate.

[5] While the highest overnight rate (92 percent) on an individual day was observed in January, the most protracted episode of high rates followed the Russian crisis of August, when the overnight rate averaged about 35 percent for three consecutive weeks.

interest rate from 14 percent in September 1998 to 5 percent in June 1999, its lowest level in the 1990s, with market interest rates following in step. In mid-1999, the authorities also introduced a fiscal stimulus package which included a temporary jobs program; some additional public sector investment; tax benefits on the purchase of new middle-income homes over a limited period; a rescheduling of tax liabilities of small businesses and the self-employed; and a rescheduling of debt of small businesses to the state-owned Banco del Estado.

7. **The expansionary monetary and fiscal policies in 1999, together with a steady increase in copper prices, helped reverse the weakening of the economy**. By the fourth quarter of 1999 the fall in domestic demand was coming to an end and output was growing again (year-on-year). Unemployment was also declining, in part due to seasonal factors and the temporary jobs program, though it remained significantly above historical levels.[6] For 1999 as a whole, real GDP fell by 1 percent, and domestic demand by about 10 percent, primarily reflecting a large drop in investment.[7] By end-1999, inflation had fallen to 2.3 percent, its lowest level in several decades, significantly undershooting the official target of 4.3 percent.

8. **The expansionary fiscal stance in 1999, together with the decline in domestic demand and economic activity, led to a deterioration of the fiscal position** (Table 3). The central government position weakened significantly, reflecting both lower revenue (mainly lower tax collections) and a marked increase in expenditure (mostly transfers to the private sector, wages, and pensions).[8] At the same time, the deficit of the public enterprises fell in reflection of higher revenue (mostly from Codelco)[9] and a reduction in capital expenditure, while central bank operational losses are estimated to have remained stable at about 1 percent

[6] In the fourth quarter of 1999 the unemployment rate was 8.9 percent (and it would have been about 1½ percentage points higher in the absence of the temporary jobs program), compared to 7.2 percent a year earlier.

[7] Output was also affected by a severe drought and electricity rationing in early 1999.

[8] In the official presentation of the fiscal accounts, the central government balance switched from a surplus of 0.4 percent of GDP in 1998 to a deficit of 1.5 percent of GDP in 1999. For the same period, in the staff's presentation the central government balance moved from a deficit of 0.1 percent of GDP to a deficit of 2.4 percent of GDP. The main differences in presentation involve the treatment of the operations of the Copper Stabilization Fund and the capital gains from privatization (see Appendix IV).

[9] Owing to an increase in its export volume and the real depreciation of the peso.

of GDP.[10] As a result, the deficit of the combined public sector is estimated to have increased to 3.6 percent of GDP from 2.3 percent of GDP in 1998.

9. **The decline in domestic demand in 1999 also led to the virtual elimination of the external current account deficit** (Table 4). This deficit fell to 0.1 percent of GDP, from 5.7 percent of GDP in 1998, mainly reflecting a sharp drop in import volume. Export volume grew considerably, driven by copper exports, and the terms of trade improved slightly.

10. **The reduction in the differential between domestic and foreign interest rates in 1999 led to moderate net capital outflows, which resulted in a decline in international reserves and some downward pressure on the peso. However, indicators of external vulnerability remained at comfortable levels** (Table 5). Net foreign direct investment inflows rose sharply, but inflows under other capital account items weakened, resulting in net capital outflows of 1 percent of GDP.[11] Including some negative valuation changes, net international reserves fell in 1999 by US$1.3 billion, to US$14.7 billion (eight months of imports of goods and services, and more than three times the estimated level of short-term external debt on a residual maturity basis, excluding direct trade credits). The peso depreciated by 6.3 percent in real effective terms during the year. Standard & Poor's and Moody's maintained their investment grade ratings for Chile's sovereign long-term debt (A- and Baa1, respectively), the highest among Latin American countries.

11. **In September 1999 Chile abandoned the sliding exchange rate band system, which had been in place for many years, and switched to a freely floating exchange rate.** The central bank indicated that this measure would facilitate dealing with external shocks in the future. It explained that it would not intervene in the foreign exchange market, except under extraordinary circumstances that in each case would be explained to the public, and to signal its commitment to this policy it started publishing twice-monthly information on the sources of changes in international reserves.[12] The change in regime was well received by the

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[10] These losses result from the low yield on the bank's foreign currency-denominated assets (international reserves and claims against the treasury arising from the central bank's capitalization in 1985) compared with the carrying cost of its indexed domestic liabilities.

[11] The jump in capital outflows mainly reflected the accumulation of short-term foreign assets by domestic residents using the proceeds from the sale of Chilean enterprises, and banks' acquisition of foreign exchange to cover their growing short position in the forward market.

[12] Even without intervention in the foreign exchange market, international reserves may vary due to changes in the foreign currency deposits at the central bank held by the nonfinancial public sector and financial institutions (the latter in part to comply with reserve requirements), direct foreign exchange transactions of the central bank with the central government and Codelco, interest earnings on international reserves, and valuation changes.

market, and was accomplished without a noticeable increase in exchange rate volatility. Factors that may have contributed to make this transition smooth include the absence of pressures on the currency around the time when the change was implemented, the gradual widening of the exchange rate band since late-1998 (to about 10 percent on each side of its mid-point at the time of change in regime), the authorities' prior indications that the band would eventually "fade away," and new regulations facilitating the use of derivatives to hedge exchange rate risk.

12. In September 1999 **the authorities also announced their end-2000 inflation target (3.5 percent) and their decision to modify their inflation targeting regime starting in 2001; the objective will no longer be to reach a given inflation *level* at *year-end* but to keep inflation *within a band* (2–4 percent) on a *continuous basis*** (Box 1). The central bank also took steps to increase transparency in the formulation and implementation of monetary policy.

13. In the area of **trade policy**, Chile proceeded with the unilateral reduction of its uniform external tariff by 1 percentage point at the beginning of each year; the uniform tariff is now 9 percent and will continue to decline until it reaches 6 percent on January 1, 2003.[13] Since late 1999 Chile has used **safeguards** on the importation of certain agricultural products to continue the long-standing practice of keeping the domestic prices of those products within pre-established bands related to past international prices.[14] Previously, this objective was achieved by using variable tariffs, but with the recent decline in world commodity prices such tariffs had come to exceed Chile's WTO limit for these goods of 31.5 percent. The safeguards introduce ad valorem surcharges to keep domestic prices within the bands. Surcharge-inclusive tariff rates on those products recently ranged between 40 and 90 percent. The authorities also have announced recently that Chile will seek to move from associate member to full member of **Mercosur**, the customs union formed by Argentina, Brazil, Paraguay, and Uruguay.

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[13] Chile has an open trade regime, now rated 1 on the 1–10 scale of the Fund's trade restrictiveness index.

[14] Imports of these goods are subject to Chile's uniform external tariff. If world prices *fall below the band floor by more* than the uniform tariff, tariff rates on these goods are raised to make domestic prices equal to the band floor. If world prices are *below the band ceiling by less* than the uniform tariff, tariff rates on these goods are reduced so that domestic prices are equal to the band ceiling. If world prices are *above the band ceiling,* however, no import subsidy is granted, and so domestic prices could exceed the band ceiling; this asymmetry in the scheme introduces a bias in favor of subsidies to domestic producers.

Box 1. Inflation Targeting in Chile

Since the central bank was granted autonomy by constitutional law in 1990, its primary goal has been to control inflation. For the following 10 years, it has targeted an annual inflation *level*, measured as the 12-month change in the consumer price index at end-year. During this period, gradually declining targets have been achieved with considerable precision, with annual inflation falling from 26 percent in 1990 to 2.3 percent in 1999.

The central bank recently announced that starting in January 2001, it will target inflation within a *band* of 2–4 percent on a continuous basis. The aim of monetary policy will be to keep inflation at the mid-point of the band over an horizon (the "band length") of 1–2 years, which is the estimated lag for monetary policy to have its main effect on inflation in the case of Chile. The targeted variable is *headline* inflation, although monitoring and policy decisions are based on *underlying* inflation (which is based on a consumer price index that excludes fuel and some food items). Forecasts are provided for both types of indicators; for horizons of 1–2 years, the forecasts for headline inflation and for underlying inflation are essentially equal. In forecasting inflation, the central bank uses models and judgement based on several indicators, including, among others, the output gap, the unemployment rate, the evolution of monetary aggregates, wage growth, the outlook for the world economy, commodity prices, the exchange rate, and the stance of fiscal policy. The central bank's operating objective is the overnight inflation-indexed interest rate; it announces a benchmark interest rate, to communicate its policy stance, and manages liquidity (through open market operations, repurchase agreements, and credit lines and deposit facilities) to guide the market rate toward the benchmark rate.

The central bank is accountable to the Senate, and discharges this responsibility via the presentation of a report to a senate commission every January and May, and an annual report to the senate as a whole in September. To increase transparency, the central bank recently started publishing a *Monetary Policy Report* that contains both a backward-looking part which explains its performance in achieving the inflation target in the recent past, and a forward-looking part which presents projections for underlying and headline inflation over the next two years and describes the balance of risks around the baseline projection. This report will be issued three times a year, and will serve as the basis for the scheduled Board presentations to the senate (January, May, and September). To further enhance transparency, the central bank recently started publishing a calendar of its Board meetings six months in advance, and a summary of the Board decisions on monetary policy (including the votes of its members) 90 days after the meetings. The central bank also started making public the results of a survey of market forecasts for the main macroeconomic variables in Chile.

14. Since the beginning of 1999 the authorities have advanced further with the implementation of their privatization program. Three water and sewage companies have been privatized for the equivalent of 1.3 percent of GDP, four seaports have been transferred to private operators, and several road concessions have been granted to private firms.

III. Policy Discussions

A. Macroeconomic Policies

15. **Discussions took place amid growing signs of a pickup in domestic demand and output, and some inflationary pressures arising in part from the recent rise in world oil prices**. In the first quarter of 2000, domestic demand rose by 5.4 percent (year-on-year) and real GDP by 5.5 percent, and unemployment continued to ease gradually.[15] As domestic demand picked up, imports grew by 20 percent (year-on-year) in U.S. dollar terms in the first quarter. The 12-month inflation rate rose from 2.3 percent in December 1999 to 3.4 percent in March 2000, while underlying inflation (which excludes the prices of fuel and some food items) increased from 2.1 percent to 2.9 percent. The pass-through of world oil prices to domestic prices intensified in early 2000 when the authorities reduced the subsidies financed by the Petroleum Stabilization Fund (FEP), as this fund was running out of resources (and had to be replenished).[16] In view of the buildup of price pressures, the central bank raised the benchmark real interest rate twice in the first quarter, to 5.5 percent.

16. The authorities were satisfied with the favorable signs regarding the evolution of economic activity and unemployment. So far the recovery in demand had reflected stronger exports, domestic consumption, and replenishing of inventories, but investment in fixed capital was also expected to pick up as the year progresses. **The authorities said that, in a context in which private demand was gaining strength, it was their intention to restrain government expenditure to strengthen the fiscal position. They also emphasized their**

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[15] While the rate of unemployment, at 8.2 percent, was the same as a year earlier, this was the first observation for which this rate did not increase with respect to the same period in the previous year since mid-1998. A seasonally-adjusted rate of unemployment calculated by the staff declined from a peak of 10.5 percent in the third quarter of 1999 to 8.9 percent in the first quarter of 2000 (the unadjusted rate fell from 11.4 percent to 8.2 percent during that period).

[16] The FEP was created in 1991 with the objective of stabilizing the domestic prices of oil products. For each product, a band is defined with limits at 12.5 percent on each side of a reference price set discretionally by the government. When the import price is below the band floor, a tax of 60 percent of the difference is applied, and the proceeds are deposited in the FEP. When the import price is above the band ceiling, a subsidy for 100 percent of the difference is granted, using the resources in the FEP. The government has recently submitted to congress a proposal to modify the rules for the operation of the FEP (see text below).

commitment to guide monetary policy on the basis of their inflation target, and to continue with a freely floating exchange rate regime. The mission shared the authorities' broad policy intentions and their view on the outlook for the economy in 2000. Real GDP is expected to grow by about 6 percent, 12-month inflation is projected at around 4 percent at year's end (compared with a target of 3.5 percent), and the external current account deficit is expected to widen moderately as a strong recovery in imports would be only partly offset by export growth and an improvement in the terms of trade.

17. There was agreement between the authorities and the mission that the envisaged deviation of inflation from its end-2000 target should not be a cause for concern (it would be small, and it had originated mainly from the recent increase in world oil prices), and that the focus of public discussion should be shifting away from the target level for end-2000 and toward the continuous target band of 2–4 percent for 2001 and beyond. The mission advised a further moderate increase in **interest rates** in the coming months in view of the price pressures that are likely to arise as the recovery in domestic demand gains momentum. The aim would be to ensure that inflation stays inside the target band beginning early next year, thus helping enhance the credibility of the band. The authorities on their part considered that headline inflation would tend to decline as the effect of the recent increase in domestic oil prices subsided, and that underlying inflation would remain inside the band, and thus did not see a need to increase interest rates in the circumstances.[17]

18. In discussing their **inflation targeting framework**, the authorities explained that the chosen target band of 2–4 percent was preferable to a lower band because it would facilitate any needed change in relative prices in the presence of downward stickiness of nominal prices, and because the upward bias in the measurement of consumer price inflation that has been found in a variety of countries may be even more significant in a rapidly growing economy such as Chile's.[18] They indicated, however, that the band could be lowered in the future if experience indicated that such a change was warranted. They also explained that monetary policy will aim at keeping inflation at the mid-point of the band over a horizon of 1–2 years, which is the estimated lag for monetary policy to have its main effect on inflation. The announced target refers to *headline* inflation, but as usually done in countries with formal inflation targeting, monitoring and policy decisions are based on *underlying* inflation, as this

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[17] A recent survey of private forecasts made public in June by the central bank indicated that markets expect the benchmark real interest rate to be raised from 5.5 percent currently to about 6 percent by end-2000.

[18] This bias results in part from quality improvements and the incorporation of new products in consumption patterns, which are not properly captured in the measurement of inflation.

variable provides a better basis for assessing future inflationary pressures.[19] The central bank projects and discusses the evolution of both types of indicators; for horizons of 1–2 years, the forecasts for headline inflation and for underlying inflation are essentially equal.

19. **The authorities indicated their intention to strengthen the fiscal position in 2000 and over the medium term.** They considered that a strong fiscal position had been a crucial element in Chile's superior economic performance over the last decade, and thus they felt it was important to reverse the trend for a weakening of the public accounts that had occurred in the last few years. This trend reflected lower revenues from declining copper prices and the recent recession, and strong growth in central government expenditure. The authorities' plans involve limiting the growth of government expenditure (to about 3 percent in real terms in 2000, in line with the budget approved by Congress), and introducing measures that would enhance tax administration and close loopholes (including legislative initiatives still in the planning stage).[20]

20. On the basis of the authorities' plans, the staff estimates that the deficit of the central government would decline from 2.4 percent of GDP in 1999 to 1 percent of GDP in 2000, reflecting expenditure restraint.[21] Government revenue would remain relatively stable as a percentage of GDP, with an increase in tax revenue resulting from the recovery in economic activity and in copper prices being approximately offset by a decline in special transfers from public enterprises.[22] The deficit of the public enterprises is projected to increase slightly as a percentage of GDP, and central bank losses would decline somewhat, owing primarily to a lower differential between the interest rate on its domestic liabilities and on its international reserves. As a result, the deficit of the combined public sector is projected to fall from 3.6 percent of GDP in 1999, to 2.1 percent of GDP in 2000. The mission considered that the envisaged strengthening of the fiscal position in 2000 was appropriate, particularly in view of

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[19] In Chile, underlying inflation is calculated on the basis of on a consumer price index that excludes fuel and some volatile food items.

[20] These measures would include, among others, providing additional resources to the tax collection agency SII (part of which would be used to increase the number of tax inspectors), strengthening the authority of the SII, customs, and the treasury in their inspection and collection roles, and enhancing the coordination among the entities involved in tax collection.

[21] Using the official presentation, the central government accounts would move from a deficit of 1.5 percent of GDP in 1999 to virtual balance in 2000.

[22] In 1999 one state-owned company transferred to the government dividends accumulated over several years.

the authorities' plans for further strengthening in subsequent years and the low level of public debt.[23]

21. **The authorities have announced the objective of achieving a "structural" fiscal surplus of 1 percent of GDP in 2001**. They have been developing a measure of the structural fiscal balance that would take into account deviations of output from its potential level and deviations of copper prices from their "long-term" levels, and they plan to use this measure to guide fiscal policy.[24] The mission agreed with the general idea, but expressed the view that the structural fiscal balance should include the losses of the central bank (the authorities planned to include only central government operations). Also, the methodology should recognize that copper prices tend to return very slowly to their long-run average level. Thus, there is the risk that using a "long-term" copper price that is significantly higher than the current spot price could result in a situation of persistent *structural surpluses* combined with *actual deficits*. The mission suggested as a possible solution using futures prices as a proxy for "long-term" prices. The authorities took note of these observations and would seek further feedback from the staff before finalizing their methodology, which they plan to do around July, in time for the preparation of the budget for 2001.

22. The authorities were planning steps to enhance fiscal transparency, including by disseminating information that would become available as a result of the development of a new information system for the fiscal accounts, aimed at improving financial management in the public sector. Once they make sufficient progress with their plans, probably later this year, they would like Chile to be included as a candidate for a Fiscal Transparency Report.

23. The **external current account** deficit is expected to increase moderately in 2000. Following the sharp adjustment that took place in 1999, the staff is projecting a current account deficit of 2.4 percent of GDP in 2000. Imports would grow strongly, in line with their evolution in the first quarter and the strong pickup in domestic demand envisaged for the rest of the year. Export volume is expected to grow moderately, mainly reflecting low growth of copper shipments after a surge of 15 percent in 1999 that resulted from the opening of new

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[23] As of end-1999, the nonfinancial public sector debt (excluding debt to the central bank) was estimated at 9.3 percent of GDP.

[24] In the staff's projections for 2001 (which assumes government expenditure growing by 4 percent in real terms and a copper price of US$0.85 per pound) the central government deficit would decline to 0.2 percent, the public enterprises' deficit would remain at 0.4 percent of GDP, and the central bank losses would fall to 0.4 percent of GDP, a strengthening of the public accounts which the staff considers appropriate. The level of the "structural" fiscal balance associated with this strengthening will depend, among other things, on how comprehensive is the coverage of the public sector accounts in the definition of structural balance, on the estimated output gap, and on the assumed "long-term" copper price.

mines. The value of exports, however, would increase significantly mainly on account of higher copper prices. The balance of payments projections for 2000 also assume a return to net capital inflows (to levels similar to those observed in 1998 but still significantly below those earlier in the 1990s). Indicators of external vulnerability are expected to remain at comfortable levels, with international reserves more than twice the level of short-term external debt (on a residual maturity basis) by end-2000. The authorities expressed broad agreement with the staff's projections, although they were of the view that import growth and the current account deficit in 2000 were likely to be somewhat lower than envisaged by the staff.

24. The authorities were satisfied with the experience with the **freely floating exchange rate** so far, and restated their intention of intervening in the foreign exchange market only under exceptional circumstances. They explained that the economy was now properly equipped to operate under increased exchange rate flexibility, as the possibilities for hedging exchange rate risk had been enhanced by the central bank issuance of medium-term debt instruments indexed to the U.S. dollar and by new regulations facilitating the use of derivatives. The mission supported the authorities' decision to let the currency float freely, as this would help the country deal with external shocks, and would be consistent with Chile's move toward a more explicit and formal inflation targeting framework, with low and stable inflation as the primary objective of monetary policy.

B. Financial Sector and Structural Issues

25. The authorities explained that notwithstanding some inevitable adverse effects of the recent downturn in economic activity on bank profitability, the **banking system** remained strong, a view that was shared by the mission. As of March 2000, nonperforming loans accounted for 1.8 percent of total loans, bank provisions for loan losses amounted to 156 percent of nonperforming loans, and the ratio of capital to risk-adjusted asset was 13.6 percent for the banking system as a whole. The mission noted that in Chile only the loan-installments in arrears are recognized as nonperforming, and argued that it would be more appropriate to recognize the entire loan as nonperforming. The authorities expressed the view that this was not an important issue, as Chile's rules on provisioning requirements were appropriately rigorous, irrespectively of the criteria used to recognize nonperforming loans. Also, they estimated that using the more comprehensive criteria would increase the ratio of nonperforming loans to only 2.7 percent of total loans.[25] They also stressed that the Chilean banking system stood out in comparison with those of other countries when all relevant factors were taken into account.[26] The authorities considered that it would be desirable to

[25] The change in criteria would have a relatively small impact on the share of nonperforming loans because commercial loans, which account for ¾ of total loans, are mostly bullet loans.

[26] Moody's has recently ranked Chile as 15th out of 75 countries in terms of strength of their banking systems, above three G7 countries.

move forward with the **supervision of consolidated balance sheets of financial holdings**, but indicated that this issue had not been included in the political agenda as yet.

26. The authorities have submitted to congress a proposal to introduce **regulations on bank concentration** aimed at limiting the risk of moral hazard (the presence of banks that would be "too big to fail") and the possibility of market control by a single bank. This proposal would authorize the Superintendency of Banks and Financial Institutions (SBFI) to tighten prudential requirements for banks with relatively large market shares. In addition, the SBFI, in conjunction with the central bank, would have the authority to prevent bank mergers which would result in banks with market shares above a certain percentage (still to be determined) if they considered that such merger would be detrimental to the stability of the banking system or to competition. Mergers would also need to be approved by the Antitrust Commission. The mission recommended that any decision on bank mergers be based on prudential or competition grounds, and that it be transparent so as to prevent the perception that factors unrelated to those criteria (for instance, whether the merged institution would be controlled by domestic or foreign capital) play a role.

27. The authorities indicated that the **re-capitalization of the central bank** is not in the official short-term agenda. They explained that the current situation does not interfere in any way with the central bank's operations, and that they would tackle this issue after the government's fiscal position had strengthened. The mission recommended a prompt solution to this problem, as this would serve to enhance fiscal transparency and to consolidate public confidence in the central bank's independence.

28. The authorities have recently submitted to congress a proposal to modify **the rules for the operation of the FEP**. The proposed modifications aim at preventing situations of persistent subsidies, in part by reducing discretion in the operation of this fund.[27] The new rules would include: (i) mandatory weekly adjustments of oil reference prices on the basis of a formula based on past and projected world oil prices; and (ii) levels of subsidies and taxes that depend on the resources available in the fund, so that the fund would neither require new injections nor accumulate resources indefinitely.[28] The mission recognized that the proposed revision would address the problems posed by the existing rules. However, it favored phasing out the FEP, because this would enhance resource allocation (with consumers facing undistorted prices) and because the FEP's existence in itself had the potential for political

[27] The resources in the FEP dwindled during 1999, and the fund had to be replenished to continue its operations, because reference prices did not accompany the marked increase in world oil prices that year (in fact, reference prices were slightly reduced in August).

[28] Essentially, the formulas that determine the levels of subsidies and taxes ensure that the subsidy rate would decline to zero if the resources of the fund were to decline to zero, and the tax rate would decline to zero if the resources of the fund were to increase to a given maximum amount (approximately US$350 million).

interference in the determination of oil prices. The authorities considered that the FEP played a valuable role in preventing spikes in world oil prices from having a persistent effect on inflation, and thought that the risk of interference in its operations was minimal, as any modification of its rules would require legislative action.

29. The mission noted Chile's liberal **trade regime**, and supported the country's continued unilateral reduction of its uniform external tariff. It expressed concern, however, over the high tariffs now being generated by the *price-band* scheme for selected agricultural products, and the recent use of safeguards to allow those tariffs to exceed Chile's WTO limit of 31.5 percent. In its view, those high tariffs caused a misallocation of resources, were likely to have undesirable income distribution effects, and had drawn negative responses from several trading partners. The mission argued, therefore, for the elimination of the price bands altogether, or, as a first step, a modification of the scheme to ensure that tariffs on such goods would not exceed the WTO-agreed limit. The authorities indicated, however, that they were not planning to reduce the current tariffs.[29] The authorities explained that Chile's planned move toward full membership in **Mercosur** would take some time, and that any steps in this direction would not entail an increase in Chile's tariffs.

30. The authorities were planning measures to remove **restrictions on capital flows**, some of which were implemented after the mission ended. In May 2000 the authorities: (i) eliminated the rule which prevented certain capital inflows to be repatriated before one year; (ii) reduced, from 35 percent to 4 percent, the tax on interest payments on foreign-debt denominated in pesos or in UFs (a widely used inflation-indexed unit of account);[30] and (iii) widened the type of transactions banks may undertake to hedge against exchange rate risk and credit risk. These measures were well received by the business community and market analysts.[31] The authorities were also preparing a proposal to be submitted shortly to congress to exempt non-residents from the payment of taxes on capital gains. They indicated that they would consider formally eliminating the unremunerated reserve requirement that applies to

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[29] After the return of the mission, the new safeguards law was used to apply provisional higher tariffs (but still below WTO limits) to synthetic fiber socks. Previously, this law had been used only for agricultural goods covered by the price band scheme.

[30] This change is aimed at facilitating foreign borrowing that would not involve foreign exchange rate risk. In a move that should help develop an international market for UF-denominated bonds, the World Bank issued in May 2000 a five-year bond indexed to the UF, for the equivalent of US$105 million (75 percent of the issue was acquired by Chilean institutional investors, and the rest by foreign investors).

[31] The stock market index also increased significantly at the time, but it is difficult to say whether the announcement of these measures was the main factor behind such increase.

certain capital inflows (the reserve requirement rate has been zero since September 1998).[32] However, they first wanted to have in place a legal framework requiring firms to provide detailed information on their foreign-currency exposure, so as to make it easier for banks to assess the risk that such exposure implies for their lending operations.[33] The authorities have sent to congress a proposal on corporate governance aimed at protecting minority shareholders and thus increasing the attractiveness of investing in Chilean stocks.

31. This set of initiatives is aimed at strengthening Chile's integration in international capital markets, and should improve the country's outlook for investment and growth. The ongoing liberalization of the capital account should not expose Chile to undue risks arising from volatile capital flows. Vulnerability would continue to be limited by pursuing sound macroeconomic policies and maintaining a strong financial system, the latter helped by the various measures that have been taken to facilitate banks' management of their currency and credit risks.

32. The authorities have submitted to congress a proposal for creating an **unemployment protection scheme** (Box 2). One shortcoming of the prevailing protection system is the existence of significant severance payments which increase automatically with tenure. The revised scheme would keep this provision, but would reduce some of the distortions they generate and enhance the protection of low-tenure workers. This scheme would increase indirect labor costs by up to 3 percent of wages.

33. The authorities have been preparing a second initiative on labor market reform, designed mainly to reduce government intervention in unions' affairs and collective bargaining, extend the coverage of collective bargaining (to temporary workers and others), extend the content of collective agreements to non-wage issues, and limit the hiring of replacement workers during strikes. They said that the proposed reforms were in part motivated by the desire to bring Chilean labor market legislation in line with ILO norms (to which Chile is a signatory). They also expressed the view that the practical impact of the proposed limit on the hiring of replacement workers would not be significant, as the current right to hire those workers has rarely been used, and the new legislation would allow for exemptions when needed to protect "vital functions" of the firm.

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[32] If the unremunerated reserve requirement were formally eliminated, the main remaining regulations on capital flows would be minimum credit ratings for entities issuing bonds abroad, and for banks issuing ADRs.

[33] In April 2000 the SBIF issued a regulation requiring banks to take into account the foreign currency exposure of their clients in their analysis of credit risk.

Box 2. Unemployment Protection in Chile: Current System and Government Proposal

Social protection of the unemployed currently comprises 2 benefits, which are granted only when lay-offs are due to "needs of the firm:" (1) state-funded unemployment payments for up to 1 year in monthly amounts of about US$33 in the first 3 months, US$22 in the next 3 months, and US$17 in the last 6 months; and (2) a lump-sum severance payment ("indemnization") which is proportional to the employee's tenure at the firm (1 month of salary for every year worked at the firm, up to a maximum payment of 11 months of salary).

The current system is unsatisfactory both in terms of the social protection it provides and because it gives rise to multiple distortions. Due to the extremely low level of the unemployment benefit (on average, about $23 a month in 1999, which is below the indigence line), coverage is very poor. Less than 10 percent of the unemployed were receiving the benefit even during the 1999 recession. Moreover, employers—particularly small and medium firms—often refuse to pay the full severance payment. As a result, the indemnization system strains labor relations and invites litigation. Finally, automatically increasing indemnization rights bias the firms' decisions toward firing primarily junior workers when they need to reduce their labor force, discourages training, discourages both lay-offs and voluntary separation of senior workers, and adds to moral hazard, as senior workers have an incentive to get fired when they approach retirement.

The government proposal is designed to enhance social protection of the unemployed and at the same time reduce the distortions arising from indemnization rights (these rights would remain unchanged under the proposal as it is politically difficult to reduce them). It envisages a hybrid system comprising:

- *Individual accounts*, to which employers and employees would contribute (1.4 percent and 0.6 percent of remuneration, respectively). These accounts could be accessed in the event of (involuntary) lay-off, voluntary separation, retirement, or work disability. Severance payments could be financed by the accumulated employer contributions to the worker's individual account; consequently, the proposal would lower the *marginal* cost of lay-offs for employers (at least when compared to the current system under full compliance). Moreover, the fact that the balance on the individual account can become available to the worker in circumstances other than just a lay-off would reduce moral hazard and disincentives for voluntarily separation that exist under the status quo.

- *An insurance fund*, financed by employer contributions (1 percent of remuneration) and a fiscal contribution. The purpose of this fund is to ensure a minimal level of protection for workers who have low balances in their individual accounts.

Thus, this proposal would reduce some of the distortions in the present system and would provide better social protection. At the same time, however, it would increase indirect labor costs by up to 3 percent, and might introduce a new distortion by creating an incentive for employees to quit merely to liquidate the balance in their individual accounts.

34. Regarding **other structural reforms**, the authorities plan to move further in the area of privatization, including the sale of remaining state-owned water and sewage companies, the transfer of an additional seaport to private operators, and the granting of concessions for the management of roads.[34] They indicated that they have no plans for privatizing Codelco (which would require modifying Chile's constitution), the national oil company, the national mining company, or Banco del Estado, which are the main assets still in the hands of the state. They, however, did not rule out the possibility of privatizing some of those enterprises in the future, a move that was favored by the mission. The authorities are also proceeding with the education reform, which is supported by the World Bank, and which includes extending school hours, updating the curricula, and enhancing teachers' training programs. However, progress in this area would be slower than initially planned, in part to spread the up-front fiscal costs over a longer period.

C. Medium-Term Outlook

35. The medium-term outlook has changed considerably since the last Article IV consultation, when the issues centered around Chile's then-sizable current account deficit and the prospects for adequate financing in light of adverse global credit conditions. Since then, those conditions have eased, and the new departure point for medium-term analysis is the nearly-balanced current account of 1999. Since this outcome partly reflects cyclically weak demand that year, the current account deficit is expected to increase over the next few years, but the risk of Chile's sliding into an unsustainable situation seems remote in the foreseeable future, in part owing to prospects for continued improvements in the terms of trade and an envisaged strengthening of the fiscal position.[35]

[34] Some of these concessions could involve payments between the government and the holders of the concessions that are contingent on the evolution of the real exchange rate. If the real value of the currency falls below a certain level, the government would make a transfer; conversely, if the real value of the currency increases above a certain level, the government would receive a payment. These clauses, which aim at providing protection against exchange rate risk to holders of concessions with domestic-currency revenue and foreign-currency debt, have not been included in any of the concessions granted so far. The authorities consider that they would probably not be used at all now that the tax on foreign borrowing in domestic currency and in UFs has been reduced from 35 percent to 4 percent.

[35] The combined public sector balance is envisaged to shift from a deficit of 2.1 percent of GDP in 2000 to a surplus of about 1 percent of GDP in 2005, partly on account of higher revenue from enhanced tax administration, but mostly due to moderate expenditure growth. In particular, the staff's scenario assumes that government expenditure on wages and on pensions, after having increased by an annual average of 7 percent in real terms over the last five years (in the case of wages to help them catch up with those in the private sector), would

(continued…)

36. In the illustrative medium-term scenario presented in Table 6, the staff envisages that by 2002 the current account deficit would widen to about 3½ percent of GDP, a level at which it would stabilize. In this scenario, room for a recovery of private investment expenditure would be created not only by flows of external savings, but also by an increase in public sector saving over the medium term.[36] Real growth would settle at about 6⅓ percent after 2001, and the value of total exports would grow essentially in line with that of GDP, with non-copper exports growing at a faster pace. This projected output growth would be supported by an environment of lower and stable inflation rates, as well as by the authorities' commitment to continue widening and deepening the domestic capital and monetary markets, to further liberalize the capital account, and to continue with their programs of unilateral trade liberalization and education reform. At the same time, growth would be somewhat lower than the average in the decade before the 1999 recession, reflecting a diminished margin for catch-up with more advanced economies, the completion of one-time gains from past structural reforms, somewhat smaller net capital inflows, and slower expansion of the mining sector in particular.

37. In the staff's judgment, the current account deficit of 3½ percent of GDP in this scenario would be within the sustainable range. It would be consistent with a steady decline in debt and debt service ratios and with stable net factor payments in relation to GDP over the medium term (Table 7).

38. In assessing the risks in this medium-term scenario, the staff came to the view that negative shocks would be unlikely to induce an external crisis or disorderly adjustment. Plausible risks would be a matter of degree, involving less favorable outcomes for growth and the level of absorption that could be supported. For instance, in line with WEO projections, the scenario assumes a small improvement of the terms of trade over the medium term, based mainly on rising copper prices. Historically, such prices have been volatile, and a substantial negative shock cannot be ruled out.[37] As in the past, however, a negative shock to copper prices would likely induce mechanisms that would act to stabilize the current account. Also, the direct, short-term impact on the current account of plausible shocks to the prices of

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grow by an annual average of 3 percent and 4 percent, respectively, in real terms over the projection period.

[36] Private savings would decline gradually from their peak of 19.3 percent of GDP in 1999, to about 16½ percent of GDP by 2005, which was the average level in the period 1990–98. This scenario is also consistent with the negative correlation (minus 0.73) between public and private savings (as ratio to GDP) observed during the 1990s.

[37] One factor now limiting the range for potential copper price declines is that prices are still not much above the levels that would cause widespread closures of the less-efficient foreign mines, essentially setting a cost-based floor on the world price of copper.

copper exports, oil imports, or foreign credits tends to be small in relation to Chile's level of reserves, even when the latter is expressed net of short-term debt. Various other aspects of Chile's economy, including the strength of the banking system and the new floating exchange rate regime, also point to limited external vulnerability (Box 3).

39. The authorities expressed no major disagreements with the illustrative scenario outlined by the mission, and shared the view that Chile's external position and medium-term outlook was considerably more favorable than in late 1998. As regards competitiveness, the mission understands that the authorities are inclined to focus directly on the current account rather than exchange rate-based indicators, and correspondingly on influencing national saving rather than the nominal exchange rate. The staff believes that this focus is appropriate, particularly given the new emphasis on exchange rate flexibility and inflation targeting. In any case, as of end-May 2000 the peso was estimated to be about 10 percent weaker in real effective terms than at its peak in late 1997; such a level should be consistent with continued growth of export volumes.

D. Statistical Issues

40. Chile meets the Special Data Dissemination Standard (SDDS) requirements. The quality and timeliness of official data are generally good, and although certain areas for improvement remain, the staff believes the data are broadly adequate for surveillance purposes.[38]

41. The authorities have continued to work in contact with the BIS to clarify the differences between official and BIS **data on Chile's short-term external debt** (US$3.9 billion vs. US$7.2 billion at end-1999). Part of the difference results from what the authorities consider to be methodological deficiencies in BIS data,[39] while most of the remaining difference is due to the omission of trade credits from the official data. The authorities are working on obtaining a reliable measure of trade credits and expressed interest in receiving Fund technical assistance on this issue. The mission also discussed **the coverage of military transactions** in official statistics; some of these transactions are missing from official fiscal and external data. More generally, the mission suggested that more detailed data on public sector financing be published.

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[38] See Appendix III.

[39] In particular, the BIS considers as external debt foreign currency lending in Chile by resident branches of foreign banks, estimated at US$2.5 billion as of end-1999.

Box 3. Chile: External Vulnerability and the Chilean Economy

One of the background papers for the Article IV consultation examines the external vulnerability of Chile, emphasizing comparisons to a sample including not only other high-rated emerging markets but also certain advanced economies. (Closely corresponding to these two groups, subsamples are defined according to whether a country has higher or lower income per capita than Chile.) Comparisons on the recent levels of a wide range of liquidity and solvency indicators are presented; the paper also documents differences across countries in the response of several market-based summary indicators to the 1998 ("Russia") crisis. In addition to the cross-country comparisons, Chile's position is discussed in terms of various qualitative factors and the adequacy of the available data for vulnerability assessment.

Main findings include the following:

- By most external indicators, the higher-income countries do appear stronger than the ones with per capita income below Chile's level. However, this is not so for reserve levels (and comparisons based on external debt levels are prevented by lack of comparable data).

- Relative to the lower-income countries, Chile's stronger external position is confirmed—even though this group includes other high-rated emerging markets.

- Relative to the higher-income economies, Chile remains only a bit behind, according to bond spreads and private credit ratings. In terms of the degree of vulnerability revealed by responses to the 1998 Russia crisis, Chile was not shown to be entirely out of this league. For several of the crisis response indicators examined, Chile looks more like a higher-income country than an emerging market.

- As regards liquidity, Chile's high level of reserves, considered against its relatively moderate level of short-term debt, suggests a position of strength. Reserves exceed (BIS-reported) short-term debt by about 8 percent of GDP, considerably more than the additional short-term financing needs that might result from plausible adverse shocks to the prices of copper, oil, or foreign credit.

- Chile's external position now looks stronger than it has in several years. The main weakness perceived in the latter 1990s, the current account deficit, all but disappeared in 1999, and the terms of trade have recently improved. Among Chile's other notable strengths are a sound banking system and the low level of public sector debt.

- Chile's least favorable indicator might be the level of external debt. The recent steep rise in external debt ratios is not likely to continue, but such ratios have moved outside the low ranges, and the level of external debt bears monitoring. Still, this debt should be considered against Chile's foreign assets, so the more important issue may not be solvency of the economy as a whole but the foreign exchange exposure of individual private sector agents.

Finally, the paper identifies a few areas for improvement in the set of information available for assessing Chile's external position, including International Investment Position data (especially private holdings of foreign assets), data on short-term trade credits, and more complete coverage of the military sector in the balance of payments and external debt data.

IV. Staff Appraisal

42. Chile enjoyed very strong economic performance during most of the 1990s, largely on account of sound macroeconomic policies and continued market-oriented reforms. This performance was challenged in late 1997 and 1998, when the country faced a series of adverse external shocks in the midst of surging domestic demand, which resulted in a widening external current account deficit and recurrent pressures on the peso. In response, the authorities tightened monetary policy sharply to prevent a large depreciation of the currency, and scaled back expenditure plans. In the event, domestic demand fell significantly and at a faster pace than initially expected, leading to a downturn in economic activity in 1999 and the undershooting of the end-1999 inflation target. The authorities shifted to an expansionary monetary and fiscal stance in 1999, and this succeeded in reversing the recessionary trend relatively quickly, with some help from improving terms of trade. Recovery began in the final quarter of the year and is now firmly on track.

43. In a context of a strengthening private demand, and some inflationary pressures arising in part from rising world oil prices, the firming-up of the stance of monetary and fiscal policies for 2000 is appropriate. Monetary policy began to be tightened early in the year, and a restrained government expenditure policy was introduced. The outlook for the year includes strong output growth, a small increase in inflation, a significant strengthening of the fiscal position, and a widening but moderate external current account deficit.

44. Over the past year, the authorities have launched a set of important initiatives aimed at enhancing macroeconomic management. Regarding monetary policy, they have improved their approach to inflation targeting by shifting its focus from a specific end-year inflation level to a continuous inflation band of 2–4 percent (starting in 2001), and by increasing transparency in policy formulation and implementation.

45. On fiscal policy, the new government has commitment to further strengthen the fiscal position over the medium term, which is commendable. Future fiscal objectives are to be set in terms of a measure of structural fiscal balance that would take into account fluctuations in output and copper prices that are perceived to be temporary, and thus would help guide fiscal policy with a medium-term perspective. It would be important, however, to ensure that the measure of structural balance is comprehensive (in particular, by including central bank losses) and is based on conservative estimates of long-term copper prices; otherwise, there would be a risk that estimated persistent structural surpluses would go hand in hand with actual deficits.

46. On the external sector, the authorities abandoned the long-standing exchange rate band in favor of a transparently-conducted float, which will help the country deal with external shocks and will allow monetary policy to be focused on its primary objective of maintaining low and stable inflation. They also advanced in the liberalization of capital flows by abolishing the one-year minimum stay requirement on certain capital inflows, by reducing taxation on foreign borrowing denominated in domestic currency (or in an inflation-adjusted unit of account), and by widening the type of transactions that banks may undertake to hedge against

exchange rate and credit risks. These steps to liberalize the capital account, together with proposed new regulations on corporate governance aimed at protecting minority shareholders, should strengthen Chile's integration in international capital markets.

47. The financial position of the banking system continues to be strong, despite some adverse effect of the recent downturn in economic activity. The authorities have submitted to congress a proposal to limit potential risks from concentration in the banking system. This regulation would need to be implemented cautiously, so as to make clear to the public that decisions are focused exclusively on limiting moral hazard and monopolistic behavior on the part of banks. To make further progress in ensuring the health of the banking system, it would be important to move forward with the supervision of consolidated balance sheets of financial holdings.

48. The authorities have submitted to congress a proposal to address long-recognized problems of the system of unemployment protection, and they are working on other labor market reform initiatives. The proposed unemployment insurance scheme is a step in the right direction in terms of improving employers' and employees' incentives and providing better social protection, but it is important not to ignore the possible impact that it may have on raising indirect labor costs. The authorities also need to be watchful that the package of other labor market reforms currently under discussion does not undermine the flexibility of Chile's labor markets.

49. Chile has a very open trade regime, and the authorities' continued efforts to reduce unilaterally the country's uniform external tariff are commendable, as is their stated intention to ensure that the planned move toward full membership in Mercosur will be carried out without an increase in the country's tariffs. However, the very high tariffs that have been generated by the price band scheme for certain agricultural products, on the basis of the new law on safeguards, are a source of concern as a step backward in the effort to improve resource allocation. It would thus be highly desirable to reconsider the price band scheme, and more generally to be very cautious in the use of the safeguards law.

50. The medium-term outlook for the economy is favorable, with an envisaged recovery in private investment and a return to high and sustained rates of growth of real GDP. This outcome needs to be supported by continued prudent monetary and fiscal policies as intended by the authorities—to ensure an environment of low and stable inflation—and by their commitment to structural reforms, including the further liberalization of the capital account, the programs of unilateral trade liberalization, privatization, and education reform. Risks to this outlook arise primarily from a less favorable external environment, including lower global economic growth, weaker terms of trade, and lower capital flows to emerging economies. Chile's comfortable level of reserves, strong banking system, and increased exchange rate flexibility should help the country deal with these risks.

51. Chile has subscribed to the Special Data Dissemination Standard, and its metadata are displayed in the Dissemination Standard Bulletin Board. It regularly provides the staff with adequate and timely data which are broadly adequate for surveillance purposes. The authorities already have made successful efforts to clarify the differences between official and BIS data on Chile's short-term external debt. They should, however, persevere with the efforts to improve the statistical base, particularly by continuing to widen the coverage of statistics on the external and fiscal sectors.

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

Table 1. Chile: Selected Economic Indicators

	1995	1996	1997	1998	Est. 1999	Proj. 2000
	(Annual percentage change)					
Production, prices, and trade						
Real GDP	10.6	7.4	7.4	3.4	-1.1	6.0
Real domestic demand	16.2	7.9	9.1	1.9	-9.9	9.5
Consumption	9.2	8.8	7.9	3.5	-2.4	6.3
Investment	34.2	7.0	11.8	-1.4	-26.2	20.9
Fixed capital formation	23.5	8.0	11.5	2.2	-17.1	4.6
Consumer prices						
End of period	8.2	6.6	6.0	4.7	2.3	4.0
Average	8.2	7.4	6.1	5.1	3.3	3.2
Underlying inflation 1/	7.5	7.4	5.4	6.3	2.1	...
Real wages	4.8	4.1	2.4	2.7	2.4	...
Unemployment rate (in percent)	7.4	6.5	6.1	6.2	9.7	...
Exports (U.S. dollars)	38.1	-3.9	8.2	-11.0	5.3	14.2
Imports (U.S. dollars)	34.7	12.7	10.5	-4.8	-19.6	23.9
Terms of trade	14.5	-15.5	2.6	-12.6	0.9	5.8
Real effective exchange rate 2/	1.2	4.0	9.7	-6.1	-6.3	...
Money, credit, and interest rates						
Broad money (M3)	27.4	22.0	13.0	8.5	5.2	13.3
Credit to the private sector	27.5	20.8	18.0	11.2	3.0	10.7
Three-month real interest rate 3/	6.1	7.3	6.8	9.6	6.0	...
Velocity of money (M1A)	10.0	9.9	9.5	10.6	8.9	8.8
	(In percent of GDP)					
Savings and investment						
Gross domestic investment	25.8	26.9	27.2	26.5	21.1	24.2
Public	4.3	6.1	5.8	5.8	5.2	4.8
Private	21.5	20.8	21.4	20.7	15.9	19.4
National savings	23.7	21.8	22.3	20.8	21.0	21.8
Public 4/	7.0	6.5	5.3	3.3	1.7	3.2
Private	16.8	15.3	16.9	17.5	19.3	18.5
External savings	2.1	5.1	5.0	5.7	0.1	2.4
Public sector						
Nonfinancial public sector balance	3.6	2.1	1.0	-1.2	-2.5	-1.3
Central government balance	3.6	2.6	2.1	-0.1	-2.4	-1.0
Public enterprise balance	0.0	-0.5	-1.1	-1.1	-0.1	-0.3
Central bank balance	-0.6	-0.7	-1.1	-1.1	-1.1	-0.8
Combined public sector balance	3.0	1.4	-0.1	-2.3	-3.6	-2.1
Balance of payments						
Current account	-2.1	-5.1	-5.0	-5.7	-0.1	-2.4
Capital and financial account 5/	3.7	6.8	9.2	2.9	-0.9	3.1
Overall balance of payments	1.6	1.7	4.3	-2.8	-1.0	0.7

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

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

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

	1995	1996	1997	1998	1999	Proj. 2000
I. Central Bank						
(Annual flows in millions of U.S. dollars)						
Net international reserves	1,060	1,181	3,209	-2,066	-683	484
Medium- and long-term net foreign liabilities	-442	-1,488	0	0	-1	0
(Annual percentage change with respect to liabilities to the private sector)						
Net domestic assets	-247.9	-209.3	-139.2	195.3	-11.3	-18.5
Net credit to nonfinancial public sector	-19.1	-24.1	-40.7	30.6	82.2	3.7
Net credit to financial intermediaries	-164.9	-67.0	-116.5	-29.7	-64.9	-26.9
Central bank promissory notes	-29.5	-62.9	-108.5	73.7	5.2	87.6
Other	-34.4	-55.4	126.5	120.8	-33.8	-82.8
Liabilities to private sector	17.7	9.5	14.6	-0.9	21.7	2.6
II. Financial System						
(Annual flows in millions of U.S. dollars)						
Net international reserves	1,525	1,732	5,421	-1,562	2,314	-562
Medium- and long-term net foreign liabilities	-68	-1,478	-161	-1,817	-3,645	-1,528
(Annual percentage change with respect to liabilities to the private sector)						
Net domestic assets	10.9	7.9	6.9	12.5	3.9	17.2
Credit to the private sector	18.0	12.6	11.7	4.1	2.0	8.4
Liabilities to private sector	21.0	16.9	16.3	9.7	15.7	18.5
Of which: Pension funds	7.6	6.2	7.4	3.9	11.0	9.4
(In percent of GDP)						
Narrow money (M1A) 2/	10.0	10.1	10.6	9.4	11.2	11.4
Broad money	37.7	42.1	42.6	43.5	44.7	45.3
Liabilities to private sector 3/	83.4	89.3	93.0	96.3	109.2	115.6
Of which: Pension funds	40.0	41.4	42.9	43.9	53.3	56.8
Credit to private sector	67.0	71.2	73.3	73.1	73.8	74.2
(Annual percentage change)						
Memorandum items:						
Growth of credit to private sector	22.8	16.1	15.0	5.8	3.5	12.5
Growth of credit to private sector, excluding pension funds	27.5	20.8	18.0	11.2	3.0	10.7
Inflation rate (CPI)	8.2	6.6	6.0	4.7	2.3	4.0
Narrow money (M1A)	23.5	10.5	16.6	-5.5	22.6	13.3
Broad money	27.4	22.0	13.0	8.5	5.2	13.3
(In percent: annual average)						
Interest rates (in real terms) 4/						
Commercial banks deposits	5.9	6.9	6.4	9.5	5.9	...
Commercial banks loans	8.5	9.3	8.8	11.9	8.2	...
On 90-day central bank promissory notes	6.1	7.3	6.8	9.6	6.0	...

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

1/ Flows measured at constant exchange rates (at the level of the end of the year under consideration). The financial system comprises the central bank, commercial banks, nonbank financial institutions, and private pension funds.

2/ Defined as currency plus sight deposits.

3/ Includes time and savings deposits, deposits in U.S. dollars, and pension funds' liabilities.

4/ Annual average yield on 90-365 days indexed operations.

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

	1995	1996	1997	1998	1999	Proj. 2000
I. Central Government						
Total revenue	**24.0**	**24.2**	**23.9**	**23.0**	**22.1**	**22.1**
Current revenue 2/ 3/	23.8	24.1	23.8	22.8	22.0	22.1
Capital revenue	0.2	0.1	0.1	0.1	0.1	0.1
Total expenditure	**20.4**	**21.6**	**21.8**	**23.1**	**24.4**	**23.2**
Current expenditure 3/	17.3	18.0	18.0	19.2	20.4	19.6
Capital expenditure	3.1	3.6	3.7	3.9	4.1	3.5
Central government balance	**3.6**	**2.6**	**2.1**	**-0.1**	**-2.4**	**-1.0**
II. Public Enterprises						
Current revenue	**13.9**	**12.6**	**12.0**	**10.5**	**11.0**	**11.1**
Current expenditure	**12.8**	**11.6**	**11.4**	**9.7**	**10.1**	**10.2**
Of which: Net taxes and transfers to CG	5.2	4.3	3.9	2.7	2.8	3.7
Current account balance	**1.1**	**1.1**	**0.6**	**0.8**	**1.0**	**0.9**
Capital revenue	0.0	0.9	0.3	0.1	0.1	0.0
Capital expenditure	1.2	2.5	2.0	1.9	1.2	1.2
Overall balance	**0.0**	**-0.5**	**-1.1**	**-1.1**	**-0.1**	**-0.3**
III. Nonfinancial Public Sector						
Total revenue	**32.7**	**33.4**	**32.2**	**30.8**	**30.4**	**29.6**
Current revenue	32.4	32.5	31.9	30.6	30.3	29.5
Capital revenue	0.3	1.0	0.4	0.2	0.1	0.1
Total expenditure	**29.1**	**31.4**	**31.3**	**32.0**	**32.9**	**30.9**
Current expenditure	24.9	25.3	25.5	26.2	27.7	26.1
Capital expenditure	4.3	6.1	5.8	5.8	5.2	4.8
Overall surplus or deficit	**3.6**	**2.1**	**1.0**	**-1.2**	**-2.5**	**-1.3**
Privatization receipts	0.0	0.0	0.2	0.1	0.5	1.1
Financing needs	**-3.6**	**-2.1**	**-1.2**	**1.1**	**2.1**	**0.2**
Foreign	-2.4	-0.1	-0.2	0.5	0.5	-0.1
Domestic (including statistical discrepancies)	-1.2	-2.0	-1.0	0.6	1.6	0.3
IV. Combined Public Sector						
Central bank balance	-0.6	-0.7	-1.1	-1.1	-1.1	-0.8
Combined public sector result	**3.0**	**1.4**	**-0.1**	**-2.3**	**-3.6**	**-2.1**
Memorandum items:						
Central government balance (official presentation) 4/	2.6	2.3	2.0	0.4	-1.5	-0.1
Deposits at Copper Stabilization Fund (flows)	1.1	0.3	0.1	-0.5	-0.7	-0.2
Central government balance (at const. copper price) 5/	1.8	2.1	1.6	0.5	-1.4	-0.6
Central government fiscal impulse 6/	0.3	-0.2	0.6	0.7	1.5	-0.3
Current account of NFPS	7.6	7.2	6.4	4.4	2.6	3.4
Public sector size index I 7/	16.2	18.6	18.3	19.0	19.3	17.9
Public sector size index II 8/	21.5	24.1	23.8	25.0	25.6	24.4
Central government employment 9/	2.6	2.5	2.5	2.5	2.6	...
External debt of the NFPS	7.4	6.3	6.1	7.3	8.1	7.5
Domestic debt of the NFPS 10/	0.7	0.4	0.4	0.8	1.2	1.6

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

1/ Nonfinancial public sector and operational losses of the central bank.
2/ Includes taxes paid and transfers made by the public enterprises.
3/ Includes amounts transferred directly by CODELCO to the military.
4/ See Apendix IV.
5/ Calculations made at a price of copper of 0.9 U.S. dollar per pound.
6/ Change in the actual balance in excess of the the cyclically neutral balance in relation to the preceding year.
7/ Central government expenditure less interest payments and transfers plus investment of public enterprises.
8/ Central government expenditure plus investment of public enterprises.
9/ Percentage of total employment.
10/ Credit from the banking system (excluding the central bank). There are no outstanding domestic bonds, and data on suppliers' credit are not available.

Table 4. Chile: Balance of Payments

	1995	1996	1997	1998	Est. 1999	Proj. 2000
	(In millions of U.S. dollars)					
Current account	**-1,345**	**-3,512**	**-3,728**	**-4,143**	**-78**	**-1,773**
Trade balance	1,382	-1,091	-1,556	-2,516	1,664	552
Exports, fob	16,024	15,405	16,664	14,830	15,616	17,835
Copper	6,487	6,029	6,841	5,332	5,889	6,958
Noncopper	9,537	9,376	9,823	9,498	9,727	10,877
Imports, fob	-14,643	-16,496	-18,220	-17,346	-13,951	-17,283
Financial services (net)	-2,712	-2,667	-2,738	-1,976	-1,881	-2,519
Other services and transfers (net)	-15	247	567	349	138	194
Capital account, incl. errors and omissions	**2,405**	**4,692**	**6,937**	**2,077**	**-605**	**2,257**
Foreign investment	2,454	4,627	5,740	1,328	4,526	1,610
Chilean investment abroad	-765	-1,318	-2,105	-4,217	-7,221	-5,238
Direct investment	-752	-1,187	-1,867	-2,797	-4,855	-3,401
Portfolio investment	-13	-130	-238	-1,419	-2,366	-1,838
Foreign investment in Chile	3,219	5,945	7,845	5,545	11,747	6,848
Direct investment	3,170	4,715	5,243	4,955	9,251	4,998
Portfolio investment	49	1,230	2,602	590	2,496	1,850
Medium- and long-term loans (net)	-84	558	3,333	3,676	722	1,499
Disbursements	3,406	5,315	6,236	6,077	4,105	4,756
Public sector	212	840	717	1,034	991	305
Private sector	3,193	4,475	5,519	5,043	3,114	4,451
Amortizations	-3,490	-4,756	-2,903	-2,401	-3,384	-3,257
Public sector	-2,165	-2,752	-715	-337	-359	-542
Private sector	-1,325	-2,005	-2,188	-2,064	-3,025	-2,715
Other capital (net) 1/	-92	157	-1,696	-1,747	-6,011	-852
Public sector	-138	206	-125	-264	-148	191
Private sector	46	-49	-1,570	-1,484	-5,862	-1,044
Errors and omissions (net)	127	-650	-441	-1,180	158	0
Overall balance of payments	**1,060**	**1,181**	**3,209**	**-2,066**	**-683**	**484**
Valuation adjustment	279	-512	-842	217	-598	0
Change in official reserves (increase -)	-1,339	-669	-2,367	1,849	1,282	-484
Memorandum items:						
Current account (percent of GDP)	-2.1	-5.1	-5.0	-5.7	-0.1	-2.4
Trade balance (percent of GDP)	2.1	-1.6	-2.1	-3.5	2.5	0.8
External debt, all maturities (percent of GDP) 2/	33.3	33.5	35.6	43.6	50.4	50.6
Copper price (LME; U.S. cents per pound)	133.2	103.2	103.2	75.0	71.3	81.0
Copper exports (thousands of metric tons)	2,347.1	2,885.3	3,432.0	3,651.3	4,205.4	4,288.0
CODELCO	1,085.3	1,116.6	1,328.0	1,442.1	1,528.6	1,406.0
Other	1,261.8	1,768.7	2,104.0	2,209.2	2,676.8	2,882.0
GDP (billions of U.S. dollars)	65.2	68.6	75.0	72.8	67.4	73.5
	(Annual change in percent)					
Copper export price (net of discount)	34.9	-24.4	-4.6	-26.7	-4.1	15.9
Copper export volume	13.4	22.9	18.9	6.4	15.2	2.0
Noncopper export prices	18.2	-8.7	0.0	-10.1	-2.4	5.0
Noncopper export volume	9.5	7.3	4.7	7.5	4.9	6.5
Total export price	23.8	-15.2	-2.0	-17.1	-2.6	9.1
Total export volume	11.5	13.4	10.4	7.4	8.1	4.8
Total import price	8.1	0.3	-4.5	-5.2	-3.5	3.1
Total import volume	24.4	11.8	15.6	0.7	-16.5	20.1
Terms of trade	14.5	-15.5	2.6	-12.6	0.9	5.8

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

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

2/ Does not include short-term trade credits.

Table 5. Chile: Indicators of External Vulnerability

(In percent; unless otherwise indicated)

	1992-95	1996	1997	1998	Est. 1999	Proj. 2000
Financial indicators						
Broad money (percent change)	21.9	22.0	13.0	8.5	5.2	13.3
Ratio of bank credit to GDP	49.8	57.6	60.9	63.8	64.1	63.4
30-day central bank promissory note (nominal) interest rate (averages) 1/	...	...	13.1	16.3	8.9	...
90-day central bank promissory note (real) interest rate (averages)	6.1	7.3	6.8	9.6	6.0	...
Share of foreign currency deposits in total deposits	8.6	4.3	3.7	6.9	10.5	12.5
Share of foreign currency loans in total credit (excl. pension funds)	15.5	10.6	8.3	9.1	8.6	8.6
Share of nonperforming loans in total loans	1.0	1.0	1.0	1.4	1.6	...
Loan-loss provisions as percent of nonperforming loans	315.5	154.6	148.3	131.7	145.9	...
Risk-based capital-assets ratio, end of period 2/	...	...	...	12.5	13.5	...
Return on bank capital	11.7	15.5	13.7	11.5	10.0	...
External indicators						
Exports, U.S. dollars (percent change)	17.0	-3.9	8.2	-11.0	5.3	14.2
Imports, U.S. dollars (percent change)	18.9	12.7	10.5	-4.8	-19.6	23.9
Terms of trade (percent change)	5.2	-15.5	2.6	-12.6	0.9	5.8
REER (end of period, percent change)	5.6	4.0	9.7	-6.1	-6.3	...
Exchange rate (pesos per US$, period average)	395.9	412.3	420.6	460.7	509.1	...
Current account (percent of GDP)	-3.3	-5.1	-5.0	-5.7	-0.1	-2.4
Capital account (percent of GDP) 3/	7.1	6.8	9.2	2.9	-0.9	3.1
Gross official reserves (in US$ billion) 4/	12.1	15.5	17.8	16.0	14.7	15.2
Central bank short-term foreign liabilities (in US$ billion)	0.2	0.0	0.0	0.0	0.0	0.0
Gross official reserves in months of imports of goods and nonfactor services	8.9	8.3	9.9	10.6	8.1	7.5
Gross official reserves to broad money (M3)	46.4	55.3	58.3	51.9	50.6	45.0
Gross official reserves to total short-term external debt 5/	215.3	347.6	496.4	403.7	376.9	215.1
Short-term foreign assets of commercial banks (in US$ billion) 6/	0.5	0.6	1.2	1.8	4.2	3.4
Short-term foreign liabilities of commercial banks (in US$ billion) 6/	3.1	2.4	0.8	0.9	0.3	0.5
Total external debt (percent of GDP)	41.4	33.5	35.6	43.6	50.4	50.6
Of which: Public sector debt (percent of GDP) 7/	18.2	7.5	6.8	7.9	8.6	8.0
Total external debt to exports of goods and services	146.1	120.5	128.5	167.2	175.1	169.2
External interest payments to exports of goods and services	9.3	7.0	6.8	8.0	7.8	8.2
External amortization payments to exports of goods and services	11.7	24.9	14.0	12.7	17.4	14.8
Financial market indicators						
Stock market index (in US$; period average)	...	98.2	104.4	74.8	75.6	...
Sovereign long-term debt rating 8/						
Moody's	Baa2 (2/17/94)		Baa1 (6/29/95)			
S&P	BBB+ (12/21/93)		A- (7/11/95)			

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

1/ The series starts in July 1997.
2/ This indicator is not available before 1998.
3/ Includes errors and omissions.
4/ Gold valued at end-period market prices.
5/ Total short-term external debt is measured as the official figure on short-term debt (which includes amortization of medium- and long-term debt falling due during the following year). Total short-term external debt does not include trade credits.
6/ Refers to the commercial banking sector including the Banco del Estado de Chile.
7/ Includes private debt with public guarantee.
8/ Ratings are only shown for the dates on which they were revised by the rating agencies.

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

	1998	1999	2000	2001	2002	2003	2004	2005
			Projections					
	(In billions of U.S. dollars)							
Current account	-4.1	-0.1	-1.8	-2.6	-3.1	-3.4	-3.8	-4.2
Trade balance	-2.5	1.7	0.6	-0.1	0.1	0.2	0.2	0.3
Exports	14.8	15.6	17.8	19.2	21.0	22.9	24.8	27.2
Copper	5.3	5.9	7.0	7.4	8.2	8.9	9.5	10.3
Noncopper	9.5	9.7	10.9	11.8	12.8	14.0	15.4	16.9
Imports	-17.3	-14.0	-17.3	-19.3	-21.0	-22.7	-24.6	-26.8
Financial services (net)	-2.0	-1.9	-2.5	-2.8	-3.2	-3.6	-4.1	-4.5
Other services and transfers (net)	0.3	0.1	0.2	0.2	0.0	0.0	0.0	0.0
Capital account 1/	2.1	-0.6	2.3	3.6	4.2	4.5	4.9	5.4
Foreign investment (net)	1.3	4.5	1.6	3.3	3.4	4.1	4.1	4.8
Assets	-4.2	-7.2	-5.2	-4.9	-5.1	-5.2	-5.4	-5.6
Liabilities	5.5	11.7	6.8	8.3	8.5	9.4	9.5	10.4
Other capital flows	0.7	-5.1	0.6	0.3	0.8	0.4	0.9	0.6
Medium- and long-term (net)	3.7	0.7	1.5	0.1	0.4	-0.1	0.4	0.1
Disbursements	6.1	4.1	4.8	6.4	6.9	6.4	5.6	5.0
Amortizations	-2.4	-3.4	-3.3	-6.3	-6.5	-6.5	-5.2	-4.9
Other capital (net) 1/	-2.9	-5.9	-0.9	0.2	0.4	0.4	0.4	0.4
Overall balance	-2.1	-0.7	0.5	0.9	1.1	1.1	1.1	1.2
Valuation adjustment	0.2	-0.6	0.0	0.0	0.0	0.0	0.0	0.0
Change in net official reserves (increase -)	1.8	1.3	-0.5	-0.9	-1.1	-1.1	-1.1	-1.2
	(In months of imports of goods and services)							
Gross official international reserves 2/	8.9	9.8	8.4	8.0	7.8	7.7	7.5	7.3
Main assumptions								
Copper price (LME; U.S. cents per pound)	75.0	71.3	81.0	85.0	91.0	94.0	97.0	100.0
Volume of copper exports (in thousands of metric tons)	3,651	4,205	4,288	4,334	4,470	4,673	4,814	5,048
CODELCO	1,442	1,529	1,406	1,500	1,518	1,598	1,610	1,710
Other	2,209	2,677	2,882	2,834	2,952	3,075	3,204	3,338
	(Annual change in percent)							
Copper export prices 3/	-26.7	-4.1	15.9	5.3	7.7	3.6	3.4	3.4
Copper export volumes	6.4	15.2	2.0	1.1	3.1	4.5	3.0	4.9
Noncopper export prices	-10.1	-2.4	5.0	2.9	1.8	2.0	1.9	1.9
Noncopper export volume	7.5	4.9	6.5	5.7	6.5	7.1	7.6	8.0
Total export prices	-17.1	-2.6	9.1	3.8	4.1	2.6	2.5	2.5
Total export volume	7.4	8.1	4.8	3.9	5.2	6.1	5.8	6.8
Total import volume	0.7	-16.5	20.1	9.2	6.8	6.3	6.4	6.3
Total import price	-5.2	-3.5	3.1	2.3	1.9	1.9	1.9	2.5
Terms of trade	-12.6	0.9	5.8	1.5	2.2	0.8	0.6	0.0
Real GDP	3.4	-1.1	6.0	6.8	6.3	6.3	6.3	6.3
LIBOR (in percent)	5.6	5.5	6.8	7.1	7.1	7.1	7.1	7.1
	(In percent of GDP)							
Gross domestic investment	26.5	21.1	24.2	24.3	24.6	24.5	24.7	24.9
Public sector	5.8	5.2	4.8	4.6	4.8	4.7	4.6	4.6
Private sector and inventory change	20.7	15.9	19.4	19.6	19.7	19.9	20.0	20.4
External current account balance	-5.7	-0.1	-2.4	-3.2	-3.4	-3.4	-3.5	-3.4
Gross national savings	20.8	21.0	21.8	21.1	21.2	21.2	21.2	21.5
Combined public sector	3.3	1.7	3.2	3.5	3.9	4.3	4.9	5.3
Private sector	17.5	19.3	18.5	17.5	17.3	16.9	16.3	16.2

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

1/ Includes errors and omissions.
2/ Gold at market valuation.
3/ Chilean export price.

Table 7. Chile: External Debt and Debt Service

	1998	1999	2000	2001	2002	2003	2004	2005
			Projections					
	(In billions of U.S. dollars, end of period)							
Total debt outstanding 1/	**31.7**	**34.0**	**37.2**	**38.5**	**40.5**	**42.6**	**44.9**	**47.4**
Medium- and long-term 2/	30.1	32.8	35.6	36.9	38.7	40.5	42.5	44.8
International organizations	1.8	1.6	1.6	1.6	1.5	1.5	1.4	1.4
Official lenders	1.6	1.0	0.8	0.6	0.5	0.3	0.2	0.0
Private creditors	26.7	30.1	33.2	34.7	36.7	38.7	40.9	43.4
Short-term 1/ 2/	1.6	1.2	1.6	1.6	1.8	2.1	2.3	2.6
Short-term debt, residual maturity basis 1/	4.0	3.9	7.1	8.1	8.3	7.3	7.3	7.3
Total debt service	**3.9**	**4.9**	**5.1**	**8.3**	**8.6**	**8.7**	**7.5**	**7.3**
Amortization	2.4	3.4	3.3	6.3	6.5	6.5	5.2	4.9
Interest	1.5	1.5	1.8	2.0	2.1	2.2	2.3	2.4
IMF								
Credit outstanding	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repurchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	(In percent of GDP)							
Total external debt, end-period 1/	43.6	50.4	50.6	46.7	44.4	42.3	40.5	38.9
Of which: external public debt	7.9	8.6	8.0	6.5	6.1	5.8	5.4	5.1
Interest payments on external debt	2.1	2.2	2.5	2.4	2.3	2.2	2.1	2.0
	(In percent of export of goods and services)							
Debt-service payments	20.6	25.2	23.1	34.9	33.1	30.8	24.5	21.9
Of which: interest	8.0	7.8	8.2	8.3	8.0	7.7	7.5	7.2
IMF repurchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total external debt outstanding at year-end 1/	167.2	175.1	169.2	162.6	156.6	151.0	146.8	141.8
IMF credit outstanding	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum item:								
Net financial services payments, percent of GDP	2.7	2.8	3.4	3.3	3.5	3.6	3.7	3.7

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

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

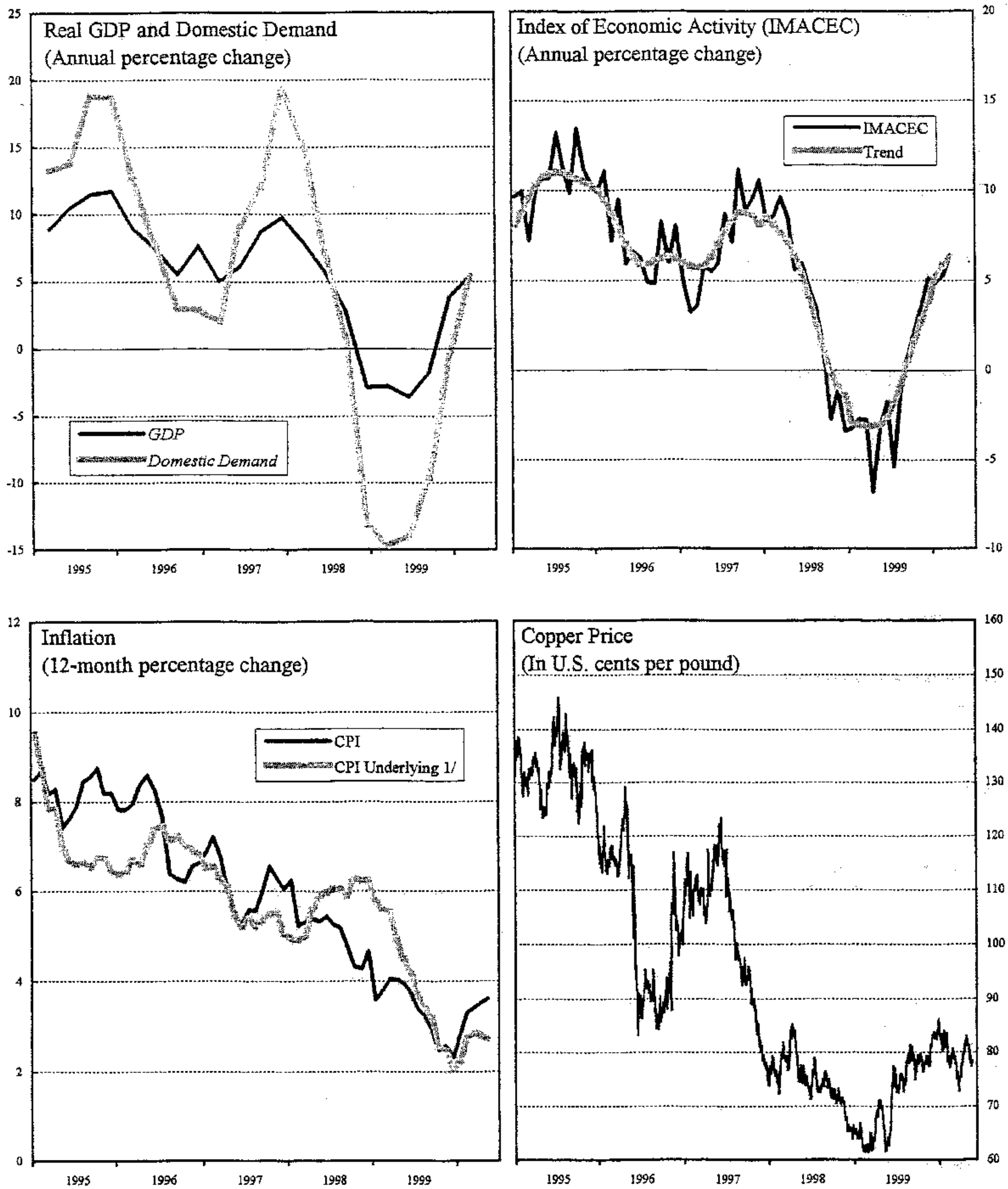
Table 8. Chile: Social Indicators

	1977		1987		1997		Latin America and Caribbean 1997		Upper- Middle Income 1997	
Population										
Total population (millions)	10.7		12.4		14.6		493.9		574.0	
Growth rate (annual percent)	1.5		1.6		1.4		1.6		1.5	
Urban population (percent of population)	79.5		82.9		84.2		74.2		73.8	
Total fertility rate (births per woman) 1/	3.0		2.7		2.4		2.7		2.5	
Poverty (percent of population)										
National headcount index	...		45.1		21.7	2/	...		...	
Urban headcount index	...		43.6		20.7	2/	...		...	
Rural headcount index	...		51.5		27.6	2/	...		...	
Income/consumption distribution										
GNP per capita (US$)	1,088.5		1,556.8		4,822.2		3,937.3		4,543.8	
Consumer price index (percent change)	152.6	3/	18.0	4/	10.2	5/	...		...	
Food price index (percent change)	...		17.2	4/	10.5	5/	...		...	
Income/consumption distribution (percentages)										
Lowest quintile	...		4.3		4.1		...		...	
Highest quintile	...		57.2		56.9		...		...	
Public expenditure										
Health (percent of GDP)	...		...		2.3	6/	2.8	7/	3.0	7/
Education (percent of GDP)	4.1	8/	3.3		3.1	9/	3.7	9/	4.8	9/
Social spending welfare (percent of GDP)	...		...		6.6		...		...	
School enrollment rate										
Male										
Ages 6-13 (percentage)	...		...		98.7		...		...	
Ages 14-17 (percentage)	...		...		98.0		...		...	
Female										
Ages 6-13 (percentage)	...		...		98.6		...		...	
Ages 14-17 (percentage)	...		...		94.0		...		...	
Access to safe water (percent of population)										
Total	70.0	8/	86.0	10/	91.0	6/	75.3	6/	83.2	11/
Urban	78.0	8/	97.0	10/	99.0	6/	82.8	6/	88.7	11/
Rural	28.0	8/	21.0	11/	47.0	6/	36.5	6/	64.1	11/
Immunization rate (percent under 12 months)										
Measles	...		92.0		92.0		92.7		92.0	
DPT	100.0	12/	93.0		91.0		82.2		82.2	
Child malnutrition (percent under 5)	...		2.5	13/	0.8	9/	8.2	9/	...	
Life expectancy at birth (years)										
Total	67.2		72.7		75.2		69.6		69.8	
Male	63.9		69.6		72.3		66.5		66.6	
Female	70.6		75.9		78.3		72.9		73.2	
Mortality										
Infant (per thousand live births)	45.0		18.0		11.0		31.8		29.9	
Under 5 (per thousand live births)	96.0	14/	35.0	15/	13.0		41.1		38.4	
Adult 14/										
Male (per 1,000 male adults)	301.0	15/	217.6	16/	143.0		189.4		193.4	
Female (per 1,000 female adults)	177.0	15/	120.0	16/	73.0		116.0		115.7	

Sources: World Development Indicators; Ministry of Planning and Development (MIDEPLAN); and "*Estadísticas de las Finanzas Públicas 1989-1998", Dirección de Presupuestos, Ministerio de Hacienda, República de Chile.*

1/ Number of children that would be born to a woman if she were to live to the end of her childbearing years.
2/ Refers to 1998.
3/ Average annual change in prices in the period 1970-77.
4/ Average annual change in prices in the period 1980-87.
5/ Average annual change in prices in the period 1990-97.
6/ Refers to 1995.
7/ Refers to 1994.
8/ Refers to 1975.
9/ Refers to 1996.
10/ Refers to 1985.
11/ Refers to 1988.
12/ Refers to 1979.
13/ Refers to 1986.
14/ Probability of dying between the ages of 15 and 60.
15/ Refers to 1970.
16/ Refers to 1980.

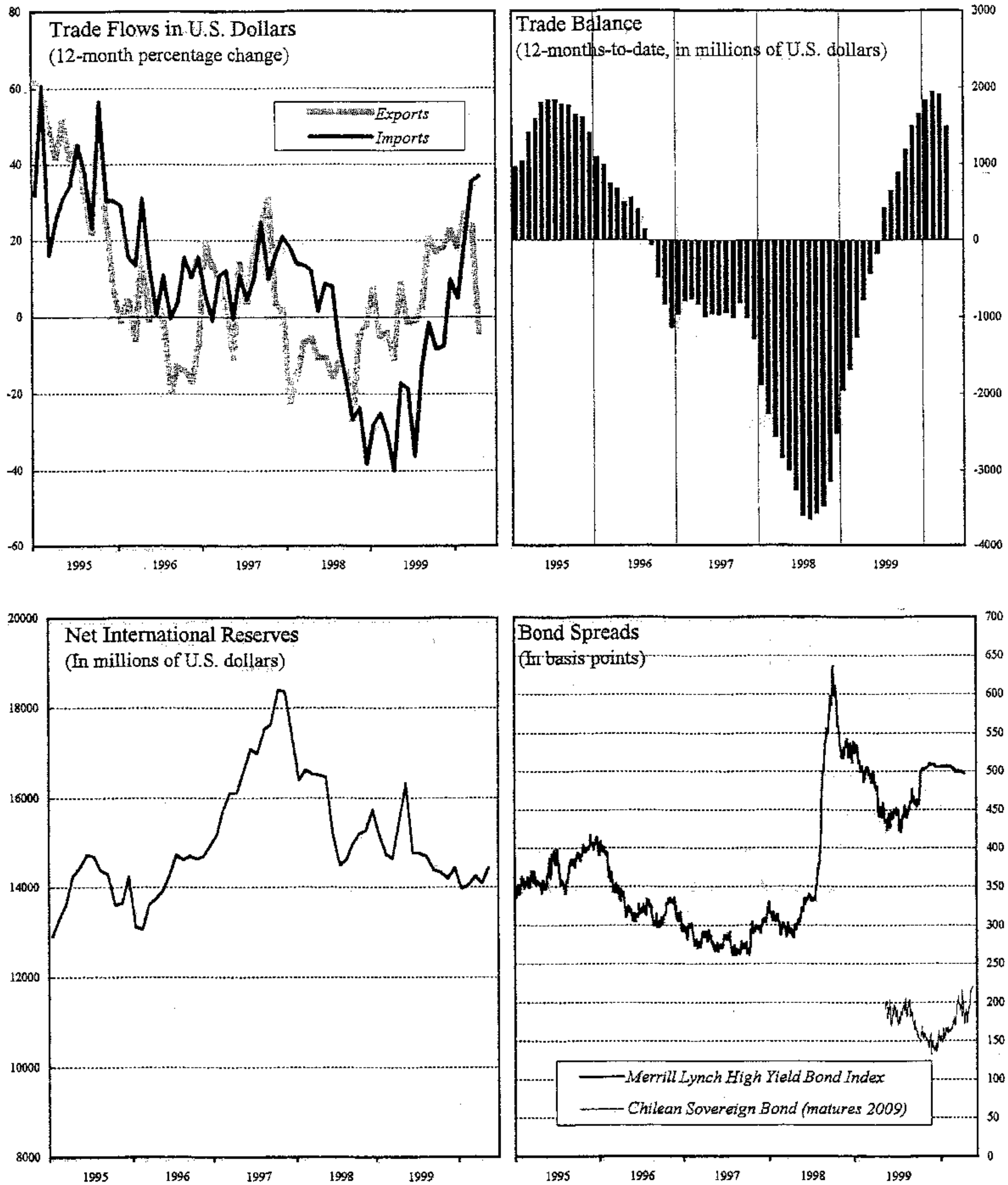
Figure 1. Chile: Selected Economic Indicators, 1995 - 2000



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

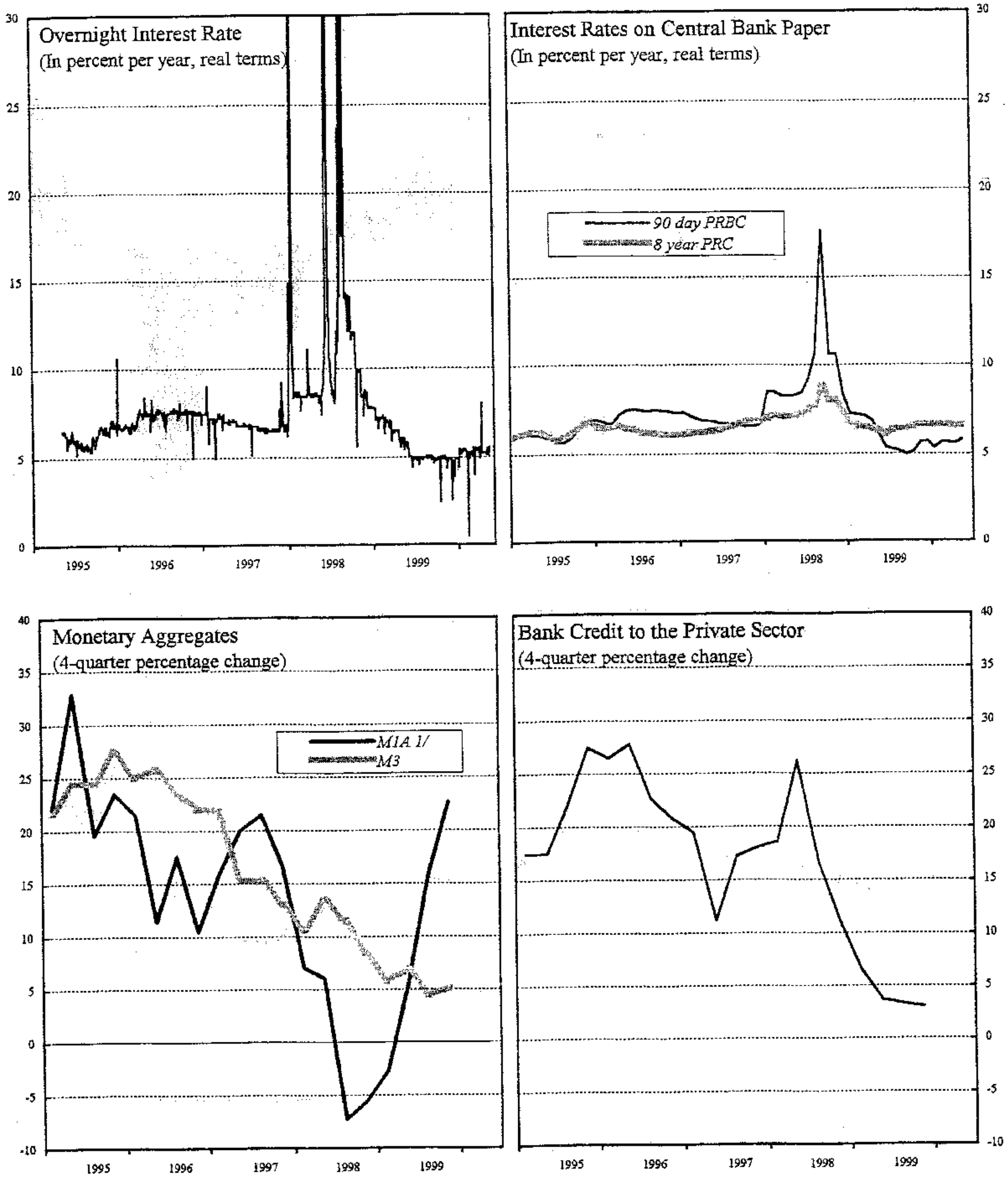
1/ Excluding gasoline, natural gas, and perishable foods.

Figure 2. Chile: External Sector Indicators, 1995 - 2000



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

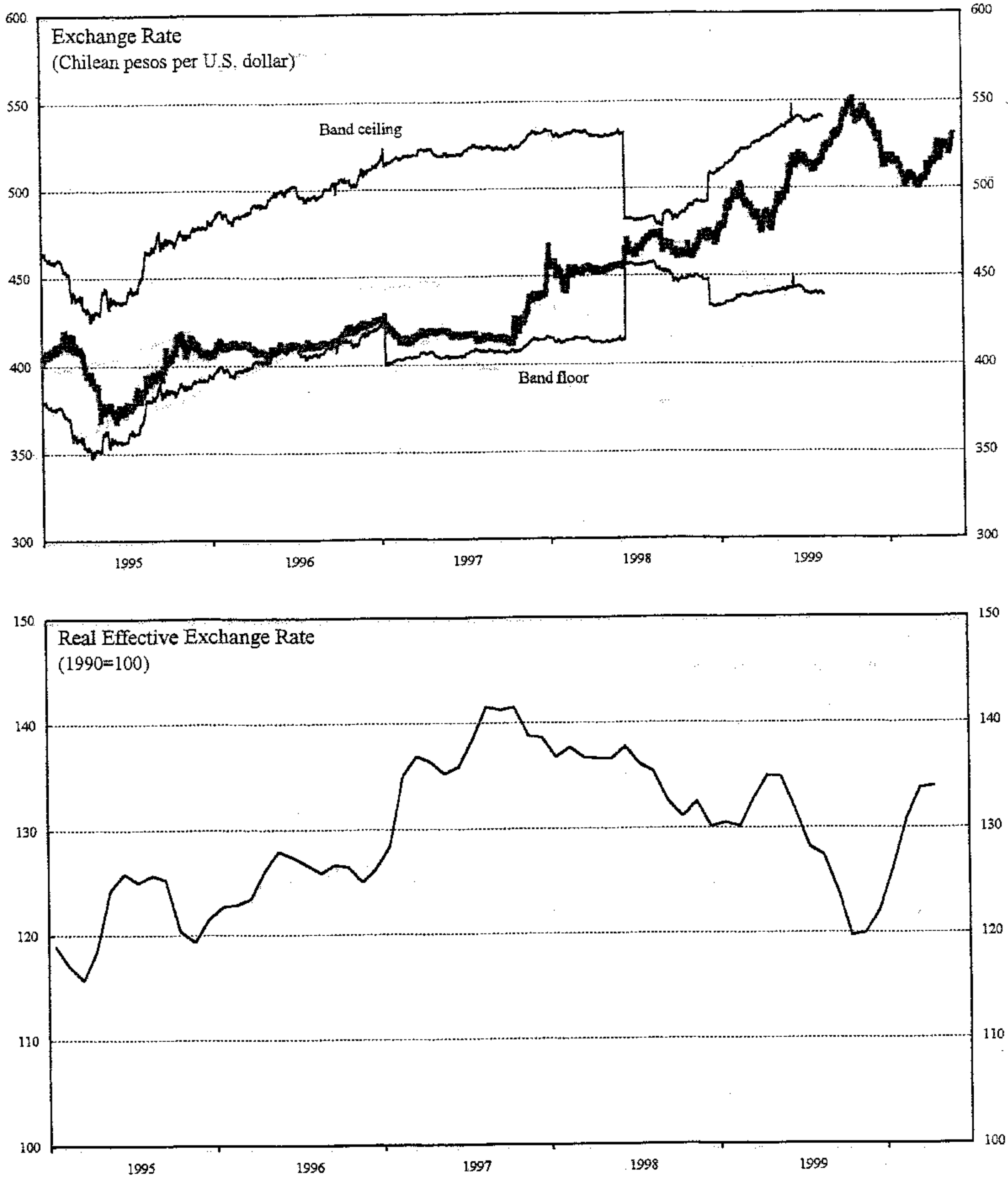
Figure 3. Chile: Financial Sector Indicators, 1995 - 2000



Source: Central Bank of Chile.

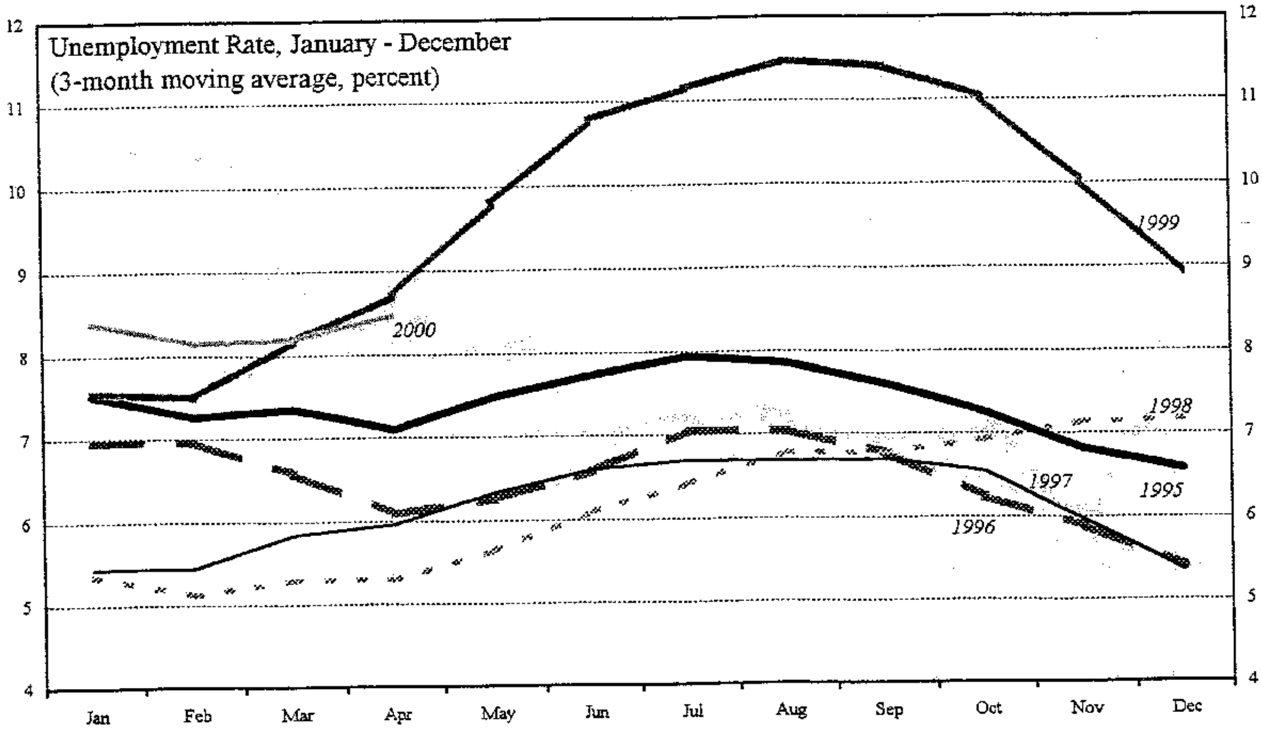
1/ M1 plus savings accounts.

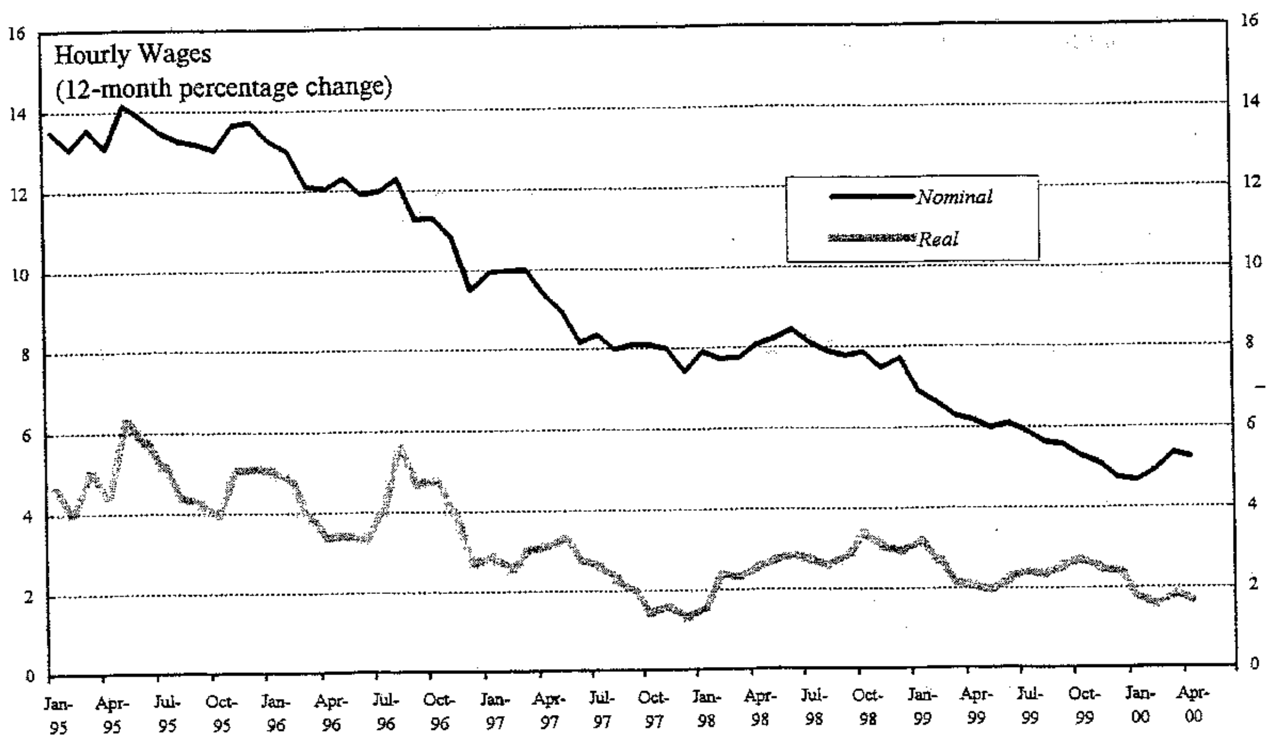
Figure 4. Chile: Exchange Rate Developments, 1995 - 2000



Source: *El Mercurio* ; and IMF's Information Notice System.

Figure 5. Chile: Labor Market Developments, 1995 - 2000





Source: Central Bank of Chile.

Chile: Fund Relations
(As of April 30, 2000)

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

II. **General Resources Account**

	SDR Million	Percent Quota
Quota	856.10	100.0
Fund holdings of Chilean pesos	570.23	66.6
Reserve position in Fund	285.87	33.4
Operational budget transfers (net)	-6.00	

III. **SDR Department**

	SDR Million	Percent Allocation
Net cumulative allocation	121.92	100.0
Holdings	14.91	12.2
Designation plan	10.00	

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

V. **Financial Arrangements:**

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

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

VII. **Exchange Arrangements**: The exchange rate is permitted to float freely. On May 31 the interbank exchange rate was Ch$520.0 per U.S. dollar.

VIII. **Article IV Consultations:** The Executive Board concluded the 1998 Article IV consultation on January 25, 1999 (SM/99/6). The 2000 Article IV consultation has been delayed due to the recent presidential elections and change in government, as reported to the Executive Board in EBD/00/30.

IX. **Technical Assistance:** In May 1997 a mission from the Fiscal Affairs Department (FAD) assisted the authorities in the evaluation of Chile's tax system. In June 1998 an FAD mission advised on the desirability of moving to a system of accrual accounting and budgeting. In June 1999 a mission from FAD and STA advised on public expenditure management, the implementation of accrual based accounting, and government finance statistical systems. In April 2000 a mission from STA advised on money and banking statistics.

Chile: Financial Relations with the World Bank

The most recent Country Assistance Strategy (CAS) for Chile was discussed by the Board in April 1995. The emphasis of the Bank's assistance program for Chile was on selectivity and an increased reliance on the government in determining future assistance priorities for both sector work and new lending, through a strategic and productive dialogue with the Bank. It aimed at implementing about one new project each year and at providing guarantees to certain infrastructure projects. The latter was not realized and, after operations for secondary education and rural poverty were approved, Chile was not an active borrower between FY 96 and FY 98. However, Chile made use of Bank nonlending services, including the preparation of a poverty assessment and a study on tax reform, as well as technical assistance under the reimbursable program in area such as privatizations, regulatory issues, and education. After the hiatus in borrowing from the Bank since FY 96, three new operation totaling US$160 million, were approved in FY 99: Higher Education Reform Loan (US$145 million), Second Municipal Development Loan (US$10 million), and the Millennium Science Initiative LIL (US$5 million). The undisbursed balance of the Chile portfolio totals US$196.7 million, as of March 31, 2000.

Lending for FY 2000-02 is now expected to target water resources, public financial management, and technical education. The World Bank will be preparing a new CAS for Chile in FY 01.

Chile: Financial Relations with the World Bank

(In millions of U.S. dollars)

	Commitments (Net of Cancellations)	Disbursements	Undisbursed
I. IBRD Operations (as of March 31, 2000)			
Fully disbursed loans	2,876.36	2,876.36	...
Loans in process of disbursement			
Agriculture	15.00	11.50	3.50
Education	185.45	36.75	148.70
Environment	...	...	...
Health	...	...	...
Municipal and urban	10.10	0.60	9.50
Public sector management	...	...	...
Transport	120.00	85.00	35.00
Water supply	...	...	...
Total loans	3,206.91	3,010.21	196.70
Repaid 1/	2,102.62	...	...
Outstanding	1,104.29	...	...

II. IFC Operations (as of March 31, 2000)

	IFC			
	Loans	Equity	Quasi Equity	Participation
Held	41.75	58.80	20.88	17.95
Disbursed	41.75	58.72	20.88	17.95
Approvals pending commitment	...	...	...	...

III. IBRD Loan Transactions (calendar year)

	Actuals			
	1997	1998	1999	2000 2/
Disbursements	84.50	67.30	43.28	24.29
Repayments	109.37	105.03	110.67	25.16
Net lending	-24.87	-37.73	-67.39	-0.87

Source: World Bank

1/ Includes repayment from third parties.
2/ As of May 10, 2000.

Chile: Statistical Issues

Monetary and real sectors

The central bank publishes comprehensive statistics on the real and monetary sectors on a bi-weekly basis.

Government finance

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

Balance of payments

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

Chile: Core Statistical Indicators
as of June 5, 2000

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance 1/	GDP/ GNP 2/	External Debt/ Debt Service 3/
Date of Latest Observation	6/1/2000	5/15/2000	5/2000	5/15/2000	5/15/2000	6/2/2000	4/31/2000	4/31/2000	Q1/2000	Q4/1999	Q1/2000	3/31/2000
Date Received	6/5/2000	5/23/2000	6/6/2000	5/23/2000	5/23/2000	6/2/2000	5/23/2000	5/23/2000	5/23/2000	3/15/2000	5/23/2000	5/23/2000
Frequency of Data 4/	D	M	M	M	M	D	M	M	Q	Q	Q	M
Frequency of Reporting 4/	D	O (twice monthly)	M	O (twice monthly)	O (twice monthly)	D	O (twice monthly)	O (twice monthly)	O (twice monthly)	Q	O (twice monthly)	O (twice monthly)
Source of Update 5/	C	A	A	A	A	A	A	A	A	A	A	A
Mode of Reporting 6/	O (web site)	E	E	E	E	E	E	E	E	E	E	E
Confidentiality 7/	C	C	A	C	C	C	C	C	C	A	C	C
Frequency of Publication 4/	D	M	M	M	M	D	M	M	Q	Q	Q	M

1/ General government only (excluding municipal governments).
2/ Quarterly data at constant prices only.
3/ External debt only. General information on interest and amortization payments is available on a quarterly basis from the balance of payments. Detailed information on debt service payments is only available for missions.
4/ D-daily, M-Monthly, and Q-quarterly.
5/ A-direct reporting by central bank, ministry of finance, or other official agency; N-official publication or press release; P-commercial publication; and C-commercial electronic data provider.
6/ E-electronic transfer.
7/ A-for use by the staff only; and C-for unrestrictive use.

Methodological Adjustments to the Official Presentation of Chile's Fiscal Accounts

The official presentation of the fiscal accounts is adjusted by the staff as follows:

1. **Operations of the Copper Stabilization Fund (CSF)**: The CSF receives transfers from the state-owned copper company Codelco on account of "excess revenue" which result when world copper prices are above a benchmark price; these funds can be withdrawn by the government when copper prices are below the benchmark price.

The official presentation includes as **government current revenue** the *withdrawals* from the CSF, but it does not include in the government accounts the *transfers* from Codelco to the CSF. The reasons for this presentation are: (i) to reduce pressures to increase expenditure that might arise when the copper price exceeds the benchmark price and the government's financial position improves; and (ii) not to present what the authorities consider would be an unduly weakening of the government's finances when the copper price falls below the benchmark price, which they view as the long-term price.

The staff's presentation aims at reflecting the actual, rather than underlying, government position. It considers that the CSF is a government account, and thus registers the *withdrawals* from the CSF as a financing item (below the line), and treats as **government current revenue** the *transfers* from Codelco to the CSF. As a result, when copper prices are above the benchmark price the staff 's presentation would show higher government current revenue than the official presentation, and vice-versa.

2. **Codelco's transfers to the military**: By law, Codelco must transfer 10 percent of its export revenues to the military. These transfers are not included in the official presentation of the government accounts. The staff includes them as **government current revenue**, matched by an equivalent amount of **government current expenditure** (this implicitly assumes that the military spend these resources in the same period that they are accrued). While this adjustment does not affect the government balance, it provides a more accurate view of the level of government expenditure.

3. **Privatization receipts**: The official presentation includes capital gains on privatization as **government current revenue**. The staff's presentation considers those receipts as a financing item (below the line).

Statement by the IMF Staff Representative
July 7, 2000

1. This buff contains information which has become available since the staff report (SM/00/116) was issued. This information does not modify the thrust of the staff appraisal.

2. The monthly index of **economic activity** (IMACEC) increased in April by 6.4 percent (year-on-year), bringing the rate of growth in the first four months of the year to 5.7 percent. In May industrial production grew by 11.3 percent (year-on-year). Recent figures for industrial and retail sales suggest that the recovery of domestic demand may be slowing, although imports have continued to grow strongly. **Unemployment** increased moderately in April and May due to seasonal factors; the seasonally adjusted unemployment rate remained roughly unchanged. The 12-month **inflation** rate continued to increase gradually, from 2.3 percent in December 1999 to 3.6 percent in May 2000, while underlying inflation (which excludes the prices of fuel and some food items) only increased from 2.1 percent to 2.7 percent. Recent official projections for end-2000 point to an inflation rate in the range of 4–4.5 percent, with underlying inflation of about 3.5 percent.

3. Figures on the **central government accounts** for the first quarter of the year are in line with the staff's projections for the year as a whole. In the first quarter of 2000 the central government balance was in surplus by 1.6 percent of GDP, compared with a deficit of 0.2 percent of GDP a year earlier (using the staff's presentation of the fiscal accounts). Revenues increased by over 15 percent in real terms (year-on-year), mainly reflecting a recovery in tax collections, while expenditure increased by 7 percent in real terms.

4. The evolution of the **trade balance** in the first five months of 2000 was broadly in line with the staff's projections for the year as a whole. In this period, imports grew by 26 percent (year-on-year) in U.S. dollar terms, while exports expanded by 20 percent.

5. On June 9 **Mercosur** countries (Argentina, Brazil, Paraguay, and Uruguay) and associate members (Bolivia and Chile) agreed on various steps to advance in their process toward macroeconomic coordination and convergence. In particular, they agreed to start publishing fiscal statistics on the basis of a common methodology by September 2000, and to jointly set targets for inflation and for several fiscal indicators by March 2001.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 00/56
FOR IMMEDIATE RELEASE
August 9, 2000

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

IMF Concludes Article IV Consultation with Chile

On July 7, 2000, the Executive Board concluded the Article IV consultation with Chile.[1]

Background

Chile's overall economic performance during 1990–97 was very strong. Real GDP grew at an annual average rate of 7.7 percent, inflation declined gradually from 26 percent to 6 percent, and social indicators improved significantly. This performance was based on important structural reforms, strong banking supervision, an open trade regime, and prudent macroeconomic policies. During this period, the authorities targeted a declining year-end inflation rate, adjusted short-term interest rates to achieve that objective, and maintained strong public sector finances; they also managed the exchange rate within a sliding band and administered a set of controls on capital flows.

By early 1998, Chile faced the difficult combination of a widening external current account deficit and a slowdown of capital inflows. The authorities scaled back expenditure plans, and tightened monetary policy strongly to prevent a large depreciation of the currency. In the event domestic demand fell sharply and the current account deficit started to narrow. However, from late 1998 through most of 1999, Chile experienced declining output and rising unemployment.

In 1999, as the size of the drop in demand became apparent, the authorities responded with expansionary monetary and fiscal policies. These policies, helped by an improving external environment, succeeded in initiating a recovery of output and employment in the latter part of the year. For 1999 as a whole, however, real GDP declined by about 1 percent, and inflation dropped to 2.3 percent by year-end. The current account deficit shrank from 5.7 percent of

[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. In this PIN, the main features of the Board's discussion are described.

GDP in 1998 to near-zero in 1999, reflecting cyclically weak domestic demand, but also supported by a real depreciation of the currency and strong export volume growth. With moderate net capital outflows and some negative valuation effects, the stock of international reserves declined by about 8 percent during the year, but at end-1999 still remained at a comfortable level of more than three times the estimated level of short-term debt on a residual maturity basis (excluding trade credits).

The economic recovery that began in late 1999 is by now well-established. In the first quarter of 2000, real GDP was up 5½ percent from the same quarter of 1999, and unemployment continued to ease gradually. Accordingly, the authorities began to firm both monetary and fiscal policies with respect to the expansionary stance of 1999. For 2000 real GDP is expected to grow by 6 percent, inflation would be around 4 percent at year's end, and the external current account deficit would widen moderately.

Since mid-1999 the authorities have launched a set of major policy initiatives. Regarding the monetary policy regime, they abandoned the exchange rate band in favor of a transparently-conducted float and enhanced their approach to inflation targeting by establishing a continuous inflation target band of 2–4 percent (starting in 2001) and by taking steps to increase the transparency of monetary policy. They also introduced a number of measures to further liberalize the capital account, including the abolition of the one-year minimum stay requirement. On the side of fiscal policy, the new government has expressed its commitment to further strengthen the fiscal position over the medium term, with future fiscal objectives to be set in terms of a measure of structural fiscal balance that excludes the fiscal effect of fluctuations in output and copper prices that are perceived to be temporary.

Proposals for a number of other significant policy steps have been submitted to Congress. These include a revision of the mechanism for administering fuel prices to prevent persistent subsidies; regulations on corporate governance to protect minority shareholders; regulations on bank concentration aimed at limiting the risk of moral hazard and the possibility of market control by a single bank, and a new system of unemployment protection. The authorities are also working on other labor market reform proposals.

In 1999 the new trade safeguards law was applied to a number of agricultural products, allowing the import tariffs generated by a price-stabilization scheme to exceed Chile's WTO-agreed maximum tariff. However, Chile maintains a very open trade regime in general and continues to unilaterally implement a phased reduction of its general external tariff rate.

Executive Board Assessment

Executive Directors praised Chile's long record of sound economic policies, which in the 1990s had resulted in high economic growth and a gradual decline in inflation. Directors noted that the deterioration in the external environment and surging domestic demand in 1998 had created new challenges and prompted a sharp tightening of monetary policy and a scaling back of public expenditure plans, resulting in a downturn in economic activity in 1999. Directors considered that the shift to a more accommodating monetary and fiscal stance in

1999 had been appropriate, as it had succeeded in reversing the recessionary trend relatively quickly, leading to a recovery that was now on track.

Directors saw the authorities' move early this year toward a more neutral macroeconomic policy stance as still consistent with strong output growth, low inflation, and a moderate widening of the external current account deficit this year.

Directors welcomed the new three-pillar framework for policies consisting of conservative, rules-based fiscal and monetary policies, greater emphasis on sound supervisory and regulatory frameworks, as well as new social policies. They considered that this framework would provide a solid foundation for a durable continuation of Chile's impressive overall record of economic performance.

Directors welcomed the authorities' decision to enhance their inflation targeting framework by shifting the focus from a specific year-end inflation level to a continuous inflation band starting next year, and by taking steps to increase transparency in the formulation and implementation of monetary policy. They considered that this new approach would add to the credibility of monetary policy and help the country maintain its low and stable inflation. In this regard, a few Directors considered that early progress in recapitalizing the central bank would help consolidate credibility in its operational independence, and that the time was appropriate to do so, given the low level of government debt and the improving economic situation. Several Directors felt that current demand conditions did not provide clear evidence to justify an increase in interest rates at present, while several other Directors considered a further increase in interest rates to be appropriate, particularly with a view to strengthening the credibility of the new inflation band.

Directors welcomed the authorities' intentions to further strengthen the fiscal position beyond this year, although a few regarded the structural fiscal surplus envisaged as slightly ambitious. Directors also supported the idea of formulating fiscal policy on the basis of a measure of structural fiscal balance that would exclude the effects of transitory fluctuations in output and copper prices. They also considered that a comprehensive definition of the public sector balance, including central bank losses, would be appropriate, although some questioned the merits of this approach, citing the instability of such losses over the business cycle.

Directors supported the authorities' decision to float the peso, as the added flexibility would help the country deal with external shocks while allowing monetary policy to remain focused on achieving the inflation target. Several Directors commended the authorities on the smoothness and appropriate timing of the exit from the sliding exchange rate band. They also supported the proposed new regulations on corporate governance and the recent measures to liberalize capital flows, citing Chile as exemplifying an effective and well-sequenced approach to the use of capital controls and their eventual replacement by prudential controls.

Available indicators suggest that the banking system remains strong, and Directors encouraged the authorities to continue to implement strict supervision practices and to advance in the introduction of supervision of consolidated balance sheets of financial holdings. Directors also stressed the need to implement the proposed regulations on bank concentration cautiously, with the focus kept on limiting moral hazard and avoiding monopolistic behavior on the part of banks.

Directors praised the continued unilateral reduction of Chile's uniform external tariff and highlighted the strong contribution to economic performance of the country's very open trade regime. Several Directors noted that the price band scheme currently implemented on the basis of a new law on safeguards had resulted in high tariffs on a few agricultural products, and they urged the authorities to reconsider the price band scheme because of its possible distortionary effects. Several other Directors, however, pointed out that these measures were intended to be temporary and in line with WTO rules, and should be seen against Chile's overall strong record of openness and the planned tariff reductions going forward.

Directors welcomed the authorities' intention to improve the system of unemployment protection, but suggested caution in its application because of the potential increase in indirect labor costs. Directors also recommended that the package of other labor reforms be crafted in a way that preserves the flexibility of Chile's labor markets.

In discussing the indicators of external vulnerability presented by the staff, some Directors observed that, in general, assets held abroad, and not just external liabilities, should be considered in assessing a country's susceptibility to adverse external conditions. This was particularly relevant in the Chilean case because of the country's large holdings of external financial assets. On this point, a number of other Directors suggested that, at times of financial turmoil, balances held abroad could not necessarily be counted on to meet external obligations.

Directors considered that the medium-term outlook for the economy was favorable, on the basis of the continued implementation of prudent monetary and fiscal policies, and of further advances with structural measures, including unilateral tariff reduction, capital account liberalization, privatization, and educational reform. They thought that Chile's comfortable level of international reserves, strong banking system, and increased exchange rate flexibility would provide a good buffer against external risks.

Chile regularly provides the staff with timely data that are broadly adequate for surveillance purposes. Directors welcomed the authorities' progress in clarifying the differences between official and BIS data on Chile's short-term external debt, and encouraged them to continue improving Chile's statistical base, especially in the fiscal and external areas.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. As part of a pilot project, the staff report for the 2000 Article IV consultation with Chile is also available.

Chile: Selected Economic Indicators

	1995	1996	1997	1998	Est. 1999	Proj. 2000
Real economy (annual percentage change) 1/						
Real GDP growth	10.6	7.4	7.4	3.4	-1.1	6.0
Unemployment (in percent)	7.4	6.5	6.1	6.2	9.7	...
Change in consumer prices (end of period)	8.2	6.6	6.0	4.7	2.3	4.0
Money and credit (year-end percentage change) 1/						
Broad money (M3)	27.4	22.0	13.0	8.5	5.2	13.3
Bank credit to the private sector	27.5	20.8	18.0	11.2	3.0	10.7
Three-month real interest rate 2/	6.1	7.3	6.8	9.6	6.0	...
External sector (in percent of GDP) 1/						
Trade balance	2.1	-1.6	-2.1	-3.5	2.5	0.8
Current account balance	-2.1	-5.1	-5.0	-5.7	-0.1	-2.4
Capital account balance 3/	3.7	6.8	9.2	2.9	-0.9	3.1
Overall balance of payments	1.6	1.7	4.3	-2.8	-1.0	0.7
Gross official reserves (in percent of short-term external debt 4/	286.2	347.6	496.4	403.7	376.9	215.1
External debt 5/	33.3	33.5	35.6	43.6	50.4	50.6
Real effective exchange rate (in percent change) 6/	1.2	4.0	9.7	-6.1	-6.3	...
Terms of trade (annual percentage change)	14.5	-15.5	2.6	-12.6	0.9	5.8
Copper price (U.S. cents per pound)	133.2	103.2	103.2	75.0	71.3	81.0
Public finances (in percent of GDP)						
Combined public sector balance	3.0	1.4	-0.1	-2.3	-3.6	-2.1
Central government balance	3.6	2.6	2.1	-0.1	-2.4	-1.0
Public enterprise balance	0.0	-0.5	-1.1	-1.1	-0.1	-0.3
Central bank balance	-0.6	-0.7	-1.1	-1.1	-1.1	-0.8
Memorandum item:						
Central government balance (official presentation) 7/	2.6	2.3	2.0	0.4	-1.5	-0.1

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

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

August 9, 2000

Statement by the Chilean Authorities

1. The Chilean economy exhibited a strong performance over most of the 1990's, with real GDP growth averaging 7.8 percent between 1990 and 1997, and inflation declining gradually from 27 percent to 6 percent. These positive results notwithstanding, Chile was not spared the contagion effects of the Asian and Russian crisis, which resulted in a sharp deterioration of the terms of trade and a decline in net flows of capital in 1998. This, coupled with a sharp surge of domestic demand, led to a further widening of the current account deficit causing recurrent pressures on the peso during the year. In response to these pressures, monetary policy was tightened significantly in 1998, while public expenditure was reduced to below budgeted levels, and the exchange rate was allowed to depreciate in real effective terms. As a result, real GDP growth slowed to 3.4 percent in 1998 with domestic demand growth decelerating from over 9 percent to below 2 percent, while inflation continued to decline. By year-end, domestic demand was contracting and unemployment had risen to close to 9 percent. This situation prompted the central bank to ease the stance of monetary policy starting in the fourth quarter of 1998, and the government to implement countercyclical fiscal measures in mid-1999. Fiscal impulse doubled to 1.5 percent of GDP in 1999, with the central government position moving from a surplus of 2 percent of GDP in 1997 to a deficit of 1.5 percent. Domestic demand contracted by 10 percent while GDP fell by 1 percent in 1999, reflecting also the effects of a severe drought and electricity rationing.

2. Output and demand growth turned positive in the second half of 1999, and preliminary figures point to output growth of over 6 percent in the period January-May 2000. The recovery in employment, however, has been somewhat slower than anticipated, because growth has been led by exports which are less labor intensive than other sectors linked to domestic demand, such as construction and commerce. The government has moved to accelerate the implementation of labor intensive projects, as they believe that it is just a matter of time for employment to recover as expected from the evolution of the cycle.

3. The Chilean government agrees with the thrust of the report prepared by the staff of the IMF. Therefore, we would like to complement the report by discussing in more detail the underpinnings of the economic policy that the new administration is putting in place. The economic policy is based on three pillars: The **first pillar**, is a conservative macroeconomic policy which is rules-based in the fiscal and monetary areas. The **fiscal rule** seeks to attain a 1 percent of GDP structural surplus for the central government from 2001 onwards, based on a measure of structural position defined by correcting for the state of the cycle and incorporating long-term copper prices. Defining the fiscal stance in this manner provides fiscal policy with a key countercyclical dimension. Although the level of public debt is low at 9 percent of GDP, the government has decided to achieve fiscal consolidation over a two-

year period to recover fiscal soundness, which has been one of Chile's main distinctive landmarks over the past decade and which, together with a sound financial system, has sheltered the economy from contagion in the past. This is particularly important as the turmoil in the international markets for emerging economies still continues as evidenced by the effects on spreads following the decline in the NASDAQ Index earlier in the year. The **monetary rule** seeks to maintain inflation in a 2-4 percent range, and the central bank will react whenever the inflation rate forecast, under the assumption of no change in the stance of monetary policy, within a 12 to 24 month horizon threatens to deviate from the middle of the band. This is a symmetric rule which is being implemented against the backdrop of a freely floating exchange rate, with no intervention by the central bank, in sharp contrast with monetary policy which is active. In the context of inflation targeting and a freely flexible exchange rate, the central bank has more degrees of freedom to pursue a countercyclical monetary policy even if external shocks push the economy into the opposite side of the cycle being faced by the world economy.

4. The **second pillar** of the economic policy is given by sound supervisory and regulatory frameworks, including that concerning the financial system. These frameworks are based on market-friendly regulations intended to foster competition in a number of areas, by setting the right incentives, including continuing to reduce import tariffs. The financial system is the showcase sector in this area, as discussed below.

5. The **third pillar** consists of bold social policies. Pillars one and two are instruments that will make possible the achievement of sustainable high rates of growth which will provide resources for the implementation of far-reaching social policies. Chile has attained a reduction in poverty levels that can be considered a world record, with the poverty rate being halved to 22 percent in just 11 years. According to a World Bank study, 80 percent of the reduction in poverty can be ascribed to growth. Growth results in an increase in employment and income and provides the fiscal sector with resources to level the playing field for the poor through public expenditure in health, education, training and technological enhancements.

6. In the fiscal front, as noted above, the government is engaged in a substantive effort to strengthen the public finances to attain a structural surplus of 1 percent of GDP for the central government from 2001 onwards, with no increase in taxes. This requires a tight control of public expenditure, which will increase about 4 percent in real terms over 2000-2001, therefore below the rate of growth of GDP. In other words, the consolidation of the public finances will come not only from riding the upside of the cycle but also, and more importantly, from structural improvements. These improvements are needed because the weakening of the public finances that occurred over the past few years was not just cyclical. Given that central government expenditure increased significantly faster than GDP in 1998-99, the budgetary gap will not close automatically with the resumption of growth in the short run. A further effort will be required in order to generate a structural adjustment in the government finances.

7. The strong fiscal adjustment, which has encountered resistance and has implied investing a significant amount of political capital by the new administration, is viewed by the administration as key to return to a sound macroeconomic position that creates the conditions for sustained growth. The question is why go to a surplus and not a small deficit that maintains the debt to GDP ratio constant, when government revenues are expected to increase as the cycle reverses? First, it is to be noted that this objective will be pursued against the backdrop of central bank losses, which are projected to amount to about 0.4 percent of GDP. Second, the proposed fiscal policy stance aims at increasing central government savings from 2 percent of GDP to 4-5 percent. It is to be noted that the substitution between public and private savings (as a ratio to GDP) is estimated at 0.50 compared with 0.73 assumed in the IMF report. Therefore public savings constitute a powerful device to increase domestic savings. This, in turn, is the key mechanism to reduce external vulnerability by maintaining the current account deficit under control. Furthermore, it is difficult to put in place incentives to increase private savings by the required amounts, because in a fast growing economy people tend to anticipate consumption, which is facilitated through increased financial intermediation. Consequently, it is essential to increase public savings to attain the savings necessary to finance the investment rate required to grow at 6 to 7 percent, which, in turn, is key to continue to reduce poverty as noted above.

8. It is worth noting that the fiscal effort implies an intergenerational distribution effect, as the present generation will finance public investment outlays that will impact favorably on future generations. This is an appropriate path to follow because the resolution of poverty cannot wait, and there is a need to contain external indebtedness to reduce vulnerability to external shocks. It has been argued that growth alone is not the answer to poverty resolution. Again let us reiterate that we do not favor the concept of trickle down at all. Growth provides the resources to finance bold social policies in the areas of education, training, health and judiciary reform, areas where the government has already embarked in important initiatives. These include among others, the extension of the school day, doubling the number of computers in schools, and providing health services in a more timely manner. These are key measures to improve income distribution over the medium-term.

9. It should also be noted that the government is strongly fostering fiscal transparency. We are starting to implement measures that should result in fiscal data that meets the highest IMF standards in three years time.

10. On labor issues, the administration considers that the unemployment insurance bill (already in congress) and the labor market reform (under discussion) will not impact adversely on labor market flexibility and consequently on private investment. These reforms have been discussed extensively with business associations and unions, and changes have been incorporated in the government proposals to reflect their concerns. In fact, because unemployment insurance is partially based on individual saving accounts and operates in the event of either voluntary or involuntary job separation, it will ease distortions arising from the severance payment scheme which depends on workers' tenure (e.g., biases turnover against low tenure workers and creates moral hazard to promote layoffs rather than voluntary

separation). Furthermore, the government has stated clearly that the primary objective of the reforms is to facilitate collective bargaining at the firm level rather than at the industry level.

11. Public enterprises in Chile are managed in a holding company by a decentralized agency and have a market orientation. Most of these enterprises are highly profitable and some will be traded in the stock exchange. Investment decisions are determined by profitability criteria as in the private sector. Consequently, in defining the stance of fiscal policy, it is appropriate to focus on the central government. Moreover, although the central bank losses are being taken into consideration to determine the size of the structural surplus of the central government that is required, they will not be included in the structural balance because they are highly unstable along the business cycle, and because the central bank does not provide financing to the central government. Focusing fiscal policy on the central government structural balance aims at having a measure of the fiscal stance that is transparent and clear. Fiscal policy is implemented and will continue to be implemented through the budget.

12. Regarding the establishment of supervisory and regulatory frameworks, the government's approach is to foster competition through market-friendly regulations. One key area is the capital account. In this regard, it is very important to note that although the administration has modified the approach taken on capital controls, it has not forsworn the past, meaning that the philosophy regarding the use of capital controls has not changed. We are now moving from second best policies to first best ones following a continuum of policies made possible by external and domestic developments, and based on empirical evidence which has shown that portfolio-equity flows are not as volatile as once believed. The Chilean experience has been that net portfolio-equity flows decline but do not reverse in the event of a crisis. Investors face large losses if they liquidate their positions as a result of a large depreciation of the exchange rate and high interest rates, so they weather the crisis staying in the country. This is not the case with short-term loans, which are very volatile. Measures implemented include the elimination of the one-year permanence requirement, while the unremunerated reserve requirement on capital inflows has been maintained at zero, remaining as a contingency instrument.

13. During the 1990's, capital controls were used to prevent overindebtedness and overspending and to change the composition of foreign financing towards less volatile flows, like investment and longer-term liabilities so as to reduce vulnerability. In a freely floating exchange rate system relative to the crawling band system implemented prior to September 1999, investors are more aware of the exchange risk, and there is some dampening of capital inflows as a result. This consideration of exchange risk notwithstanding, the bulk of Chile's foreign debt is dollar denominated, so the use of synthetic financial products, as has been promoted in Chile, serves the purpose of a better distribution of risk among the residents of the country, but the aggregate exchange risk of the country is not hedged. Conscious of this fact, we are putting in place incentives for the development of a market for local currency denominated instruments in the international capital markets. In this connection, tax treatment has been equated on interest paid for debt in dollars and in pesos (indexed or not), and the World Bank has issued indexed debt in pesos (UFs) which will help for

benchmarking. Moreover, there is a segmentation of the market as there are corporations that tap the external market directly with ADRs, due to the fact that the domestic stock exchange is not integrated enough with international markets. To promote further integration of markets, we intend to eliminate the tax on capital gains to non-residents, and further legislation to protect the rights of minority shareholders. It is important to deepen the domestic stock exchange while making it more liquid, so that small and medium-sized enterprises (PYMEs) can have access to financing through this market.

14. In sum, the administration is moving towards better targeted instruments in the area of capital account and prudential regulations, promoting the use of hedging to reduce the exchange risk. A devaluation would affect favorably the trade balance, but depending on the size of foreign currency liabilities there is also a negative effect on the balance sheets of banks and corporations. Consequently, there is a tension in the system. At the time of the Asian and Russian crisis, the central bank was forced to intervene to sustain the exchange rate, as there were mismatches in currencies, with the system being better prepared to deal with high interest rates than with a large devaluation. Although banks did not have a large open exposure in foreign currency, their clients did. In this connection, from May 11, 2000 banks and third parties have been authorized to trade forwards with foreign counterparts whenever Chilean currency is involved (pesos or UFs), and banks have been allowed to hedge credit risk associated with their fixed-income portfolio and commercial loans with residents, by making use of financial derivatives for both domestic and foreign currency.

15. External loans are very procyclical and there is a need to maintain a strict control of the open position of the banks, which cannot exceed 20 percent of capital and reserves. The Superintendency of Financial Institutions is working in establishing a system to ensure that the currency mismatch of corporations does not constitute a source of vulnerability for the banking system. The objective is to improve the transparency and the timeliness of information that corporations provide to banks, and to the financial market in general. Banks will now have to take into account currency mismatching of the clients in their pricing of risk. If the Superintendency detects that banks are pricing risk derived from currency mismatching incorrectly, it will move to impose additional provisioning. The administration intends to replicate the philosophy underlying the unremunerated reserve requirement in this manner, but not in an indiscriminate manner as before, but on the basis of actual risk.

16. While agreeing with the overall thrust of the report as noted above, we strongly believe that the advice given by the Fund staff in the report regarding the future level of the monetary policy rate (referred in the report as benchmark interest rate) is debatable and thus should be carefully qualified. Moreover, the expectations regarding developments in domestic demand on which the advice was based, failed to materialize and consequently, it became outdated. The central bank conducts monetary policy in a forward looking manner based on inflation prospects. Thus, the bank monitors economic conditions to assess their effects on inflationary pressures on the basis of a comprehensive forecasting model for inflation, and relays its findings to the market through the Monetary Policy Report and monthly statements. This is done on a continuous basis because conditions do change and, more importantly, conclusions on policy actions have to be modified as a result. In the more than three months that have

elapsed since the Fund staff was in Chile, domestic demand has clearly recovered at a slower pace than expected at that time, unemployment rates are higher than projected, and long-term interest rates have fallen by more than 40 basis points, signaling that the market is not expecting an increase in the monetary policy rate. Up to date core inflation remains in the lower part of the central bank's inflation target range (2.7 percent in May-June when using the IPCX measure which excludes perishables and fuel products; 1.6 percent using IPCX1 which excludes transportation costs), there are no signs of acceleration in core inflation measures or wages despite the increase in oil-related prices. There is no indication of a propagation effect of the increase in petroleum prices and the first round increase in transportation costs, which have been affecting headline inflation.

17. In the area of trade policy, the report is somewhat unbalanced because although it recognizes the openness of the Chilean economy, it does it in a perfunctory manner and focuses instead on the use of price-bands and safeguards, implemented in the face of a sharp decline in commodity prices in the last two years. These are mentioned several times throughout the report notwithstanding the fact that they relate to five agricultural products, have been imposed on a temporary basis, for a time period which is significantly less (maximum of two years compared with eight years) than allowed by the WTO.

18. Chile is an open economy, with an index value of 1 under the Fund's trade restrictiveness index, one of only 18 countries in the world in this category, and ranked second (behind Singapore) in the recently published Emerging Market Access Index for 2000 in The Economist (06/10/00, page 114). Chile's open trade regime and the efforts made through the unilateral tariff reduction program, despite the turmoil prevailing in world markets in the last two years, received little attention in the report, thus painting an overall negative picture. For example, it could have been noted in the report that given the bilateral agreements negotiated by Chile, the actual average tariff is even lower than 9 percent (on a trade-weighted basis). Also, the fact that by 2003 Chile's uniform tariff will be 6 percent is not even mentioned in some parts of the report, or not enough emphasis given to the fact that Chile's tariff will fall by 45 percent (from 11 to 6 percent).

19. Moreover, the price-band scheme is not a new policy. It has been in place for more than 15 years. Its purpose is to reduce the adverse impact of instability in world prices of sugar, wheat and vegetable oils. The current levels of the tariffs reflects a sharp decline in these prices over the past two and a half years, and are not permanent. As international prices for these commodities rise, the tariff levels for these products will fall. To the extent that lower international prices continue to prevail, the tariff levels will also decline.

20. Also, two assertions made in regards to the price-bands and safeguards are contestable. First, that the high tariffs resulting from the price-band scheme caused a misallocation of resources. How would temporarily high tariffs lead to a misallocation of resources? Shouldn't producers respond to permanent changes in tariffs? Second, that such tariffs have caused undesirable income distribution effects. A significant number of the producers protected by the price-band scheme are small and medium producers with no access to other mechanisms to protect them from sudden and sharp price declines. So although important

food items are covered by the price band, the income distribution effects are in principle ambiguous. However, we recognize that without proper research no definite conclusions can be provided. Incidentally, in spite of the actual tariff levels, the domestic price of sugar in Chile is one of the lowest domestic prices of the world. This suggests that, if anything, protection in Chile is lower than in most countries

21. On the issue of the discrepancy regarding official data on short-term debt with creditor data prepared by the BIS, the central bank is making efforts to reconcile the existing differences. The discrepancies have already been reduced significantly by identifying that the BIS numbers include credit in foreign currency that branches of foreign banks extend to their clients in Chile, which is not foreign debt. Further narrowing of the differences requires quantification of Chilean securities held by foreign commercial banks so as to avoid double counting, and to estimate trade-related credits. We question also if the definition used to estimate these liabilities does in practice correspond to international standards. In particular, this question arises from the fact that under Fund-supported programs it is customary to exclude trade related credits from the definition of short-term debt for the purpose of establishing performance criteria. These liabilities arise in the conduct of trade operations, and are not viewed as increasing the vulnerability of a country, but just the opposite if they reflect an opening of the economy to international trade.

22. Two other issues merit attention. One is the methodology used to calculate the vulnerability indicators on external debt. As mentioned in the discussion of debt and reserve indicators of external vulnerability, by failing to take into account the net liability position of the private sector, i.e. foreign assets as well as liabilities, the report concludes in Box 3 that Chile's least favorable indicator might be the level of external debt and point to the fact that it has been rising rapidly relative to GDP over the past few years. Although the report notes that the external debt ratios should be considered against Chile's foreign assets, it does so in the context of concluding that the more important issue may not be the solvency of the economy as a whole, but the monitoring of the foreign exchange exposure of individual agents in the private sector. In our view, the conclusion should be that in a globalized world where financial markets have become more integrated, the normal path followed is that the private sector acquires both assets and liabilities abroad. Consequently, efforts should be made to gather information on assets to obtain a correct assessment of the vulnerability stemming from the debt indicators. Proceeding in this manner also is the only way for constructing indicators that allow comparability among countries.

23. The second issue refers to the pension system. The Chilean pension system has been used as an example by many countries. Despite this recognition, the system requires some adjustments in order to improve efficiency. In particular, investment policy regulation needs to be updated to allow for greater flexibility in portfolio management and limit herd-behavior, maintaining appropriate risk regulations. Regulations should also foster enhanced competition in the system in order to decrease administration costs. Finally, reforms are needed to improve the functioning of the annuity market and increase the coverage of the system.

24. In concluding, we want to convey our appreciation to the Fund staff for a very good set of papers and interesting and useful discussions, including on the topics reviewed in the Selected Issues paper.