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Chile: 2006 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Chile

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation with Chile, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 26, 2006, 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 July 11, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of July 26, 2006 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its August 2, 2006 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Chile.

The document(s) listed below have been or will be separately released.

Selected Issues Paper

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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CHILE

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the
2006 Consultation with Chile

Approved by Markus Rodlauer and Adrienne Cheasty

July 11, 2006

- The 2006 Article IV consultation discussions were held in Santiago during May 15-26, 2006. The staff team comprised Mr. Terrier (head), Ms. Karasulu, Mr. Walsh, Ms. Tsounta-EP (all WHD), and Ms. Holland (MFD). Messrs. Singh and Rodlauer (both WHD) participated in the policy discussions.

- The mission met with Minister of Finance Velasco, Central Bank President Corbo, Minister of Labor Andrade; Economy Minister Antonijevic; other senior officials; and labor union and private sector representatives. Drafts of the Selected Issues Papers were discussed in a seminar.

- Ms. Bachelet, the candidate of the *Concertación* coalition, was elected President for a four-year term in January 2006. In the December 2005 congressional elections, the *Concertación* coalition also won a majority of seats in both chambers of congress.

- In previous consultations, the Fund commended the Chilean authorities for their continued implementation of sound policies, centered on a prudent fiscal rule, the inflation targeting framework, and trade liberalization. They noted that these policies, together with a robust and deep financial system, have led to sustained economic growth and contributed to a marked reduction in poverty. Prudent policies have continued to be implemented since the last Article IV consultation, in line with the recommendations of Executive Directors. In the fiscal area, higher copper revenues have been sterilized and the overall surplus of the government has been used to selectively prepay debt and accumulate financial assets.

- Chile maintains an exchange rate system free of restrictions on payments and transfers for current international transactions and has accepted the obligations of Article VIII, Sections 2, 3, and 4 (Appendix I).

EXECUTIVE SUMMARY

Structural reforms and prudent economic policies have helped anchor Chile's successful economic performance over the last one-and-a-half decade. Fiscal restraint, including under the structural surplus rule since 2000, prudent monetary policy in the context of the inflation targeting framework and a freely floating currency, a sound and deep financial system, and an outward-looking trade policy have provided Chile with enviably high rates of economic growth and low inflation.

President Bachelet's administration, which assumed office in early March, has reaffirmed its support for the current macroeconomic framework. The new administration has announced that it would abide by the structural fiscal surplus rule of 1 percent of GDP, while announcing plans to strengthen social services and undertake a comprehensive reform of the private pension system.

The authorities are cognizant of the need to gear macroeconomic policies toward managing the copper boom. Since 2003, the price of copper, Chile's main export commodity, has more than tripled. Consistent with the structural surplus rule, and in line with projected copper prices, the central government would register an overall surplus of close to 6 percent of GDP in 2006. In 2007, an expected increase in the copper reference price would accommodate higher fiscal spending under the structural surplus rule, but the authorities are firmly committed to keeping the rate of growth of such spending at a moderate level.

The government has sent a bill to congress to establish rules for investing and managing the fiscal surpluses. The draft bill envisages using part of the surpluses to invest in a pension fund and to gradually recapitalize the central bank, and to lodge any remaining surpluses in a newly-created Fund for Economic and Social Stabilization (FESS). The FESS will be allowed to invest its assets abroad, to help alleviate upward pressure on the currency.

The central bank is planning to continue gradually removing monetary stimulus. The central bank considers the policy rate, set at 5 percent since April 2006, below the neutral rate and projects the output gap to close in 2007. However, in light of a recent slowdown in economic activity, further interest rate hikes would be largely data-dependent, particularly with respect to core inflation, non-mining output growth, and the possibility of additional fiscal stimulus in 2007.

Improving Chile's private pension system is one of the main priorities of the government. The government has appointed a commission to formulate proposals on the five main following issues: low density of contributions; coverage of the social pillar; lack of competition in the system; rules governing the investments of the funds; and how to increase the participation of women. The commission is expected to report by early-July to an interministerial committee which will draft reform legislation. The congressional process is expected to take place in 2007.

I. BACKGROUND

1. ***Structural reforms and prudent economic policies have helped anchor Chile's successful economic performance over the past fifteen years.*** Fiscal restraint, independent monetary policy, a sound and deep financial system, and an outward-looking trade policy have provided Chile with enviably high rates of economic growth and low inflation. During the 15–year period through 2005, its rate of economic growth averaged 5½ percent a year, per capita income tripled in U. S. dollar terms, and the poverty rate was cut in half, to about 18 percent.[1] Income inequality, however, remains high.

2. ***Following a sharp slowdown during 1998–2003, Chile has returned to a path of strong economic growth.*** In 1998, a sharp drop in the terms of trade, combined with the impact of global financial turmoil, initiated a prolonged period of slow growth and led to a jump in the unemployment rate. This was compounded by a sharp increase in domestic interest rates, which contributed to a contraction in consumer spending. With the improvement in the global economy and the rise in copper prices since late 2003, economic growth has rebounded in recent years, from 2½ percent a year on average during 1999–2003 to 6¼ percent during 2004–05. This recovery also testifies to the credibility of Chile's consistent policy framework and to the strength of its institutions.

3. ***Since 2003, the price of copper, Chile's main export commodity, has surged to record-high levels.*** Chile is the world's largest copper producer, with one third of global supply (the copper sector accounts for 15 percent of Chile's GDP and over 40 percent of its total exports). Copper prices rose from US$0.8 a pound on average in 2003 to US$3.7 in May 2006, but have eased somewhat, to US$3.5 in mid-July 2006. The strength in prices has been driven in part by an increase in world demand (particularly from China), capacity constraints, low inventories, and a worldwide shift in financial investments toward commodities.

4. ***President Bachelet's administration, which assumed office in early March, has reaffirmed its support for the current macroeconomic framework***. Upon taking office, the new administration confirmed that it would abide by the structural surplus rule of 1 percent of GDP, but also announced its intention to strengthen social services and to undertake a comprehensive reform of the private pension system.

5. ***Against this backdrop, the 2006 consultation discussions centered on three key issues:*** (a) the appropriate policy mix, given the current stage of the economic cycle and the social spending plans of the government; (b) how to manage best the copper boom; and (c) how to help ensure long-term sustained growth.

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[1] See companion Selected Issues Paper on The Experience of Poverty Reduction in Chile.

II. Recent Developments

6. ***Since mid-2005, Chile's rate of economic growth has moderated, reflecting a slowdown in investment.*** Annualized quarterly GDP growth has slowed to about 4 percent since mid–2005 (Figure 1). Domestic demand remains the main driver of economic growth but, after a surge in 2004–05, the rate of investment growth has sharply decelerated while consumption continues to be strong. Year-on-year real GDP growth was 5.1 percent in the first quarter of 2006.

Figure 1. GDP and Determinants of Growth

Contribution to GDP growth (ctg) from investment, total consumption and net exports vs. copper prices

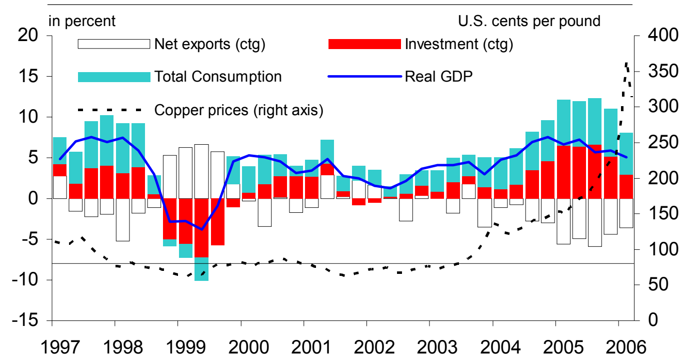
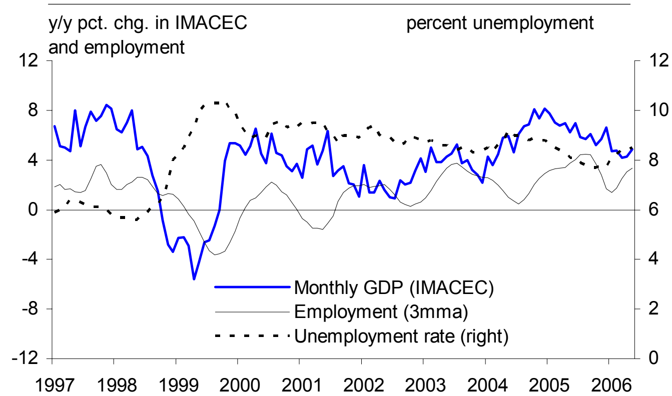
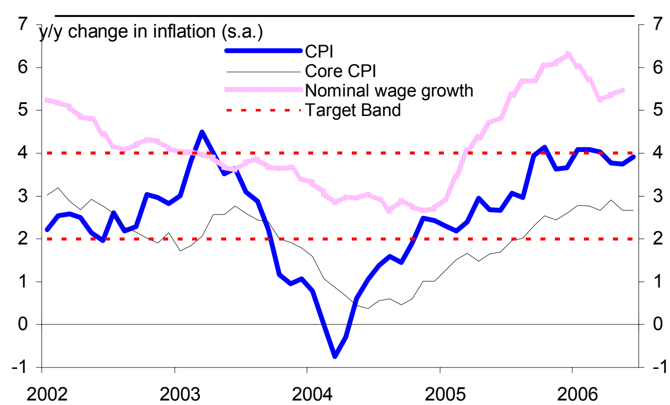


Figure 2. Real GDP and Labor Market developments



7. ***The unemployment rate has dropped to its lowest level since 1999, but it remains above the level of the last economic expansion (Figure 2).*** Employment has increased sharply since end–2003, registering a cumulative increase of 8½ percent through end-May 2006. Nevertheless, the unemployment rate has continued to hover around 8 percent in seasonally-adjusted terms (near the top of the central bank's estimate of the NAIRU), with still high unemployment among the young (close to 20 percent). Since mid-2005, the 12–month rate of wage increase has been close to 5¾ percent in nominal terms (Figure 3).

Figure 3. Trends in CPI Inflation and Wages

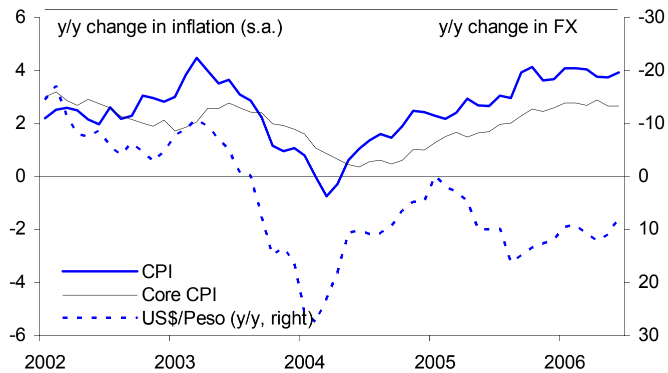


8. ***Headline inflation has moved to the upper limit of the target range, primarily reflecting higher energy prices.*** Since the beginning of 2003, the Chilean peso has appreciated by 25 percent in nominal terms against the U.S. dollar and by 22 percent in real effective terms (Figure 4). Despite this

appreciation, 12–month headline CPI inflation rose steadily during 2005, moving at the top of the central

bank's 2–4 percent target range in the first quarter of 2006. Part of this increase was driven by petroleum and nontradable goods prices. Headline inflation was 3.9 percent in June 2006, with narrowly-defined 12-month core inflation (excluding perishables, energy, and regulated prices) at 2.7 percent (up from 1.7 percent a year earlier).

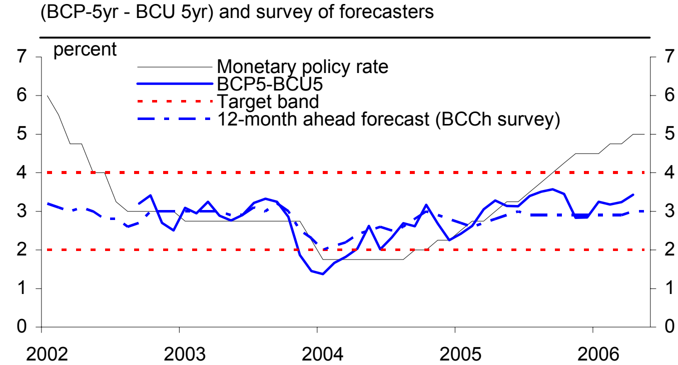
Figure 4. CPI Inflation and the Exchange Rate
Components of inflation vs. the exchange rate



9. ***In 2005, the external current account surplus narrowed from 1½ percent of GDP in 2004 to ½ percent of GDP.*** Driven by the rise in copper prices, Chile's terms of trade improved by 12½ percent, on top of a 21 percent increase in 2004. Despite the appreciation of the peso, non-mining exports have continued to grow strongly, albeit at a slower pace than in the previous year (volume rose by 10 percent in 2005). These factors were more than offset by a drop in mining export volume (by 3 percent from 2004, a year during which exports had been boosted by inventory sales) and a sharp rise in imports (21 percent in volume terms).

10. ***Chile has continued to adhere strictly to a sound macroeconomic framework***. Consistent with the structural surplus rule and copper price levels, the central government registered an overall surplus of 4¾ percent of GDP in 2005, up from 2¼ percent in 2004. The surplus was used by the government in broadly equal amounts to prepay debt and increase its liquid asset holdings. The central bank continued to manage monetary policy prudently, in the context of the inflation targeting framework. Since September 2004, it has raised its policy rate by a total of 325 basis points, to 5 percent, in response to the economic recovery and a gradual closing of the output gap (Figure 5). Since April 2006, it has kept the policy rate unchanged, citing the deceleration in growth, moderation in trend inflation, and well-contained inflation expectations. The authorities view present monetary conditions as still somewhat expansionary, with the policy rate at about 1 percent in real terms.

Figure 5. Monetary Policy and Inflation Expectations
Policy rate vs. expected inflation measures: market-based (BCP-5yr - BCU 5yr) and survey of forecasters



11. ***Vulnerability indicators have continued to improve, reflecting strong economic growth and the strengthening of the fiscal position.*** The ratio of net public sector debt (including central bank debt) to GDP fell from about 13 percent in 2003 to 7½ percent in 2005; over the same period, gross public sector debt declined from 44½ percent of GDP to 31½ percent. Private sector indebtedness abroad fell sharply (by 15 percentage points), to close to 31 percent of GDP at end–2005. Gross official international reserves, at US$17 billion (15 percent of 2005 GDP), are equivalent to close to 110 percent of Chile's short-term external debt, covering close to five months of imports of good and services.

12. ***The recent correction in emerging market assets had a limited impact in Chile, confirming the resilience of the economy.*** In June, the Chilean peso depreciated by almost 3 percent against the U.S. dollar and the stock market fell by about 1½ percent, both from elevated levels. Chile's sovereign spreads, however, tightened slightly, to around 80 basis points, in contrast to the widening in Latin America EMBI spreads.

III. Outlook

13. ***The outlook for Chile is positive, reflecting strong prospects for copper and robust domestic demand.*** Global demand and the improvement in the terms of trade are expected to support investor and consumer confidence, underpinning strong domestic demand. Real GDP is projected to grow by 5-6 percent in 2006–07, as the economic cycle matures, and inflation is projected to gradually return to the middle of the inflation target range. Reflecting the impact of higher copper prices, the central government is expected to register a surplus of close to 6 percent of GDP in 2006, while the external current account surplus would widen to about 2 percent of GDP.

14. ***The risks to the outlook appear broadly balanced.*** Global imbalances remain at elevated levels, carrying the risk of a disorderly adjustment and a sudden reversal in investor sentiment. Disruptions in the supply of natural gas from Argentina and further increases in oil prices could also negatively impact growth in Chile. On the upside, the continued strength of global growth could push economic growth in 2006–07 beyond current projections.

- ***Global and regional risks.*** A disorderly adjustment in global imbalances and increased uncertainty about interest rates in the U.S. could weigh more heavily on emerging market assets than the recent sell-off, lead to a pronounced drop in commodity prices and available financing, and negatively impact growth. Regional political developments could also reduce investors' appetite for Latin American risks and affect capital flows. Chile enjoys an investment grade rating and should, in principle, be sheltered from such developments, but its asset prices have in the past shown a close correlation with regional movements, especially in Brazil.[2]

- ***Energy.*** Disruptions in the supply of gas from Argentina and further oil price increases could put pressure on production costs and weigh down economic growth. Since 2004, Argentina has reduced its gas exports to Chile. Gas cuts in the second quarter of 2006 were close to 40 percent on average, up from 30 percent during the same period last year. Although these cuts have not thus far had a major impact on economic growth, there is a risk that deeper cuts could materialize. These risks are somewhat mitigated by the fact that three-fourths of Chilean firms that use gas in their production process have already converted their plants to alternative sources of energy. Staff estimates that the effect of further increases in oil prices would be moderate (e.g., a 10 percent increase above the baseline scenario could reduce GDP growth by a ¼ of a percentage point).

- ***Copper prices.*** Low stocks and little recent capacity expansion have combined with rising demand, especially from China, to raise copper prices to record levels. Speculative capital has flowed into copper as well, increasing volatility and the risk of a sudden price correction. However, analysts expect market conditions to continue supporting high prices, at least in the near-to-medium term.

IV. Report on the Discussions

15. ***Discussions took place against the backdrop of the surge in world copper prices.*** With the economy close to full potential, discussions focused on how best to manage this stage of the cycle, at a time when the tightening of monetary policy was being gradually felt through the economy. The authorities considered that one of the main challenges for economic policy was how to deal with the copper boom, which they considered temporary. They noted that the attendant increase in government revenue would boost spending pressures at a time when the output gap was closing. However, they were committed to avoid placing excessive pressure on resources and, to that effect, to limit aggregate demand growth. To further help alleviate upward pressure on the currency and avoid Dutch disease effects, the authorities announced their intention to lodge abroad part of the financial assets accumulated by the government.[3]

[2] Chile’s sovereign spreads remain the lowest in the region. In July, Moody’s upgraded Chile's foreign currency sovereign rating from Baa1 to A2, one of only three investment-grade ratings in Latin America.

[3] As of April 2006, the government had accumulated US$6 billion in assets, of which US$3.8 billion were invested abroad.

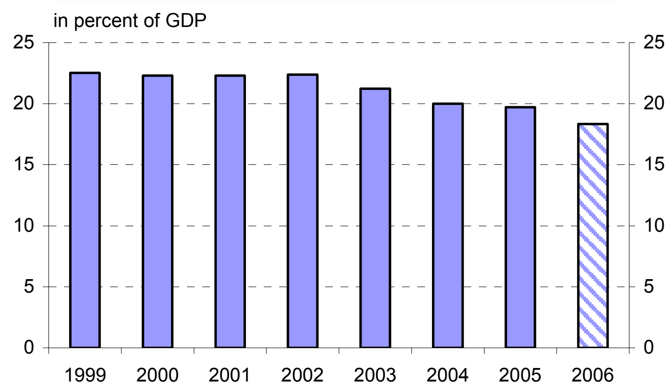
16. ***A key question for Chile is how to help ensure long-term sustained economic growth***. The potential rate of growth is estimated at around 5 percent a year, with trend productivity growth estimated at ½–1 percent, significantly slower than its 2 percent annual growth observed during the 1990s. Increasing long-term productivity growth will require the adoption of structural reforms to improve competitiveness, skills, and economic efficiency at the microeconomic level. Economic growth would also benefit from labor market reform to combat still-high unemployment rates, particularly among the young, and improve labor force participation by women, which remains low by international standards.

Macroeconomic policy mix

17. ***The gradual tightening in monetary policy has helped moderate pressures on resources.*** Most analysts were of the opinion that the output gap was gradually closing, but there were differences of views on its timing. Central bank staff considered that the gap would close by early 2007, while some private analysts thought that the large investments undertaken in 2004–05, together with the significant increase in labor force participation, would push the closing of the gap into the future. Given the paucity of data on labor costs and on resource pressures more generally, it was difficult to assess with precision the extent to which the recent increase in various measures of inflation reflected capacity constraints.[4] The staff considered that the increase in headline inflation mostly reflected the pass-through from oil price increases, and that the upward trend in core inflation signaled a mean-reversion to its well-anchored level of 3 percent, after a drop in 2004 caused by a sharp appreciation of the peso.

18. ***Fiscal policy remains guided by sound principles (Figure 6).***[5] Beginning with the 2006 budget, the structural surplus rule has been amended to smooth out the impact of higher copper prices on revenue collections accruing not only from the state copper company CODELCO but also from private mining companies.[6] Molybdenum receipts from CODELCO are also now included in the computation of structural revenue, based on the

Figure 6. Central Government Expenditure



[4] A new labor survey, in operation since January, created a break in the series, complicating assessment of labor market conditions since then.

[5] For a description of the structural surplus rule, see Country Report No. 05/315.

[6] Corporate tax collections from private mining companies rose from less than US$0.3 billion in 2003 to US$1.7 billion in 2005.

average price observed in previous years. These changes have helped reduce the cyclicality of fiscal spending. In the year to April, spending by the central government rose by 5.5 percent in real terms over the same period in 2005, below the budgeted increase of 6.3 percent, while higher copper revenues boosted the surplus to 3.8 percent of annual GDP.

19. ***In the period ahead, the authorities are committed to keeping the rate of growth of fiscal spending at moderate levels.*** The authorities noted that social spending, particularly in health and education, would rise in 2007 and in subsequent years, consistent with the program of the new administration. However, they also reaffirmed their commitment to the fiscal surplus rule of 1 percent of GDP and emphasized the importance of moderation in expenditure growth, to avoid aggregate demand pressures at a time when the output gap was closing. They recognized that the long-term copper reference price, to be announced by the Copper Committee in July, would be critical to the 2007 fiscal stance, and expressed their confidence that the Committee would be conservative in its assessment.[7] The authorities also noted that the envisaged medium-term increases in social expenditure, planned before the recent upswing in copper prices, were consistent with such a conservative assessment. They also shared staff's view that care should be taken to avoid too sharp an increase in recurrent spending, to avoid creating fiscal rigidities in subsequent years. To that effect, they intended to give priority in the 2007 budget to non–recurrent outlays and the purchase of tradable goods.

20. ***Buoyant fiscal revenues offer an opportunity to reduce distortionary taxes.*** Staff noted that the stamp tax, which is paid every time a debt security is issued or a bank credit is extended, constitutes an impediment to efficiency in the financial system. It recommended equating the incidence of the tax across maturities and eliminating it for some operations, including on-lent bank borrowing from abroad. The authorities acknowledged the possible efficiency gains from a modification, including through higher competition in the banking sector, but noted that revenue collections from the tax were significant (0.6 percent of GDP in 2005). As a first step, they planned to eliminate the tax for the refinancing of loans (a measure already in place for mortgage loans since 2003) and indicated that they might consider other changes at a later stage. They also planned to send a bill to congress to simplify the tax regime for small and medium enterprises. The mission also suggested eliminating the small tax on electronic transactions and checks, to help widen access to banking services.

21. ***The central bank plans to continue gradually removing monetary stimulus.*** The authorities and staff concurred that the recent slowdown in economic activity reflected a weakness in supply, driven by specific factors which included the adverse effect of poor weather conditions on agriculture, and that macroeconomic policies could do little to offset

[7] The 2007 budget will include interest on accumulated fiscal surpluses as structural revenue, allowing for an up tick in expenditure. Beyond this, expenditure increases are expected to remain broadly in line with GDP growth.

this. The central bank considered that the policy rate, set at 5 percent since April 2006, remained below the neutral rate. The authorities and staff agreed that such further moves would be largely data-dependent, particularly with respect to new data on core inflation, nonmining output growth, industrial production, and capital good imports. The monetary stance would also need to take into account, if needed, the possibility of additional fiscal stimulus in 2007.

22. ***Chile's economic data are generally of good quality, but there is room for improvement, particularly with respect to the CPI and labor cost components.***[8] The authorities indicated that steps were underway to expand the CPI survey sample outside Santiago, and saw merit in staff's suggestion to undertake a new household expenditure survey and use hedonic price analysis to take into account changes in the quality of goods and services. In the area of labor cost statistics, the mission suggested that the recently overhauled establishment survey may need to be reviewed to ensure data quality with respect to compensation and hours worked. The mission also noted that, while aggregate expenditure data collected by the Central Bank were timely and comprehensive, data on inventories could be improved to help distinguish better between persistent consumption shifts and transitory stockpiling increases. The authorities and staff agreed that such changes, which would require significant investments in time and labor, would bring considerable dividends.

Managing the copper boom

23. ***The Chilean macroeconomic framework is sound and has grown increasingly effective at managing external shocks.*** Since the late 1990s, the introduction of the fiscal rule, inflation targeting in the context of a floating exchange rate, and trade openness have significantly enhanced the resilience of the economy. In addition, the financial system is solid and has deepened further in recent years, particularly with the development of the bond and derivatives markets, improving the capacity of the economy to absorb shocks. Well-designed social policies have also helped ensure policy sustainability in the face of continued high income inequality. There is room to strengthen some areas of policy, however, and this has been highlighted by the unprecedented size of the current copper boom.

24. ***The mission welcomed the authorities' commitment to continue letting the peso float freely, despite renewed pressures to intervene in the foreign exchange market.*** Since 2003, the peso has appreciated by 22 percent in real effective terms, and some sectors of the economy have called for the central bank to intervene in the foreign exchange market. The central bank has reaffirmed its position that it would only intervene if the following three conditions were met: (i) there is evidence of a misalignment of the currency; (ii) such a misalignment impacts negatively on economic activity; and (iii) intervention has a good

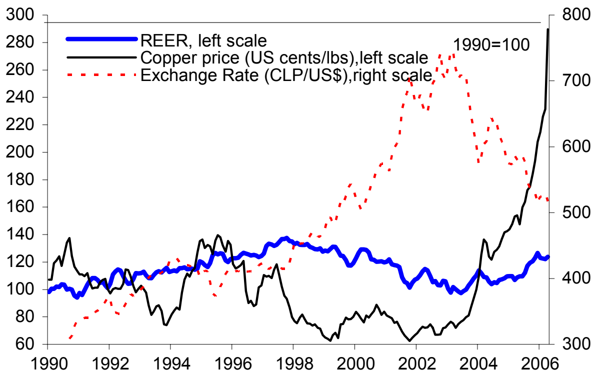
[8] See companion Selected Issues Paper on Improving Data and Procedures Used in Current Analysis and Forecasting at the Central Bank of Chile.

chance of success at correcting the misalignment. The authorities did not think that any of these conditions were met, and reaffirmed their plans to let the peso float freely. Staff shared the central bank's view, noting that this policy has enhanced the development of a deep and efficient market for hedging foreign exchange rate risks. In addition, the peso does not seem out of line with long-term trends (Figure 7) and the growth of nonmining exports has remained strong, an indication that the level of the currency is not hurting competitiveness.

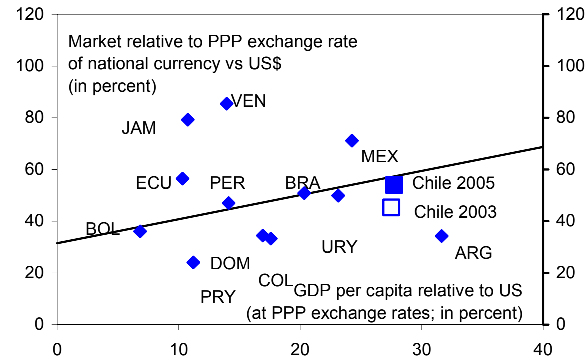
25. ***The authorities' decision to define a policy for investing the fiscal surpluses is sound***. The government has recently sent a bill to congress to establish rules for investing and managing the fiscal surpluses:

Figure 7. International Competitiveness

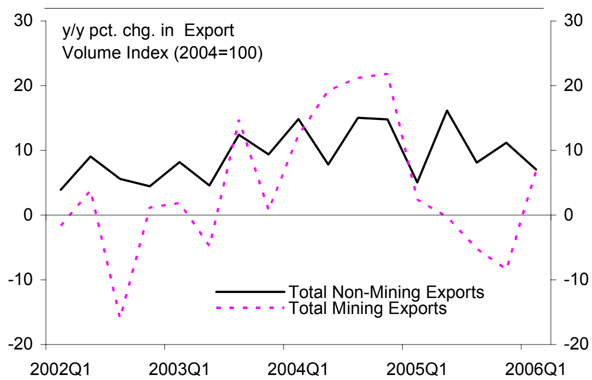
The real appreciation of the peso since 2003 is less than in other copper price booms...



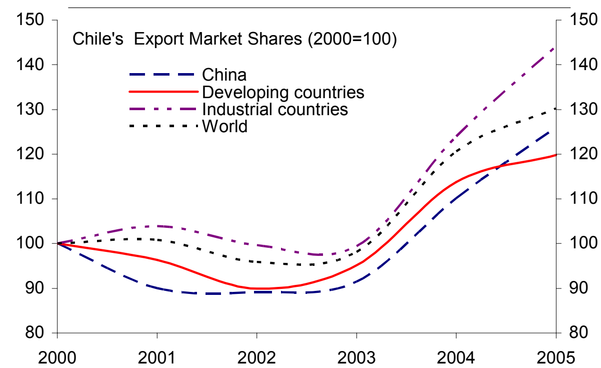
...and is in line with long-term fundamentals as indicated by the relationship between PPP real exchange rates and per capita GDP levels



...allowing non-traditional exports to continue performing well



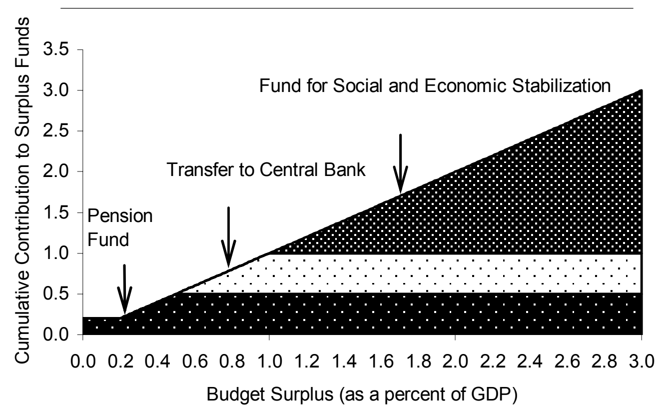
...and improving export market shares globally.



- ***Pension fund***. Each year, at least 0.2 percent (and, should the cash surplus allow, up to 0.5 percent) of previous-year's GDP would be invested in a pension fund aimed at covering future pension liabilities of the government (Figure 8). The amounts in the fund would remain locked for a 10–year period; its investment policies would be guided by the same regulations that apply to private pension funds, which are currently allowed to invest up to 30 percent of their assets abroad.

- ***Central bank recapitalization***. Additionally, up to 0.5 percent of GDP would be assigned to the gradual recapitalization of the central bank for each of the next five years, covering

Figure 8. Use of Prospective Fiscal Surpluses



about half of its total recapitalization need. Although staff pressed for an upfront recapitalization of the central bank, the government explained its choice of a gradual approach by the need to take political constraints into account. The central bank plans to use the funds to build up its foreign reserves.

- ***Fund for Economic and Social Stabilization (FESS)***. Finally, all remaining surpluses would be lodged in a newly-created fund, the FESS. This fund would operate in a transparent manner and, to that effect, the government plans to inform the public on the composition of its assets on a quarterly basis. It will be allowed to invest its assets abroad, with a view to helping alleviate upward pressure on the currency. The guidelines would initially allow foreign investment only in government and high-grade corporate bonds. The authorities and staff agreed that investments could become more diversified in the future, including with investment in equities.

Boosting Long-Term Growth

26. ***Boosting long-run total factor productivity growth is a major challenge for Chile.*** This will require building on the existing strengths of the Chilean economy through greater efficiency in the financial sector, further enhancements in human capital through education and Research and Development (R&D), and reforms to increase labor productivity. A cross-cutting theme is the need to step up competition in the economy. Efficiency improvements in the labor and financial markets will contribute to this goal, but the authorities explained that they were also taking steps to strengthen competition policy, with a view to reducing conflicts of interest in corporate governance, increasing fines for antitrust violations while tying them to damages, and protecting whistleblowers.

Reforming the pension system

27. ***Improving Chile's privatized pension system is one of the priorities of the government.*** Since their creation in 1981, private pension funds have grown to manage around US$68 billion in assets, equivalent to three-fifths of Chile's GDP. A commission has been appointed by the government to hear from specialists and a wide spectrum of society about their concerns on the pension system, discuss possible areas of reform, and develop specific proposals. The commission will report by early-July to an interministerial committee which will draft reform legislation, expected to be sent to congress by late 2006 (Box 1). The

Box 1. Chile: Pension Reform

The commission has been charged with formulating responses to five main issues: low density of contributions; coverage of the social pillar; competition; rules governing the investments of funds; and how to increase the participation of women.

Chile's pension system suffers from low density and contribution rates, particularly among the young and the self-employed. While the system currently does an exemplary job at providing for the retirement of workers spending their adult lives in formal employment, various studies have shown that retirement income is uncertain for part of Chile's workforce. Many workers, particularly young and informal-sector workers, do not understand the need to save in a private account, and education in this area has been neglected. Many self-employed workers are in the formal sector, but increasing their participation (currently only 5 percent participate in the pension system) would require addressing differences in taxation and benefits between the self-employed and others.

The current system does not provide a sufficient safety net for the poor elderly. The pension system was designed to provide a minimum benefit to participants after at least 20 years of participation. A welfare pension is available to the very poor, but eligibility is based on broad assistance-program requirements and takes into account other considerations than income; the minimum pension guarantee is tied only to years of contribution, not need. The commission is researching ways to tie old-age security more closely into the pension system, such as by changing the eligibility requirement for a minimum pension from a time basis to a financial threshold, which would benefit the self-employed and temporary workers (their contributions are not frequent enough to achieve the 20-year minimum record). Any increase in government support for this pillar is likely to be costly, and observers expect this to be funded from general revenue, rather than an additional "solidarity contribution" from workers or employers.

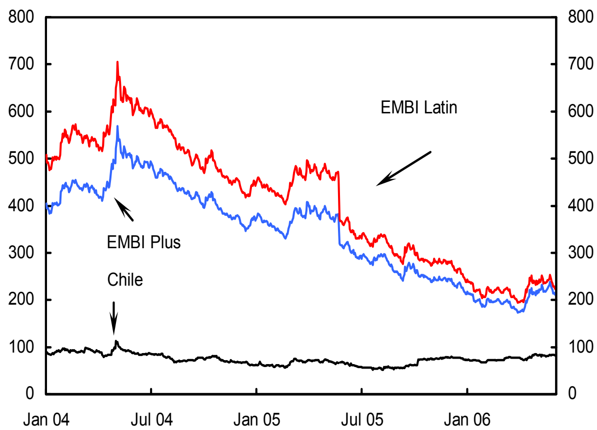
The Chilean pension-fund industry has become monopolistic. The need for a sales force, marketing, and sizeable front- and back-office operations has created significant economies of scale. The commission is analyzing proposals that would reduce costs by separating the management of investments from the administration of accounts. However, studies have found that Chilean workers do not respond elastically to private pension fees (estimated at 2.4 percent of wages). Other proposals include effectively auctioning the accounts of groups of workers (sorted possibly by age or occupational category) to pension funds, allocating new workers to the lowest-cost funds, or restricting the ability of workers to move into higher-cost funds.

Rules for investment of pension-fund assets are generally seen as too restrictive. Complex restrictions on portfolio risk, foreign investment, and asset allocation have combined to depress overall returns and reduce the variance among funds' returns. The commission is looking at streamlining the more than ninety limits and sub-limits that govern investments in order to increase the funds' ability to respond to market conditions and at codifying the rules as administrative regulations, to improve flexibility.

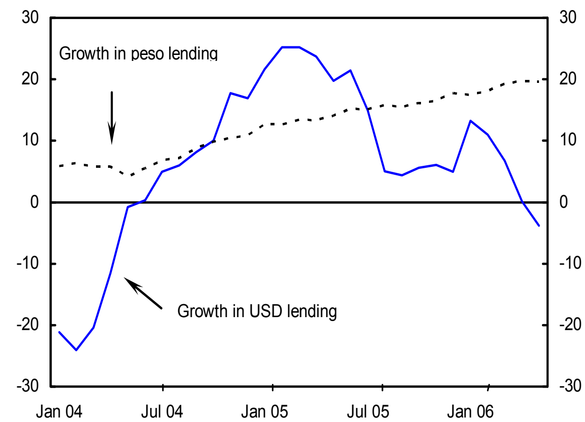
Women gain much less than men from the pension system, due to a confluence of issues. Lower wages, more informal employment, childbearing responsibilities, earlier retirement ages, and longer life spans combine to reduce the retirement earnings of women under the current system. Proposals to address the gender disparity in pension earnings focus on the need to encourage more years of contribution for women, for example, by delaying the retirement age (currently, about 60 percent of workers retire early; the average retirement age for women is 54 years and 57 for men), making early retirement less attractive, or subsidizing the pension contributions of mothers. President Bachelet has announced other measures to encourage higher female workforce participation, which may help mitigate the problem.

Figure 9. Chile: Financial Market Developments

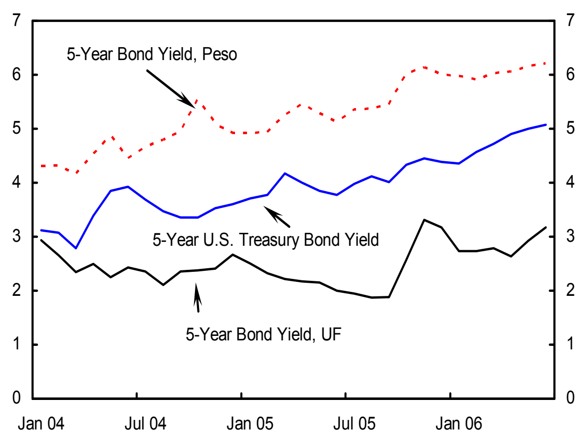
Sovereign spreads in Chile remain well below regional levels.



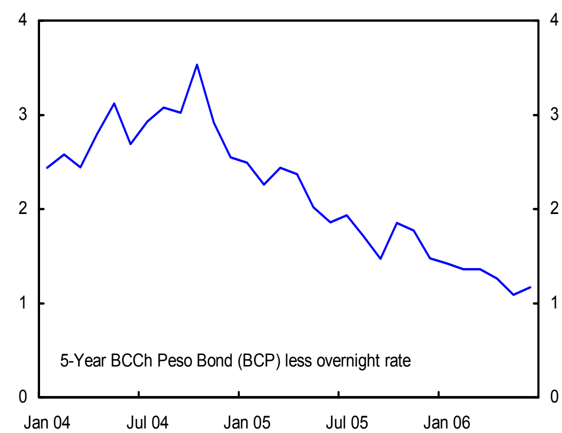
Bank lending has grown steadily since the economic recovery began in 2003.



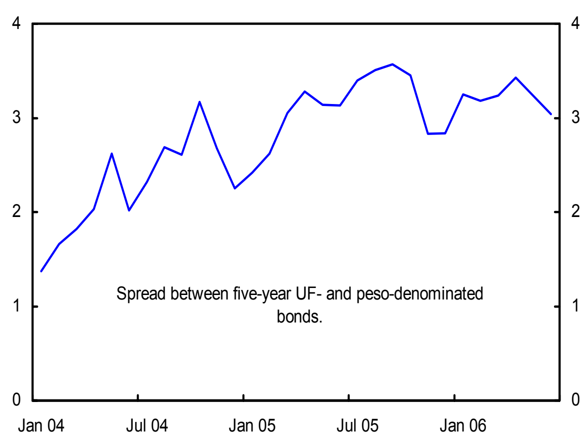
Medium-term interest rates have been rising, mirroring the increase in U.S. rates...



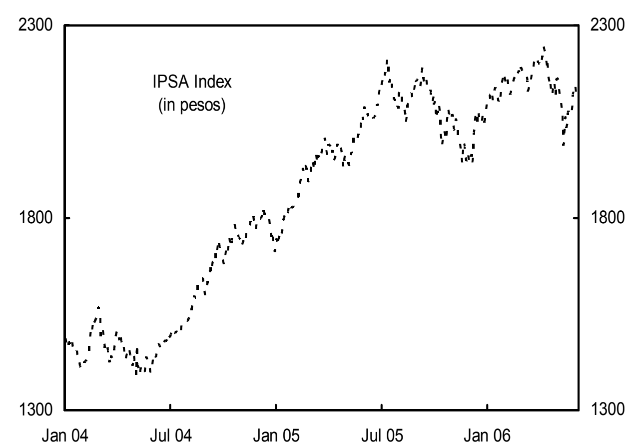
...and, as in the U.S., the yield curve has flattened.



Inflationary expectations rose in 2004 but now appear to have stabilized, and...



...a stock market rally that started in 2004 has also begun to slow.



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

staff recommended making participation in the pension system compulsory for the self-employed and rationalizing investment restrictions on the pension funds, including raising the limit on investments abroad. The authorities saw merit in these recommendations and noted that they awaited the report of the pension committee to formulate specific policies.

Improving Competition in the Financial Sector

28. ***Prudential indicators continue to show that the banking system is sound, with high capital, a low level of impaired assets, and high provisioning.*** The authorities were closely tracking developments in consumer credit, which had continued to rise rapidly (the 12–month increase in real terms was 22 percent at end-March), but noted that it accounted for only a small portion (15 percent) of total bank credit and, as such, did not represent a systemic risk to the financial sector. Staff emphasized the need to improve consolidated information on credit risks in the financial sector and, to that effect, supported the creation of a central credit database covering not only banks but also cooperatives and department store credit card lending (estimated to account for at least 20 percent of total consumer credit). With respect to small and medium-sized enterprises, the mission advised the authorities to introduce mechanisms aimed at ensuring the collection of data under a simplified version of the *FecuPymes* reporting system.

29. ***The authorities intend to continue pressing forward with the draft Capital Market Law II, which has not made headway in congress in recent months, partly due to its broad coverage and technical complexity.*** They were considering various alternatives to move ahead with the reform, including giving consideration to narrowing its scope in order to ensure early passage by congress. The draft law would bring wide-ranging improvements to several existing laws and introduce incentives for risk capital and entrepreneurship, a new national registry for pledges aimed at improving SMEs' access to financing, strengthen corporate governance legislation to bring it to OECD standards, and increase powers for the superintendents to share information. A separate draft law, aiming at restoring some of the powers of the Financial Intelligence Unit, is expected to be approved by congress in the near future; passage of this law is critical to ensure that the FIU is capable of effectively combating money laundering.

30. ***In recent years, the domestic bond market has grown steadily, but it remains characterized by a relatively low level of activity.*** Staff recommended that liquidity be improved by relaxing some of the investment restrictions on the private pension funds and reviewing the procedures surrounding the taxation of foreign investors.[9] Staff also suggested removing the distortions caused by the stamp tax and considering introducing a system of specialists in public debt with obligations tailored to the needs of the market. As the Central

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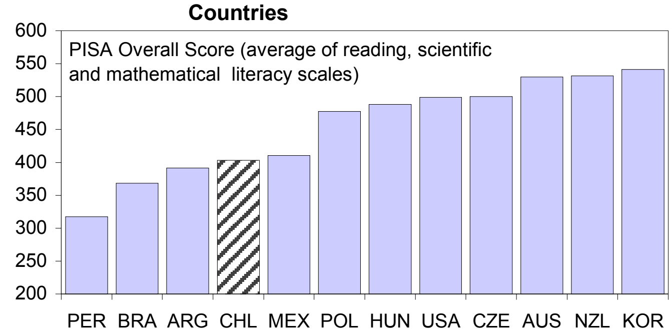
[9] See companion Selected Issues Papers on Deepening Liquidity in Chilean Fixed Income Markets, and Public Sector Debt and Market Development.

Bank has successfully set out an explicit objective for its debt management and effectively communicated it to the market, the government should do so as well. Sporadic bond issuance by the Finance Ministry has created uncertainty in the market, highlighting the need for a coordinated medium-term debt management strategy with the Central Bank. An asset-liability management approach would suggest that the Finance Ministry should concentrate on the long end of the curve, including through inflation-indexed issues, providing benchmarks at the longer tenors and complementing the Central Bank's issuance at the medium- and shorter-tenors. The authorities considered that they needed more time to specify their policy in this area. The Central Bank authorities also noted that, since the last Article IV consultation, they had made public key aspects of their reserve management policy, including with respect to currency composition.

Making the economy more flexible

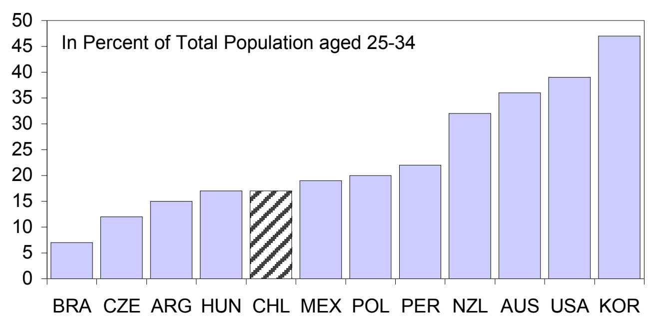
31. ***Improving the quality of human capital and boosting innovation will be key to Chile's long-term development.*** Taking into account Chile's low attainment and performance in education by international standards, the new government has placed education at the top of its priorities (Figure 10 and 11). Over its four-year term, it plans to make pre-school care coverage universal; broaden the system of preferential subsidy vouchers; increase the number of scholarships and government loan guarantees to improve access to tertiary education for the poor; and provide grants for Chileans to study abroad. In the R&D area, a law establishing a Fund for Innovation financed with the proceeds of the special tax on mining is awaiting approval by congress.[10] A transitional commission is preparing guidelines for projects and financing, based on successful experiences in foreign countries. To enhance technological innovation and productivity growth, this fund will provide resources for seed and venture

Figure 10. Student Performance: Chile and Selected Countries



Source: OECD (2003), Literacy Skills for the World of Tomorrow-Further Results for PISA 2000, Paris.

Figure 11. Tertiary Education Attainment: Chile and Selected Countries



Source: OECD (2005) Education at a Glance, OECD Indicators.

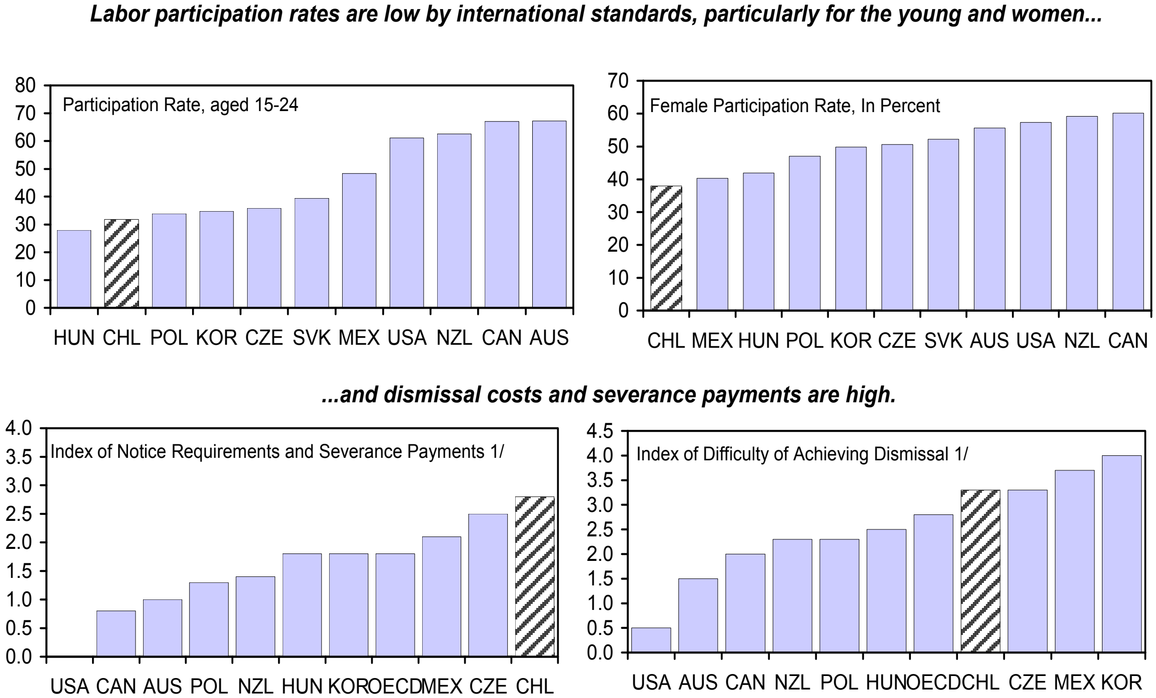
[10] Spending from the fund will be on-budget and covered by the structural surplus rule.

capital, partly through the National Development Corporation (CORFO) and the National Commission for Scientific and Technological Research (CONICYT). Performance will be closely monitored to ensure results.

32. ***The authorities intend to build a social consensus for labor market reforms.*** Staff supported this approach, while noting the pressing need for action in this area, as unemployment is still high and the labor market plagued with rigidities (Figure 12). Chile's

Figure 12. Chile and Selected Countries: Labor Market Impediments

Labor participation rates are low by international standards, particularly for the young and women...



Source: OECD, Labor Force Statistics; OECD (2003), *Chile Country Survey*, Paris; and INE.
1/ Indices prepared by OECD. Scores are in the range of 0-6, with lower scores implying less rigidity.

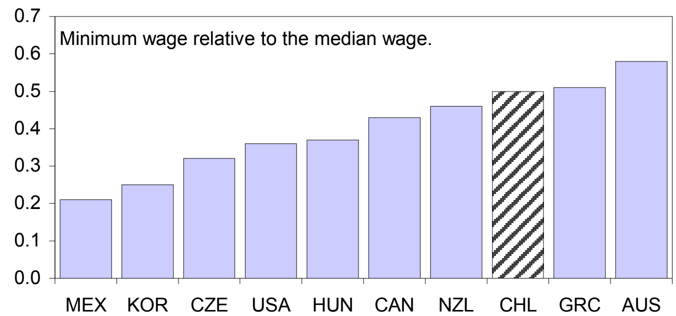
labor force participation rates are low by international standards, particularly for the young and for women, severance payments are high, and about one fourth of Chile's workforce is under temporary work arrangements:

- ***Increasing employment for the young and women is a priority of the government***. To help enhance job creation for the young, the authorities agreed that there was some room to make more intensive use of short-term and part-time contracts for them. The government plans to subsidize 50 percent of the minimum wage for some 1,500 first-time young workers and extend this benefit to workers up to 25 years old (from 21years old at present). Bonuses will also be offered to firms that employ youths at social risk. With respect to women, the authorities considered that the broadening of childcare coverage would help improve their participation in the labor force.

- ***Severance payments are high by international standards***. Severance payments in Chile, equivalent to one month's wages for each year of service (up to a maximum of 11 months' wages), are considered to hinder job creation. Workers' dismissal rules are generally flexible, but the rules governing permissible dismissals remain narrowly defined, hampering the matching of jobs with employees' skills, and penalties for unjustified dismissal are usually prohibitively high.

- ***Chile's minimum wage is relatively high, hindering formal employment contracts, particularly for the unskilled***. In July 2005, the previous government increased the minimum wage by 6¼ percent and announced that it would be raised again by close to 6 percent in July 2006, leaving no flexibility to the new government for this year. The mission advised restraint in the determination of the minimum wage for next year, taking into account that, when compared to the median wage, its level is significantly higher than in emerging and OECD countries (Figure 13).

Figure 13. Minimum Wages: Chile and Selected Countries



Source: OECD, Labor Force Statistics and OECD (2003), Chile Country Survey.
Note: Data for OECD counties refer to 2000. Chile's data are OECD staff estimates for 2002.

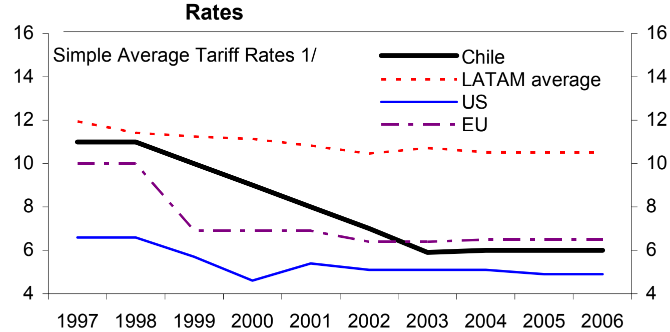
- ***In the formal sector, about one fourth of all workers are under temporary work arrangements***. Chile does not allow fixed-term employment contracts with a duration of more than a year. In practice, this is often circumvented by annual contracts which are renewed at the end of each year, the use of subcontractor services, and the hiring of temporary workers. A draft law was recently approved in congress, requiring firms to ascertain that their subcontractors comply with existing labor and social security regulations. The government planned to veto some aspects of the draft law, with a view to ensuring that it does not lead to excessive bureaucratic demands and to the introduction of new rigidities.

33. ***Access to energy is key for Chile to ensure sustainable long-term growth***. In the electricity sector, the approval in 2005 of changes in the regulatory framework has led to a strong increase in investment in electricity generation, including hydroelectric capacity. Faced with the uncertainty associated with the supply from Argentina, Chile has worked to reduce its reliance on natural gas. In the Northern part of the country, many mining companies have been investing in their own sources of energy supply, including coal and diesel plants. Concerns about the reliability of supply to the center of the country have led the government to initiate construction of a liquid natural gas terminal near Santiago.

34. ***The authorities and staff agreed that trade liberalization has served Chile well.*** Officials noted that Chile has one the lowest tariff rates in the world and that almost four-

fifths of all trade is undertaken under some level of tariff preference (Figure 14). Partly as a result of the implementation of a series of free trade agreements, including with the United States and the European Union, non-mining exports grew at an annual rate of 13 percent during 2001-05. An FTA with China and a trans-Pacific trade pact with Singapore, New Zealand, and Brunei are to become operational by end–2006. A partial trade agreement was signed with India in March, and trade negotiations are under way with Japan. The authorities have also reiterated their strong commitment to multilateral trade liberalization.

Figure 14. International Comparison of Average Tariff Rates



1/ Average tariff is the unweighted mean of all tariff lines and includes other duties and charges.

V. Staff Appraisal

35. ***With a very favorable external environment, prospects for the Chilean economy remain strong, notwithstanding the recent slowdown in activity.*** Economic growth has slowed since mid–2005, in part because investment has returned to a more sustainable rate of growth after a spurt during the previous two years. Consumer confidence remains high, private consumption is growing at a sustainable rate, and the economy is set to continue expanding at a steady pace in 2006 and 2007.

36. ***Risks to the outlook are mitigated by the quality of macroeconomic policies***. The fiscal surplus rule, inflation targeting in the context of a floating exchange rate, and trade openness have significantly improved the resilience of the Chilean economy. In addition, the financial system is solid and has deepened in recent years with the development of the bond and futures markets, improving the capacity of the economy to absorb shocks. The relatively modest reaction to the recent sell-off in emerging markets confirms Chile's resilience to market turbulence and the ability of the markets to differentiate Chile from other risks in the region.

37. ***Macroeconomic policymaking remains first-rate and well coordinated***. The authorities are appropriately treating the sharp increase in copper price as temporary. Fiscal policy has continued to be managed prudently, with expenditure growth tied via the structural surplus rule to Chile's long-term revenue capacity, while the central bank is appropriately gradually removing monetary stimulus. Chile's external competitiveness does not appear to have suffered from the appreciation of the currency, as nonmineral exports have continued to perform well. Staff supports the authorities' decision to invest part of the fiscal surpluses abroad while providing more transparency in the information given to the public. A prudent

fiscal policy stance, together with investing the fiscal surpluses abroad, should help limit upward pressure on the currency.

38. ***The uncertainty surrounding measures of the output gap poses a challenge to policymakers.*** Central bank estimates point to a closing of the gap in early 2007, but some computations show that the gap may still persist next year, reflecting large investments and a sizeable labor force growth in recent years. The recent pickup in inflation in early 2006 seems to largely reflect the effect of higher energy prices; there are also no conclusive data on possible pressures on resources and labor costs.

39. ***Against this background, staff agreed with the authorities that the monetary stance in the period ahead should largely be data driven***. Inflation expectations remain well anchored near the mid-point of the inflation target range, and the central bank's communications strategy with the markets works well. Given that the policy rate remains below the neutral rate, there is still room for the central bank to remove stimulus, particularly if fiscal policy were to become more expansionary in 2007.

40. ***The 2007 budget should keep the growth in central government expenditure at a moderate level.*** Under the structural surplus rule, revenue in 2007 could be boosted by an increase in the reference price for copper, leading to undesirable pressures to expand spending. Beyond their commitment to the rule as a disciplining device, the authorities have helpfully reaffirmed their intention to limit expenditure increases in the 2007 budget and to give prominence to nonrecurrent spending.

41. ***Staff welcomes the government's intention to gradually recapitalize the central bank***. The government's plans to provide the central bank with about half of its capital need over a five-year period will help strengthen the institutional independence of the bank as well as its foreign reserves position, but it will not allow the central bank to cover all its losses. Although the fiscal surpluses provided an opportunity for an upfront and full recapitalization of the central bank, the government' decision to opt for gradual recapitalization reflects the need to take political constraints into account.

42. ***The rapid increase in consumer credit growth requires vigilance and better information sharing between banks and non-bank credit card issuers***. To enhance the consolidation of risk information, it would be desirable to create a central database applied not only to banks but also to cooperatives and credit card lending by department stores. Proceeding with a simplified version of the *FecuPymes* reporting system would help provide better information on credit risks of small and medium-sized enterprises and improve their access to financing.

43. ***To enhance efficiency and competition in the financial sector, the scope and rate of the stamp tax should be reduced***. Beyond the government's plans to waive the stamp tax in the refinancing of existing loans, a more comprehensive reform of the stamp tax would help reduce the costs of financial intermediation and encourage competition, by giving borrowers

more flexibility in securing the best cost of financing possible. Consideration should also be given to eliminating the small tax on electronic transactions and checks.

44. ***Improving liquidity in the capital market is a priority.*** The government is encouraged to develop a medium-term public debt strategy, beyond the political cycle, and decide if it will maintain a presence in issuing bonds. Regulations are needed to clarify exemptions from capital gains tax for foreign institutional investors. This may help enhance further the development of the financial sector and contribute to internationalizing the peso.

45. ***Improving the quality of human capital and boosting innovation is key to Chile's long-term development.*** The new administration has placed education at the top of its priorities, with plans to generalize pre-school care, broaden university education for the poor, and provide grants to study abroad. Its plan to support R&D and innovation, based on successful experiences abroad, appears well placed.

46. ***The labor market remains in need of further reform***. The authorities' approach in this area, aimed at seeking consensus among the main social partners, is well advised. Staff urges the authorities to take bold action in this area, to help address the still high unemployment rate—especially among the young—and improve labor force participation. In particular, reforms should aim at introducing more flexibility in working hours, allowing longer fixed-term contracts, and avoiding too rapid increases in the minimum wages rather than subsidizing them.

47. ***Further improving data quality and coverage would help improve economic management.*** Strengthening data quality in the areas of the consumer price index, labor indicators, and inventories would help better assess short-term developments. These improvements would likely require a significant investment in time and labor, but would bring considerable dividends over time.

48. ***It is recommended that the next consultation occur on the usual 12-month cycle***.

Table 1. Chile: Selected Economic Indicators

	2001	2002	2003	2004	2005	Projections 2006	2007
(Annual percentage change)							
Production and prices							
Real GDP	3.4	2.2	3.9	6.2	6.3	5-6	5-6
Total domestic demand	2.4	2.4	4.9	8.1	11.4	6.8	6.1
Consumption	2.9	2.5	4.0	6.1	7.6	6.6	6.6
Investment	0.8	2.2	7.8	14.3	22.2	7.4	5.2
Fixed	4.3	1.5	5.7	11.7	24.7	8.1	5.0
Inventories 1/	-0.8	0.2	0.5	0.8	-0.3	-0.1	0.1
Net exports 1/	1.0	-0.2	-0.9	-1.9	-5.2	-2.0	-1.1
Consumer prices							
End of period	2.7	2.9	1.1	2.5	3.7	3.4	3.0
Average	3.6	2.5	2.8	1.1	3.1	3.5	3.1
Real wages	1.6	2.0	0.9	1.8	1.9	...	...
Unemployment rate (annual average)	9.2	9.0	8.5	8.8	8.0	7.7	7.5
Money, credit, and interest rates							
Broad money	4.9	3.3	2.3	11.7	22.1	...	...
Credit to the private sector	8.1	9.6	11.4	14.8	15.4	...	...
Three-month interest rate 2/	7.2	3.9	2.8	1.8	3.5	...	...
(Billions U.S. dollars, unless otherwise indicated)							
Balance of Payments							
Current account	-1.1	-0.6	-1.0	1.6	0.7	2.8	1.6
In percent of GDP	*-1.6*	*-0.9*	*-1.3*	*1.7*	*0.6*	*2.0*	*1.1*
Trade Balance	1.8	2.4	3.7	9.2	10.2	17.4	11.0
Exports of Goods	18.3	18.2	21.7	32.2	40.6	52.2	48.6
Copper Exports	6.5	6.3	7.8	14.5	18.3	28.1	23.9
In percent of total exports	*35.8*	*34.8*	*36.1*	*45.0*	*45.1*	*53.9*	*49.2*
Agricultural Exports	1.7	1.8	2.1	2.3	2.5	2.6	2.6
In percent of total exports	*9.5*	*9.9*	*9.8*	*7.3*	*6.1*	*4.9*	*5.3*
Imports of Goods	16.4	15.8	18.0	23.0	30.4	34.8	37.6
Oil Imports	1.6	1.5	2.0	2.7	3.6	4.8	5.3
In percent of total imports	*10.0*	*9.7*	*11.2*	*11.9*	*11.8*	*13.9*	*14.1*
(Annual percentage change)							
Exports	-4.9	-0.5	19.2	48.7	25.9	28.7	-6.9
Imports	-3.9	-3.9	13.8	28.0	32.0	14.5	8.0
Terms of trade	-7.2	3.7	9.7	20.7	12.5	17.6	-12.0
Real effective exchange rate 3/	-10.1	-6.9	13.4	-3.7	11.9	13.8	...
Net Foreign Direct Investment	196.5	-14.8	22.4	109.0	-19.9	36.4	-2.5
In percent of GDP	*3.8*	*3.3*	*3.7*	*5.9*	*3.9*	*4.4*	*4.4*
(In percent of GDP)							
Saving and investment							
Gross domestic investment	22.1	21.7	21.9	21.4	23.0	22.3	22.1
Public	2.6	2.6	2.3	2.1	2.1	2.2	2.7
Private	19.5	19.1	19.6	19.2	20.9	20.1	19.4
National savings	20.5	20.8	20.6	23.0	23.6	24.3	23.2
Public 4/	2.4	1.6	2.5	4.9	7.7	9.6	7.7
Private	18.2	19.1	18.2	18.1	15.9	14.7	15.5
External savings	1.6	0.9	1.3	-1.7	-0.6	-2.0	-1.1
Public sector finance							
Net debt	10.9	11.0	13.1	10.8	7.7	3.4	1.3
Excluding public enterprises	6.4	5.5	7.2	5.5	2.6	-2.1	-5.0
Gross debt 5/	41.9	42.8	44.6	39.4	31.7	28.0	28.0
Central government	15.0	15.7	13.1	10.8	7.5	5.6	4.7
Central government balance	-0.5	-1.2	-0.5	2.2	4.7	5.9	3.5
External Debt							
Gross external debt	56.2	60.2	58.4	45.8	39.0	33.8	35.1
Public	8.9	10.7	12.6	10.3	8.3	6.8	6.4
Private	47.3	49.5	45.8	35.5	30.7	27.0	28.7

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

1/ Contribution to growth.

2/ Nominal rates, in percent per annum, period average, on 90-day central bank promissory notes.

3/ End of period; INS definition of the real effective exchange rate. A decline indicates a depreciation of the peso; data for 2006 as of April 30, 2006.

4/ Gross saving of the general government sector, including the deficit of the central bank.

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

Table 2. Chile: Summary Operations of the Central Government
(in percent of GDP)

	2000	2001	2002	2003	2004	2005	Projections 1/ 2006	2007
I. Central Government Accounts								
Overall balance	-0.6	-0.5	-1.2	-0.4	2.1	4.7	5.9	3.5
Total revenue	21.7	21.8	21.1	20.8	22.2	24.5	24.8	23.8
Taxes	16.5	16.6	16.7	15.9	15.7	17.3	16.8	16.6
Income on assets	0.5	0.7	0.6	0.6	0.4	0.4	0.4	0.5
Social contributions	1.4	1.4	1.5	1.4	1.4	1.4	1.3	1.4
Grants	0.2	0.3	0.2	0.2	0.1	0.1	0.1	0.1
Transfers from public enterprises	1.8	1.3	1.2	1.7	3.7	4.4	5.7	4.8
Other	1.2	1.4	0.9	1.0	0.8	0.7	0.4	0.4
Total expenditure	22.3	22.3	22.4	21.3	20.1	19.8	18.9	20.3
Consumption	6.2	6.2	6.1	5.8	5.7	5.8	5.2	5.7
Social benefits	5.6	5.6	5.5	5.3	4.9	4.8	4.4	4.9
Subsidies and grants	5.9	5.7	5.9	5.5	5.2	5.1	5.4	5.5
Interest payments	1.2	1.2	1.2	1.2	1.0	0.9	0.8	0.7
Other	0.2	0.2	0.2	0.2	0.1	0.0	0.0	0.0
Gross investment	2.2	2.2	2.2	2.0	1.8	1.9	1.9	2.4
Defense	1.7	1.7	1.6	1.4	1.4	1.3	...	...
Non-defense	0.5	0.6	0.6	0.6	0.4	0.5	...	...
Net capital transfers	1.0	1.1	1.2	1.3	1.3	1.3	1.2	1.1
II. Structural Balance and Authorities Forecast 2/								
Structural balance	0.1	0.9	0.5	0.7	0.9	1.0	1.0	...
Overall balance	-0.6	-0.5	-1.2	-0.4	2.1	4.7	5.3	...
Revenue	21.7	21.8	21.1	20.8	22.2	24.5	24.2	...
Expenditure	22.3	22.3	22.4	21.3	20.1	19.8	18.9	...

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

1/ Based on the 2006 Budget and updated staff estimates, including copper price assumptions of US$2.56 in 2006 and US$2.15 in 2007.
2/ Figures for 2006 based on the June 2006 budget update.

Table 3. Central Government Spending, 1997-2005 1/
(by GFSM functional classification, in percent of GDP)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	Average 1997-2000	Average 2001-05
Total expenditure	**19.6**	**20.7**	**22.5**	**22.3**	**22.3**	**22.4**	**21.3**	**20.1**	**19.8**	**21.3**	**21.1**
Defense & public safety	2.6	2.8	3.0	2.9	3.0	2.9	2.7	2.7	2.7	2.8	2.8
Defense	1.5	1.6	1.7	1.7	1.7	1.6	1.4	1.4	1.3	1.6	1.5
Public safety	1.1	1.1	1.3	1.2	1.3	1.3	1.3	1.3	1.3	1.2	1.3
Non-defense	17.0	17.9	19.5	19.4	19.3	19.5	18.6	17.4	17.1	18.5	18.4
General public services	1.3	1.3	1.4	1.4	1.5	1.5	1.5	1.4	1.3	1.4	1.4
Economic & cultural affairs	3.0	3.0	3.2	3.1	2.8	2.9	2.8	2.6	2.7	3.1	2.7
Economic affairs	2.9	2.9	3.1	3.0	2.7	2.8	2.6	2.4	2.6	3.0	2.6
Cultural affairs	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Social & environmental protection	12.7	13.6	14.9	14.9	15.1	15.0	14.3	13.4	13.1	14.0	14.2
Social protection	7.0	7.4	7.9	7.9	7.9	7.8	7.3	6.7	6.6	7.6	7.3
Education	2.9	3.3	3.8	3.7	3.9	4.0	3.8	3.6	3.3	3.4	3.7
Health	2.4	2.6	2.8	2.8	3.0	3.0	3.0	2.8	2.9	2.7	2.9
Housing	0.2	0.2	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.3	0.2
Environmental protection	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1

Source: Ministry of Finance: DIPRES.

1/ Totals may not be identical to those in Table 2 due to of minor accounting and methodological differences.

Table 4. Chile: Summary Operations of the Public Sector
(In percent of GDP)

	2000	2001	2002	2003	2004	2005	Projections 2006	2007
I. Central government								
Balance	-0.6	-0.5	-1.2	-0.4	2.1	4.7	5.9	3.5
Total revenue	21.7	21.8	21.1	20.8	22.2	24.5	24.8	23.8
of which: intragovernmental receipts	1.2	1.1	1.1	1.0	0.9	0.9	0.9	0.9
Total expenditures 1/	22.3	22.3	22.4	21.3	20.1	19.8	18.9	20.3
of which: intragovernmental transfers	0.01	0.01	0.01	0.01	0.01	0.02	0.01	0.01
Current	19.1	18.9	18.9	18.0	16.9	16.5	15.8	16.8
Capital	3.2	3.4	3.5	3.3	3.1	3.2	3.1	3.5
II. Municipalities 2/								
Balance	-0.1	0.0	0.0	0.0	0.0	0.2	0.0	0.0
Total revenue	3.3	3.3	3.3	3.1	2.8	3.0	3.1	3.2
of which: intragovernmental receipts	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditures	3.3	3.2	3.3	3.1	2.8	2.8	3.0	3.1
of which: intragovernmental transfers	1.2	1.1	1.1	1.0	0.9	0.9	0.9	0.9
Current	2.8	2.8	2.8	2.7	2.4	2.5	2.7	2.8
Capital	0.6	0.4	0.4	0.4	0.4	0.3	0.3	0.3
III. Central bank								
Balance	-1.4	-1.0	-1.2	-0.7	-0.8	-0.5	-0.3	-0.3
Net operating balance	-0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
Net interest balance 1/	-1.4	-1.0	-1.1	-0.7	-0.7	-0.5	-0.2	-0.2
IV. State-owned enterprises (non-financial)								
Balance	0.6	0.9	-0.3	-0.4	1.0	1.2	1.5	1.0
Total revenue	11.2	11.0	11.6	10.7	14.2	12.5	13.2	13.5
of which: intragovernmental receipts	0.1	0.1	0.2	0.2	0.1	0.1	0.1	0.1
Total expenditures	10.6	10.1	11.9	11.1	13.3	11.3	11.7	12.4
of which: intergovernmental transfers	1.8	1.3	1.2	1.6	3.7	4.4	5.5	4.6
Current	9.0	9.1	9.8	9.5	11.5	9.3	9.7	10.1
Capital	1.6	0.9	2.1	1.7	1.8	2.0	2.0	2.4

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

1/ Includes the effects of valuation changes (inflation) to the stock of UF debt and accrued interest on Treasury debt.

2/ On a cash basis.

Table 5. Chile: Indicators of External Vulnerability
(In percent; unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	Proj. 2006
Financial indicators							
M3 (percent change)	11.7	10.3	6.3	3.7	10.6	11.9	...
less pension funds' deposits (annual percentage change)	10.4	9.6	3.9	6.2	6.6	10.8	...
Credit to Private Sector to GDP 1/	72.4	72.9	75.1	76.1	76.8	79.5	...
90-day central bank promissory note (nominal) interest rate (avg.)	10.8	7.2	3.9	2.8	1.8	3.5	...
Share of foreign currency deposits in total deposits	11.3	14.0	12.9	13.2	11.5	10.1	...
Share of foreign currency loans in total credit	11.6	13.7	14.5	10.3	10.0	10.0	...
Share of nonperforming loans in total loans 2/ 3/	1.7	1.6	1.8	1.6	1.2	0.9	0.9
Loan-loss provisions as percent of nonperforming loans 2/ 3/	145.7	146.4	129.5	133.2	165.5	176.9	175.3
Risk-based capital-assets ratio, end of period 3/	13.3	12.7	14.0	14.1	13.6	13.0	13.9
Return on bank capital 3/	12.7	17.7	14.4	16.6	16.7	16.4	18.8
External indicators							
Exports, U.S. dollars (annual percentage change)	11.9	-4.9	-0.5	19.2	48.7	25.9	28.7
Imports, U.S. dollars (annual percentage change)	16.0	-3.9	-3.9	13.8	28.0	32.0	14.5
Terms of trade (annual percentage change)	4.5	-7.2	3.7	9.7	20.7	12.5	17.6
REER (end of period, percent change) 3/	-2.2	-10.1	-6.9	13.4	-3.7	11.9	13.8
Exchange rate (pesos per US$, period average)	539	635	689	691	610	560	...
Current account (percent of GDP)	-1.2	-1.6	-0.9	-1.3	1.7	0.6	2.0
Financial account less reserves accumulation (percent of GDP)	1.6	0.7	1.0	0.8	-1.9	0.9	3.0
Gross official reserves (in US$ billion) 5/	15.1	14.4	15.4	15.9	16.0	17.0	16.6
Gross official reserves, months of imports of goods and services	8.5	8.3	7.8	6.4	5.0	4.7	4.3
Gross official reserves to broad money	41.9	44.0	47.0	49.6	37.1	29.7	...
Gross official reserves to short-term external debt 6/	147.6	144.8	134.4	125.4	113.7	111.8	126.0
Total external debt (percent of GDP)	49.4	56.2	60.2	58.4	45.8	39.0	33.8
Of which: external public sector debt	8.0	8.9	10.7	12.6	10.3	8.3	6.8
Total external debt to exports of goods and services	159.6	171.9	179.5	161.6	113.7	94.3	78.7
External interest payments to exports of goods and services	8.3	7.9	6.6	4.8	3.4	2.9	2.6
External amortization payments to exports of goods and services	18.2	24.0	28.8	23.5	22.9	15.6	13.2
Financial market indicators							
Stock market index (in US$; period average) 7/	668	590	483	601	832	1105	1247
Sovereign long-term foreign-currency debt rating (end of period)							
Moody's	Baa1	Baa1	Baa1	Baa1	Baa1	Baa1	A2
S&P	A-	A-	A-	A-	A	A	A
Fitch Ratings	A-	A-	A-	A-	A-	A	A

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

1/ Includes Central Bank, DMBs and other banking institutions
2/ Official measure of non-performing loans.
3/ Data for 2006 as of April 30, 2006. For risk-based capital ratio, as of March 30, 2006.
4/ Includes errors and omissions.
5/ Gold valued at end-period market prices.
6/ As measured by the central bank; includes amortization of medium/long-term debt due during the following year.
7/ Morgan-Stanley Capital International index (Dec/1987=100).

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

						Projections				
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
				(In millions of US$)						
Current account	-1,100	-580	-964	1,586	703	2,780	1,581	-2,557	-3,720	-4,334
In percent of GDP	-1.6	-0.9	-1.3	1.7	0.6	2.0	1.1	-1.9	-2.6	-2.8
Trade balance	1,844	2,385	3,685	9,196	10,180	17,436	11,020	5,004	4,012	4,113
Exports	18,272	18,180	21,664	32,215	40,574	52,235	48,612	45,051	46,746	49,873
Copper	6,537	6,323	7,815	14,483	18,306	28,134	23,899	18,538	17,074	17,074
Non-copper	11,735	11,856	13,849	17,733	22,268	24,101	24,713	26,513	29,671	32,798
Imports	-16,428	-15,794	-17,979	-23,020	-30,394	-34,799	-37,591	-40,047	-42,734	-45,759
Net services	-844	-702	-646	-689	-588	-898	-1,181	-1,124	-1,227	-1,168
Net income	-2,526	-2,847	-4,608	-7,999	-10,624	-15,613	-10,758	-9,130	-9,250	-10,037
Net transfers	427	583	605	1,079	1,735	1,855	2,500	2,694	2,745	2,758
Capital Account Balance 1/	504	696	598	-1,782	1,013	4,251	5,183	5,628	7,170	8,155
Foreign investment (net)	2,590	2,207	2,701	5,646	4,521	6,166	6,013	5,599	5,916	6,265
Direct Investment Abroad	-1,610	-343	-1,606	-1,527	-2,146	-1,611	-1,435	-1,403	-1,483	-1,570
Direct Investment in Chile	4,200	2,550	4,307	7,173	6,667	7,777	7,449	7,002	7,399	7,834
Portfolio investment (net)	139	-2,317	-2,526	-3,552	-2,533	-161	640	1,409	2,585	3,363
Financial Derivatives	-86	-124	118	-84	-63	-58	-44	-49	-36	-70
Other Investments	-1,282	1,869	972	-4,218	219	-1,696	-1,426	-1,331	-1,295	-1,403
Reserves Assets	596	-199	366	191	-1,716	-7,031	-6,764	-3,072	-3,450	-3,821
Chg. in official reserves (millions of USD, increase -)	710	-951	-500	-165	-947	373	-835	283	317	-77
				(In months of imports of goods and services)						
Gross official international reserves 2/	8.1	8.8	8.1	6.5	5.3	4.6	4.5	4.2	3.8	3.6
				(Annual change in percent)						
Copper export prices	-13.7	0.0	21.2	55.7	31.6	55.2	-16.1	-32.5	-17.2	-9.1
Copper export volume	4.2	-3.6	1.9	19.0	-3.8	-0.1	1.0	15.0	11.3	10.0
Agricultural exports volume	6.2	11.7	11.2	7.8	4.6	0.7	4.0	10.6	13.0	13.0
Industrial exports volume	17.1	4.3	7.9	14.2	11.1	9.0	6.5	12.0	12.0	12.0
Total export prices	-12.3	-1.2	12.6	29.2	22.5	17.9	-7.4	-19.1	-7.0	-4.4
Total export volume	8.3	0.7	5.9	16.3	0.7	3.1	4.4	15.6	12.5	12.5
Total import price	-5.5	-4.6	2.7	7.0	8.9	0.6	5.0	1.5	1.8	0.9
Total import volume	1.9	1.1	10.2	19.9	20.6	7.7	6.8	5.9	5.7	6.9
Terms of trade	-7.2	3.7	9.7	20.7	12.5	17.6	-12.0	-20.3	-8.7	-5.3
Real GDP	3.4	2.2	3.9	6.2	6.3	5-6	5-6	5.4	5.1	5.0
6-month LIBOR on U.S. dollar deposits (in percent)	3.7	1.9	1.2	1.8	3.8	5.2	5.4	5.4	5.5	5.5
				(In percent of GDP)						
Gross domestic investment	22.1	21.7	21.9	21.4	23.0	22.3	22.1	20.2	19.8	18.3
Public sector	2.6	2.6	2.3	2.1	2.1	2.2	2.7	2.9	2.9	2.5
Private sector and inventory change	19.5	19.1	19.6	19.2	20.9	20.1	19.4	17.3	17.0	15.8
External current account balance	-1.6	-0.9	-1.3	1.7	0.6	2.0	1.1	-1.9	-2.6	-2.8
Gross national savings	20.5	20.8	20.6	23.0	23.6	24.3	23.2	18.3	17.3	15.5
Public sector 3/	2.4	1.6	2.5	4.9	7.7	9.6	7.7	5.7	5.4	5.0
Private sector	18.2	19.1	18.2	18.1	15.9	14.7	15.5	12.6	11.9	10.5
Total external debt (end of period)	56.2	60.2	58.4	45.6	38.9	33.8	35.1	35.7	34.8	33.8
Memorandum items:										
Copper price (LME; U.S. cents per pound) 4/	72	71	81	130	167	256	215	145	120	109
Volume of copper exports (2004=100)	86	82	84	100	96	96	97	112	124	137

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

1/ Includes errors and omissions.

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

3/ Net of estimated losses of the central bank.

4/ Updated staff forecasts.

Table 7. Chile: External Debt and Debt Service Projections

	2001	2002	2003	2004	2005	Projections 2006	2007	2008	2009	2010	2011
	(In billions of U.S. dollars, end of period)										
Total debt outstanding 1/	**38.5**	**40.5**	**43.1**	**43.5**	**45.0**	**47.3**	**48.4**	**49.1**	**50.5**	**51.9**	**53.6**
Of which: external private debt	32.4	33.3	33.8	33.7	35.4	37.8	39.6	41.2	43.1	44.7	46.5
Of which: external public debt	6.1	7.2	9.3	9.8	9.6	9.5	8.8	7.9	7.3	7.2	7.1
Medium- and long-term debt	33.2	34.9	35.9	35.7	37.9	38.7	39.7	40.5	41.5	42.5	43.7
Public sector	5.3	6.3	7.9	9.1	8.7	8.8	8.0	7.1	6.6	6.5	6.4
Of which: central government	3.0	3.6	4.6	4.7	4.0	4.1	3.4	2.5	1.9	1.8	1.7
Private sector	27.9	28.6	28.0	26.6	29.2	29.9	31.6	33.4	34.9	36.0	37.3
Financial sector 1/	1.5	2.6	3.1	3.8	6.0	5.8	5.9	6.0	6.0	6.0	6.0
Non-financial sector	26.4	26.0	24.9	22.7	23.2	24.1	25.7	27.4	29.0	30.0	31.3
Short-term debt 2/	5.3	5.7	7.2	7.9	7.1	8.7	8.7	8.6	8.9	9.4	10.0
Residual maturity basis	9.9	11.4	12.6	14.1	15.2	13.2	12.8	13.1	11.2	12.0	12.6
Total debt service	**7.2**	**8.0**	**7.6**	**10.1**	**8.8**	**9.5**	**7.7**	**5.6**	**5.4**	**3.3**	**3.3**
Amortization	5.4	6.5	6.3	8.8	7.5	8.0	6.3	4.5	4.4	2.5	2.6
Interest	1.8	1.5	1.3	1.3	1.4	1.5	1.5	1.1	1.0	0.8	0.6
	(In percent of GDP)										
Total external debt, end-period 2/	**56.2**	**60.2**	**58.4**	**45.8**	**39.0**	**33.8**	**35.1**	**35.7**	**34.8**	**33.8**	**32.3**
Of which: external private debt	47.3	49.5	45.8	35.5	30.7	27.0	28.7	30.0	29.7	29.1	28.0
Of which: external public debt	8.9	10.7	12.6	10.3	8.3	6.8	6.4	5.7	5.0	4.7	4.3
Gross change (in percent)	6.8	4.0	-1.8	-12.6	-6.8	-5.2	1.3	0.6	-1.0	-1.0	-1.4
Gross change of nominal stock (in percent)	3.7	5.1	6.3	1.0	3.4	5.5	2.2	1.5	2.8	2.9	3.3
Interest payments on external debt	2.6	2.2	1.7	1.4	1.2	1.1	1.1	0.8	0.7	0.5	0.4
	(In percent of exports of goods and services)										
Debt-service payments	32.0	35.4	28.3	26.4	18.5	15.8	13.7	10.6	9.7	5.6	5.1
Of which: interest	7.9	6.6	4.8	3.4	2.9	2.6	2.6	2.2	1.8	1.4	1.0
Total external debt outstanding 2/	171.9	179.5	161.6	113.7	94.3	78.7	85.6	92.6	90.7	87.4	84.0
	(In billions of U.S. dollars)										
Memorandum items:											
Gross international reserves	14.4	15.4	15.9	16.0	17.0	16.6	17.4	17.1	16.8	16.9	17.3
GDP 3/	68.6	67.3	73.7	95.0	115.3	140.1	137.8	137.3	145.1	153.7	165.8
percent change	*-8.8*	*-1.9*	*9.6*	*28.9*	*21.4*	*21.5*	*-1.6*	*-0.3*	*5.7*	*5.9*	*7.9*

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

1/ Includes bank and nonbank institutions.
2/ Original maturity basis; end of period basis.
3/ At current prices and exchange rates.

Table 8. Chile: Financial System Structure, 2000-2005
(Assets as percent of GDP, as of December of each year)

	2000		2001		2002		2003		2004		2005	
	Number	Assets	Number	Assets	Number	Assets	Number	Assets	Number	Assets	Number	Assets
Total Financial System	**291**	**174**	**308**	**181**	**329**	**186**	**336**	**187**	**382**	**186**	**434**	**184.9**
Banking System	**29**	**97.7**	**27**	**99.6**	**26**	**98.4**	**26**	**92.8**	**27**	**92.4**	**26**	**95.0**
Banks	28	96.8	26	99.0	25	98.0	26	92.8	27	92.4	26	95.0
Private	27	83.7	25	85.9	24	83.5	25	78.4	26	77.7	25	78.6
Domestic	9	38.5	9	39.5	10	39.6	12	40.6	14	40.8	13	42.5
Foreign	18	45.1	16	46.4	14	43.9	13	37.8	12	36.9	12	36.1
State-owned	1	13.2	1	13.2	1	14.4	1	14.4	1	14.7	1	16.4
Finance Companies	1	0.9	1	0.6	1	0.4	0	0.0	0	0.0	0	0.0
Institutional investors	**262**	**76.6**	**281**	**81.7**	**303**	**87.4**	**310**	**94.2**	**355**	**94.1**	**408**	**89.9**
Insurance companies	56	16.5	54	17.9	55	19.1	53	21.3	52	21.0	51	17.6
Life and Retirement	33	16.0	32	17.5	32	18.7	30	20.1	30	19.9	29	17.2
Non-life	23	0.4	22	0.4	23	0.5	23	1.2	22	1.1	22	0.4
Pension funds	8	51.0	7	53.6	7	55.8	7	59.7	7	59.1	6	59.4
Foreign-owned	3	28.4	3	29.9	3	30.8	4	34.8	4	32.7	3	32.4
Domestically owned	5	22.6	4	23.7	4	24.9	3	24.9	3	26.4	3	27.0
Mutual funds	150	6.4	177	7.3	199	9.9	206	10.1	256	11.6	311	10.9
Investment funds	29	1.9	30	2.0	31	2.0	35	2.2	40	2.4	40	2.0
Foreign capital investment func	18	0.9	13	0.9	11	0.7	9	0.9	7	0.8	7	0.7
Foreign venture capital funds	1	0.0	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0

Sources: Central Bank of Chile, Superintendency of Banks (SBIF), Superintendency of Insurance (SVS).

Table 9. Social and Demographic Indicators

GDP (2005)		**Poverty rate (2003)**	**18.8**
Chilean pesos (billions)	64,549	Indigent	4.7
U.S. dollars (billions)	115.3	Poor, not indigent	14.1
Per capita (U.S. dollars)	7,124		
Population and Country Information (2005		**Health**	
Total (in millions)	16.2	Population per physician (2003)	916
Urban population (in percent of total)	87.3	Population per hospital bed (2002)	385
Area (thousand sq. km.)	756.1		
Density (per sq. km)	21.4		
Annual rate of growth, 1996-2005	1.3		
Population characteristics (2004)		**Access to electricity (2003)**	
Life expectancy at birth (years)	78.0	Percent of population	98.9
Crude birth rate (per thousand)	16.1	Urban (2003)	99.7
Crude death rate (per thousand)	5.4	Rural (2003)	74.6
Infant mortality rate (per thousand births, 2(	7.6		
Mortality rate (ages 1-4, per thousand, 200	8.4		
Income distribution (2000)		**Access to safe water (2003)**	
Percent of total income received:		Percent of population	93
By richest 10 percent of households	47.0	Urban	99
By poorest 20 percent of households	3.3	Rural	58
Gini coefficient	57.1		
Distribution of labor force, in percent of total (2005)		**Education (2003)**	
Agriculture and fishing	11.6	Adult literacy rate (2004)	95.72
Mining	1.2	Gorss enrollment rates, percent of the age group	
Industry	12.3	Primary education (2003)	100
Construction	7.3	Secondary education (2003)	88
Services, Public Utilities, and Trade	67.6	Tertiary education (2003)	42

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

Table 10. Millennium Development Goals

	1990	1995	2001	2002	2003	2004	2015 Target
Goal 1: Eradicate extreme poverty and hunger							
Population below $1 a day (in percent of population)	6.2	...	...	...	...	...	1.0
Poverty gap at $1 a day (in percent of total population,)	2.1	...	...	...	...	...	...
Percent of income or consumption held by poorest 20 percent	...	...	3.3	3.3	...	...	...
Prevalence of child malnutrition (in percent of children under 5)	...	2.4	...	1.5	...	...	0.5
Pop. below min. of dietary energy consumption (in percent of total)	8.0	5.0	4.0	...	...	...	4.0
Goal 2: Achieve universal primary education							
Net primary enrollment ratio (in percent of relevant age group)	87.7	87.3	88.8	86.46	...	...	100.0
Percentage of cohort reaching grade 5 (in percent)	...	100.0	101.2	...	...	...	100.0
Youth literacy rate (in percent of ages 15-24)	98.1	98.5	98.9	99.0	...	99.0	100.0
Goal 3: Promote gender equality							
Ratio of girls to boys in primary and secondary education (in percent)	101.0	100.3	99.6	99.5	99.3	...	100.0
Ratio of young literate females to males (in percent of ages 15-24)	100.4	100.4	100.3	100.3	...	100.38	100.0
Share of women employed in the nonagricultural sector (in percent)	36.2	36.2	36.6	...	...	...	...
Proportion of seats held by women in national parliament (in percent)	...	8.0	...	10.1	10.1		...
Goal 4: Reduce child mortality							
Under 5 mortality rate (per 1,000)	19.0	14.0	12.0	12.0	9.0	8.4	12.7
Infant mortality rate (per 1,000 live births)	17.0	12.0	10.0	10.0	8.0	7.6	...
Immunization, measles (in percent of children under 12 months)	82.0	97.0	99.0	99.0	99.0	95	...
Goal 5: Improve maternal health							
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	...	31.0	17.0	...	...	23.3
Births attended by skilled health staff (in percent of total)	...	99.5	100.0	100.0	...	...	...
Goal 6: Combat HIV/AIDS, malaria and other diseases							
Prevalence of HIV, female (in percent of ages 15-24)	...	...	0.1	...	...	...	0.1
Contraceptive prevalence rate (in percent of women ages 15-49)	56.0	...	...	...	...	...	...
Number of children orphaned by HIV/AIDS	...	...	4,100.0	...	...	...	...
Incidence of tuberculosis (per 100,000 people)	...	...	20.0	18.0	18.0	...	...
Tuberculosis cases detected under DOTS	...	79.0	97.0	112.1	112.1	113.7	...
Goal 7: Ensure environmental sustainability							
Forest area (in percent of total land area)	21.0	...	20.7	...	...	...	...
Nationally protected areas (in percent of total land area)	...	18.9	18.9	18.9	18.7	18.9	...
GDP per unit of energy use (PPP $ per kg oil equivalent)	4.5	5.7	6.2	6.2	5.9	...	...
CO2 emissions (metric tons per capita)	2.7	3.1	3.9	3.6	...	...	...
Access to an improved water source (in percent of total population)	90.0	...	93.0	95.0	...	...	95.0
Access to improved sanitation (in percent of total population)	85.0	...	...	92.0	...	...	...
Access to secure tenure (in percent of total population)	...	...	...	...	...	...	...
Goal 8: Develop a Global Partnership for Development							
Youth unemployment rate (in percent of labor force ages 15-24)	13.1	11.5	...	...	...	...	...
Fixed line and mobile telephones (per 1,000 people)	67.0	141.2	568.1	658.6	732.4	799.1	...
Personal computers (per 1,000 people)	9.4	33.2	106.5	119.3	125	132.6	...

Sources: World Bank Development Indicators database, April 2004; authorities' estimates for 2003.

APPENDIX I. CHILE—FUND RELATIONS

(As of April 30, 2006)

I. ***Membership Status:*** Joined 12/31/45; Article VIII.

II. ***General Resources Account***

	SDR Million	percent Quota
Quota	856.10	100.00
Fund holdings of Chilean pesos	759.61	88.73
Reserve tranche position	96.49	11.27

III. ***SDR Department***

	SDR Million	percent Allocation
Net cumulative allocation	121.92	100.00
Holdings	36.90	30.26

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):

	Forthcoming				
	2006	2007	2008	2009	2010
Principal					
Charges/Interest	2.21	2.99	3.00	2.99	2.99
Total	2.21	2.99	3.00	2.99	2.99

VII. ***Exchange Arrangements****:* The exchange rate is permitted to float freely. On June 26, 2006 the interbank exchange rate was Ch$549.6 per U.S. dollar. Chile's exchange system is currently free of restrictions on the making of payments and transfers for current international transactions.

VIII. ***Article IV Consultation:*** The Executive Board concluded the 2005 Article IV consultation on July 29, 2005 and the staff report was released as IMF Country Report No. 05/315.

IX. ***Technical Assistance:*** In October 2002, a mission from MFD and WHD advised on nominalization and interest rate pass-through. In January 2003, a joint FAD/STA mission advised on fiscal statistics. In late 2003 and early 2004, an FSAP mission (joint Fund-Bank) assessed the Chilean financial system. In late 2004, a STA mission advised on fiscal statistics. Another STA mission in February, 2005 advised on national account statistics. An MFD mission trained the FIU staff on AML/CFT issues in 2005 and an FAD mission conducted a pilot study on fiscal risks of public enterprises. In 2006 two MFD missions advised on coverage and quality of short term economic indicators, and on strengthening liquidity in fixed-income markets.

APPENDIX II. CHILE—FINANCIAL RELATIONS WITH THE WORLD BANK

The most recent Country Assistance Strategy (CAS) for Chile, covering Fiscal Years 2002-06, was discussed by the Executive Board of the Bank in February 2002. The CAS calls for selectively focusing on areas in which the Bank had accumulated substantial knowledge and where the government felt that the Bank can be instrumental in ensuring the successful implementation of its initiatives. To that aim, the strategy proposed to diversify the forms of financial assistance by providing direct financing through regular investment and policy-based lending, as well as contingent financing. A new CAS is planned for the second quarter of FY07.

The CAS reflects efforts by the current administration to address persistent social challenges through improvements in human capital. Support in the area of human capital development has been provided through the Science for Knowledge Economy Project (FY03), which fosters the development of an effective innovation system and aims at improving the stock of human capital in the Chilean science and technology sector. Additional support in this area has been provided through the Lifelong Learning and Training Project (FY02), which aims at assisting in establishing the foundation of a lifelong learning and training system with the participation of the private sector.

The CAS also reflects the current administration's focus on improving the inclusion of rural populations and vulnerable groups and the social safety net. In line with this objective, in FY05 the Bank approved the Infrastructure for Rural Development Project, which aims at improving the access of rural communities to infrastructure services. Support in the area of social protection has been provided under the Social Protection Adjustment Loan DDO (FY04) and the accompanying TA loan, which aims at increasing access to social protection and social services for the neediest households. This loan also supports *Chile Solidario.*

The IFC provides support for private infrastructure, small and medium enterprises, specialized financing in housing, and the social sector. The IFC considers that Chile is a country from which experience can be learned for other countries, both within and outside the Latin America region. In addition, the IFC provides support to Chilean companies in their efforts to grow abroad. MIGA's support is expected to facilitate foreign direct investment in Chile.

There are currently seven investment loans in Chile's operations portfolio, totaling US$215.1 million in commitments. The seven loans, in support of Public Expenditure Management (FY02), Lifelong Learning (FY02), Science for the Knowledge Economy (FY03), Social Protection TA Loan (FY04), Infrastructure for Territorial Development (FY05), Transantiago TA (FY06) and Tertiary Education Finance for Results (FY06) are covered by the current CAS. A Santiago Urban Transport Adjustment Loan in the amount of US$30.2 million, also approved in FY06, has been fully disbursed.

Chile: Financial Relations with the World Bank
(In millions of U.S. dollars)

	Commitments (Net of Cancellations)	Disburs- ments	Undisbursed
I. IBRD Operations (as of June 15, 2005)			
Fully disbursed loans	**3422.0**	**3422.0**	**0.0**
Loans in process of disbursement	**215.1**	**71.8**	**143.3**
Education	126.2	46.0	80.2
Public sector management	23.2	18.1	5.1
Social protection	10.7	5.2	5.5
Transport	55.1	2.5	52.5
Total loans	**3637.1**	**3493.8**	**143.3**
Repaid	**3162.8**		

II. IFC Operations (as of May 31, 2005)

	Loans	Equity	Quasi Equity	Participation
Committed	111.3	110.8	15.4	93.3
Outstanding	70.8	101.2	11.7	82.8

III. IBRD Loan Transactions (calendar year)

	2001	2002	2003	2004	2005 1/
Disbursements	38.6	29.7	37.5	258.7	54.6
Repayments	118.5	201.6	172.7	239.9	205.8
Net lending	-79.9	-171.9	-135.2	18.8	-151.2

Source: World Bank.

1/ As of December 31, 2005.

APPENDIX III. CHILE: STATISTICAL ISSUES

Economic and financial data are timely, of good quality, and adequate for surveillance purposes. Chile is in observance with the Special Data Dissemination Standards (SDDS).

Monetary sector

Monetary and financial statistics are broadly in line with the Fund's *Monetary and Financial Statistics Manual (MFSM).* There are only few deviations from the guidelines of the MFSM, i.e., the inclusion of nonbank financial intermediaries in the private sector, and the use of accounting valuation criteria, which are not always in line with the measurements at market prices prescribed by the MFSM. Nevertheless, for purposes of expressing in local currency, assets and liabilities in foreign currency and indexed units of account, the accounting criterion is consistent, in general terms, with the MFSM (see accounting conventions and other aspects).

Real sector

A change to 2003 as the benchmark and base year is planned to take place in 2007. Annual and quarterly GDP series for 1986–2003 are scheduled to be compiled in 2007. An STA mission to Chile in January 2006 found that the overall strategy, planning, and implementation of the benchmarking exercise, as well as the professional standard of the methods used are of a high standard when measured against similar projects in other countries and internationally recognized best practices. However, the 2003 benchmarking will not benefit from a new household expenditure survey or a census for agriculture. Currently, the BCCH compiles annual and quarterly national accounts with 1996 as the base (and benchmark) year. Following technical assistance from STA, new and more comprehensive GDP series were published by the central bank in March 2005.

Plans are for a much improved business register to be available in 2006. The January 2006 mission recommended that the present method for the treatment of imputed rent of owner occupied dwellings be reconsidered with a view to better reflect current market conditions.

There is room to improve price and labor market statistics. For the CPI, expanding the survey sample outside Santiago and updating the weights to the 2006-2007 HBS would considerably improve the index. On labor market statistics, the National Statistical Institute (INE) introduced a new household survey in 2006, modeled on the U.S. BLS surveys and in line with standards set by the International Labor Organization. The recent labor market survey of business establishments could also benefit from a similar review to improve data quality.

Government finances

Following agreements reached with the Fund in 2002, the authorities have made substantial progress in implementing the *GFSM 2001*. They made significant improvements regarding coverage, classification, and consolidation. The authorities have developed a statement of central government operations with consolidation of extra budgetary central government units, and the reclassification of budgetary revenue and spending. A new functional classification of total outlays for the central government aligned with international standards has been disseminated. In addition separate sets of accounts were compiled for municipalities and for public corporations. A detailed description of the methodologies, institutional tables on coverage, and data for the entire public sector were made available in the October 2004 publication *Estadísticas de las Finanzas Públicas 1987-2003*.

Progress in the fiscal accounts is ongoing. The authorities expect to produce estimates for the consumption of fixed capital and apply accrual and cash accounting using the System of Information for the Financial Management of the Public Sector. This will permit the compilation of opening and closing balance sheets covering the central government, municipalities and public corporations.

Following 2004 FAD recommendations to reinforce fiscal transparency, the Ministry of Finance included complementary information in the *October 2004 Public Finance Report on the Budget Law Project*. It includes debt liabilities and financial assets of the central government, contingent liabilities (especially government guarantees and concessions), and tax expenditures. In 2006 the government began to publish a report of investments of its assets.

However, further improvements are needed. The most urgent are disaggregating subsidies and grants by level of government; disseminating more detailed data on functional outlays by the level of government; disseminating data on military debt; and reconciling the recording of interest across liabilities, especially with regard to dollar-denominated bonds versus dollar-indexed bonds.

Balance of payments and external debt

The central bank compiles balance of payments and external debt statistics on a quarterly basis, and publishes selected statistics on the external sector on a weekly basis. Beginning in 2002, the central bank has been publishing the International Investment Position consistent with the *fifth edition of the Balance of Payments* Manual (*BPM5*).

The coverage of the military sector in the external statistics is not complete. In particular, the accuracy of data on military imports needs to be verified, as imports that do not go 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. Published data on military expenditure are outdated.

CHILE: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

AS OF JUNE 23, 2006

	Date of latest observation	Date received	Frequency of Data[4]	Frequency of Reporting[4]	Frequency of Publication[4]	Memo Items: Data Quality – Methodological soundness[5]	Memo Items: Data Quality – Accuracy and reliability[6]
Exchange Rates	06/15/2006	06/16/2006	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities	05/31/2006	06/7/2006	M	TM	M		
Reserve/Base Money	05/31/2006	06/7/2006	M	TM	M	LO, LO, LO, LO	LO, LO, LO, NA
Broad Money	05/31/2006	06/7/2006	M	TM	M		
Central Bank Balance Sheet	05/31/2006	06/7/2006	M	TM	M		
Consolidated Balance Sheet of the Banking System	04/30/2006	05/30/2006	M	M	M		
Interest Rates	06/15/2006	06/16/2006	D	D	D		
Consumer Price Index	05/2006	06/05/2006	M	TM	M	O, LO, O, O	LO, O, LO, NA
Revenue, Expenditure, Balance and Composition of Financing[1] – General Government[2]	Q1/2006	5/15/2006	Q	Q	Q	O, LNO, O, O	LO, NA, O, NA
Revenue, Expenditure, Balance and Composition of Financing[1] – Central Government	4/2006	05/31/2006	M	TM	M		
Stocks of Central Government Debt[3]	12/2005	03/31/2006	A	A	A		
External Current Account Balance	Q1/2006	05/23/2006	Q	TM	Q	LO, LO, LO, LO	O, O, LO, O
Exports and Imports of Goods and Services	5/2006	06/7/2006	M	TM	M		
GDP/GNP	Q1/2006	05/23/2006	Q	TM	M	O, O, O, O	LO, O, LO, NA
Gross External Debt	04/2006	06/07/2006	M	TM	M		

[1] Foreign, domestic bank, and domestic nonbank financing.

[2] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds), excluding municipalities.

[3] Including type of instrument, maturity and type of creditor.

[6] Daily (D), Weekly (W), Monthly (M), Twice Monthly (TM), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).

[5] Reflects the assessment provided in the data ROSC published on July 30, 2001 and based on the findings of the mission that took place during March 28-April 11, 2001 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are not applicable (NA), fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

[6] Same as footnote 5, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation, and revision studies.

APPENDIX IV. CHILE: DEBT ANALYSIS (DSA)

Table 1. Public Sector (Central Government) Debt Sustainability Framework, 2001-2011
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2001	2002	2003	2004	2005			2006	2007	2008	2009	2010	2011	
								I. Baseline Projections						**Debt-stabilizing primary balance 12/**
Public sector debt 1/	15.0	15.7	13.1	10.8	7.5			**5.6**	**4.7**	**6.1**	**6.9**	**7.4**	**7.4**	**-0.1**
o/w foreign-currency denominated	13.9	14.7	11.8	9.0	5.4			3.7	2.9	2.0	1.5	1.4	1.2	
Change in public sector debt	1.3	0.8	-2.7	-2.3	-3.3			-1.9	-0.8	1.3	0.8	0.4	0.1	
Identified debt-creating flows (4+7+12)	-0.8	-0.7	-5.3	-6.3	-8.7			-9.1	-6.0	-3.5	-3.5	-3.6	-4.0	
Primary deficit	-2.1	-1.4	-2.2	-4.5	-7.3			-8.6	-6.2	-3.8	-3.5	-3.6	-3.9	
Revenue and grants	23.9	23.3	22.9	24.1	26.6			27.1	26.2	25.0	24.0	23.6	23.2	
Primary (noninterest) expenditure	21.8	21.9	20.7	19.6	19.3			18.5	20.0	21.1	20.5	20.0	19.3	
Automatic debt dynamics 2/	1.3	0.7	-3.1	-1.8	-1.4			-0.6	0.2	0.3	0.0	0.0	-0.1	
Contribution from interest rate/growth differential 3/	-0.5	-0.4	-0.9	-1.1	-0.7			-0.6	0.2	0.3	0.0	0.0	-0.1	
Of which contribution from real interest rate	0.0	-0.1	-0.3	-0.4	-0.1			-0.2	0.5	0.6	0.3	0.3	0.3	
Of which contribution from real GDP growth	-0.4	-0.3	-0.6	-0.7	-0.6			-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	
Contribution from exchange rate depreciation 4/	1.8	1.2	-2.2	-0.7	-0.7			...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	2.1	1.4	2.7	4.1	5.4			7.3	5.1	4.8	4.3	4.0	4.1	
Public sector debt-to-revenue ratio 1/	62.6	67.5	56.9	44.7	28.0			20.6	18.1	24.4	28.9	31.3	32.0	
Gross financing need 6/	1.5	2.9	1.8	-0.1	-1.8			-5.5	-2.8	0.1	0.1	-0.3	-0.7	
in billions of U.S. dollars	1.0	2.0	1.3	-0.1	-2.1	10-Year Historical Average	10-Year Standard Deviation	-7.7	-3.9	0.1	0.1	-0.5	-1.2	Projected Average
Key Macroeconomic and Fiscal Assumptions														
Real GDP growth (in percent)	3.4	2.2	3.9	6.2	6.3	4.3	2.3	5.2	5.5	5.4	5.1	5.0	5.0	5.2
Average nominal interest rate on public debt (in percent) 7/	3.7	3.4	3.7	3.8	4.0	3.5	0.3	6.1	6.5	7.9	6.9	6.8	6.9	6.9
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-0.1	-0.8	-2.1	-3.2	-0.8	-0.7	1.4	-2.8	9.7	12.5	5.5	5.1	4.1	5.7
Nominal appreciation (increase in US dollar value of local currency, in percent)	-12.7	-7.9	18.8	7.1	8.9	-1.9	10.1	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	3.8	4.2	5.8	7.0	4.8	4.2	1.6	8.9	-3.2	-4.6	1.5	1.7	2.8	1.2
Growth of real primary spending (deflated by GDP deflator, in percent)	3.2	2.5	-1.8	0.4	5.0	5.2	4.8	0.9	13.9	11.5	1.8	2.4	1.6	5.3
Primary deficit	-2.1	-1.4	-2.2	-4.5	-7.3	-3.2	2.0	-8.6	-6.2	-3.8	-3.5	-3.6	-3.9	-4.9
								II. Stress Tests for Public Debt Ratio						**Debt-stabilizing primary balance 12/**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2005-10 8/								**5.6**	**7.3**	**8.7**	**9.6**	**10.2**	**10.8**	**-0.5**
A2. No policy change (constant primary balance) in 2005-10								**5.6**	**2.3**	**-1.3**	**-5.6**	**-10.2**	**-14.6**	**0.1**
B. Bound Tests														
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006								**5.6**	**4.3**	**5.2**	**6.0**	**6.5**	**6.5**	**-0.1**
B2. Real GDP growth is at historical average minus one standard deviations in 2005 and 2006 10/								**5.6**	**6.6**	**11.6**	**15.4**	**18.8**	**21.6**	**-0.2**
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006								**5.6**	**11.8**	**18.4**	**19.3**	**19.8**	**19.8**	**-0.2**
B4. Combination of B1-B3 using one standard deviation shocks								**5.6**	**9.7**	**13.6**	**14.8**	**15.5**	**15.8**	**-0.1**
B5. One time 30 percent real depreciation in 2005 11/								**5.6**	**6.0**	**7.4**	**8.3**	**8.7**	**8.8**	**-0.1**
B6. 10 percent of GDP increase in other debt-creating flows in 2005								**5.6**	**14.7**	**16.9**	**17.8**	**18.2**	**18.2**	**-0.2**

1/ Gross debt of the central government. The forecast for the debt stock implicitly includes the effect of the redemption of recognition bonds (amortizations amount to around 1¼ percent of GDP annually in the forecast horizon). The recognition bonds are converted to debt, if the fiscal surplus is not large enough to cover the entire financing needs for the year.

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

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

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

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

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

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

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

9/ The implied change in other key variables under this scenario is discussed in the text.

10/ The two-standard deviation estimate is from 1996-2004, because of the exceptional growth rate in 1995 (10 percent) distorts the results.

11/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

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

Table 2. External Debt Sustainability Framework, 2001-2011
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2001	2002	2003	2004	2005			2006	2007	2008	2009	2010	2011	
								I. Baseline Projections						**Debt-stabilizing non-interest current account 7/**
External debt	56.2	60.2	58.4	45.6	38.9			**33.8**	**35.1**	**35.7**	**34.8**	**33.8**	**32.3**	**-10.9**
Change in external debt	6.8	4.0	-1.8	-12.9	-6.7			-5.1	1.3	0.6	-1.0	-1.0	-1.4	
Identified external debt-creating flows (4+8+9)	0.6	-1.4	-10.3	-22.8	-16.9			-11.9	-10.7	-8.1	-7.6	-7.7	-7.5	
Current account deficit, excluding interest payments	-0.9	-1.3	-0.4	-3.0	-1.8			-3.1	-2.2	1.0	1.9	2.3	2.6	
Deficit in balance of goods and services	-1.5	-2.5	-4.1	-9.0	-8.3			-11.8	-7.1	-2.8	-1.9	-1.9	-2.0	
Exports	32.7	33.5	36.2	40.3	41.4			42.9	41.0	38.6	38.3	38.6	38.5	
Imports	31.2	31.0	32.0	31.3	33.1			31.1	33.9	35.8	36.4	36.7	36.5	
Net non-debt creating capital inflows (negative)	-5.8	-3.3	-6.4	-8.0	-8.3			-8.2	-7.6	-8.0	-8.5	-8.9	-8.9	
Automatic debt dynamics 1/	7.3	3.2	-3.5	-11.8	-6.8			-0.6	-0.8	-1.1	-1.0	-1.1	-1.2	
Contribution from nominal interest rate	2.5	2.1	1.7	1.3	1.2			1.1	1.1	0.8	0.7	0.5	0.4	
Contribution from real GDP growth	-1.8	-1.3	-2.2	-2.8	-2.4			-1.7	-1.9	-1.9	-1.7	-1.6	-1.6	
Contribution from price and exchange rate changes 2/	6.6	2.3	-3.1	-10.3	-5.6			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	6.2	5.4	8.6	9.9	10.2			6.8	12.0	8.7	6.6	6.7	6.1	
External debt-to-exports ratio (in percent)	172.0	179.5	161.6	113.1	93.9			78.7	85.6	92.6	90.7	87.4	84.0	
Gross external financing need (in billions of US dollars) 4/	9.0	11.3	11.6	13.0	11.7			12.3	9.8	10.8	12.2	9.8	9.7	
in percent of GDP	13.1	16.8	15.7	13.7	10.2	8-Year Historical Average	8-Year Standard Deviation	8.8	7.1	7.9	8.4	6.4	5.9	Projected Average
Key Macroeconomic Assumptions														
Nominal GDP (US dollars)	68.6	67.3	73.7	95.0	115.3			140.1	137.8	137.3	145.1	153.7	165.8	
Real GDP growth (in percent)	3.4	2.2	3.9	6.2	6.3	3.6	2.3	5.2	5.5	5.4	5.1	5.0	5.0	5.2
Exchange rate appreciation (US dollar value of local currency, change in percent)	-15.0	-7.8	-0.4	13.4	8.9	-3.1	9.8	6.0	-3.6	-0.9	-0.9	-0.8	0.0	0.0
GDP deflator (change in domestic currency)	3.8	4.2	5.8	7.0	4.8	4.3	1.7	8.9	-3.2	-4.6	1.5	1.7	2.8	1.2
GDP deflator in US dollars (change in percent)	-11.8	-4.0	5.4	21.4	14.1	1.2	11.6	15.5	-6.7	-5.4	0.6	0.8	2.8	1.3
Nominal external interest rate (in percent)	4.6	3.7	3.1	3.0	3.3	4.0	0.9	3.4	3.1	2.4	2.0	1.6	1.2	2.3
Growth of exports (US dollar terms, in percent)	-3.8	0.7	18.1	43.6	24.7	11.4	16.9	25.9	-6.0	-6.2	5.0	6.7	7.4	5.5
Growth of imports (US dollar terms, in percent)	-2.2	-2.5	13.1	26.1	28.2	-17.1	74.4	14.3	7.1	5.2	7.6	6.8	7.3	8.0
Current account balance, excluding interest payments	0.9	1.3	0.4	3.0	1.8	1.0	1.9	3.1	2.2	-1.0	-1.9	-2.3	-2.6	-0.4
Net non-debt creating capital inflows	5.8	3.3	6.4	8.0	8.3	7.1	2.7	8.2	7.6	8.0	8.5	8.9	8.9	8.4
								II. Stress Tests for External Debt Ratio						**Debt-stabilizing non-interest current account 7/**
A. Alternative Scenario														
A1. Key variables are at their historical averages in 2005-09 5/								33.8	34.4	32.1	29.9	28.0	26.2	-7.3
B. Bound Tests														
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006								33.8	36.1	38.0	36.9	35.8	34.3	-11.0
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								33.8	37.5	40.5	39.1	37.7	35.8	-12.3
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006								33.8	42.4	51.9	49.6	47.2	44.1	-15.7
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006								33.8	40.2	42.8	41.5	40.3	38.4	-11.3
B5. Combination of B1-B4 using one standard deviation shocks								33.8	42.1	48.0	46.6	45.2	43.2	-13.3
B6. One time 30 percent nominal depreciation in 2005								33.8	49.2	49.7	47.6	45.4	42.5	-14.9

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

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

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

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

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

6/ The implied change in other key variables under this scenario is discussed in the text.

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

INTERNATIONAL MONETARY FUND

CHILE

Staff Report for the 2006 Article IV Consultation
Supplementary Information

Prepared by the Western Hemisphere and Policy Development and Review Departments

Approved by Markus Rodlauer and Adrienne Cheasty

July 26, 2006

This supplement provides an update of policy developments since the release of the staff report (www.imf.org). The thrust of the staff appraisal remains unchanged.

1. In its July meeting, the central bank increased its policy rate by 25 basis points (to 5.25 percent) and announced that further monetary tightening would be data-dependent and more gradual.

2. The presidential commission appointed to suggest proposals for the reform of the pension system presented its findings on July 6, 2006. The report recommends the creation of a solidarity pillar guaranteeing a basic universal pension for the poor, introducing a requirement for the self-employed to contribute, streamlining and liberalizing the pension fund investment regime, and separating account and investment management functions. In the coming months, the government is expected to decide how to go forward with the pension reform, including which proposals of the commission to retain, and to send a draft bill to congress to that effect.

3. On July 20, the Minister of Finance announced a set of reforms aimed at encouraging entrepreneurship, improving technological competitiveness, deepening the capital markets, and continuing to build modern institutions. Some of these measures have a limited fiscal impact, which the authorities plan to accommodate under the structural surplus rule. The main measures are as follows:

- The draft fiscal responsibility law (see www.imf.org for details) was designated a legislative priority, to ensure its expeditious passage by congress.

- The government plans to rekindle the legislative process on the draft Capital Market II reform bill in August, and to send a revised bill to congress to ensure its prompt approval.

- The government will seek legislative approval to streamline financial taxation, including with a proposal to gradually reduce the stamp tax rate from 1.6 percent at present to 1.2 percent by 2009 and to exempt all refinancing operations from the tax. The government also plans to issue regulations to simplify the capital gains tax and clarify the conditions for exemptions, in line with staff recommendations.

- To enhance the internationalization of the peso, the government plans to facilitate the issuance of peso bonds by foreign investors, including multilateral organizations, in both the Chilean market and abroad. The settlement and netting arrangements for derivative instruments will be brought to international standards.

- To improve technology and innovation the authorities plan to unify taxes on imported software, patents, and other technological services, at a reduced rate of 15 percent. They also plan to provide subsidies and tax exemptions for research and development spending by private companies.

INTERNATIONAL MONETARY FUND
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IMF Executive Board Concludes 2006 Article IV Consultation with Chile

On August 2, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Chile.[1]

Background

Over the past fifteen years, structural reforms and prudent economic policies have helped anchor Chile's successful economic performance. Since 2000, its economic strategy has been based on a fiscal policy rule, inflation targeting with a floating exchange rate, trade liberalization, and an open capital account, within a sound financial regulatory and supervisory framework. These policies have provided Chile with enviably high rates of economic growth and low inflation. During the 15–year period through 2005, growth averaged 5½ percent a year, per capita income tripled in U. S. dollar terms, and the poverty rate was cut in half, to about 18 percent. Income inequality, however, remains high.

In recent years, Chile has continued to deepen its sound macroeconomic framework, in the context of a surge in the world price of copper, its main export commodity. Chile's new administration, which assumed office in March, has reaffirmed its support for this framework. The central bank has continued to manage monetary policy prudently, in the context of the inflation targeting framework. Since September 2004, it has raised its policy rate by a total of 350 basis points, to 5.25 percent, in response to the economic recovery and the gradual closing of the output gap. Consistent with the structural surplus rule and high copper price levels, the central government registered an overall surplus of 4¾ percent of GDP in 2005, up from 2¼ percent in 2004. The ratio of Chile's net public sector debt (including the debt of the central bank and public enterprises) fell from about 13 percent of GDP in 2003 to 7½ percent in 2005.

[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.

The outlook for Chile remains positive, reflecting strong prospects for copper and robust domestic demand. Following growth of 6.3 percent in 2005, real GDP is projected to rise by 5-6 percent in 2006, buttressed by a favorable external environment and still supportive monetary policy. Domestic consumption growth is expected to remain buoyant, boosted by higher incomes and employment. Consistent with the structural surplus rule, and in line with projected copper prices, the central government would register an overall surplus of close to 6 percent of GDP in 2006. The current account surplus is projected at close to 2 percent of GDP in 2006, reflecting high copper prices and a moderation in capital goods imports. Inflation expectations remain well anchored and headline inflation is expected to move gradually to the middle of the 2-4 percent target range. Despite steady employment growth, the unemployment rate is still relatively high, at about 8 percent, as strong economic growth has encouraged more workers to return to the labor market.

Executive Board Assessment

Executive Directors commended the Chilean authorities for their continued exemplary implementation of sound macroeconomic policies, based on strong and well-established institutions, and reinforced by strict adherence to the structural fiscal surplus rule, a highly-regarded inflation targeting framework, increasing trade integration, and a robust financial system. These policies have yielded substantial benefits, including low inflation, sustained economic growth with an attendant significant reduction in poverty, and strengthened investor confidence and resilience to external shocks.

Directors noted that the near-term outlook appears bright, with the continuing strength of domestic consumption and exports expected to contribute to rapid economic growth, at a time when investment is returning to more sustainable levels. The risks to the outlook appear broadly balanced and the authorities have appropriately recognized the need to gear macroeconomic policies toward managing the copper price boom effectively.

Directors welcomed the authorities’ strict adherence to the structural fiscal surplus rule, which calls for a structural surplus of 1 percent of GDP in the overall balance of the central government, and provides effective counter-cyclical support to the economy. They commended the authorities for keeping spending growth in check, despite higher revenues associated with the surge in copper prices. Going forward, Directors advised continued commitment to fiscal discipline, while recognizing the priorities of the government to increase social spending in health and education. They welcomed plans to use the copper windfalls prudently, by accumulating resources to cover future contingent liabilities, recapitalizing the central bank, and investing the surpluses. A few Directors suggested a faster pace of recapitalization than currently envisaged.

Directors highlighted the success of Chile’s inflation targeting framework in anchoring inflation expectations. They supported the gradual tightening of monetary policy under way, and concurred that any further tightening should be largely data driven, given the difficulty of assessing the exact timing of the closing of the output gap. Directors also noted that, if the fiscal stance were to evolve differently than expected in 2007, the central bank should be ready to adjust monetary policy accordingly.

Directors observed that the floating exchange rate regime has allowed the economy to adjust smoothly to external shocks. The transparent policy framework, with no central bank intervention in the foreign exchange market and supported by fiscal prudence, has helped sustain competitiveness, as evidenced by the continued strength of nontraditional exports. Directors noted that, going forward, continued fiscal restraint, together with the investing of the fiscal surpluses abroad, would help limit upward pressures on the currency.

While commending the soundness of Chile's financial sector, Directors saw room for further efficiency improvements, while maintaining sound oversight, consistent with the recommendations of the 2004 Financial System Stability Assessment. They encouraged the authorities to keep the growth in consumer lending under close scrutiny and to continue enhancing the consolidation of risk information. In this context, Directors welcomed the authorities' recent announcement to restart the legislative process towards early approval of the Capital Markets II draft law. They also supported the plans to streamline financial taxation, including the stamp tax and capital gains tax, and to reform the private pension system with a view to extending its coverage, strengthening the social safety net, improving competition in the sector, and liberalizing the investment regime of the pension funds. Directors welcomed the recent revision to the AML/CFT legislation that will enhance the ability of the Financial Intelligence Unit (FIU) to obtain information and more effectively combat money laundering.

Directors supported the authorities' medium term emphasis on promoting sustained growth and reducing income inequality. They welcomed reforms to improve pre-school coverage for low-income groups, enhance funding for tertiary education, and promote research and development. Directors also encouraged the authorities to improve labor market flexibility further in order to increase employment opportunities and address the still high unemployment rate, especially among the young. Progress in these areas will be key to enhancing productivity and competitiveness and to supporting further economic diversification in the medium term.

Directors welcomed Chile's leadership role in opening markets through comprehensive and sustained trade and financial market liberalization. They commended the authorities for the implementation of recent bilateral free trade agreements and for their strong commitment to multilateral trade liberalization.

	2000	2001	2002	2003	2004	2005
(Annual percentage change)						
Production and prices						
Real GDP	4.5	3.4	2.2	3.9	6.2	6.3
Total domestic demand	6.0	2.4	2.4	4.9	8.1	11.4
Consumption	3.6	2.9	2.5	4.0	6.1	7.6
Investment	14.0	0.8	2.2	7.8	14.3	22.2
Fixed	8.9	4.3	1.5	5.7	11.7	24.7
Inventories 1/	1.2	-0.8	0.2	0.5	0.8	-0.3
Net exports 1/	-1.3	1.0	-0.2	-0.9	-1.9	-5.2
Consumer prices						
End of period	4.6	2.7	2.9	1.1	2.5	3.7
Average	3.8	3.6	2.5	2.8	1.1	3.1
Real wages	1.4	1.6	2.0	0.9	1.8	1.9
Unemployment rate (annual average)	9.2	9.2	9.0	8.5	8.8	8.0
Money, credit, and interest rates						
Broad money	5.3	4.9	3.3	2.3	11.7	22.1
Credit to the private sector	12.1	8.1	9.6	11.4	14.8	15.4
Three-month interest rate 2/	10.8	7.2	3.9	2.8	1.8	3.5
(Billions U.S. dollars, unless otherwise indicated)						
Balance of Payments						
Current account	-0.9	-1.1	-0.6	-1.0	1.6	0.7
In percent of GDP	*-1.2*	*-1.6*	*-0.9*	*-1.3*	*1.7*	*0.6*
Trade Balance	2.1	1.8	2.4	3.7	9.2	10.2
Exports of Goods	19.2	18.3	18.2	21.7	32.2	40.6
Copper Exports	7.3	6.5	6.3	7.8	14.5	18.3
In percent of total exports	*37.9*	*35.8*	*34.8*	*36.1*	*45.0*	*45.1*
Agricultural Exports	1.7	1.7	1.8	2.1	2.3	2.5
In percent of total exports	*8.8*	*9.5*	*9.9*	*9.8*	*7.3*	*6.1*
Imports of Goods	17.1	16.4	15.8	18.0	23.0	30.4
Oil Imports	2.0	1.6	1.5	2.0	2.7	3.6
In percent of total imports	*11.7*	*10.0*	*9.7*	*11.2*	*11.9*	*11.8*
(Annual percentage change)						
Exports	11.9	-4.9	-0.5	19.2	48.7	25.9
Imports	16.0	-3.9	-3.9	13.8	28.0	32.0
Terms of trade	4.5	-7.2	3.7	9.7	20.7	12.5
Real effective exchange rate 3/	-2.9	-10.1	-6.9	13.4	-3.7	11.9
Net Foreign Direct Investment	-85.9	196.5	-14.8	22.4	109.0	-19.9
In percent of GDP	*1.2*	*3.8*	*3.3*	*3.7*	*5.9*	*3.9*
(In percent of GDP)						
Saving and investment						
Gross domestic investment	21.9	22.1	21.7	21.9	21.4	23.0
Public	2.7	2.6	2.6	2.3	2.1	2.1
Private	19.1	19.5	19.1	19.6	19.2	20.9
National savings	20.7	20.5	20.8	20.6	23.0	23.6
Public 4/	2.0	2.4	1.6	2.5	4.9	7.7
Private	18.6	18.2	19.1	18.2	18.1	15.9
External savings	1.2	1.6	0.9	1.3	-1.7	-0.6
Public sector finance						
Net debt	...	10.9	11.0	13.1	10.8	7.7
Excluding public enterprises	...	6.4	5.5	7.2	5.5	2.6
Gross debt 5/	40.9	41.9	42.8	44.6	39.4	31.7
Central government	13.7	15.0	15.7	13.1	10.8	7.5
Central government balance	-0.7	-0.5	-1.2	-0.5	2.2	4.7
External Debt						
Gross external debt	49.4	56.2	60.2	58.4	45.8	39.0
Public	8.0	8.9	10.7	12.6	10.3	8.3
Private	41.4	47.3	49.5	45.8	35.5	30.7

Statement by Javier Silva-Ruete, Alternate Executive Director for Chile and Eduardo López-Escobedo, Senior Advisor to Executive Director
August 2, 2006

Key Points

- *Against the backdrop of the continuing favorable external environment, Chile's GDP and domestic demand growth are expected to be around 5 to 6 percent in 2006-07, approximately in line or slightly above potential output growth. Although headline inflation is at the top of the target range due to high fuel prices, core inflation measures and expectations are well-anchored around the middle of the range over the policy time horizon.*

- *Thanks to prudent management of the copper price boom, the credibility of the macro-financial policy framework and the favorable external outlook, the risks to macroeconomic and financial stability are limited.*

- *Chile's new government has focused its policy agenda on ensuring conditions for sustained growth while guaranteeing a wide network of social protection for citizens. To meet such goals several policy initiatives have been proposed.*

Our authorities would like to thank the IMF staff for another comprehensive and useful report, and for continuing the tradition of a collaborative policy dialogue with Chile's authorities. We look forward to conveying the results of this Board discussion to our authorities.

Recent Economic Developments, Outlook and Risks

1. **The external environment relevant for the Chilean economy remains very favorable**. In a context of high and more balanced growth of the global economy, copper and oil prices have reached record-high levels during the first half of 2006. Notwithstanding the recent correction of stock and commodity prices in the global market, Chile's external conditions are clearly supportive.

2. Coherent with the transitory nature of these positive developments in terms of trade, **the current account will post a surplus this and next year**. In line with this evaluation of external conditions and following the gradual normalization of monetary policy, **domestic demand and GDP** growth have moderated in the first two quarters of 2006, getting closer to their medium-term growth path. Moreover, during the second half of the year, latest output indicators point toward a somewhat lower increase in growth rates than what was previously considered around the time of IMF mission to Chile. Meanwhile, **wage-based employment** continues to increase relatively vigorously, but our authorities are aware that drawing strong

conclusions on unemployment trends, employment growth, productivity and unit labor costs is very difficult at the time, due to methodological changes in the official labor survey implemented during the first half of 2006. Nevertheless, Chile's National Institute of Statistics (INE) is working on methodologies to make the data comparable.

3. Headline **inflation** is currently at the top of the target range, and the Central Bank considers that it will converge to the center a few quarters ahead, once one-off higher fuel prices effects fade away. Measures of core inflation —that exclude fuels, perishables and some regulated utilities— and of inflation expectations are well-anchored around 3 percent. While fuel prices have continued on the rise, the rate of increase in aggregate **wages** has eased in 2006, bringing about well behaved unit labor costs pressures.

4. The external environment, coupled with Chile's strong monetary and fiscal fundamentals, should continue to support growth in 2006-2007. The Chilean economy is widely expected to grow in the range of 5 to 6 percent over the next two years – roughly in line or slightly above with the expansion in potential output. In this respect, the key **risks for the outlook** of the Chilean economy remain largely external and broadly balanced, related, on the downside, to the uncertainty in commodity prices —specially further oil price increases—, abrupt increases in international interest rates and its subsequent negative effects on emerging market investors sentiment; and the uncertainty regarding the evolution of house prices in some important industrial economies. On the upside, a more favorable development could result from growth of the global economy and the continuation of high copper prices. In addition to these risks, the staff also suggests that disruptions in the gas supply from Argentina could lead to an upward adjustment of production costs, with negative implications for domestic demand and growth. However, our authorities consider that the extensive conversion process to alternative energy sources that has taken place, plus the recent negotiations with Argentine authorities, ensure a moderated impact.

5. Against the backdrop of domestic financial conditions still expansionary, our authorities' assessment is that the **risks for the financial stability** are reduced. First, Chile's financial system is profitable, well-capitalized with historically low levels of non performing loans, and effectively supervised and regulated. Second, the corporate sector and households' balance sheets are in solid position. And third, the risks of accessing to external funding are low, since Chile's economy has no external financing needs in 2006-07, the external debt ratio has continued its improvement in the first half of 2006, while corporate and banking sectors have appropriately hedged their currency risks. Moreover, the Central Bank of Chile's (CBC) foreign reserve adequacy ratios, together with the external assets accumulated by the government due to high copper prices, provide an additional buffer against external shocks.

Macroeconomic Policy Stance

6. Chile's **monetary policy** framework –a target of 3 percent ± 1 percent for the inflation rate, together with a floating exchange rate– continues to serve the economy well. The CBC has pursued a cautious and pragmatic approach by withdrawing monetary stimulus, consistent with the goal of maintaining inflation around 3 percent over the policy horizon of 12 to 24 months. Since September 2004, the CBC has raised its policy rate by 350 basis points to 5¼ percent. Given its view that the economy is presently operating with little or almost no slack, the CBC considers that, in the most likely scenario, further gradual rate hikes would likely be necessary to bring inflation closer to the target, but new policy rate changes will be data-dependent and will probably be less frequent than in previous quarters. The monetary policy stance is clearly understood by the private sector, as it is reflected in, foremost, well anchored inflation expectations around 3 percent, and widespread expectations that further gradual rate hikes lie ahead. The market remains divided on the frequency and extent of further interest rate adjustments, with some participants arguing that the monetary tightening cycle might be coming close to an end.

7. Thanks to the copper price windfall and the adherence to the rule of structural surplus, **fiscal policy** is expected to reach a significant increase in the surplus in 2006 to around 6 percent of the GDP. This will allow further reduction of both the government's gross and net debt ratios to levels compared favorably with those of economies with similar sovereign risk grade. The strong position of public finances provides the economy enough flexibility to adjust quickly in the face of possible deterioration of the external environment. As the staff has explained in their report, government authorities are mindful of the expansive effect on spending of high cooper prices in 2007 and are committed to manage this revenue windfall prudently. In particular, to avoid Dutch-disease like effect, the authorities are planning to give priority in the 2007 budget to spending recomposition towards spending outlays with high tradable content.

Government's Structural Goals

8. After twenty years of continued high expansion of GDP per capita averaging around 4.1 percent per year during 1991-2005 to reach about US$ 7 thousand per person, Chile has registered significant distributive and poverty changes in the last fifteen years, which is mainly reflected in a reduction of poverty incidence from 45 percent in 1987 to 19 percent in 2003. Nevertheless, Chile still belongs to the group of middle-income emerging economies which face vulnerabilities from external shocks. Mindful on this reality, the new administration has emphasized that Chile faces two challenges looking forward: ensuring conditions for **sustained growth** in an increasingly flexible economy while guaranteeing a wide network of **social protection** for citizens.

Boosting Productivity and Growth

9. In order to maintain and to deepen Chile's favorable economic outlook beyond for 2006-07 and reach sustained growth in the long-term, it is important to build up and consolidate appropriate conditions for the **entrepreneurship**, with a special emphasis on the development of small and medium size enterprises (SME). This will lead to more investment and job creation while reducing social inequalities. Our authorities have taken concrete initiatives such as a tax debt relief for SMEs reaching up to 80 percent of interest and penalties, a gradual reduction of the stamp tax on debt reschedulings that take into account revenue collection, the establishment of a simplified tax system for SMEs, strengthening of the *Fondo de Garantia para Pequeñas Empresas* (FOGAPE) —a government fund that provides guarantees on bank loans to SMEs—by adding US$ 10 million to allow 46 percent more government-guaranteed loans to this sector, the enlargement of SME base of BancoEstado, Chile's state-owned bank to reach 300 thousand customers by 2008, specific measures to strengthen the liquidity position of SMEs, the development of the risk and venture capital industry through the congressional approval of the Capital Market Reform (MKII) package.

10. Our authorities believe that strengthening **innovation** is also crucial to Chile's long-term development. Macroeconomic stability, market-friendly FDI and trade regimes constitute important conditions for promoting innovation. But, Chile's innovation activities are driven and funded by the public sector through a fragmented National Innovation System, which result in R&D spending of only around 0.7 percent of GDP. To overcome this drawback, our authorities intend to put in practice the recommendations of the National Innovation Council set up during the former administration, financed with the resources from the mining royalty which are estimated to reach US$ 150 million a year in steady state. In that direction, the government is committed to establish a 15 percent flat tax on the software and technology imports, and also has submitted to Congress a draft bill that establishes a 35 percent subsidy on R&D spending carried out by companies together with universities and research centers.

11. Chile's performance over the past decade is due to a large extent to the strengthening of pro-competition regulation in place. Taking further steps to **promote market competition** is another important challenge to boost productivity. In this area, the initiatives to be taken are related to strengthening the governance framework for free competition, by allocating more resources to the Office of the National Economic Attorney and the Court of Free Competition, setting up a new merger policy with penalties which discourage the risks of market collusion.

Building a Social Safety Net

12. The new administration is committed to developing an economic institutional framework that assures citizens a social safety net so as to complement steadily the efforts oriented to boost innovation and entrepreneurship. This protection framework is intended to be built upon two pillars. First, a macroeconomic policy framework oriented to strengthen the resilience of the economy against shocks. Second, a social policy focused on the creation of a social safety net.

13. Alongside the prudent management of the terms of trade boom and the reduced cost of external financing, **the monetary, exchange rate —which includes the possibility of interventions in exceptional circumstances— and fiscal policy framework** in place provides adequate shock absorbers that limit the economic and financial impact of a possible abrupt reversion of external conditions, particularly over the last several years, when the economy has been subject to a series of shocks, notably sharp increases in commodity prices and a significant appreciation of the exchange rate, all in the context of continuing global growth.

14. The government is fully committed to **fiscal prudence**, explicitly based on a target for the central government structural surplus of 1 percent of GDP, which has contributed in strengthening Chile's credibility in the international financial markets, reducing the spread at which residents can borrow abroad, and allowing automatic stabilizers to function. Furthermore, our authorities are committed to **strengthen fiscal transparency and accountability**, reflected in the Law of Fiscal Responsibility, which is expected to be approved by Congress during the second half of 2006. The initiative contemplates the legal obligation for future governments to set forth the basis for their fiscal policy during the first 90 days of their administration. In addition, it includes other initiatives such as the creation of a new Economic and Social Stabilization Fund as described in the staff report; the creation and regulation of the Pension Reserve Fund, which will accumulate resources guaranteeing future payments of minimum and assistance pensions due to rise as of 2016; the establishment of rules for the management and reporting of resources from both Funds, and the authorization for the government to make capital contributions to the Central Bank on account of actual surplus.

15. Building on the progress made by former administrations, the new government has emphasized that the focus of it social policy is on both protecting citizens over their life cycle and raising living standards. This safety net starts with **childhood protection** by removing inequities at birth, enhancing the coverage and facilitating the access to childcare centers, which may result in promoting women's labor participation. The government has already increased preschool education coverage for 20 thousand children by opening 800 childcare centers. Furthermore, the recommendations of the Advisory Committee for Childhood will be considered in the design of a new childhood protection policy, which will be brought to Congress for its legislative discussion.

16. Similar measures have been taken for the **protection of the elderly**, including initiatives such as the bills approved in Congress that raised pensions for those over 65 years-old, and guarantees gratuity in public hospitals for all citizens 60 years-old or more. Another initiative, of a more structural nature, and on which the government has put special emphasis on is that of the pension system reform, based on the assessment and recommendations made by the President's Advisory Committee. In early July the committee issued its report covering 70 reform proposals in 11 areas, whose most important element have been described by the staff in the supplementary note. After an analysis of the report by a committee of ministers, the draft bill is expected to be sent to Congress late this year. The discussion in Congress is expected to take place during 2007.

17. Last but no least, the new government also aims at **raising the population's living standards**. Since 1991 the housing defict has been halved with the help of the construction of almost 2 million units. In order to reduce this deficit further by 20 percent over the next four years, the government has recently announced the establishment of a new social housing policy, which intends to raise the standards of construction and design of government-supported houses, and subsidize the housing localization to avoid urban segregation. In a complementary direction, the government plans to take a series of measures to enhance urban security, including increased spending on the police force, and the creation of a Ministry of Homeland Security.

Conclusion

18. In a nutshell, these measures, in the context of a sound and responsible fiscal and monetary policy framework in place, will allow Chile to continue its road to development, by creating the conditions for stronger productivity growth, a key ingredient to sustained economic growth and rising living standards.