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Chile: 2007 Article IV Consultation—Staff Report; 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 2007 Article IV consultation with Chile, the following documents have been released and are included in this package:

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 5, 2007, with the officials of Chile on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 25, 2007. 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 Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 16, 2007 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Chile.

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

Selected Issues Paper

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

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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INTERNATIONAL MONETARY FUND

CHILE

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the
2007 Consultation with Chile

Approved by Markus Rodlauer and G. Russell Kincaid

June 25, 2007

- ***Discussions for the 2007 Article IV consultation took place in Santiago and by videoconference during May 22-June 5, 2007***.

- ***Given the broad consensus on economic policies, and the absence of systemic issues, the 2007 Article IV consultation is streamlined***. The last consultation was concluded on August 2, 2006. Brief summaries of ongoing background work are presented in a *Selected Issues* paper (see also Annex 1).

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

- ***Chile is a party to the Financial Action Task Force on Money Laundering in South America (GAFISUD)*** and to the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. An AML/CFT Assessment was conducted and approved by GAFISUD in 2006 (www.gafisud.org/pdf/InformeChile.pdf).

- The mission met with Governor Corbo, Finance Minister Velasco, Economy Minister Ferreiro, Labor Minister Andrade, other senior government officials; and representatives of financial institutions, the private sector, and academia.

- The staff team comprised Messrs. Mühleisen (head), Söderling, Monfort and Walsh (all WHD). M. Kumhof (RES) presented a paper at the Banco Central de Chile (BCC). Mr. A. Rojas, Senior Advisor to the Executive Director, also attended the meetings. Mr. Rodlauer (WHD) participated in the final discussions, and Mr. Singh joined the concluding videoconference with Minister Velasco.

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Executive Summary

Owing to strong institutions and sound economic policies, Chile has experienced two decades of economic stability and increasing living standards. The rules-based policy framework has helped preserve competitiveness during the recent copper boom. With trend growth at around 5 percent, further progress has been made in reducing poverty, although income inequality remains relatively high.

Following a strong performance in the first quarter, growth is expected to reach 5¾ percent in 2007, with the output gap likely to close in 2008. Fiscal policy remains anchored by the structural surplus rule; as the government has paid down debt and moved into a net creditor position, the structural surplus target has been lowered from 1 to ½ percent of GDP as of 2008. Given the strong growth outlook, monetary policy will likely tighten gradually as excess capacity is absorbed. The exchange rate is assessed to be broadly in line with fundamentals.

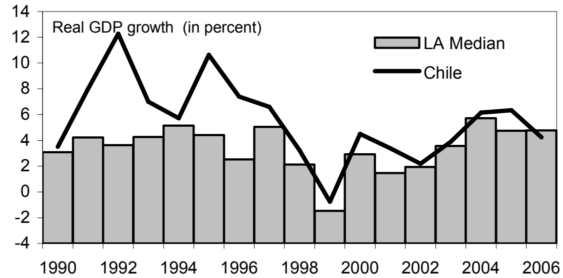
This streamlined consultation has focused on two key areas, reaffirming a broad consensus with the authorities:

- ***The macroeconomic policy framework***. The authorities remain committed to the well-tested policy framework consisting of a freely floating exchange rate, an inflation targeting framework, and responsible fiscal policy as embedded in the structural surplus rule. Successful implementation of this framework has created increasing room for addressing social priorities, which the authorities intend to pursue in an incentive-compatible manner, accompanied by further increases in transparency.

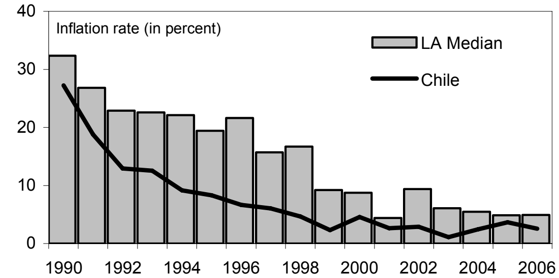
- ***Bridging the income gap with advanced economies***. Policies to raise long-term growth prospects focus on education, job-specific human capital, and innovation. Financial sector reforms are aimed at increasing depth and competition in Chile's financial sector, and integrating Chile further into the global financial system.

Figure 1. Overview

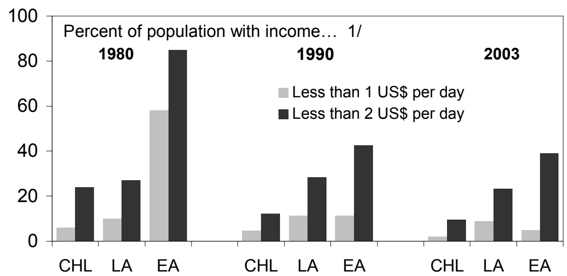
Chile has grown faster than many Latin American countries...



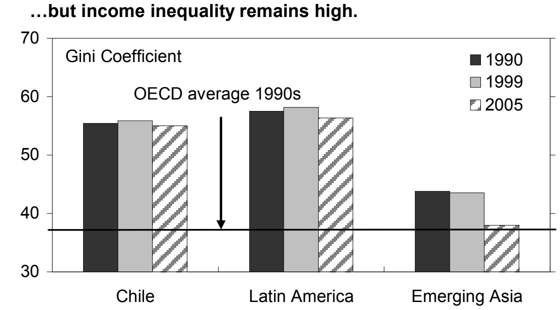
...while being at the forefront of introducing price stability to the region.



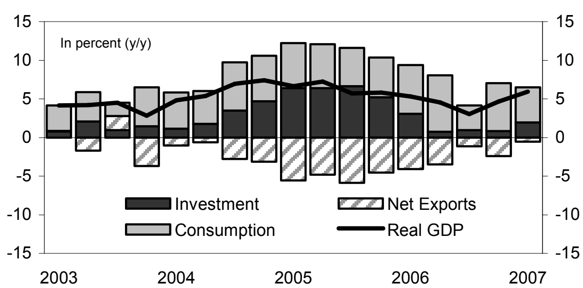
Substantial progress has been achieved in poverty reduction...



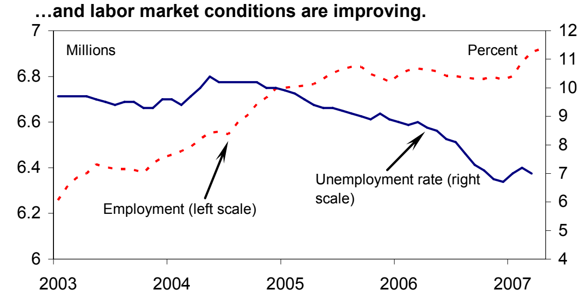
...but income inequality remains high.



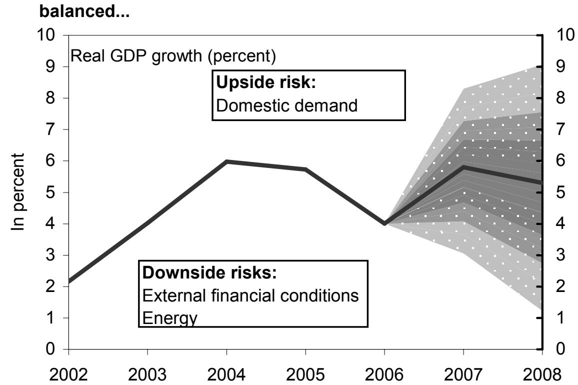
Growth is rebounding strongly from a soft patch in 2006...



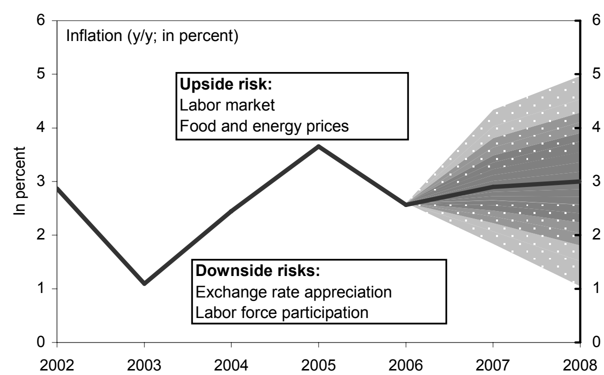
...and labor market conditions are improving.



Growth is expected to exceed potential, with risks broadly balanced...



...while risks to the inflation outlook are mildly on the upside.



Source: Haver, WDI, Economic Commission for Latin America Social Panorama (2006), and Fund Staff estimates.
1/ Chart is based on World Bank definition; this may differ from national poverty lines.

I. INTRODUCTION

1. ***Over the past fifteen years, Chile's consistent economic reforms and prudent macroeconomic policies have delivered strong growth and low inflation***. Per capita income tripled in U.S. dollar terms since 1990 and the poverty rate was cut by two-thirds, to about 14 percent. Growth was fastest during the mid-1990s, but has slowed somewhat in recent years amid stagnant employment, less FDI inflows, and declining labor productivity growth. Moreover, extreme poverty persists—although mitigated by well-targeted social programs—and income inequality remains relatively high.

2. ***Key elements of Chile's economic policies have been institutionalized, increasing transparency and reducing volatility***. With its open economy and liberal trade regime, the macroeconomic policy framework—a floating exchange rate, inflation targeting and a structural fiscal surplus rule—has been geared toward reducing economic volatility from shocks. These policies have helped maintain the economy's competitiveness despite the high price volatility of copper, Chile's main export product, and provide increasing room to address social priorities.

3. ***Domestic consensus on the policy framework remains solid***. President Bachelet took office in March 2006 with a strong mandate to strengthen social policies within a sound macroeconomic framework. The government enjoys a majority in both houses of Congress, and although it has grappled recently with a complex overhaul of Santiago's public transit system, it is actively pushing forward an ambitious reform agenda. In May, the President announced a reduction in the structural surplus target from 1 to ½ percent of GDP in 2008, with additional resources to be devoted primarily to education.

4. ***The discussions have reaffirmed a broad consensus on economic policies and reform priorities between the authorities and the Fund*** (last year's Board discussion is summarized in PIN No. 06/97).

II. OUTLOOK AND RISKS

5. ***Following a strong rebound in the first quarter of 2007, growth is projected at about 5¾ percent this year***. The completion of some large capital projects has boosted productive capacity, and consumer demand remains strong, underpinned by favorable labor market conditions and buoyant consumer credit growth.[1] Growth is also underpinned by a supportive fiscal and monetary policy stance, and a broad-based rise in exports.[2] With potential growth estimated at 5 percent, Fund and central bank staff expect the output gap to

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[1] Staff analysis suggests that credit growth in Chile is less affected by the cycle than by structural developments, such as rising department store lending to low and middle-income households.

[2] Staff estimates of the fiscal impulse (Table 2) are preliminary and work in progress.

Economic Outlook
(In annualized percent change from previous period; unless otherwise indicated)

				Est.	Projections	
	2003	2004	2005	2006	2007	2008
Real GDP	4.0	6.0	5.7	4.0	5.8	5.3
Net exports (contribution)	-0.6	-1.2	-5.0	-2.2	-1.5	-0.8
Total domestic demand	4.9	7.5	11.0	6.0	7.1	5.8
Private consumption	4.2	7.0	7.9	7.1	6.8	5.8
Public consumption	2.5	6.1	5.3	3.6	7.8	6.6
Private fixed investment	6.5	10.5	23.2	3.3	6.3	5.5
Public fixed investment	-0.4	5.7	11.2	10.9	20.9	9.8
Inventories (contribution)	0.6	0.1	0.5	0.1	0.0	0.0
Unemployment rate (percent)	9.5	10.0	9.3	7.9	...	...
Consumer price index	2.8	1.1	3.1	3.4	2.8	3.0
General government fiscal balance (in percent of GDP)	-0.4	2.1	4.7	7.8	6.1	2.9
Current account balance (in percent of GDP)	-1.1	2.2	1.1	3.6	3.4	0.8
Memorandum items:						
Output Gap	-2.5	-0.9	-0.1	-1.1	-0.3	0.0
Copper price (US$/pound)	0.8	1.3	1.7	3.1	2.7	2.0

close in 2008 (from around 1 percent at end-2006) and inflation to return to the 3 percent target.

6. ***Risks to the outlook appear broadly balanced***. The baseline forecast implies some softening in the pace of expansion toward the end of the year, but there is a possibility that the already strong domestic momentum could receive a further boost from improving labor market conditions. On the other hand, drought conditions and interruptions in gas deliveries from Argentina pose risks to electricity production; rises in oil and food prices would reduce disposable income; and tightening global liquidity might dampen domestic credit expansion.

7. ***Supply shocks and diminishing excess capacity could present upside risks to inflation***. Strong import growth has helped contain price increases, and overall labor cost growth has been moderate despite a strong pickup in hourly wages. Stronger demand conditions could imply a more rapid closing of the output gap, although officials at the Banco Central de Chile (BCC) were optimistic that a procyclical rise in labor participation would limit pressure on unit labor costs.

8. ***Banks are profitable and highly capitalized, and the financial system appears well prepared to weather an external shock***. Reflecting sound economic fundamentals and the government's strong balance sheet, staff analysis suggests that a drop in global risk appetite to the lows of 1998 could push up Chile's EMBI spread only by a modest 70 basis points. While this would also increase private sector financing costs, Chilean banks and corporates

are in a better position to accommodate external shocks than in the past. Based on model simulations, risks in the banking sector would remain well below 1998.[3]

9. ***With Chile accounting for a third of global copper production, spillover effects to the rest of the world center around the mining outlook***. Labor disputes and technical problems slowed production in 2006, but completion of several labor contracts and investment projects should propel output toward its projected medium-term growth rate of 3 percent per year. Water and environmental constraints could eventually limit the pace of expansion, but Chile's copper deposits are deemed large enough to sustain production for longer than in most other countries with non-renewable resources.

III. MACROECONOMIC POLICY FRAMEWORK

Fiscal policy

10. ***Fiscal policy remains well anchored by the structural surplus rule***. The authorities emphasized that Chile's long-standing prudent fiscal policy had created the space for the moderate reduction in the structural surplus target. They firmly expected the 2008 budget to be consistent with overall macroeconomic stability, with the amount of the expenditure increase determined—under the rules-based framework—mainly by the long-term reference price for copper and projected revenues at potential GDP growth.[4] The authorities had noted some recent weakness in VAT collections which, if sustained, would affect projected revenue—and thus spending—for next year.

11. ***Looking ahead, the authorities intend to maintain a positive surplus target in part to fund future pension costs***. The government is committed to put between 0.2 and ½ percent of GDP per year into a public pension fund, depending on the size of the actual fiscal surplus, to help finance the proposed pension reform (see below). The ongoing program of recapitalizing the BCC balance sheet will continue as planned (by ½ percent of GDP in each of the next three years).

12. ***Efforts are underway to raise further the effectiveness of government spending***. While pointing to the exemplary success of Chile's fiscal expenditure framework, officials noted the importance of spending additional resources in a cost-effective way. To that end, the government announced steps to improve public financial management, including through new agencies supervising public investment and education, impose tighter coordination over regional spending, and the introduction of a new fiscal transparency law. The officials

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[3] Banking sector vulnerabilities were modeled using a contingent claims approach developed jointly by BCC and Fund staff (BCC, *Financial Stability Report*, Fall 2006).

[4] The estimates for the reference price for copper and potential GDP growth are provided by independent expert commissions.

General Government Budget: Staff Projections (In percent of GDP)						
	2002	2003	2004	2005	2006	2007
Revenue	23.3	22.8	23.9	25.8	28.1	27.4
Mining Revenue	0.6	1.1	3.6	5.1	8.9	7.2
Expenditure	24.5	23.3	21.8	21.1	20.4	21.3
Investment	3.8	3.6	3.4	3.4	3.3	3.6
Surplus	-1.2	-0.4	2.1	4.7	7.8	6.1
Net Assets	-7.9	-6.7	-4.1	0.1	7.5	12.0
Memorandum item:						
Nonmining Balance	-1.8	-1.5	-1.5	-0.4	-1.1	-1.1

welcomed the staff's proposal to shift to a medium-term expenditure framework to tie annual budget decisions more closely to the government's strategic objectives.

Monetary and exchange rate policy

13. ***Monetary policy will likely tighten gradually as excess capacity is absorbed***. As the economy slowed in 2006, the BCC first paused the tightening cycle underway since 2004, and then lowered interest rates by 25 basis points in early 2007. With recent data pointing to a strong and broad-based recovery, policy may have to resume a gradual tightening course in the months ahead. Long-term interest rates have ticked upwards in recent weeks, and many analysts expect a resumption of rate increases. As in the past, the BCC will take into account all available information in gauging the inflation outlook and any needed policy response, including the impact of the announced reduction in the fiscal surplus target.

14. ***Monetary policy has been successful in anchoring inflation expectations firmly around the 3 percent policy target, despite major shifts in the terms of trade***. To increase transparency, the BCC in January adjusted its inflation target to "around 3 percent, with a tolerance range of ± one percentage point" to focus attention on the previous mid-point of the target range.[5] The authorities welcomed a staff suggestion to conduct periodic pre-determined reviews of the inflation targeting framework.

15. ***The value of the peso is broadly in line with fundamentals***. Despite a sizeable nominal appreciation against the U.S. dollar, the real effective exchange rate has appreciated only moderately since the onset of the copper boom in 2004. Staff's empirical work (including CGER analysis and a background study of the performance of non-copper exports) shows that competitiveness remains adequate.

[5] The previous target consisted of a range of 2–4 percent over a time horizon of meeting the target of 12-24 months. The new time horizon is set to "around 2 years."

16. ***The authorities confirmed their commitment to maintaining a floating exchange rate***. Given the strong external position and upward pressure on the peso, the government is advancing part of the planned increase in foreign investment limits for pension funds.[6] The authorities reiterated their policy of not intervening in the foreign exchange market except if they judged that a market overreaction could have potentially adverse consequences for the economy.

17. ***In light of the strong buildup in foreign assets, the authorities are developing a long-term strategy for the allocation of those funds***. The assets accumulated in the two funds created under the 2006 Fiscal Responsibility Law have been managed by the BCC since March 2007. A recent assessment of the management of foreign exchange reserves found the BCC to be in observance of the IMF *Guidelines for Foreign Exchange Reserve Management* and having adequate institutional capacity in this area.

IV. Bridging the Income Gap with Advanced Economies

18. ***Building on well-developed institutions and strong governance, Chile has set its sights on raising long-term growth to close the income gap with industrialized countries*** (table below). To address key factors limiting Chile's growth potential and further reduce vulnerabilities to external shocks, the government is pursuing an ambitious structural reform agenda, including in education, pensions, innovation, and the financial sector. Integrating Chile's financial sector system more closely with global capital markets will play an important role in strengthening competitive forces and catalyzing reforms in other sectors.

Human capital and the labor market

19. ***Education will be the prime beneficiary of the reduced fiscal target***. Most of the freed-up funds will be used to raise the value of student vouchers, and an education reform bill submitted to Congress aims at raising quality and improving access especially for low-income households. The government has also launched initiatives to improve the climate for entrepreneurship and innovation, particularly for small and medium-sized enterprises (SMEs).

20. ***A major pension reform is to raise benefits, improve coverage, increase returns to saving, and encourage participation in the formal labor market***. The proposed reform includes a universal public pension pillar and aims at boosting participation of low-income groups and the self-employed (Box 1). Although public benefits will be substantially increased, the authorities were confident that the additional cost of the new system, netted

[6] Under the pension reform plan, the investment limit is to be raised gradually from 30 to 80 percent of pension fund assets. In May, the government announced legislation to raise the limit to 45 percent.

Chile—Selected Institutional Rankings

Index (Publisher)	**Per-centile Ranking**	Overall Ranking	Latin America Ranking	Countries Surveyed	Date
Governance Indicators					
Freedom in the World (Freedom House)	**n.a.**	Free	1	193	Jan 2007
Index of Economic Freedom (Heritage Foundation)	**7**	11	1	157	Jan 2007
Economic Freedom of the World (The Fraser Institute)	**15**	20	1	130	Sep 2006
Corruption Perceptions Index (Transparency International)	**12**	20	1	163	Nov 2006
Press Freedom Index (Reporters without borders)	**29**	49	5	168	Oct 2006
Freedom of the Press Index (Freedom House)	**34**	66	4	195	May 2007
Economic and Financial Indicators					
Emerging market investment attractivness (Wilshire)	**8**	2	1	27	Apr 2007
Doing Business (World Bank)	**17**	28	3	165	Sep 2006
Global Competitiveness Index (WEF)	**22**	27	1	125	Sep 2006
Total Wealth per Capita (World Bank)	**27**	32	4	118	Sep 2005
World Competitiveness Yearbook (IMD International)	**55**	26	1	61	2006
Globalization Index (A.T. Kearney/Foreign Policy)	**62**	34	2	55	Dec 2006
High Technology Indicators					
Sixth Annual Global e-Government Study (Brown	**17**	34	1	198	Aug 2006
IT Network Readiness Index (WEF)	**25**	31	1	122	Mar 2007
The Power of Access Index (FedEx)	**43**	32	1	75	May 2006
Social and Environmental Indicators					
State of the World's Mothers (Save the Children)	**15**	19	2	125	May 2006
Human Development Index (UNDP)	**21**	38	2	177	Nov 2006
Quality of Life Index (International Living)	**25**	49	9	193	Jan 2007
Worldwide Quality-of-Life Index (The Economist)	**28**	31	1	111	Nov 2004
Environmental Sustainability Index (Yale/Columbia Univ.)	**29**	42	9	146	Jan 2005

Source: Staff calculations.

against the cost of maintaining the current system, will be kept to a maximum of one percent of GDP per year.[7]

21. ***Although employment growth has picked up, greater labor market flexibility would facilitate factor reallocation in response to external shocks and competitive pressures***. The authorities are currently building consensus for strengthening the social protection of workers and improving the unemployment insurance system. Staff noted that separation costs appeared high, and that instruments facilitating part-time employment were not being widely used.

22. ***The results of a recent ROSC Update suggest that Chile's macroeconomic statistics are generally timely and of good quality***. The mission encouraged the authorities to improve the coverage of surveys on labor costs, capacity utilization, and prices, as well as other statistical data in line with practices in industrialized economies (see table).

[7] Preliminary cost estimates by the staff are broadly in line with the authorities' calculations.

Statistical Issues and Macroeconomic Analysis	
Chile subscribes to the Fund's Special Data Dissemination Standard. The results of a recent data ROSC Update suggest that the macroeconomic statistics are generally sound, and gain high marks for assurances of integrity, serviceability, and accessibility. However, compared to economic statistics of many industrial countries, some gaps remain.	
Labor market	Genuine unit labor cost data are not available, in part because of limited information on hours worked. Time series on wages by sector were discontinued in 2005. However, monthly indices of average compensation as well as of hourly labor cost are published. The two major unemployment surveys (by the University of Chile and the National Statistics Institute) could be improved to provide a consistent labor market picture.
National accounts	Despite the overall high quality of the national accounts, data on inventories and inventory prices tend to be erratic and hard to interpret, given that they are mainly estimated as residuals in the balancing of the supply and use table. Shifting the national accounts to chain price indexing would reduce base-year distortions and improve the statistical treatment of copper price fluctuations.
Producer data and price statistics	Capacity utilization data are not yet available on a time series basis. The CPI has limited geographic coverage, and its basket and weight structure remain outdated pending planned improvements. For the PPI, adjustments for quality differences are not made (in particular, the copper price collection procedure increases quality induced volatility), and missing prices are carried forward from the last observed price in most of the categories.
Fiscal data	Adoption of the Government Finance Statistics Manual 2001 (GFSM 2001) is a major improvement. However, the reconciliation of the fiscal balance with changes in government net debt could be improved, and timely high-frequency data on tax revenue by type of tax would help the analysis of revenue and general economic trends. Some gaps remain in the coverage of military debt, but efforts are underway to improve the legal framework for compiling such data.
Capital account data	Chile provides monthly information on portfolio investment flows, as well as assets and liabilities, in line with international statistical standards. A more detailed breakdown of portfolio flows, including on a gross basis as well as geographical basis, would assist economic analysis.

Financial sector

23. ***A second round of capital market reforms was passed into law in late May, and market participants generally welcomed the progress achieved in recent years***. Planned additional measures for 2007 include steps to internationalize the peso, further develop local markets, strengthen corporate governance and facilitate foreign investment. The mission agreed that providing smaller borrowers, including SMEs, with improved capital market access could unlock productive capacity and benefit innovation, and that care was needed to not impose effective ceilings on SMEs' size.

24. ***The financial component of the pension reform could assist market development***. Broadening portfolio options for Pension Fund Administrators (AFPs) and raising their foreign investment limits could reduce excess demand for high-quality domestic assets, expose domestic borrowers to stronger competition, and help in the development of local markets. The authorities are planning a gradual approach to liberalization, with the pace depending on financial stability considerations and the capacity of AFPs to manage assets in a more complex financial environment.

V. Staff Appraisal

25. ***Reflecting its strong institutional framework and sound macroeconomic policies, Chile has experienced two decades of economic stability and increasing living standards***. Although trend growth remains below the level of the 1990s, Chile has rightly set its sights on eliminating poverty and closing the income gap with industrialized economies. Staff

supports the government's strategy of maintaining the macroeconomic framework while addressing social issues and implementing structural reforms to boost long-term growth.

26. ***Amid growing signs of a rebound, the economy is projected to expand by around 5¾ percent in 2007***. Upside risks for domestic demand are balanced by concerns over energy supply and modest downside risks from the global outlook. Inflation is expected to rise toward the BCC's 3-percent target, and the peso is assessed to be broadly in line with fundamentals.

27. ***With inflation expectations firmly anchored, monetary policy appropriately supported the economy's recovery through the slowdown in 2006***. Given strong output growth, monetary stimulus will likely be withdrawn in the coming months. The BCC's balance sheet has been strengthened, and the staff welcomes the government's commitment to continue to recapitalize the bank.

28. ***Fiscal policy remains well anchored by the structural surplus rule***. A modest reduction in the surplus target is justified by the improvement in the government's net debt position. The staff welcomes the authorities' intention—supported by the rules-based system—to keep public expenditure increases consistent with macroeconomic stability. In order to cover future pension liabilities, the authorities are committed to maintaining a positive surplus target for the foreseeable future.

29. ***Ensuring high-quality public spending remains critical***. Costs and benefits of new expenditure projects will need to be carefully weighed, and planned steps to improve the efficiency of government spending and increase transparency are well placed. Establishing a medium-term expenditure framework would allow annual budget decisions to be tied more closely to the government's strategic objectives.

30. ***The proposed pension reform addresses the main shortcomings of the current system, while maintaining many of its pioneering basic features***. A key goal of the reform is to increase pension coverage and equity in the system. The authorities are confident that the overall cost of the reform can be kept within the projected amount of one percent of GDP per year, and that incentives to save will be unimpaired. The mission welcomes steps to gradually increase foreign investment limits for pension funds, which will allow them to optimize their portfolio allocation and is timely in view of the strong external position.

31. ***The government has launched welcome initiatives to boost human capital and innovation, and integrate Chile more closely into global capital markets***. Improving education and reducing skills gaps will be key to raising long-term growth prospects. Targeted initiatives can be useful to help smaller enterprises if designed in a way that does not impose a ceiling on their future size. Financial sector reforms will play an important role in strengthening competitive forces and catalyzing reforms in other sectors.

32. ***There is room to make labor markets more flexible***, and to strengthen incentives to participate in the labor market.

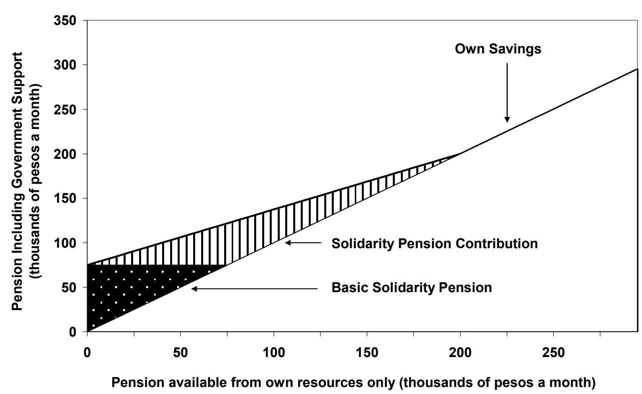
33. ***It is recommended that the next Article IV consultation take place on the regular 12-month cycle***.

Box 1. Reforming the Pension System

The government's proposals for a comprehensive reform of Chile's 26-year old pension system focus on addressing several shortcomings. The system's coverage ratio is relatively low, in part because many workers have failed to accumulate the necessary 20 years' worth of contributions. Many women, in particular, are left without incomes in old age; and investment options have been constrained. The reform is a top priority for President Bachelet's government, and has been developed by a high-level commission of experts in a broad consultative process.

The cornerstone of the reform is the Basic Solidarity Pension (BSP), which introduces a universal pillar into Chile's privatized system. The reform creates a minimum pension for Chileans over 65 (equal to about one fifth of the average wage) and provides means-tested subsidies to poor the poor. The proposal also subsidizes initial contributions by women and the young, while gradually enforcing participation among the self-employed.

Figure 1. Pensions Under Proposed System



The authorities are confident that overall incentives to work and save would not worsen under the new system, although some tradeoffs are typically unavoidable. In the new system, the marginal return on a dollar's worth of additional pension saving would be positive for all workers:

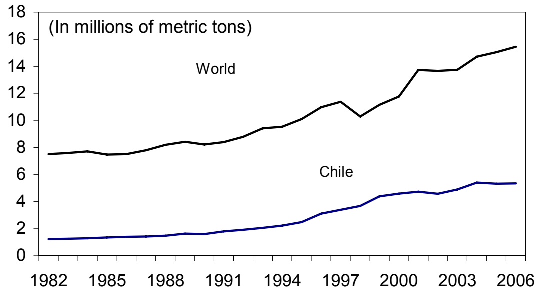
- Workers currently receiving the (flat) minimum pension guarantee do not obtain a higher pension for an additional dollar worth of pension savings. Under the new system, their marginal return would *increase* to 62.5 cents per dollar saved.
- Workers currently receiving more than the minimum pension guarantee would also face a marginal return of 62.5 cents (unless their pension income exceeds CLP 200,000 per month; see chart). In their case, however, the marginal return is *lower* than the 100 cents return they receive under the current system.

The reform also has a strong financial component, aimed at increasing competition among pension funds and raising real returns to pensioners. In addition to liberalizing investments rules for Pension Fund Administrators (AFPs), the reform boosts competition among AFPs by auctioning the right to serve new entrants and allowing domestic banks to enter the market.

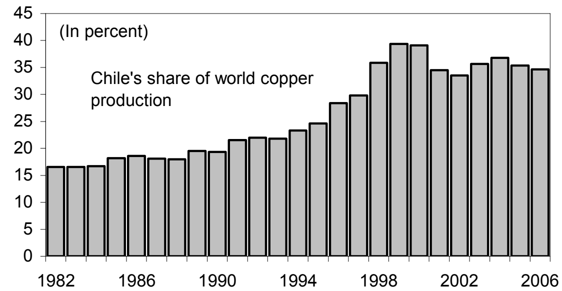
The government estimates the cost of the reform at around 1 percent of GDP per year, partly funded from returns on a pension fund accumulated with the help of structural government surpluses. Congressional debate of the reform is expected to last into 2008.

Figure 2. Delinking the Economy from Copper

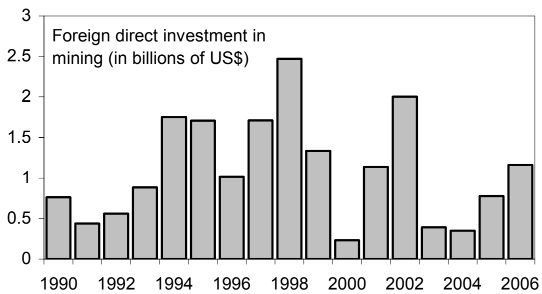
Although Chile's copper production was hurt by disruptions in 2006,



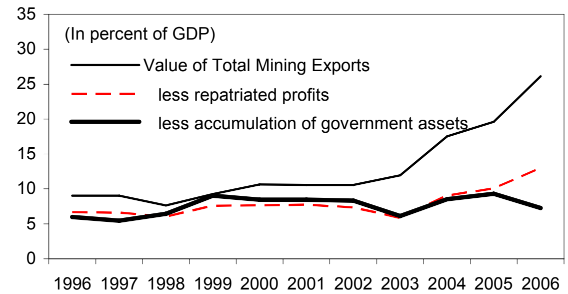
…Chile remains the world's largest copper producer.



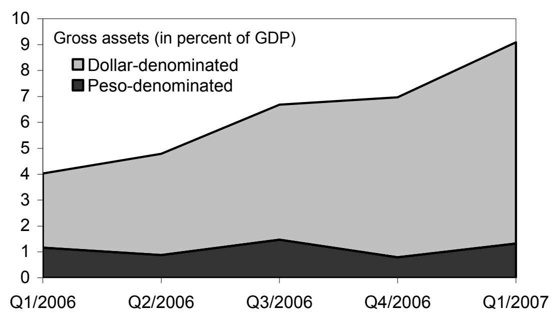
With strong participation by foreign companies,



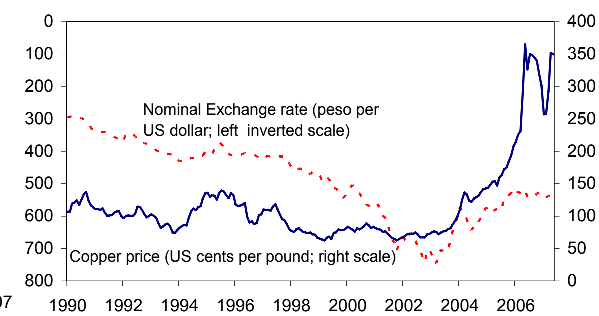
…only part of mining revenues have remained in Chile.



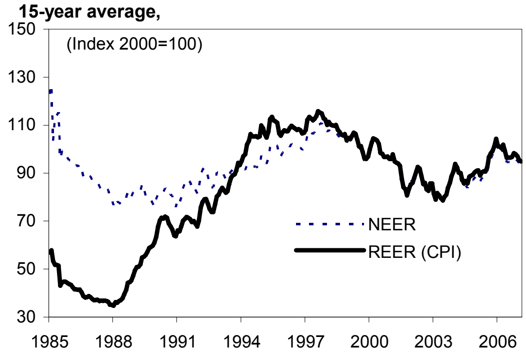
Beginning in 2006, the government has been shifting all copper revenues and most other assets abroad,



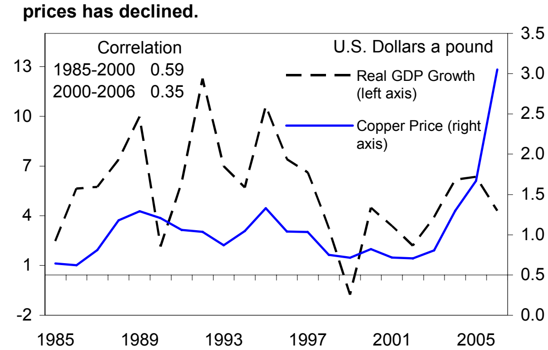
…which has curbed peso appreciation despite a surge in copper prices.



The real effective exchange rate has remained close to its 15-year average,

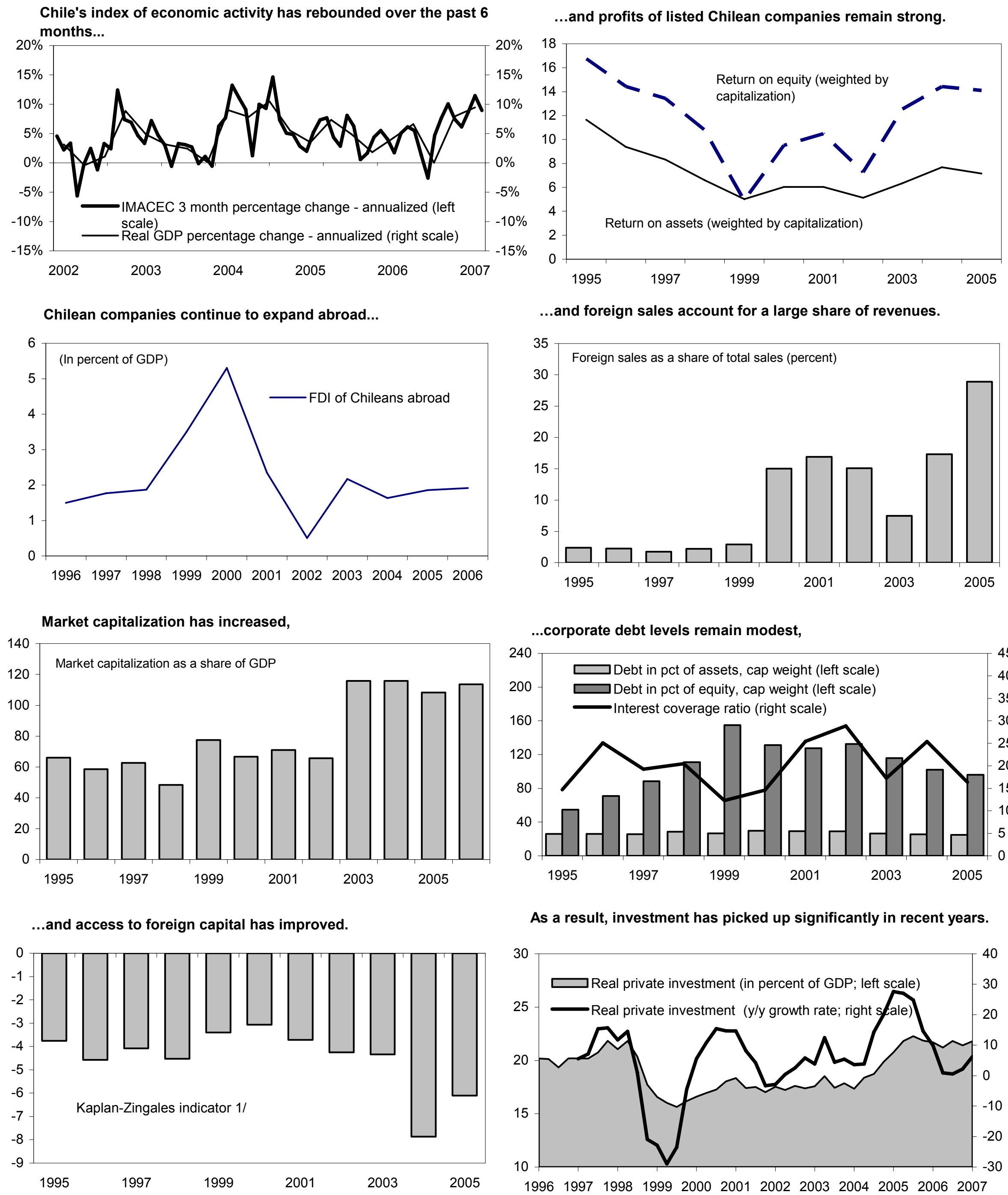


…and the correlation between GDP growth and copper prices has declined.



Source: Haver, Chilean authorities, and Fund staff estimates

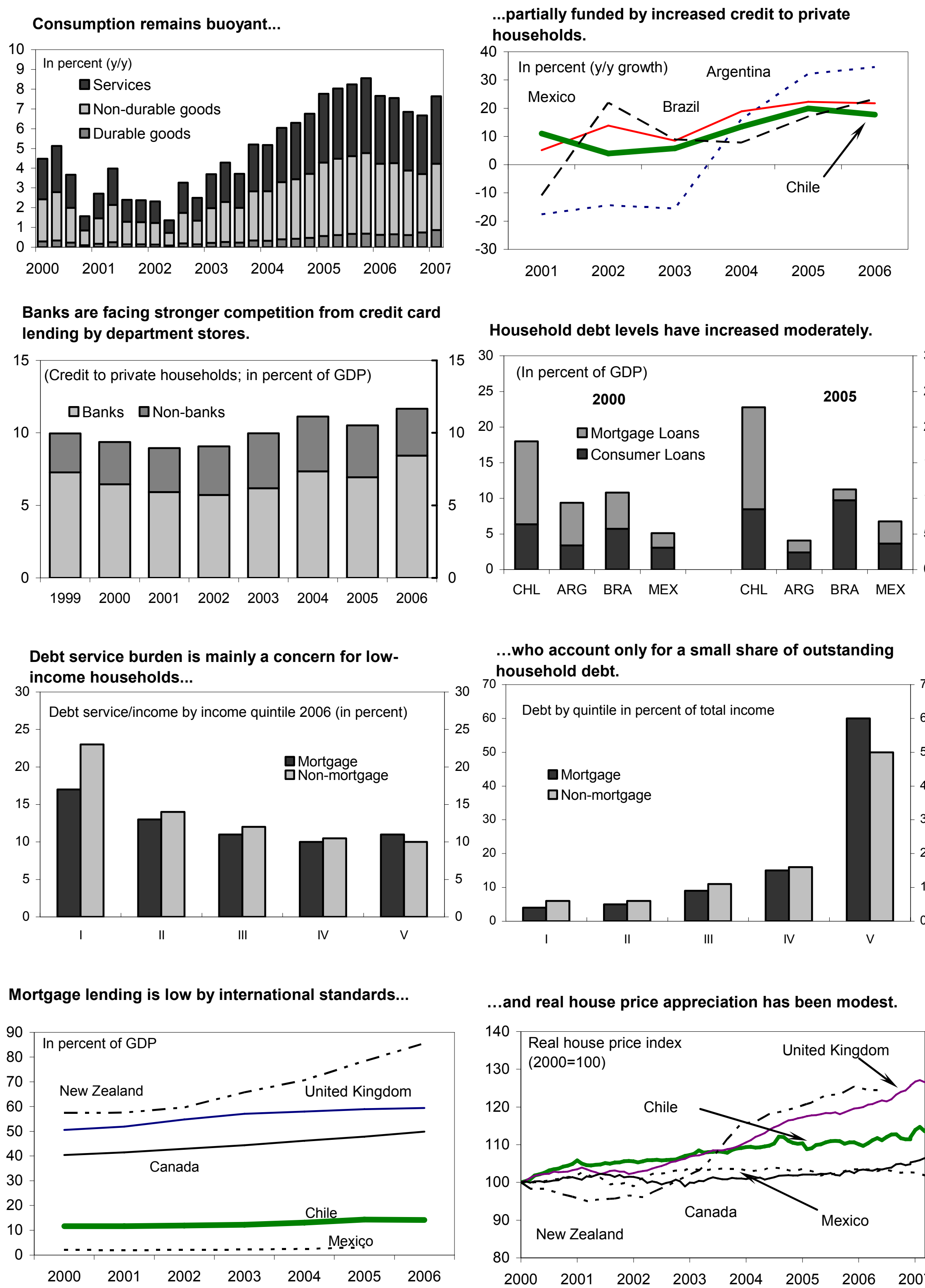
Figure 3. Corporate Financial Indicators



Source: Bloomberg, Chilean Authorities and Fund staff estimates.

1/ The Kaplan-Zingales indicator measures constraints to external finance. A lower statistic implies fewer constraints.

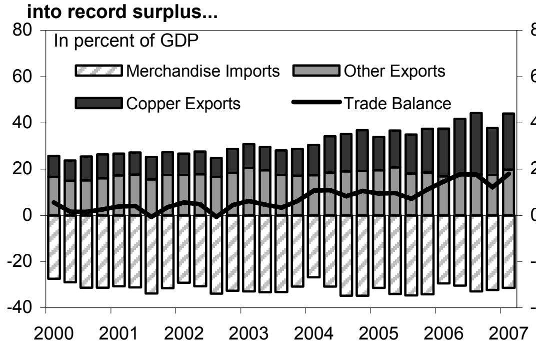
Figure 4. Household Finances



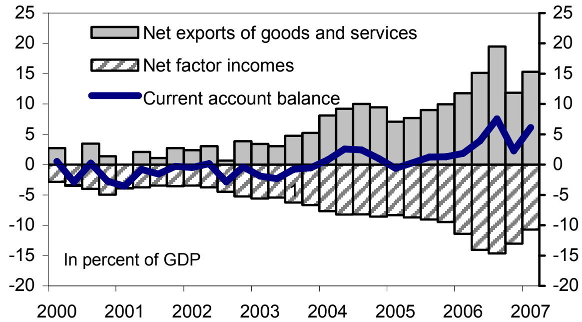
Source: Haver, National Authorities and Fund Staff estimates.

Figure 5. Trade Performance

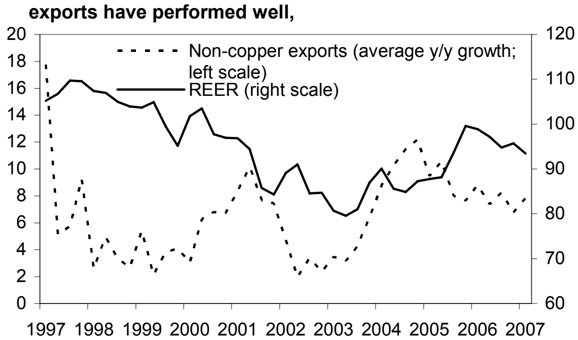
High copper prices have pushed the trade balance into record surplus...



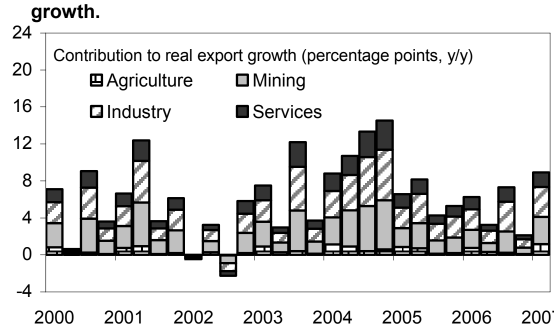
…but high profit repatriation has dampened the impact on the current account.



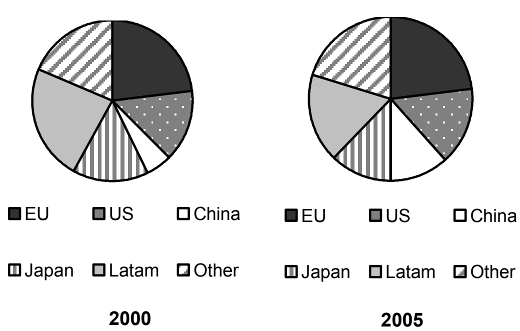
Despite some appreciation of the peso, non-copper exports have performed well,



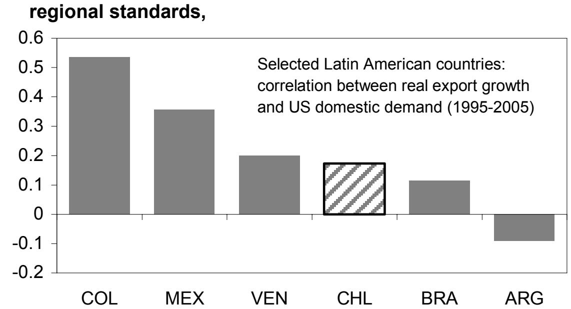
…with industry remaining a key driver of export growth.



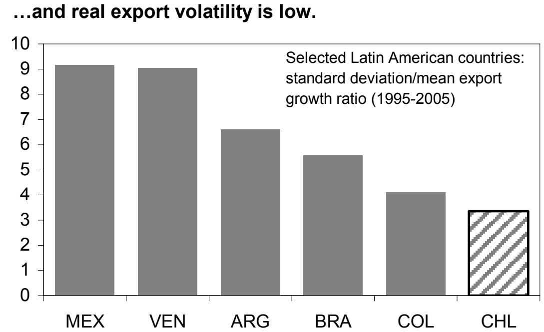
Non-copper export markets are quite diversified,



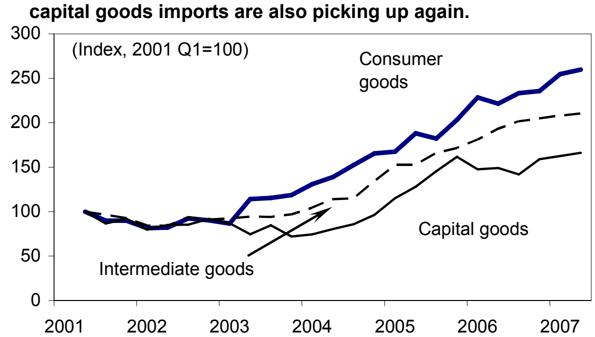
...dependence on U.S. demand for exports is low by regional standards,



…and real export volatility is low.



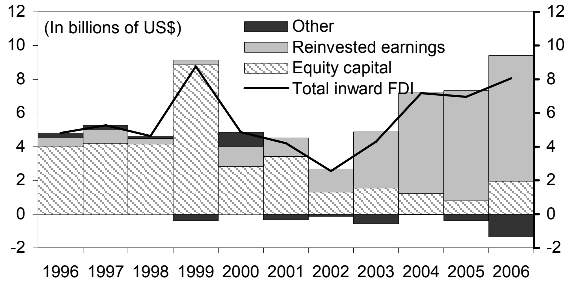
Strong consumer demand has boosted imports, but capital goods imports are also picking up again.



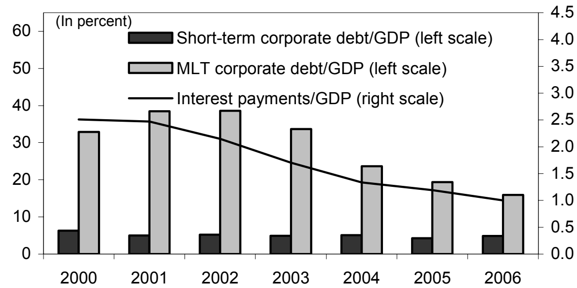
Sources: Haver, World Trade Organization, and Fund staff estimates.

Figure 6. Capital Account and Foreign Portfolios

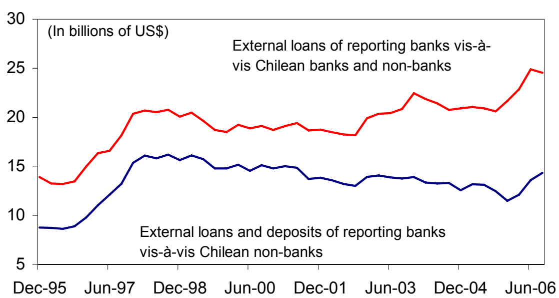
New foreign direct investment in Chile has remained low, despite the commodity boom.



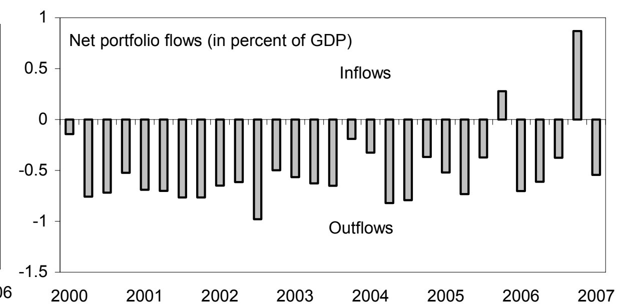
Although Chilean enterprises are borrowing less abroad,



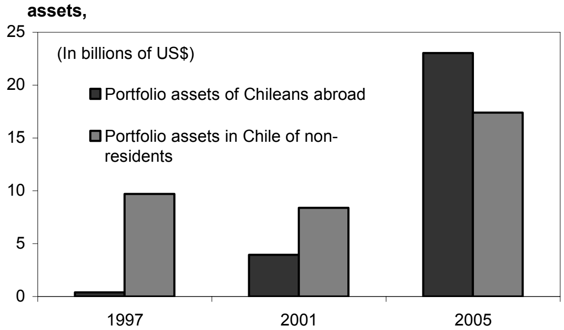
...external borrowing by domestic banks has increased, partly as a result of foreign banks entering the market.



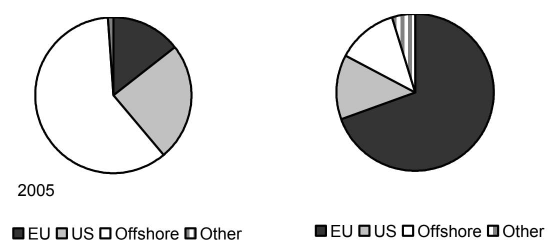
Net portfolio flows were largely outward in recent years,



…resulting in a significant accumulation of foreign portfolio assets,

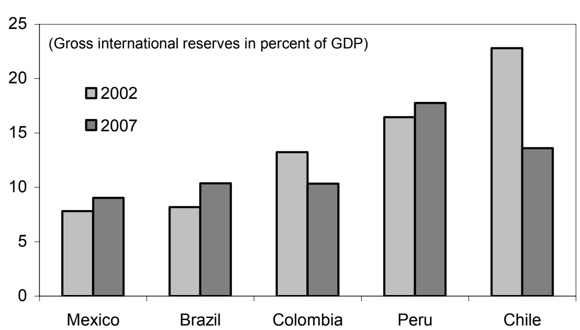


…which are largely invested through European offshore centers.

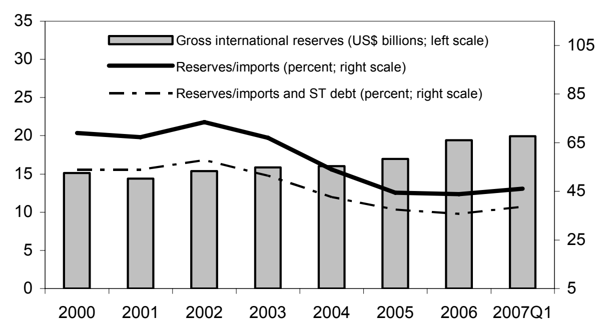


Portfolio assets of Chileans abroad **Portfolio assets in Chile of non-residents**

The BCC's reserve holdings have declined relative to GDP...

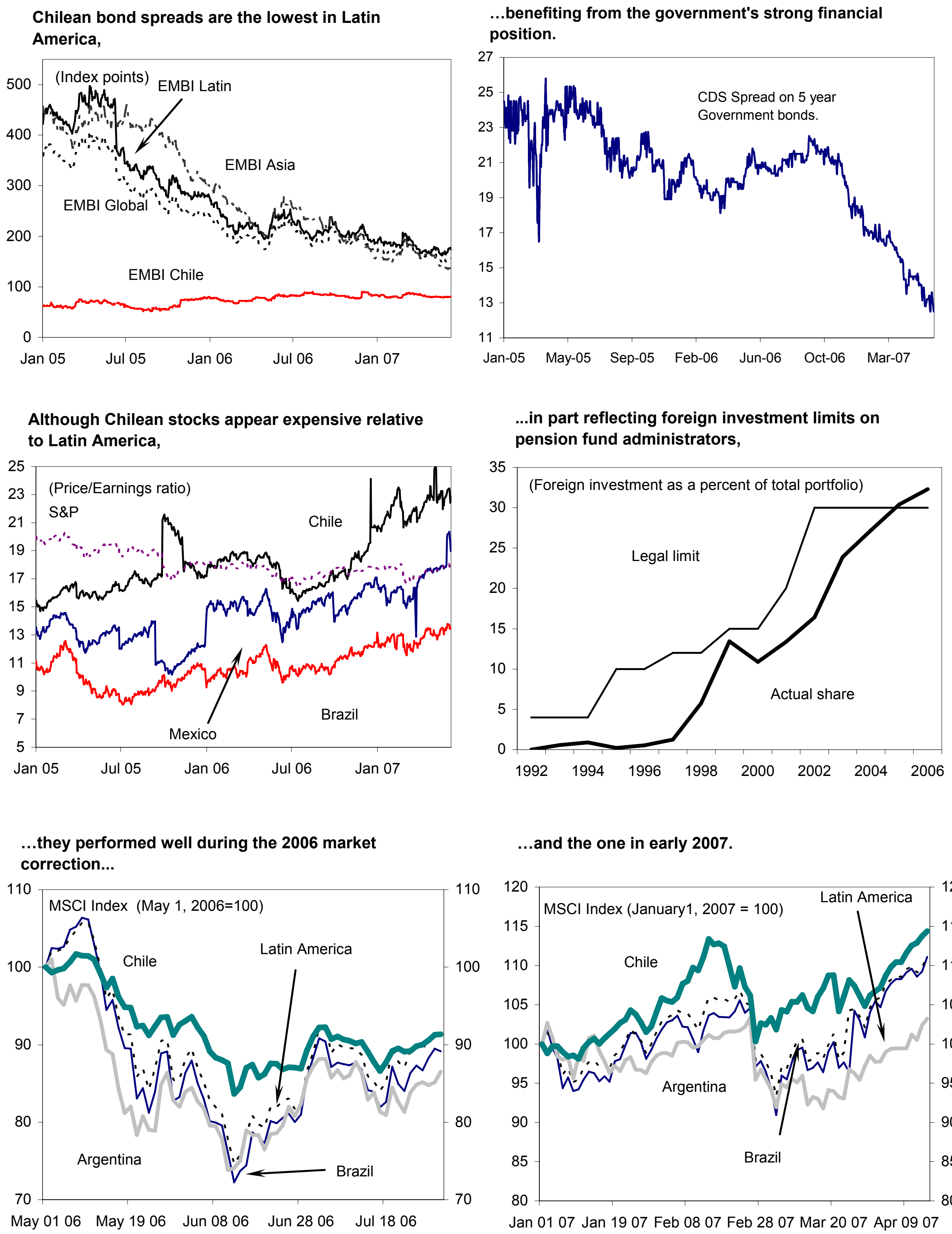


…but reserve coverage remains at a favorable level.



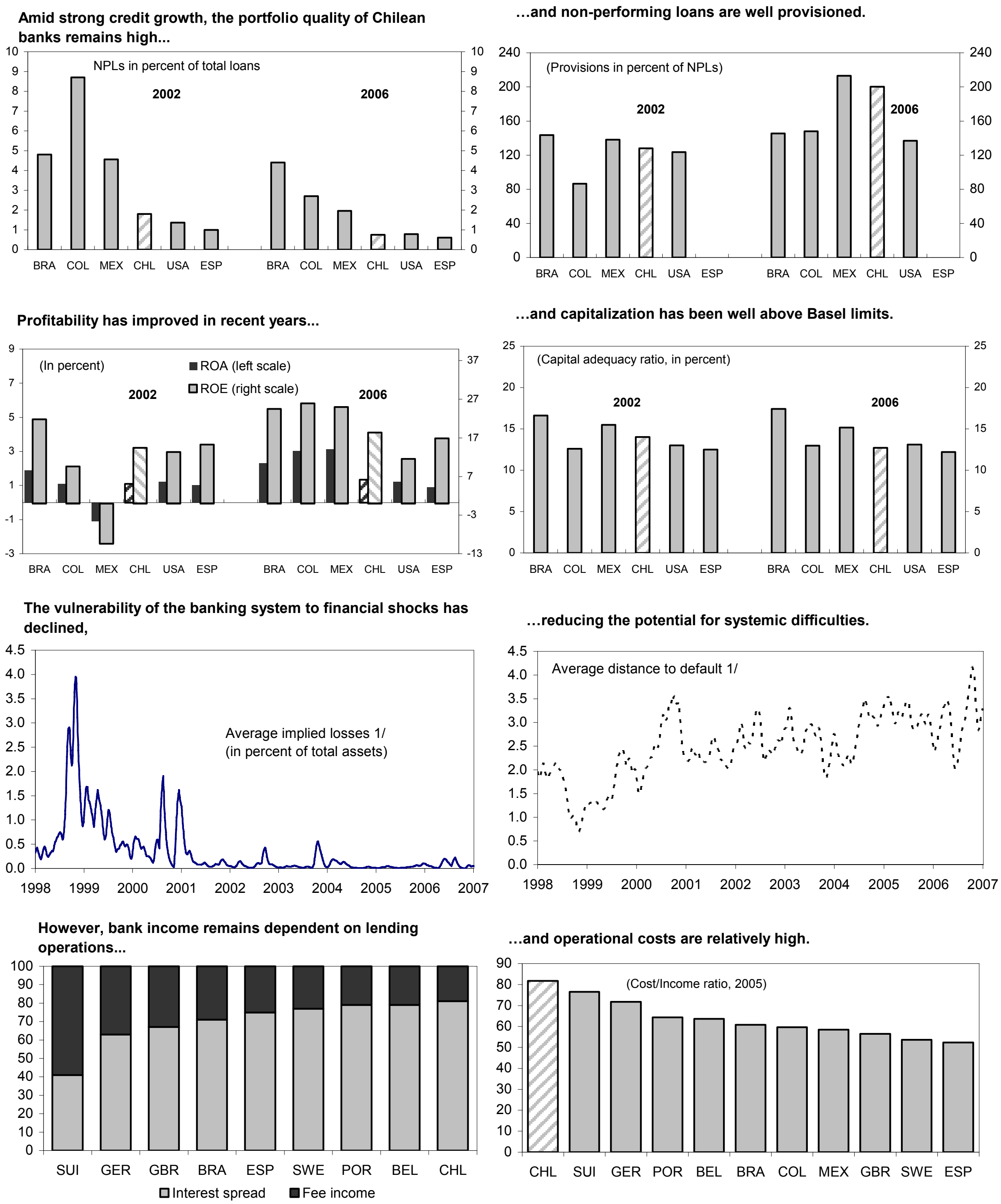
Source: Chilean Authorities and Fund staff estimates.

Figure 7. Financial Market Developments



Source: Bloomberg, Bankscope, Bank of International Settlements, IFS, and Fund Staff estimates.

Figure 8. Banking Indicators

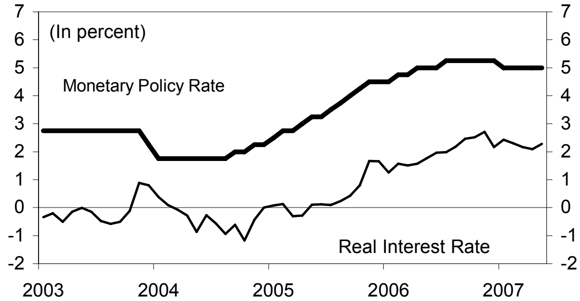


Source: Fund staff estimates.

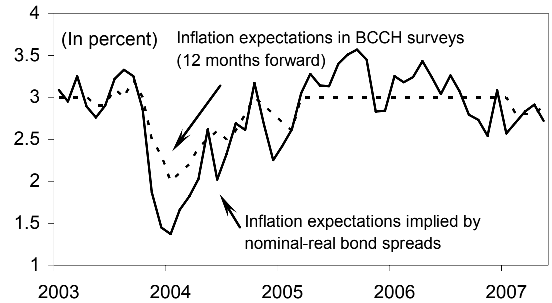
1/ Average implied losses and distance to default measures are derived from a contingent claims model for the Chilean banking system. Distance to default refers to the number of standard deviations by which implied bank assets exceed default levels. Average implied losses are the probability-weighted losses of the banking sector averaged over the next year.

Figure 9. Monetary Policy Indicators

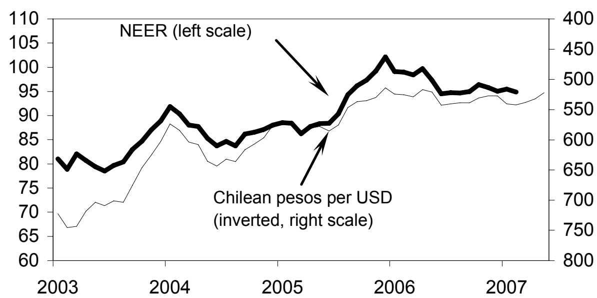
The Central Bank of Chile lowered its policy rate in January 2007...



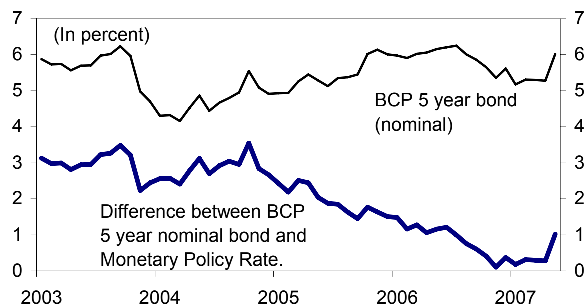
...amid moderating inflation expectations,



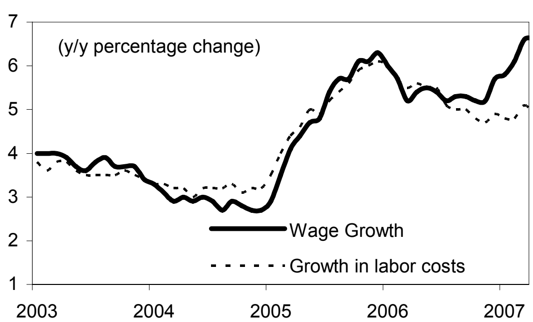
...and nominal peso appreciation.



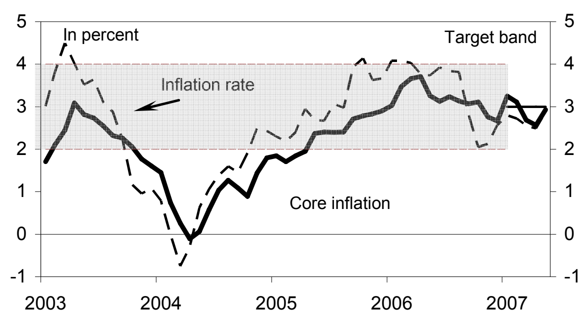
The yield curve was flattening until recently, when long rates increased.



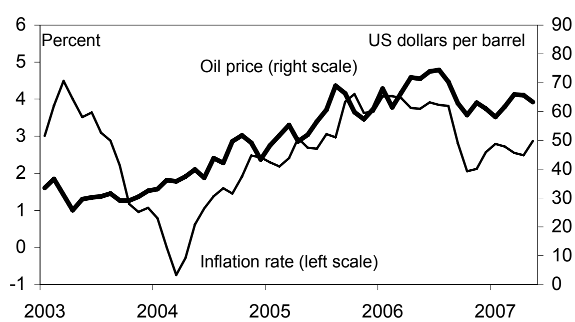
Despite increasing wage costs,



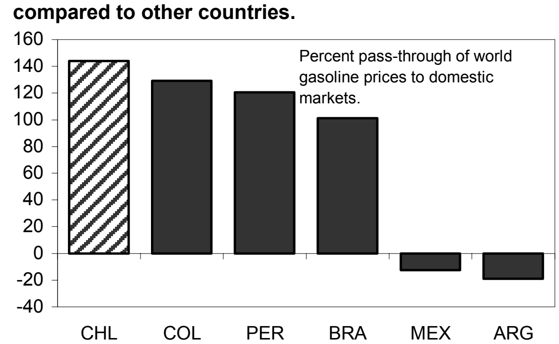
...inflation remains near the 3-percent target.



Energy price volatility remains a risk.



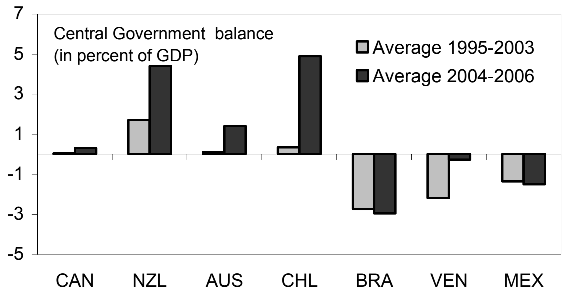
Oil price pass-through in Chile is relatively high compared to other countries.



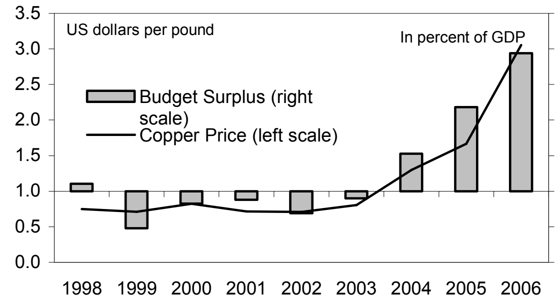
Source: Haver and Fund staff estimates.

Figure 10. Fiscal Developments

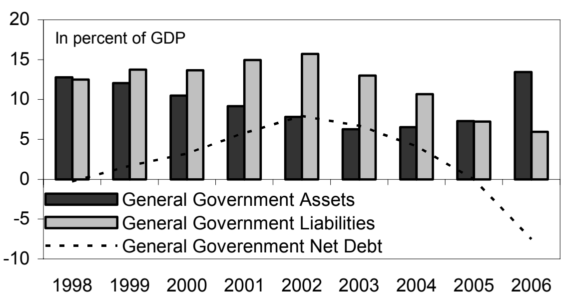
Building on a prudent fiscal policy framework,



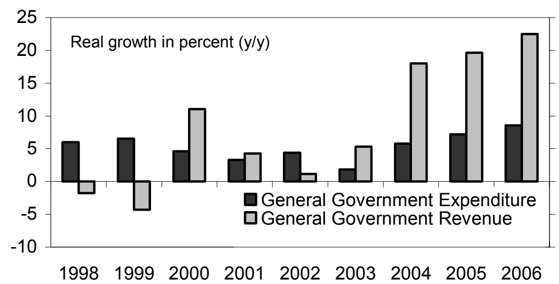
…the budget surplus has tracked rising copper prices to record levels.



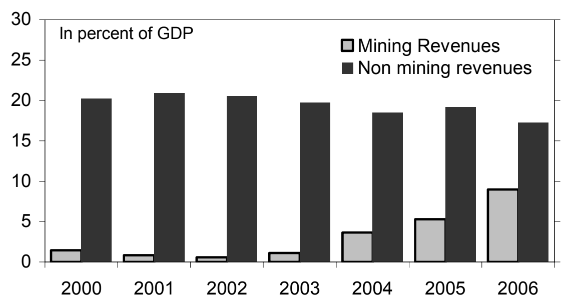
Rising surpluses have allowed the government to pay down debt and move into a net creditor position.



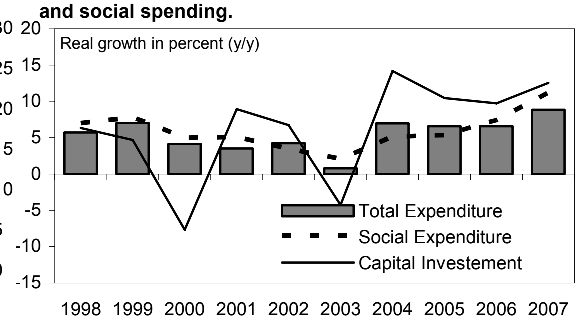
The structural surplus rule has limited expenditure increases while revenues have risen sharply...



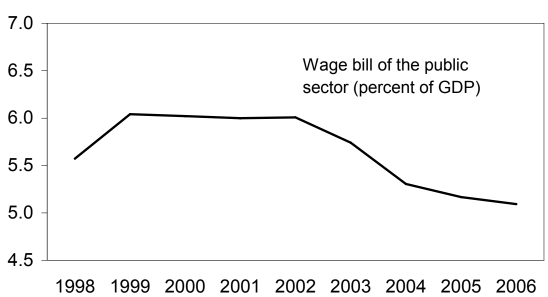
…notwithstanding a slowdown in nonmining revenues.



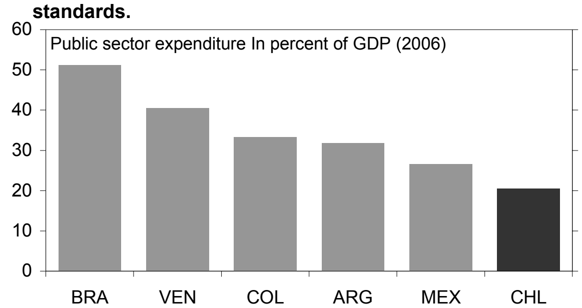
Government expenditure is focused on public investment and social spending.



Public employment costs have been contained;

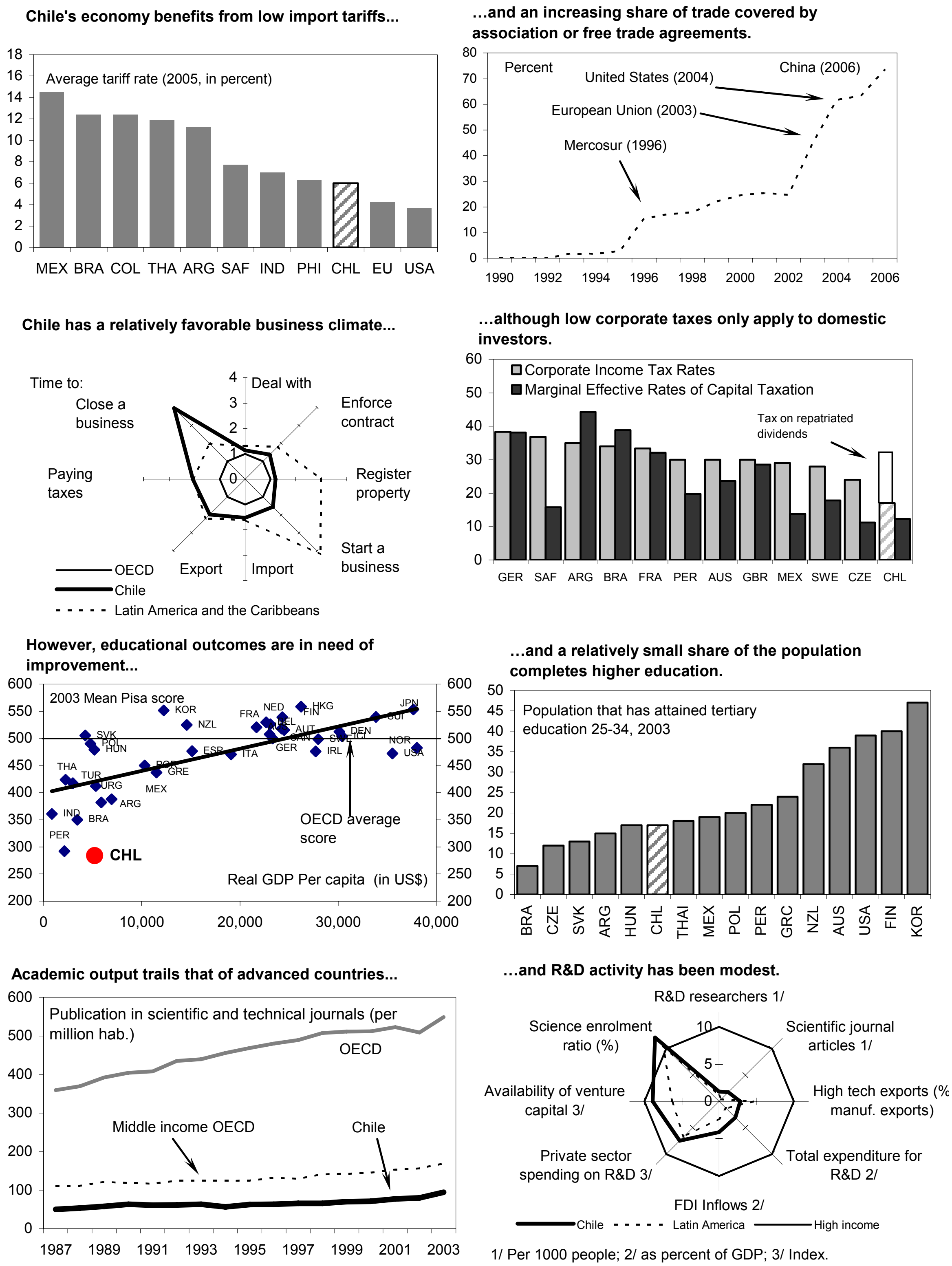


…indeed, Chile's public sector remains small by regional standards.



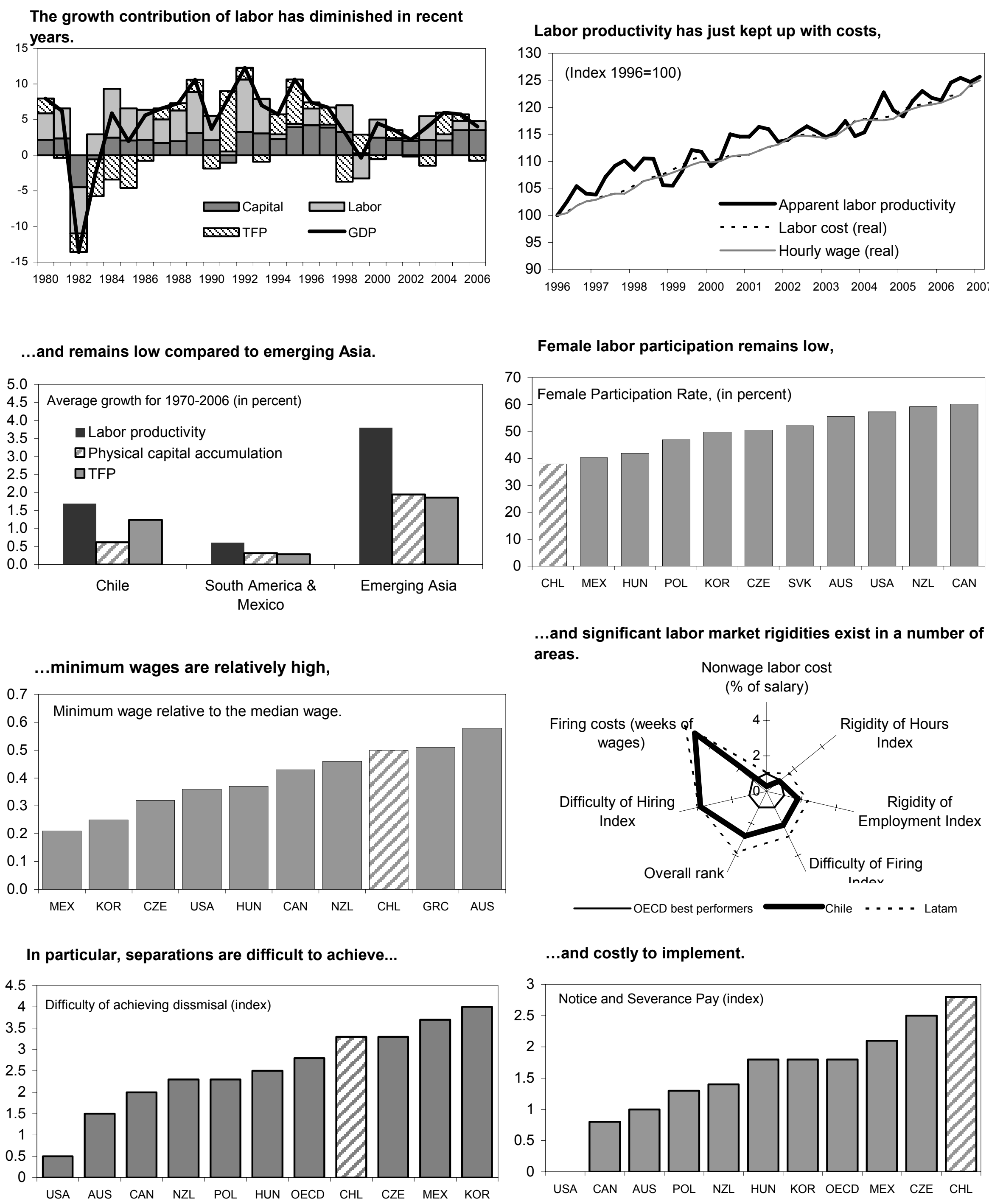
Source: Chilean Authoritites and Fund staff estimates.

Figure 11. Investment Climate



Source: World Trade Organization (2005), KPMG (2006), CD Howe (2006), World Bank Doing Business Data (2006).

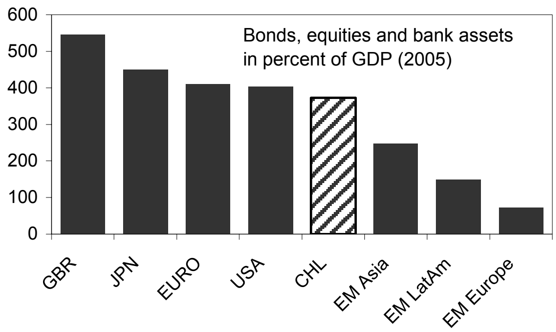
Figure 12. Productivity and Labor Markets



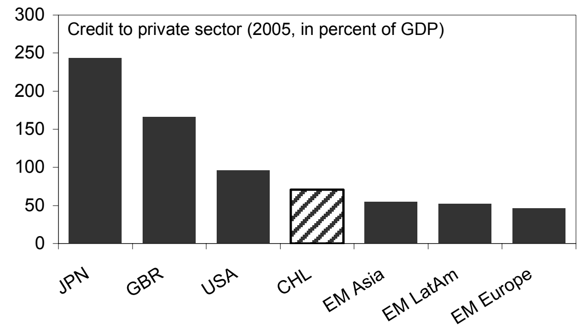
Source: World Trade Organization (2005), KPMG (2006), CD Howe (2006), OECD (2003), World Bank Doing Business Data (2006). Emerging Asia includes: China, Indonesia, Korea, Malaysia, Myanmar, the Philippines, Singapore and Thailand (weighted average).

Figure 13. Financial Market Structure

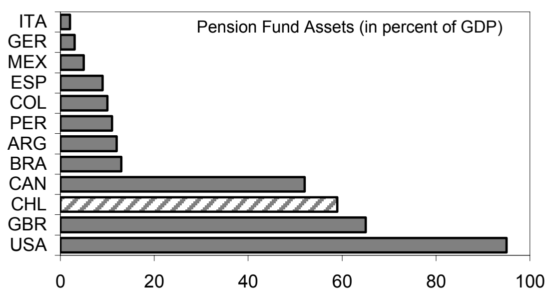
The depth of Chile's financial sector compares well with other emerging economies...



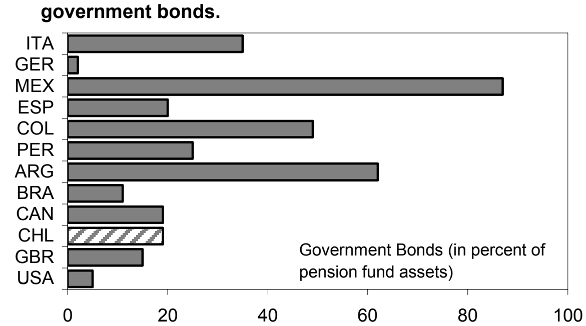
…including the availability of credit to the private sector.



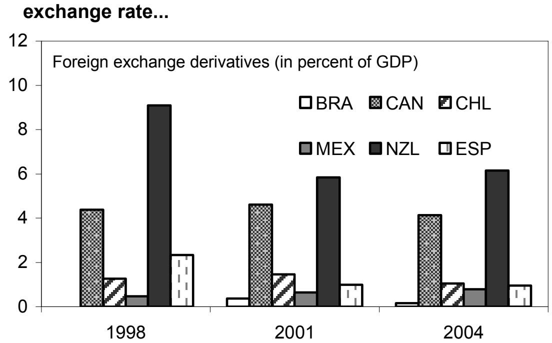
Chile's pension funds are major players in the market;



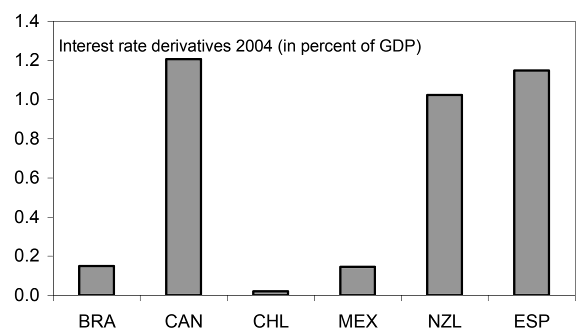
…only a relatively small part of their assets is placed in government bonds.



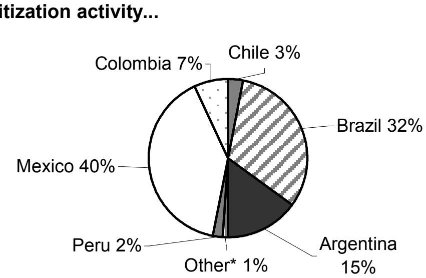
Derivatives markets in Chile focus mostly on the exchange rate...



…while interest rate derivatives are just emerging.

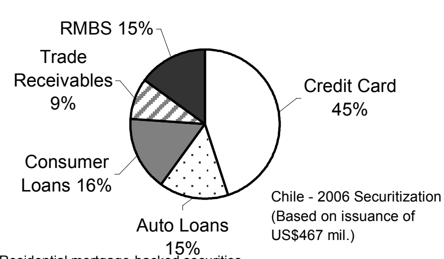


Chile accounts for a small part of Latin American securitization activity...



*Includes Central America, Ecuador, Venezuela and Bolivia

…and credit card-related issuances dominate.



RMBS - Residential mortgage-backed securities

Source: Bloomberg, Bankscope, Bank of International Settlements, IFS, World Federation of Exchange Rates and Fund Staff Estimates.

Table 1. Chile: Selected Economic Indicators

	2003	2004	2005	2006	Projections 2007	2008
			(Annual percentage change)			
Production and prices						
Real GDP	4.0	6.0	5.7	4.0	5.8	5.3
Total domestic demand	4.9	7.5	11.0	6.0	7.1	5.8
Consumption	4.0	6.8	7.5	6.6	7.0	5.9
Private	4.2	7.0	7.9	7.1	6.8	5.8
Public	2.5	6.1	5.3	3.6	7.8	6.6
Investment	8.4	9.8	23.0	4.4	7.3	5.7
Private	6.5	10.5	23.2	3.3	6.3	5.5
Public	-0.4	5.7	11.2	10.9	20.9	9.8
Inventories 1/	0.6	0.1	0.5	0.1	0.0	0.0
Net exports 1/	-0.6	-1.2	-5.0	-2.2	-1.5	-0.8
Consumer prices						
End of period	1.1	2.4	3.7	2.6	2.9	3.0
Average	2.8	1.1	3.1	3.4	2.8	3.0
GDP deflator	6.1	7.7	7.9	11.7	0.8	-2.8
Real wages	0.9	1.8	1.9	2.0	...	...
Unemployment rate (annual average)	9.5	10.0	9.3	7.9	...	...
Output gap (percent)	-2.4	-0.9	-0.1	-1.1	-0.3	0.0
Money, credit, and interest rates						
Broad money	3.6	10.6	12.0	11.4	...	...
Credit to the private sector	11.4	14.8	15.4	17.7	...	...
Three-month interest rate 2/	2.8	1.8	3.5	4.8	5.02	...
			(Billions U.S. dollars, unless otherwise indicated)			
Balance of Payments						
Current account	-0.8	2.1	1.3	5.3	5.2	1.3
In percent of GDP	*-1.1*	*2.2*	*1.1*	*3.6*	*3.4*	*0.8*
Trade Balance	3.7	9.6	10.8	22.2	19.4	11.0
Exports of Goods	21.7	32.5	41.3	58.1	58.7	53.6
Copper Exports	7.8	14.7	18.9	32.3	29.8	23.2
In percent of total exports	*36.1*	*45.3*	*45.7*	*55.6*	*50.7*	*43.2*
Imports of Goods	17.9	22.9	30.5	35.9	39.4	42.6
Oil Imports	2.0	2.7	3.6	4.6	4.8	5.5
In percent of total imports	*11.3*	*11.9*	*11.8*	*12.9*	*12.1*	*12.9*
			(Annual percentage change)			
Exports	19.2	50.1	27.0	40.7	1.0	-8.6
Imports	13.6	27.8	33.0	17.7	9.6	8.4
Terms of trade	9.7	22.1	10.8	31.0	-5.4	-15.3
Real effective exchange rate	13.4	-3.7	11.9	-5.2	...	...
Net FDI (in percent of GDP)	3.7	5.9	4.0	3.6	3.9	3.8
			(In percent of GDP)			
Saving and investment						
Gross domestic investment	21.1	20.1	22.4	20.4	20.9	22.1
Public	2.3	2.1	2.1	2.1	2.4	2.7
Private	17.8	17.0	18.6	17.2	17.6	18.6
Change in inventories	1.0	1.0	1.7	1.1	0.8	0.8
National savings	20.1	22.2	23.5	24.0	24.2	22.9
Public 3/	2.5	4.8	7.5	10.8	9.2	6.2
Private	17.5	17.3	16.0	13.2	15.2	16.7
External savings	1.1	-2.2	-1.1	-3.6	-3.4	-0.8
Public sector finance						
Net debt	13.3	11.0	7.7	-1.7	-4.5	-5.0
Excluding public enterprises	7.2	5.5	2.5	-7.3	-11.2	-12.6
Gross debt 4/	44.4	39.0	30.4	26.0	25.3	25.1
Central government	13.0	10.7	7.2	5.9	5.2	4.5
Central government balance	-0.2	2.1	4.6	7.7	6.0	2.9
External Debt						
Gross external debt	58.2	45.4	37.8	33.1	31.0	30.1
Public	12.5	10.3	8.0	7.4	6.5	5.8
Private	45.7	35.1	29.8	25.7	24.5	24.3
Memorandum items						
Nominal GDP (in billions of US$)	74.0	95.8	119.0	145.8	152.6	156.0
Copper prices (in US$ per pound)	0.81	1.30	1.67	3.05	2.72	2.04
Nominal Exchange Rate (average)	691.4	609.5	559.8	530.3	...	...

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. 2007 refers to June 8, 2007

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

4/ Gross consolidated debt of the public sector (central bank, non-financial public enterprises, and general government). For comparability purposes, does not include securitized liabilities from pre-1981 pension system totaling 9.5 percent of GDP at end-2006.

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

	2002	2003	2004	2005	2006	Proj. 1/ 2007
Overall balance	-1.2	-0.2	2.1	4.6	7.7	6.0
Non-Mining Balance	-1.8	-1.3	-1.5	-0.6	-1.1	-1.2
Total revenue	21.1	20.8	22.0	23.7	25.9	25.1
Taxes	16.7	15.9	15.6	16.8	17.1	16.8
Nonmining	16.6	15.7	15.0	15.4	14.0	14.4
Mining-related	0.1	0.2	0.6	1.4	3.1	2.4
Codelco revenues	0.5	0.9	3.0	3.7	5.7	4.8
Income on assets	0.6	0.6	0.4	0.3	0.5	1.1
Social contributions	1.5	1.4	1.4	1.4	1.4	1.4
Grants	0.2	0.2	0.1	0.1	0.1	0.1
Other	1.7	1.8	1.5	1.3	1.1	0.9
Total expenditure	22.4	21.0	19.9	19.1	18.2	19.1
Consumption	6.1	5.8	5.7	5.6	5.4	5.3
Social benefits	5.5	5.3	4.9	4.6	4.3	4.3
Subsidies and grants	5.9	5.5	5.1	5.0	4.8	5.6
Interest payments	1.2	1.1	1.0	0.8	0.7	0.6
Other	0.2	0.2	0.1	0.0	0.0	0.0
Gross investment	2.2	2.0	1.8	1.8	1.8	2.1
Defense	1.6	1.3	1.4	1.3	...	...
Non-defense	0.6	0.6	0.4	0.5	...	...
Net capital transfers	1.2	1.1	1.3	1.3	1.3	1.2
Net Assets	-7.9	-6.7	-4.1	0.1	7.5	12.0
Gross Debt	15.7	13.0	10.7	7.2	5.9	5.2
Peso-denominated Assets	7.8	6.3	6.5	7.3	8.0	7.9
Foreign currency-denominated Assets	0.0	0.0	0.0	0.0	5.5	9.2
Net Assets of the Public Sector 2/	-5.5	-7.2	-5.5	-2.5	7.3	11.2
Memorandum Items						
Nonmining Structural Balance	-1.3	-0.9	-1.4	-0.5	-1.0	-1.1
Fiscal Impulse 3/	0.1	-0.4	0.6	-0.9	0.6	0.2
Nominal GDP (trillions of pesos)	46.3	51.2	58.4	66.6	77.3	82.5
Output Gap	-2.6	-2.5	-0.9	-0.1	-1.1	-0.3

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

1/ Based on the 2007 Budget and updated staff estimates, including copper price assumption of US$2.72.
2/ Includes general government and Central Bank.
3/ Change in nonmining structural balance (-), adjusted for the impact of copper prices on the GDP deflator. Staff is working on more refined measures of fiscal impulse in Chile, including the impact of domestic versus foreign transactions.
4/ Excludes interest payments and income from government assets.

Table 3. Chile: Summary Operations of the Public Sector

(In percent of GDP)

	2001	2002	2003	2004	2005	2006	Proj. 2007
I. Central government							
Balance	-0.5	-1.2	-0.2	2.1	4.6	7.7	6.0
Total revenue	21.8	21.1	20.8	22.0	23.7	25.9	25.1
of which: intragovernmental receipts	1.1	1.1	1.0	0.8	0.8	0.8	0.8
Total expenditures 1/	22.3	22.4	21.0	19.9	19.1	18.2	19.1
of which: intragovernmental transfers	1.0	1.0	0.9	0.7	0.8	0.8	0.8
Current	18.9	18.9	17.9	16.8	16.0	15.1	15.8
Capital	3.4	3.5	3.1	3.1	3.1	3.0	3.3
II. Municipalities 2/							
Balance	0.0	0.0	0.0	0.0	0.2	0.0	0.0
Total revenue	3.3	3.3	3.1	2.7	2.9	3.0	3.1
of which: intragovernmental receipts	1.0	1.0	0.9	0.7	0.8	0.8	0.8
Total expenditures	3.2	3.3	3.1	2.7	2.7	3.0	3.0
of which: intragovernmental transfers	1.1	1.1	1.0	0.8	0.8	0.8	0.8
Current	2.8	2.8	2.7	2.4	2.4	2.7	2.7
Capital	0.4	0.4	0.4	0.4	0.3	0.3	0.3
III. Central bank							
Balance	-1.2	-1.2	-0.8	-0.6	-0.5	-0.2	-0.1
Net operating balance	-0.1	-0.1	0.0	0.0	0.0	-0.1	-0.1
Net interest balance 1/	-1.1	-1.2	-0.7	-0.6	-0.4	-0.2	0.0
IV. State-owned enterprises (non-financial)							
Balance	0.9	-0.3	-0.4	1.0	1.1	2.0	1.8
Total revenue	11.0	11.6	10.6	14.1	12.1	13.3	13.3
of which: intragovernmental receipts	0.1	0.2	0.2	0.1	0.1	0.1	0.1
Total expenditures	10.1	11.9	11.1	13.1	11.0	11.4	11.5
of which: intergovernmental transfers	1.3	1.2	1.6	3.7	4.2	6.2	5.3
Current	9.1	9.8	9.4	11.4	9.0	9.5	9.6
Capital	0.9	2.1	1.7	1.7	2.0	1.8	1.9

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

	2000	2001	2002	2003	2004	2005	2006	Proj. 2007
Financial indicators								
M3 (percent change)	11.7	10.3	6.3	3.7	10.6	11.9	11.4	...
less pension funds' deposits (annual percentage change)	10.4	9.6	3.9	6.2	6.6	10.8	27.9	...
Private Sector Credit to GDP	61.3	65.6	66.8	64.3	65.1	66.5	66.4	...
90-day central bank promissory note (nominal) interest rate (avg.)	10.8	7.2	3.9	2.8	1.8	3.5	4.8	...
Share of foreign currency deposits in total deposits	5.6	6.7	6.3	6.1	5.7	5.5	5.8	...
Share of foreign currency loans in total credit	11.6	13.7	14.5	10.3	10.0	10.0	10.3	...
External indicators								
Exports, U.S. dollars (annual percentage change)	11.9	-4.9	-0.5	19.2	50.1	27.0	40.7	1.0
Imports, U.S. dollars (annual percentage change)	16.0	-3.9	-3.9	13.6	27.8	33.0	17.7	9.6
Terms of trade (annual percentage change)	4.5	-7.2	3.8	9.7	22.1	10.8	31.0	-5.4
REER (end of period, percent change)	-2.2	-10.1	-6.9	13.4	-3.7	11.9	-5.2	...
Exchange rate (pesos per US$, period average)	539	635	689	691	610	560	530	...
Current account (percent of GDP)	-1.2	-1.6	-0.9	-1.1	2.2	1.1	3.6	3.4
Financial account less reserves accumulation (percent of GDP)	1.6	0.7	1.0	0.6	-2.4	0.3	-2.2	-0.7
Gross official reserves (in US$ billion) 1/	15.1	14.4	15.4	15.9	16.0	17.0	19.4	16.9
Gross official reserves, months of imports of goods and services	8.5	8.3	7.8	6.4	5.0	4.6	4.8	3.9
Gross official reserves to broad money	21.2	21.6	23.5	23.5	19.0	16.5	16.0	...
Gross official reserves to short-term external debt 2/	147.6	144.8	134.4	125.4	115.6	111.8	117.0	118.7
Total external debt (percent of GDP)	49.4	56.2	60.2	58.2	45.4	37.8	33.1	31.0
Of which: external public sector debt	8.0	8.9	10.7	12.5	10.3	8.0	7.4	6.5
Total external debt to exports of goods and services	159.6	172.0	179.5	161.1	112.9	93.2	73.5	70.2
External interest payments to exports of goods and services	8.1	7.6	6.4	4.7	3.3	2.9	2.2	2.0
External amortization payments to exports of goods and services	18.2	19.5	27.4	21.6	19.9	12.3	16.3	6.7
Financial market indicators								
Stock market index (in US$; period average) 3/	668	590	483	601	832	1105	1278	1648
Sovereign long-term foreign-currency debt rating (end of period)								
Moody's	Baa1	Baa1	Baa1	Baa1	Baa1	Baa1	Baa1	...
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, and Fund staff estimates.

1/ Gold valued at end-period market prices.
2/ As measured by the central bank; includes amortization of medium/long-term debt due during the following year, but not trade credits.
3/ Morgan-Stanley Capital International index (Dec/1987=100). 2007 data averaged up to end-May.

Table 5. Chile: Balance of Payments

	2004	2005	2006	Projections 2007	2008	2009	2010	2011	2012
(In percent of GDP)									
Current account	2.2	1.1	3.6	3.4	0.8	-1.2	-1.9	-1.9	-1.8
Excluding copper	-13.2	-14.8	-18.6	-16.1	-14.0	-12.8	-11.7	-10.9	-10.0
Trade balance	10.0	9.1	15.2	12.7	7.1	3.6	1.9	1.4	1.0
Exports	33.9	34.7	39.8	38.5	34.4	31.7	30.0	29.3	28.5
Copper	15.4	15.9	22.2	19.5	14.8	11.6	9.8	9.0	8.1
Non-copper	24.9	24.7	22.8	24.6	25.2	26.1	26.2	26.3	26.4
Imports	-23.9	-25.6	-24.6	-25.8	-27.3	-28.0	-28.1	-27.9	-27.6
Net services	-0.8	-0.5	-0.6	-0.5	-0.5	-0.6	-0.6	-0.4	-0.3
Net income	-8.2	-8.9	-13.3	-10.6	-7.4	-5.8	-4.9	-4.4	-4.0
Net transfers	1.1	1.5	2.3	1.8	1.7	1.6	1.6	1.5	1.5
Capital Account Balance 1/	-2.4	0.3	-2.2	-5.1	-0.8	1.2	1.9	1.9	1.8
Foreign investment (net)	5.9	4.0	3.6	3.9	3.8	3.9	3.8	3.7	3.7
Direct Investment Abroad	-1.6	-1.9	-1.9	-1.9	-2.0	-2.0	-2.0	-2.0	-2.0
Direct Investment in Chile	7.5	5.8	5.5	5.7	5.8	5.9	5.8	5.7	5.7
Portfolio investment (net)	-3.5	-2.2	-6.4	-7.8	-4.2	-2.4	-1.5	-1.6	-1.7
Financial Derivatives	-0.1	-0.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Other Investments	-4.4	-0.4	0.0	-0.6	-0.4	-0.4	-0.4	-0.3	-0.2
Reserves Assets	0.2	-1.4	-1.4	1.7	0.0	0.0	0.0	0.0	0.0
Chg. in official reserves (billions of USD, increase -)	-0.2	-0.9	-2.5	2.6	0.0	0.0	0.0	0.0	0.0
Central bank operations with commercial banks	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other 3/	-0.2	-0.9	-2.5	2.6	0.0	0.0	0.0	0.0	0.0
(In months of imports of goods and services)									
Gross official international reserves 2/	5.0	4.6	4.8	3.9	3.6	3.4	3.3	3.1	3.1
(Annual change in percent)									
Copper export prices	57.1	33.6	75.3	-12.3	-25.2	-22.2	-14.3	-6.7	-7.1
Copper export volume	19.7	-4.0	-2.1	4.6	4.2	4.1	4.0	4.6	4.5
Agricultural exports volume	7.3	8.5	3.7	7.9	5.0	4.0	4.0	4.6	4.5
Industrial exports volume	14.9	11.3	5.0	10.1	7.5	7.0	6.0	5.7	5.5
Total export prices	30.8	20.8	37.6	-5.3	-14.3	-9.5	-4.3	-0.2	0.1
Total export volume	14.7	5.2	2.4	7.6	6.9	6.3	5.5	5.2	5.0
Total import price	7.0	9.0	5.1	0.1	1.2	1.0	1.3	1.3	1.4
Total import volume	19.7	21.4	11.9	10.8	7.2	6.2	5.4	5.3	5.2
Terms of trade	22.1	10.8	31.0	-5.4	-15.3	-10.4	-5.5	-1.5	-1.3
Real GDP	6.0	5.7	4.0	5.8	5.3	5.0	5.0	5.0	5.0
(In percent of GDP)									
Gross domestic investment	20.1	22.4	20.4	20.9	22.1	22.8	23.1	23.0	23.0
Public sector	2.1	2.1	2.1	2.4	2.7	2.8	2.8	2.8	2.9
Private sector and inventory change	18.0	20.3	18.3	18.5	19.4	20.1	20.3	20.2	20.1
External current account balance	2.2	1.1	3.6	3.4	0.8	-1.2	-1.9	-1.9	-1.8
Gross national savings	22.2	23.5	24.0	24.2	22.9	21.6	21.2	21.1	21.2
Public sector 4/	4.8	7.5	10.8	9.2	6.2	6.0	5.9	5.5	5.5
Private sector	17.3	16.0	13.2	15.2	16.7	15.7	15.3	15.7	15.7
Total external debt (end of period)	45.4	37.8	33.1	31.0	30.1	29.2	27.9	26.5	25.0
Memorandum items:									
Copper price (LME; U.S. cents per pound) 5/	130	167	305	272	204	159	136	127	118
Volume of copper exports (2004=100)	120	115	113	118	123	128	133	139	145

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/ "Other" variations in reserves largely reflect changes in deposits by commercial banks and the government with the central bank, as well as the repayment of foreign currency bonds, completed in 2006.
4/ Net of estimated losses of the central bank.
5/ Updated staff forecasts.

Table 6. Chile: External Debt and Debt Service

	2002	2003	2004	2005	2006	Projections 2007
			(In billions of U.S. dollars, end of period)			
Total debt outstanding 1/	**40.5**	**43.1**	**43.5**	**45.0**	**48.2**	**47.3**
Of which: external private debt	33.3	33.8	33.7	35.5	37.5	37.4
Of which: external public debt	7.2	9.3	9.8	9.6	10.7	9.9
Medium- and long-term debt	34.9	35.9	35.7	37.9	38.2	37.2
Public sector	6.3	7.9	9.1	8.7	9.4	8.5
Of which: central government	3.6	4.6	4.7	4.0	4.2	3.4
Private sector	28.6	28.0	26.6	29.2	28.9	28.6
Financial sector	2.6	3.1	3.8	6.0	5.5	5.3
Non-financial sector	26.0	24.9	22.7	23.1	23.4	23.4
Short-term debt 1/	5.7	7.2	7.9	7.1	10.0	10.1
Residual maturity basis	11.4	12.6	13.9	15.2	16.6	14.2
Total debt service	**7.6**	**7.0**	**8.9**	**7.4**	**12.2**	**5.9**
Amortization	6.2	5.8	7.7	5.9	10.7	4.5
Interest	1.4	1.3	1.3	1.4	1.5	1.4
			(In percent of GDP)			
Total external debt, end-period 1/	**60.2**	**58.2**	**45.4**	**37.8**	**33.1**	**31.0**
Of which : external private debt	49.5	45.7	35.1	29.8	25.7	24.5
Of which : external public debt	10.7	12.5	10.3	8.0	7.4	6.5
Gross change (in percent)	4.0	-2.0	-12.8	-7.6	-4.8	-2.1
Gross change of nominal stock (in percent)	5.1	6.3	1.0	3.4	7.2	-2.0
Interest payments on external debt	2.1	1.7	1.3	1.2	1.0	0.9
			(In percent of exports of goods and services)			
Debt-service payments	33.8	26.3	23.2	15.2	18.5	8.7
Of which : interest	6.4	4.7	3.3	2.9	2.2	2.0
Total external debt outstanding 1/	179.5	161.1	112.9	93.2	73.5	70.2
			(In billions of U.S. dollars)			
Memorandum items:						
Gross international reserves	15.4	15.9	16.0	17.0	19.4	16.9
GDP 2/	67.3	74.0	95.8	119.0	145.8	152.6

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

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

Table 7. Social and Demographic Indicators

GDP (2006)		**Poverty rate (2006)**	**13.7**
Chilean pesos (billions)	77,384	Indigent	3.2
U.S. dollars (billions)	145.9	Poor, not indigent	10.5
Per capita (U.S. dollars)	8,909		
Population and Country Information (2005)		**Health**	
Total (in millions)	16.4	Population per physician (2003)	916
Urban population (in percent of total)	87.6	Population per hospital bed (2002)	385
Area (thousand sq. km.)	756.1		
Density (per sq. km)	21.7		
Annual rate of growth, 1997-2006	1.3		
Population characteristics (2005)		**Access to electricity (2003)**	
Life expectancy at birth (years)	78.2	Percent of population	98.9
Crude birth rate (per thousand)	15.7	Urban (2003)	99.7
Crude death rate (per thousand)	5.4	Rural (2003)	74.6
Infant mortality rate (per 1000 births)	8.0		
Mortality rate (ages 1-4, per 1000)	10.0		
Income distribution (2003)		**Access to safe water (2003)**	
Percent of total income received:		Percent of population	93
By richest 10 percent of households	45.0	Urban	99
By poorest 20 percent of households	3.8	Rural	58
Gini coefficient	54.9		
Distribution of labor force, in percent of total (2006)		**Education (2003)**	
Agriculture and fishing	11.7	Adult literacy rate (2006)	96
Mining	1.3	Gorss enrollment rates, percent of the age group	
Industry	12.2	Primary education (2004)	100
Construction	7.7	Secondary education (2004)	89
Services, Public Utilities, and Trade	67.1	Tertiary education (2004)	43

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

Annex I. Chile: Analytical Work and Technical Assistance

1. Ongoing Background Work

Chile's Structural Fiscal Balance Rule: A Model Based Evaluation
The paper analyzes Chile's structural fiscal rule using the IMF's Global Integrated Monetary and Fiscal Model (GIMF) to determine which parameters would minimize inflation and output volatility in a stochastic environment. It does so along two dimensions, first by comparing the use of different fiscal instruments (taxes, transfers, spending), and second by allowing for a more or less countercyclical response to excess tax or copper revenue.

Application of Contingent Claims Analysis to Chile
A background paper for the consultation produces risk indicators based on equity and debt data for seven major Chilean banks. It extends the CCA model by tying the returns on banking-sector assets to macroeconomic variables. The results suggest that banks are quite heterogeneous in their responsiveness to foreign and exchange-rate shocks and sensitivity to interest-rate changes. The paper also presents scenarios to see how bank capitalization is affected by various macroeconomic shocks.

Credit Cyclicality: A Cross-Country Comparison
This paper studies the determinants of credit cyclicality and compares Chile with 19 other emerging markets and advanced countries. Using both country-specific and panel VARs, the study focuses on the effects of financial frictions and financial development on the degree of pro-cyclicality of credit.

Trade Performance, Trade Liberalization and Competitiveness
This study analyses recent developments of non-copper exports and imports, in particular the impact of exchange rate movement and of trade liberalization. The analysis is conducted by means of a vector error correction model (VECM) using quarterly data for 1990-2006. Trade elasticities for Chile are also compared to those of other Latin American countries.

2. Recent Technical Assistance

Risk Management and Contingent Claims Analysis
The BCC and Fund staff collaborate closely in the area of contingent claims analysis and identification of domestic and external vulnerabilities. This has included several missions as well as a paper in the BCC's Financial Stability Report co-written with Fund staff.

Assessing the Institutional Aspects of Reserves Management
The BCC was appointed as the government's fiscal agent in the management of the Economic and Social Stabilization Fund and of the Pensions Reserve Fund in March 2007. An MCM mission has been assessing the BCC's compliance with Fund management reserves management guidelines in April 2007, the results of which are reported in this report.

3. Past Background Work

Toward Improving the Data and Procedures Used in Current Analysis and Forecasting at the Central Bank of Chile (2006 Selected Issues Paper)

Deepening Liquidity in Chilean Fixed-Income Markets (2006 Selected Issues Paper)

Public Sector Debt and Market Development (2006 Selected Issues Paper)

The Experience of Poverty Reduction in Chile (2006 Selected Issues Paper)

Assessing the Long-Run Shortfalls of the Chilean Pension System (2005 Selected Issues Paper)

Competition in the Chilean Banking Sector: A Cross-Country Comparison (2005 Selected Issues Paper)

Perspectives on Chile's Private External Debt (2005 Selected Issues Paper)

Experience with Public-Private Partnerships (2005 Selected Issues Paper)

INTERNATIONAL MONETARY FUND

CHILE

Staff Report for the 2007 Article IV Consultation
Supplementary Information

Prepared by the Western Hemisphere Department

Approved by Markus Rodlauer and Adnan Mazarei

July 13, 2007

1. ***This supplement reports on economic and policy developments since the staff report was issued on June 25***. The thrust of the staff appraisal remains unchanged.

2. ***Economic developments remain consistent with output growth of around 5¾ percent in 2007***. On an annualized basis, the monthly GDP indicator has been growing at above 6 percent so far this year, and strong retail sales and employment data confirm the broad-based nature of the recovery. WEO projections for copper prices have been raised since the staff report was issued, raising the projected current account and fiscal surpluses (see table).

3. ***Inflation has surprised on the upside in May and June, with both headline and core inflation now slightly above the 3 percent target***. Amid upward pressure from food and energy prices, staff projects inflation to remain around this level for the rest of the year. Medium-term inflation expectations continue to be firmly anchored at the 3 percent level.

4. ***The Banco Central de Chile (BCC) lifted its policy rate by 25 basis points to 5¼ percent on July 12***. Citing global supply shocks and reduced slack in the economy, the BCC also anticipated that it would likely be necessary to further reduce monetary stimulus in the coming months.

5. ***The 2007 central government surplus is now projected at over 7 percent of GDP, compared with 6 percent of GDP in the staff report***. The update reflects higher copper prices and a projected rebound in VAT receipts receipts based on improved collections in recent months. Invested government assets now exceed 10 percent of GDP, more than twice central government debt.

6. ***In line with its commitment to recapitalize the central bank gradually, the government transferred $736 million (½ percent of GDP) to the BCC in late June***. The first such annual payment was made in December 2006.

Main Economic Indicators

	2003	2004	2005	2006	2007	2008
			(percent)			
Real GDP growth	4.0	6.0	5.7	4.0	5.8	5.3
CPI inflation (eop)	1.1	2.4	3.7	2.6	3.2	3.0
			(percent of GDP)			
Current account balance	-1.1	2.2	1.1	3.6	4.0	2.3
Central government balance 1/	-0.2	2.1	4.6	7.7	7.3	4.5

1/ Based on authorities' projections for 2007, adjusted for higher WEO copper price assumptions.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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700 19th Street, NW
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IMF Executive Board Concludes 2007 Article IV Consultation with Chile

On July 16, 2007 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Chile.[1]

Background

The Chilean economy is enjoying a broad-based upswing, fueled by a strong global environment and buoyant domestic demand. Underpinned by supportive fiscal and monetary policies, GDP growth is expected to reach 5¾ percent in 2007, above the estimated potential growth rate of around 5 percent. Buoyant credit growth and strengthening labor market conditions continue to boost consumer spending, solid corporate profits and favorable financial conditions have contributed to higher investment, and exports are rising with strong external demand. Despite a sizeable nominal appreciation against the U.S. dollar, the real effective exchange rate has only moderately appreciated since the onset of the copper boom in 2004.

Inflation has recently increased but remains close to the 3 percent inflation target. The increase is attributable to higher global food and energy prices and reduced slack in the economy, while labor cost increases have been contained. Citing these factors, the central bank raised its policy rate by 25 basis points to 5¼ percent on July 12, noting also that it would likely be necessary to further reduce monetary stimulus in the coming months.

Fiscal developments have continued to benefit from revenues associated with strong copper prices, with expenditure increases in line with permanent revenues under the structural fiscal surplus rule. The nominal fiscal surplus is expected to be at over 7 percent of GDP in 2007,

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

based on strong corporate tax revenues and a projected rebound in VAT receipts. Invested government financial assets now exceed 10 percent of GDP, and the central government has become a net creditor. Reflecting the improvement in its financial position, the government announced a reduction of the structural fiscal surplus target from 1 percent to ½ percent of GDP beginning in 2008.

The authorities have advanced a broad structural reform agenda. A major pension reform, designed to achieve broader coverage, liberalize investment rules for pension funds, and increase competition in the financial sector has been submitted to Congress. A second round of capital market reforms was passed into law in May, aimed at further developing domestic markets and integrating the financial sector more closely into global capital markets. The government has also launched initiatives to boost education, strengthen job-specific human capital, and promote innovation.

Executive Board Assessment

Executive Directors commended Chile's strong institutions and sound macroeconomic policies, which, supported by ongoing structural reforms, have increased the resilience of the economy to external shocks, kept inflation and the public debt low, sustained high economic growth, and led to rising living standards over the past two decades. Directors supported the government's strategy of maintaining the current rules-based macroeconomic framework while addressing social issues and implementing structural reforms to boost long-term growth. A key challenge will be to further reduce income inequality and eliminate the remaining pockets of extreme poverty.

Directors commended the central bank for its success in maintaining price stability and anchoring inflation expectations at the target level. After supporting the economy through the slowdown in 2006, monetary policy has appropriately shifted toward withdrawing stimulus in view of the rebound in activity and the potential risks from higher global food and energy prices. Directors endorsed the floating exchange rate policy, and agreed that the value of the currency is broadly in line with economic fundamentals.

Directors welcomed the government's continued commitment to the structural fiscal surplus rule, which has helped maintain competitiveness under large positive terms of trade shocks. They viewed the modest reduction in the surplus target beginning in 2008 as appropriate in view of the sharp improvement in the government's financial position in recent years, noting that it provides room for additional social spending. Directors also welcomed the government's commitment to continue to build up a pension reserve fund and recapitalize the central bank. Directors noted the recent rebound in value added tax collections, and recommended that revenue performance continue to be monitored closely.

Noting the success of Chile's performance-based budgeting system, Directors considered the authorities' plans to further strengthen the quality of government spending and increase transparency as well placed. They encouraged the authorities to move toward adopting a medium-term expenditure framework to align annual budget decisions closely with the government's strategic objectives.

Directors supported the proposed pension reform, which is designed to address the main shortcomings of the current system while maintaining many of its pioneering basic features. They viewed the proposed liberalization of investment rules for pension funds as timely, in view of Chile's strong external position and the need to deepen domestic financial markets. Directors considered it important that, in implementing the reform, its overall cost be kept within the projected amount of one percent of GDP, and that incentives to save remain unimpaired.

Directors commended the authorities' structural reform agenda, aimed at raising long-term growth and closing the income gap with industrialized countries through improved education, innovation, and financial development. They noted the strength and resilience of the banking system, and welcomed recent measures to strengthen capital markets. Directors encouraged the authorities to continue with reforms aimed at fostering competition, enhancing labor market flexibility, and integrating the financial system further into global capital markets.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Table 1. Chile: Selected Economic Indicators

	2002	2003	2004	2005	2006
			(Annual percentage change)		
Production and prices					
Real GDP	2.2	3.9	6.0	5.7	4.0
Total domestic demand	2.4	4.9	7.5	11.0	6.0
Consumption	2.5	4.0	6.8	7.5	6.6
Private	…	4.2	7.0	7.9	7.1
Public	…	2.4	6.1	5.3	3.6
Investment	2.2	7.8	9.8	23.0	4.4
Private	…	6.5	10.5	23.2	3.3
Public	…	-0.4	5.7	11.2	10.9
Inventories 1/	0.2	0.5	0.1	0.5	0.1
Net exports 1/	-0.2	-0.9	-1.2	-5.0	-2.2
Consumer prices					
End of period	2.9	1.1	2.4	3.7	2.6
Average	2.5	2.8	1.1	3.1	3.4
GDP deflator	…	5.8	7.7	7.9	11.7
Real wages	2.0	0.9	1.8	1.9	2.0
Unemployment rate (annual average)	9.8	9.5	10.0	9.3	7.9
Output gap (percent)	-2.5	-2.4	-0.9	-0.1	-1.1
Money, credit, and interest rates					
Broad money	3.8	3.6	10.6	12.0	11.4
Credit to the private sector	9.6	11.4	14.8	15.4	17.7
Three-month interest rate 2/	3.9	2.8	1.8	3.5	4.8
			(Billions U.S. dollars, unless otherwise indicated)		
Balance of Payments					
Current account	-0.6	-0.8	2.1	1.3	5.3
In percent of GDP	*-0.9*	*-1.1*	*2.2*	*1.1*	*3.6*
Trade Balance	2.4	3.7	9.6	10.8	22.2
Exports of Goods	18.2	21.7	32.5	41.3	58.1
Copper Exports	6.3	7.8	14.7	18.9	32.3
In percent of total exports	*34.8*	*36.1*	*45.3*	*45.7*	*55.6*
Imports of Goods	15.8	17.9	22.9	30.5	35.9
Oil Imports	1.5	2.0	2.7	3.6	4.6
In percent of total imports	*9.7*	*11.3*	*11.8*	*11.8*	*12.9*
			(Annual percentage change)		
Exports	-0.5	19.2	50.1	27.0	40.7
Imports	-3.9	13.6	27.8	33.0	17.7
Terms of trade	3.8	9.7	22.1	10.8	31.0
Real effective exchange rate	-6.9	13.4	-3.7	11.9	-5.2
Net FDI (in percent of GDP)	*3.3*	3.7	5.9	4.0	3.6
			(In percent of GDP)		
Saving and investment					
Gross domestic investment	21.7	21.1	20.1	22.4	20.4
Public	2.6	2.3	2.1	2.1	2.1
Private	18.7	17.8	17.0	18.6	17.2
Change in inventories	0.3	1.0	1.0	1.7	1.1
National savings	20.8	20.1	22.2	23.5	24.0
Public 3/	1.6	2.5	4.8	7.5	10.8
Private	19.1	17.5	17.3	16.0	13.2
External savings	0.9	1.1	-2.2	-1.1	-3.6
Public sector finance					
Net debt	11.4	13.3	11.0	7.7	-1.7
Excluding public enterprises	5.5	7.2	5.5	2.5	-7.3
Gross debt 4/	42.8	44.4	39.0	30.4	26.0
Central government	15.7	13.0	10.7	7.2	5.9
Central government balance	-1.2	-0.2	2.1	4.6	7.7
External Debt					
Gross external debt	60.2	58.2	45.4	37.8	32.6
Public	10.7	12.5	10.3	8.0	7.4
Private	49.5	45.7	35.1	29.7	25.2
Memorandum items					
Nominal GDP (in billions of US$)	67.3	74.0	95.8	119.0	145.8
Copper prices (in US$ per pound)	0.7	0.81	1.30	1.67	3.05
Nominal Exchange Rate (average)	688.9	691.4	609.5	559.8	530.3

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. 2007 refers to June 8, 2007.

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

4/ Gross consolidated debt of the public sector (central bank, non-financial public enterprises, and general government). For comparability purposes, does not include securitized liabilities from pre-1981 pension system totaling 9.5 percent of GDP at end-2006.

Statement by Javier Silva-Ruete, Executive Director for Chile and Alvaro Rojas, Advisor to Executive Director July 16, 2007

1. This year, Chile's Article IV Consultation was conducted under the streamlining procedures, as established under the Medium-Term Strategy, given the broad consensus on economic policies and the absence of systemic issues. Our authorities would like to thank the IMF staff for a comprehensive and useful report, which clearly reflects the permanent collaborative dialogue that has characterized the relationship between Chile and the Fund, and which in no way was affected by the streamlined consultation process. We look forward to conveying the results of this Board discussion to our authorities.

Outlook and Risks

2. After growing 4 percent in 2006, due to one-off adverse events in natural resource sectors, higher energy prices and restrictions on the supply of natural gas from Argentina, some switching effects from domestic to external production in specific sectors, and a marked cycle in fixed capital investment, output growth has resumed during the first half of 2007 at a faster pace than previously envisaged. A favorable external environment, recovery in investment, firm expansion in private consumption supported by favorable financial conditions as well as positive labor market conditions and supportive macroeconomic policies have facilitated stronger growth. In addition, during 2007 the operation of new plants in the natural resources sector (pulp and mining) will further expand Chile's productive capacity. The Central Bank of Chile's (CBCh) central scenario projects GDP growth for 2007 between 5 and 6 percent, with a balance of risks with an upward bias, figures that are above the trend growth of the economy.

3. Given the positive outlook for growth in 2007, the output gap is expected to close gradually over the year, based on expansion in domestic demand and exports. Private consumption has remained a key driver of domestic demand in the current cycle. This strong consumption is expected to continue going forward, in line with increasing household income and credit expansion. Investment has exhibited a rebound from the low levels of the second half of 2006, as evidenced by an acceleration of imported capital goods, an increasing public investment, upward revisions of private investment intentions for 2008 and 2009, and also an improvement in business confidence indicators, strong firm cash flows and favorable financial conditions. In terms of external demand, the favorable outlook for the global economy should be the key driver of a broad based increase in exports, particularly from the non-copper sector which has expanded its export volume above 10 percent during the first semester of this year. It is noteworthy that, despite strong positive terms of trade shock extending over the last few years, the real effective exchange rate has remained approximately equal to its 15-year average.

4. Considering the CBCh growth scenario, risks are tilted to the upside, meaning that growth in the upper part of the range, and even above 6 percent cannot be ruled out. This is consistent with the broadly balanced-risk scenario described in the staff report, given the central scenario considered therein. As highlighted in the staff report, the downside risks are mainly external, such as an unanticipated change in global liquidity conditions, further increases in the price of oil and other food products, and the further limitations in the provision of natural gas from Argentina as well as other restrictions in the energy sector. The upside risks include an expansion of consumption above the dynamic pace already shown in recent months due to the more favorable developments in the labor markets, which could also pose an additional risk in terms of tighter excess capacity going forward.

5. Throughout large part of 2006, CPI inflation was on the upper limit of the 3 ± 1 percent target, due mainly to the incidence of higher fuel prices, while core inflation measures and other inflation trend indicators were close to 3 percent. However, during the last quarter of 2006, the pace of price increases moderated substantially, and both CPI and core inflation measures decreased below the 3 percent level. With decelerating inflation, lower inflation expectations, and below trend GDP growth, in order to ensure inflation convergence to 3 percent and after six months of stability in the policy rate, the Central Bank decreased the monetary policy interest rate in January 2007 by 25 basis points to 5 percent.

6. Over the course of the first five months of 2007, there have been both demand and supply shocks changing materially the inflation outlook. On the one hand, the higher growth rate of both domestic demand and GDP, in an overall context of diminished excess capacity could put upward pressure in inflation. On the other hand, strong price shocks in specific food items (grains and milk) and some increases in the price of oil and gasoline (instead of expected strong declines) have increase inflation marginally above the 3 percent target, much sooner than what was expected at the beginning of 2007. Inflation expectations remain well anchored at 3 percent, as evidenced by the survey data presented in the staff report, and the forward inflation compensation derived from indexed bonds. Furthermore, labor costs remain well contained, as indicated by unit labor costs. The upside risks in terms of inflation are a faster than anticipated closure of the output gap, the continuation of the observed supply shocks to food products as well as oil and gasoline, potential second round effects from higher prices of basic goods, and increases in the price of electricity. The downside risks to inflation are an exchange rate appreciation and a faster resolution of the supply shocks seen to date. So far, the authorities' view is that risks remain balanced, and if the inflation outlook shifts to a scenario in which the inflation forecast exceeds the 3 percent target over a 24 month period, the CBCh stands ready to act in order to fulfill its commitment to price stability by reducing the monetary impulse.

Fiscal Policy

7. In 2006, the central government posted an overall surplus of 7.7 percent of GDP as a result of the continued application of the structural budget surplus rule established in 2001

and high copper prices. The surplus resulted from a 23.1 percent real increase in revenues and a 6.9 percent real increase in public expenditure. A large budget surplus for a third consecutive year has allowed further major improvement in the financial position of the government via debt prepayments, and a significant increase in its assets from the savings of copper windfall revenues. This has resulted in the government becoming a net creditor if recognition bond liabilities (9.5 percent of GDP in December 2006) are excluded. The robust state of public finances guarantees solvency and flexibility in the face of a deterioration in the external environment in the future. In 2007 the central government is expected to reach a surplus of 7.1 percent of GDP. Again in line with the fiscal policy framework, in 2007 public expenditure is expected to increase by 9 percent in real terms, prioritizing social spending in health, education and social housing.

8. In order to manage copper windfall revenues prudently, in 2006 the Government passed the Fiscal Responsibility Law (FRL), which created two funds for the management of the government surpluses. The CBCh is currently responsible for the management of these funds as a Fiscal Agent. The first of these funds – the Economic and Social Stabilization Fund (ESSF) – was constituted with an initial deposit of USD 6 billion, and the second fund – the Pension Reserve Fund (PRF) – was established with a USD 600 million initial deposit. At the end of April 2007, the ESSF had a total of USD 7.2 billion in assets under management, while the PRF had a total of USD 617 million. In the setup of the two funds, the authorities have sought to establish institutions to manage the windfall gains from the high copper prices of recent years. As part of the governance structure associated with the setup of the ESSF and the PRF, an advisory body called the Financial Advisory Council constituted by a six-member panel of independent economists was established in order to provide advice to the Minister of Finance on the establishment of investment guidelines and other matters related to the funds. The FRL also allowed the government to make use of its surplus to recapitalize the CBCh by up to 0.5 percent of GDP for 5 years. The first payment of USD 600 million was made in 2006, and a second payment of USD 735 million was made recently.

9. On May 21, during her annual address to Congress, President Bachelet announced a reduction in the fiscal rule from a 1 percent to a 0.5 percent of GDP structural surplus target. Such a change in the surplus target of the rule was the result of thorough review of the conditions underlying the establishment of the 1 percent structural surplus target, namely the structural deficit of the CBCh, the existence of future contingent liabilities of the government arising from the state guarantee of minimum and basic pensions, and the vulnerabilities associated with the currency mismatches of the government's assets and liabilities.

10. During the last 6 years, the 1 percent surplus target has provided a clear anchor to fiscal policy and has allowed a significant reduction in the cost of accessing the international capital markets as well as a secular fall in long-term interest rates. At the same time, the fall in public debt and increased asset accumulation has resulted in a reduction in external vulnerability, while the CBCh has also reduced its structural deficit. As a result, it was

deemed necessary to reduce the structural surplus target to 0.5 percent from 2008 onwards. This adjustment flows from improvements in the conditions that led to the rule's establishment, and maintains the current rules-based framework for the conduct of fiscal policy.

Monetary and Exchange Rate Policy

11. Last January, the CBCh announced a refinement to its inflation targeting framework, including the inflation target itself as well as the horizon in which monetary policy aims to achieve the target. The previous framework was based on an inflation target in a range between 2 and 4 percent. Under the new framework, price stability will be understood as achieving most of the time a year-on-year CPI inflation rate of 3 percent, with a tolerance range of ± 1 percent. This change in the definition of the inflation target provides a clear signal that reassures the Central Bank's commitment to price stability and also strengthens the midpoint of the previous range as the economy's relevant nominal anchor. Regarding the policy horizon, the "12 to 24 months horizon" was replaced by a policy horizon "around two-years time". This change reflects that, on the one hand, the CBCh has been giving the practice of monetary policy a higher weight to the two-year horizon, and on the other hand, it takes into account the trend of other central banks in the definition of the policy horizon.

12. In line with the developments of the inflation outlook, monetary policy has shifted from an easing bias at the beginning of this year, which included a 25 bp. cut in January, to a restrictive bias. As correctly assessed in the staff report, the remaining monetary stimulus will probably be withdrawn in the near future, although as usual, monetary policy decisions will continue to be contingent on incoming data, particularly on its impact on the inflation outlook in a two-year horizon.

13. The floating exchange rate regime creates greater scope for monetary policy, and hence provides a buffer against external shocks. We concur with the staff's assessment that the exchange rate is broadly in line with fundamentals, and there is no evidence of misalignment of the Chilean peso (CLP). In terms of the real exchange rate, fiscal policy has played a key role due to the policy framework established to save abroad the windfall revenues of the government from the copper price boom as it has helped significantly in avoiding the loss of competitiveness that would have prevailed otherwise. These developments have been instrumental in preventing the possibility of Dutch disease in light of the large positive terms of trade shock from commodities prices.

Human capital

14. The change in the fiscal rule's target surplus from 1 percent to 0.5 percent of GDP increases available government resources by approximately USD 740 million on a permanent basis. Given the government's emphasis on social spending USD 650 million will be spent on education: the education voucher for children at mainly state-funded schools will rise by 15 percent, coupled with an increase in schools' accountability with regard to the use of these

resources; the preferential education subsidy which targets the most vulnerable children in the school system will increase; a family library program for four hundred thousand low-income families will be established; existing scholarship programs for students of technical careers will be expanded; and funds to improve the educational and financial capabilities of municipal schools will be allocated.

Labor markets

15. One of the key reforms that President Bachelet's government is committed to is a major reform of the pension system. Last year, a high-level technical commission headed by the former Budget Secretary was setup with the purpose of gathering a wide range of reform proposals from different relevant agents. Based on the proposals contained in the report, in December of 2006 the government submitted to Congress the bill with the Reform to the Pension System. The main elements of the reform is the establishment of a basic solidarity pillar which includes the basic solidarity pension (BSP) and the solidarity pension contribution (SPC) as explained in Box 1 of the report, the resolution of gender inequalities of the system, incentives to incorporate independent workers to the pension system, and increase competition by allowing new players to enter the system. The government's goal is to start paying the basic solidarity pensions by mid 2008. In order to achieve this goal, the government reached an agreement with the parties of the government coalition to accelerate the discussion in Congress, which implies that as early as August of this year the pension reform bill would be discussed in the Senate after being discussed in the Lower House, to become law by early 2008.

16. In terms of labor markets, one of the latest developments which was not covered in the report was the increase in the minimum wage of 6.7 percent, introducing a forward looking clause so that if actual growth (in the period from the 4^{th} quarter of 2006 to the 3^{rd} quarter of 2007) exceeds 5.8 percent in real terms, the minimum wage increases by an additional 0.7 percent. The introduction of this forward-looking clause based on GDP growth is seen by the government as a major step towards linking wage increases to economic performance.

Financial Sector

17. In June 2007 the Capital Markets II reform bill became law, introducing key improvements to domestic capital markets in three broad areas: promoting access to venture capital and funding for SMEs, strengthening financial market security, and promoting the development and deepening of financial markets. In the first area, the law establishes tax exemptions on capital gains from venture capital investments; promotes the participation of the public sector and bank subsidiaries in venture capital funds; simplifies the legal framework for the setup of both venture capital funds and companies; redesigns the current system for the establishment of collateral; and extends for a further eight years the existing tax benefit on trading of newly listed stocks.

18. The second area of the project improves market security by simplifying the review process for banks, insurance companies and AFPs license applications, centralizing it in the corresponding Superintendency; improves the legal protection of financial supervisors; sets higher custody requirements on securities so as to enhance the security of transactions between market participants; establishes professional requirements for traders at stockbrokers; and provides for the dematerialized issuance of securities.

19. The third area of the project promotes the development of capital markets. Among these measures are changes in the definition of sight and time deposits and reserve requirements (that will now be based on effective net worth, rather than basic capital in line with Basel II guidelines), allowing for further development of the money market; the authorization of derivatives netting in case of bankruptcy; increases in investment limits for insurance companies; modernization of the off-shore stock market; collective action clauses for bond issuance; and a new tax benefit for mutual fund investors to promote saving, competition and portfolio reallocation in the market segment.

Other Issues

20. In March 2007, the government announced the Chile Invests Plan, a package of measures aimed to boost investment, facilitate entrepreneurship, globalize the domestic financial markets, further enhance trade integration, improve government effectiveness, foster innovation and human capital, and address the country's expanding energy needs. The plan included a new accelerated depreciation tax benefit (still under review by the legislature), the identification and elimination of bottlenecks in the investment process; and an increased focus on the execution and quality of public investment. To facilitate entrepreneurship, the government will indirectly provide long-term financing products for small and medium-sized enterprises (SMEs) via the banking system, create a fund to guarantee the investments of small and medium-sized enterprises, and will create a standardized balance sheet reporting system for this sector that will be automatically prepared for SMEs using tax information. To further the integration of domestic financial markets, a derivatives law setting out a comprehensive tax framework will be submitted to Congress; to move toward the use of the Chilean peso as an international currency the government will facilitate connections to global settlement and custody systems, and will reduce the administrative burdens on foreign investors in domestic markets.

Conclusion

21. Chile's rules-based policy framework for monetary and fiscal policy has proven to be instrumental in the country's efforts towards sustaining growth so as to improve the living standards of the population, particularly those of low and middle-income Chileans, as evidenced by the latest figures on poverty reduction and income distribution. According to recently released figures, in the last 3 years the population in poverty fell by 5 percentage points, from 18.7 to 13.7 percent, and in terms of income distribution the figures show the

largest improvement since 1990, as evidenced in by a fall in the Gini coefficient. These improvements and the rules-based policy framework have been recognized recently by the invitation extended to Chile in May to open discussions for membership of the OECD.