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Chile: 2002 Article IV Consultation—Staff Report; Staff Statement; 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 2002 Article IV consultation with Chile, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 15, 2002,** 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 26, 2002.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **July 19, 2002** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its July 19, 2002 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Chile.

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

Selected Issues Paper

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

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CHILE

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representatives for
the 2002 Consultation with Chile

Approved by Claudio M. Loser and Liam P. Ebrill

June 26, 2002

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EXECUTIVE SUMMARY

Recent developments

In 2001, real GDP grew by 2.8 percent, in the context of weak domestic demand and an adverse external environment, and unemployment remained high. Since early in the year inflation stayed inside the 2–4 percent target band.

Adverse developments in neighboring countries in 2001 led to strong pressure on the peso, particularly from midyear through October. In response, the central bank stepped up its issuance of medium-term paper indexed to the exchange rate and intervened in the foreign exchange market, consistent with its policy of a floating exchange rate with intervention under extraordinary circumstances. Based on the outlook for inflation, the policy interest rate was lowered during the first half of 2001, but was kept constant the rest of the year. The authorities achieved their fiscal target of a structural surplus of 1 percent of GDP for the central government. The external current account deficit remained moderate.

Investors have been treating Chile favorably relative to other countries in the region, which has allowed the central bank to relax monetary policy in 2002 without putting pressure on the peso. Indicators of external vulnerability remain at comfortable levels.

Policy discussions

The authorities considered that their macroeconomic policy framework—inflation targeting under a floating exchange rate and an ongoing fiscal target of a structural surplus for the central government—had helped the economy cope with severe external shocks, including developments in Argentina, and planned to continue with this framework. They expected output growth to pick up later in the year, and inflation to stay within the target band.

Staff supported the authorities' policy intentions, and was broadly in agreement with their view on the outlook for the economy. Staff projects for 2002 output growth of 3 percent, end-year inflation of 3 percent, and an external current account deficit of 2.3 percent of GDP.

The spillover effects from Argentina on the Chilean economy are proving to be manageable. A broader deterioration at the regional level would have a more significant impact, but Chile's credible policy framework, high level of international reserves, and healthy banking system, inter alia, would help the country limit the consequences from such shock.

The medium-term outlook remains favorable, with economic growth supported by a continuation of sound macroeconomic policies and further structural reforms. The authorities are working on several initiatives, mostly of a microeconomic nature, which should enhance growth prospects. Chile has a very open trade regime and continues reducing unilaterally its uniform external tariff; it maintains, however, a price-band scheme that generates high tariffs on certain agricultural goods. Large increases in the minimum wage over a number of years and some aspects of a labor market reform recently introduced are likely to limit job creation; it would be important to look for ways to support labor market flexibility. Staff supports the authorities' interest in a fiscal ROSC, their request for an FSAP, and their efforts to strengthen anti-money laundering legislation.

I. Introduction

1. The 2002 Article IV consultation discussions with Chile were held in Santiago during April 30–May 15.[1] The staff team met with the ministers of finance and labor, the president of the central bank, senior officials in the government and the central bank, private sector representatives, and academics.

2. At the conclusion of the last consultation on July 16, 2001 (EBM/01/74), Directors commended the Chilean authorities for their long record of sound economic policies, which in the 1990s resulted in high economic growth, a gradual decline in inflation, and a marked reduction in poverty. Directors noted that growth had been interrupted by a recession in the late-1990s, but that a recovery of output had been underway since then. Directors supported Chile's monetary and exchange rate policy regime, including an exchange market that operates without intervention except in extraordinary circumstances, and an inflation-targeting framework focused on a continuous inflation band. They also supported the new framework for formulating fiscal policy on the basis of an ongoing target for a structural balance measure. They noted that this approach allowed the authorities to commit to a precise fiscal target without suppressing automatic stabilizers, and considered it important to achieve this target on an ongoing basis as a means to enhance credibility. Directors observed, however, that the high level of unemployment continued to be a problem, and considered it important to be cautious in granting adjustments to the minimum wage and to keep labor markets flexible more generally. Directors noted that the banking system remained strong. They called for early progress in the capitalization of the central bank, as this would add to fiscal transparency and strengthen public confidence in the bank's independence. Directors commended Chile for its very open trade regime, and supported recent steps to develop domestic financial markets and strengthen financial integration with the rest of the world. Directors considered that the medium-term outlook for the economy was favorable; while economic performance in the short term could be adversely affected by negative external developments, the country was well placed to deal with such adversity.

II. Background and Recent Developments

3. **In 2001, real GDP grew by 2.8 percent, in the context of weak domestic demand and an adverse external environment** (Table 1 and Figure 1). Domestic demand contracted,

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[1] The staff team comprised Messrs. Lizondo (Head, WHD), Espinosa, Phillips, Villafuerte (all WHD), and Rebucci (PDR). Mr. Le Fort, Alternate Executive Director for Chile, participated in the discussions. Chile has accepted the obligations of Article VIII, Section 2, 3, and 4 of the Fund Articles of Agreement and maintains an exchange system that is free of restrictions in the making of payments and transfers for current international transactions. Relations with the Fund are presented in Appendix I.

as consumption and fixed capital formation grew modestly and inventory accumulation turned negative. The weakness in demand partly reflected protracted high unemployment and worsening expectations about the outlook for the economy owing to negative external developments (including a global slowdown, the deterioration of the situation in Argentina, and a 7.6 percent drop in Chile's terms of trade, with copper prices at their lowest level in real terms in almost seventy years).[2] Demand for domestic output in 2001 was supported by strong growth in export volumes (particularly of noncopper products) amid a large real depreciation of the peso. **Unemployment remained high**, around 9 percent on a seasonally adjusted basis, more than 3 percentage points above its level before the 1998–99 recession (Figure 2). Since early 2001, **headline and underlying inflation stayed inside the 2–4 percent target band** that became effective at the start of the year.

4. **Adverse developments in neighboring countries during 2001 led to strong downward pressure on the currency particularly from midyear through October, when the exchange rate decoupled from events in Argentina** (Box 1). All in all, the peso depreciated by 10 percent in real effective terms in 2001, to a level about 23 percent below its appreciation peak in 1997 (Figure 3).

5. **In this environment, monetary policy adjusted during 2001, with a focus on achieving the authorities' inflation objective.**[3] Over the first half of the year, the central bank lowered its (overnight) policy interest rate by 150 basis points in response to signs of weakening domestic demand (Figure 4). However, as the peso came under strong pressure by mid-2001, and actual inflation and private inflation forecasts rose, the central bank kept the policy interest rate constant for the rest of the year.[4] During this period, the differential with U.S. interest rates widened significantly, as the U.S. Fed cut its rate sharply. After October, as the peso firmed up substantially, actual inflation and private inflation forecasts declined. For the year, broad money and bank credit increased broadly in line with GDP (Table 2).

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[2] Copper accounts for 36 percent of Chile's export revenues and about 10 percent of GDP. Since around 35 percent of copper output is produced by the state-owned company Codelco, changes in copper prices also have important effects on the fiscal accounts.

[3] Monetary policy focuses on bringing *headline* inflation (based on the CPI) to the midpoint of the target band over an horizon of 1–2 years, which is the estimated lag for monetary policy to have its main effect on inflation in the case of Chile. For details on Chile's inflation targeting regime see the staff report for the 2000 Article IV consultation (SM/00/116, Box 1).

[4] In August 2001, the central bank started setting its policy rate in *nominal* terms rather than in *inflation-adjusted* terms. The nominal policy rate was initially set at 6.5 percent, a level considered equivalent to the previously prevailing (inflation-adjusted) rate of 3.5 percent, assuming expected inflation of 3 percent, the midpoint of the inflation target band.

Box 1. The Recent Short-Run Behavior of Chile's Floating Exchange Rate

The Chilean peso depreciated by 25 percent against the U.S. dollar over the first ten months of 2001, a rate far in excess of earlier expectations for this low-inflation country. Substantial—and abrupt—peso declines were seen in March, July, and September of 2001, and the currency's volatility increased sharply in the third quarter. Market commentators began citing a strong relationship between Chile's peso and Argentine sovereign risk, and some analysts recommended trades on that basis. Others claimed a strong relationship between the peso and Chile's copper export prices. Such discussions were mostly based on simple, bivariate correlations.

A background paper prepared for this consultation analyzes the behavior of daily movements in Chile's exchange rate during 2½ years of Chile's new floating exchange rate regime. A dynamic regression equation for the rate of change of the peso/U.S.$ exchange rate is thus estimated on daily data. The analysis is multivariate, controlling for a wide range of potential explanatory factors. The study also investigates the possibility of contagion from Argentina during 2001. In particular, it focuses on *shift-contagion*: i.e., whether the existing fundamental linkage between Chile's exchange rate and Argentina's sovereign risk suddenly and temporarily changed in 2001. Thus the basic multivariate regression is reestimated, using a technique that allows the coefficients on the explanatory variables to change over time. Among the findings of the study:

Simple correlations have been somewhat misleading. For instance, after controlling for other variables, the explanatory power of Argentine variables is found to be much smaller than would be suggested by their simple correlations with the Chilean peso.

Developments in other economies in the region do matter. The most important factor among those considered turns out to be Brazil's exchange rate, followed by Brazil's sovereign risk. Argentine factors also seem relevant, particularly in the second half of 2001. Though the possible causal relationships are difficult to disentangle, the evidence is consistent with the idea that some of the effect of Argentina on Chile might have operated indirectly, through effects on Brazil. (More recently, in the second quarter of 2002, the peso's correlations with Brazilian variables have weakened substantially.)

Evidence of shift-contagion from Argentina is detected. The Chilean peso seems to have been affected not only by the large jump in Argentine sovereign risk that occurred after mid-2001, but also by a sudden magnification of the existing relationship with that variable: this shift-contagion began in July, abruptly intensified in early August, and had vanished by end-2001 after the peso (and other currencies) decoupled from events in Argentina, presumably reflecting a reassessment by investors of the likely spillover effects of these events on other countries, including Chile.

The market interest rate differential is found to influence the exchange rate in the expected direction. Thus, the widening of this differential in the second half of 2001, following the cuts in U.S. interest rates, may have helped support the peso during this period. (The methodology in the paper does not include a variable to capture the role of intervention in supporting the peso during this period.)

The role of copper prices is not clear. The study did not find evidence of a strong impact of copper price fluctuations and daily changes in Chile's exchange rate. Possibly, a copper-peso relationship exists, but cannot be detected in analysis of very short-term associations (e.g., if the effect of copper operated with a lag, or if only sustained copper price movements affected the peso). A further analysis did find some evidence suggesting that copper prices affect the equilibrium level of exchange rate over a longer time horizon.

6. **In response to increasing pressures on the currency, in July 2001 the central bank decided to step up its issuance of medium-term paper indexed to the exchange rate (PRDs), and subsequently also decided to intervene in the foreign exchange spot market.**[5] These actions were aimed at leaning against the wind, without targeting a specific level for the exchange rate. The maximum amounts of foreign exchange that would be used in intervention, the additional amount of PRDs to be issued, as well as the period over which these actions would take place (through end-2001) were announced in advance. In the event, the central bank sold about US$800 million in foreign exchange (gross and net international reserves were approximately US$14.5 billion at end-July), and the stock of PRDs rose from US$1.5 billion at midyear to US$3.8 billion at end-2001, and has remained stable since then.[6]

7. **In 2001 the authorities were successful in achieving their fiscal target of a *structural surplus* of 1 percent of GDP for the central government** (Table 3).[7] This represented a strengthening of the underlying central government accounts when compared with 2000. The central government *actual* balance, however, held steady at a *deficit* of about 1 percent of GDP (using the staff's presentation of the fiscal accounts).[8] For the rest of the public sector (Table 4),[9] the deficit of state-owned enterprises fell moderately to 0.4 percent

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[5] At the time of abandoning the exchange rate band system in September 1999, the authorities explained that the exchange rate would float freely, except under exceptional circumstances. Since then, the central bank has intervened only during August–October 2001.

[6] PRDs have maturities of 2–4 years, and information on this instrument is publicly available.

[7] The *structural* balance is derived from the official presentation of the *actual* balance in two steps. First, the *actual* balance is subject to accounting adjustments to better capture changes in net worth (e.g., all flows related to privatization are put below the line), resulting in an *adjusted* balance. Then, the *adjusted* balance is modified by removing the estimated revenue effects of the output gap and deviations of copper prices from a reference price, to obtain the *structural* balance. This derivation is explained in detail in the staff report and a background paper for the 2001 Article IV consultation, (SM/01/185) and (SM/01/199) respectively.

[8] In the official presentation, which includes drawings from the Copper Stabilization Fund and certain privatization receipts above the line, the central government balance moved from a slight surplus in 2000 to a small deficit in 2001. The differences in presentation are discussed in the staff report for the 2000 Article IV consultation (SM/00/116, Appendix IV).

[9] To allow for a greater focus on the central government accounts, to which the structural balance target applies, the presentation of fiscal data has been modified (from previous staff reports). The consolidated accounts for the public sector are not included, but the balance of each of the public sector components continues to be reported. This staff report also adds information on municipal governments and the debt of the consolidated public sector.

of GDP, while the central bank deficit remained stable slightly below 1 percent of GDP, and the municipal governments' balance continued near zero.[10]

8. **The external current account deficit widened moderately to 1.9 percent of GDP in 2001**, as the growth in net export volumes was more than offset by the drop in the terms of trade, and net export of services declined (Table 5). Total net capital inflows fell, despite an increase in net inflows of foreign direct investment. Overall, international reserves fell by about US$500 million (3 percent) in 2001 (Figure 5).

9. **Macroeconomic developments so far in 2002 include a continuation of weak domestic demand, low output growth, persistent unemployment, and inflation within the target band**. In the first quarter, real GDP grew by 1.5 percent (year-on-year), domestic demand fell by 2.5 percent, seasonally adjusted unemployment stood above 9 percent, and 12-month inflation in May was 2.1 percent (3 percent for the underlying index).

10. **At the same time, investors have been favorably distinguishing Chile from other countries in the region—which has allowed the central bank to further relax monetary policy in 2002 without putting pressure on the currency—and indicators of external vulnerability remain at comfortable levels** (Table 6). In the first five months of the year, the central bank cut the policy interest rate by 250 basis points (to a historical low of 4 percent), with the currency holding broadly stable with respect to the U.S. dollar. Also, the widening of Brazil's sovereign bond spread and the depreciation of the real that started in April has not been accompanied so far by similar movements in Chilean variables. In April, Standard and Poor's confirmed its investment grade (A-) rating for Chile's sovereign long-term debt and revised the outlook from stable to positive. In May, spreads on external bonds were about 150 basis points for the sovereign and 250 basis points for an index of leading Chilean firms, and international reserves stood at twice the level of short-term debt on a residual maturity basis (seven months of imports of goods and services and 20 percent of GDP).

11. **Several structural reforms were introduced in 2001.**[11] The authorities eliminated remaining **restrictions on capital flows** and introduced measures to help develop **domestic capital markets** (among others, exempting certain transactions from capital gain taxes, widening the choice for individuals to invest their pension savings, and deregulating the mutual funds and insurance industries). They also introduced a **tax administration reform** to reduce tax evasion and tax avoidance, and a **limited income tax reform**—intended to be

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[10] The nature and origin of the central bank deficit are explained in Appendix III.

[11] The staff report (SM/01/185) and staff statement (BUFF/01/98) for the 2001 Article IV consultation contain some details on these reforms.

revenue neutral—which lowered personal income taxes and raised corporate income taxes. Congress also approved an **unemployment insurance scheme** that will enhance the social safety net and reduce certain distortions arising from severance payments, although it will also increase indirect labor costs. Finally, congress approved a wide-ranging **package of labor reforms** which, among other measures: (i) increases dismissal costs when dismissal is deemed unjustified or "anti-union" by the labor court; (ii) increases penalties for violating labor laws; (iii) introduces payments that firms must make to striking workers if they are replaced during the strike; (iv) reduces the number of workers needed to set up a union; (v) widens access by workers to firms' financial information; (vi) increases costs for nightly overtime; (vii) introduces labor-training contracts for young workers that allow employers to credit training costs from (eventual) dismissal costs; (viii) establishes part-time and work-at-distance contracts; and (ix) reduces the work week (from 48 to 45 hours) by 2005.

12. **Chile has a very open trade regime**, rated 1 on the 1–10 scale of the Fund's trade restrictiveness index. The country has continued to reduce unilaterally its uniform external tariff by one percentage point a year (the tariff rate is now 7 percent, and in a final step would be lowered to 6 percent at the start of next year). Chile has reached a free trade agreement with the European Union in May 2002, and continues to negotiate bilateral trade agreements, including with the United States, Korea, and the European Free Trade Association. For a long time Chile has used import surcharges to maintain the import price of certain agricultural products (wheat, wheat flour, sugar, and edible oils) within bands related to past international prices. This price-band scheme is being challenged by trading partners at the WTO, as inconsistent with Chile's commitments under the GATT of 1994 and the Agreement on Agriculture. Also, as the (surcharge-inclusive) tariff on sugar resulting from the price-band scheme was above the WTO-agreed tariff limit for this good (31.5 percent), Chile recently negotiated an increase in this limit to 98 percent.

III. Policy Discussions

A. Macroeconomic Policies

13. The authorities considered that their macroeconomic policy framework—an inflation targeting regime under a floating exchange rate and a target for the government structural balance—had recently helped the economy adjust to a number of severe negative external shocks, without risking macroeconomic stability. In particular, they noted that Chile's financial indicators had partially disconnected from developments in Argentina, and estimated that the effects of lower exports of goods and services to Argentina would amount to no more than one-half of a percentage point of Chile's GDP in 2002. The mission restated its support for the authorities' overall policy framework, and broadly agreed with their assessment of the effects on Chile from developments in Argentina (Box 2).

Box 2. The Crisis in Argentina: Linkages and Effects on Chile

Argentina's crisis is affecting Chile through various channels.

Effects through trade links to Argentina are likely to be limited, in aggregate. For Chile, exports of goods and services are on the order of one-third of GDP, but Argentina is not a dominant part. Argentina has accounted for only 3 percent of goods exports, mostly agro-industrial, chemical, and textile products of small- and medium-sized enterprises. While minor in aggregate, the effects are potentially severe for the particular companies involved: in the first four months of 2002, exports to Argentina dropped 70 percent, though in time some of this lost trade can be redirected elsewhere. Tourism from Argentina has also been adversely affected. Argentina's large real depreciation may hurt some Chilean exports to third markets, but the two countries' export "menus" are rather different. Imports of goods from Argentina have represented about one-fifth of total imports, mainly oil, gas, and other intermediate goods, but there have been no reports of serious supply interruptions.

The scale of Chilean direct investments in Argentina, although subject to some uncertainty, is large enough to warrant analysis. The firms involved face weak local demand, potential losses from currency devaluation, and in some cases regulatory risk. According to Chile's securities regulatory body, possibly the most accurate source, at September 2001, 33 Chilean companies had direct investments in Argentina, totaling US$4 billion, or 6 percent of GDP. This stock represents 10 percent of these companies' assets and 20 percent of their net worth (in aggregate). Many of these companies also issued guarantees in Argentina, together worth US$0.9 billion. The median share of revenue from operations in Argentina was 17 percent among the companies reporting this information.

Direct investment in Argentina is concentrated in a small group of (large) companies: 85 percent is owned by just 11 companies, in the electricity, forestry, beverage, and mass-retailing sectors, with an average exposure as a share of total assets and net worth of 15 and 23 percent, respectively. In terms of individual companies' relative exposure to Argentina, this is greatest in the beverage and mass-retailing sectors, but these investments are relatively small in value (about US$0.4 billion). In absolute terms, the largest investments are in the electricity and forestry sectors. Forestry companies are less likely to be damaged since most of their production in Argentina is exportable to other markets and real depreciation may lower their costs. Electric companies are more strongly affected—as already reflected in somewhat higher bond spreads and lower stock prices—especially because of regulatory (pricing) risk. Still, their overall financial position seems solid, and credit ratings remain supportive. Since these companies are largely foreign-owned, their losses in Argentina do not directly affect Chilean national income or wealth.

In sum, the overall effects of Argentina's decline are proving to be manageable in Chile. The effect through direct trade linkages is likely to trim Chile's growth rate moderately, without placing serious strains on the economy. With income from trade to Argentina already severely diminished, in the future the corporate sector's direct investment position in Argentina could be the more relevant source of potential vulnerabilities. However, this exposure is concentrated and investors are discriminating not only among countries but also among companies, as evidenced by differentiated behavior of bond and stock prices. Other factors that help limit vulnerability are the strength of the Chilean financial system in general—and its own negligible exposure to Argentine clients—and the economy's (recently proven) ability to cope with large exchange rate movements.

14. Looking forward, the authorities considered that output growth would pick up later in the year as the world economy gained strength, terms of trade improved, the relaxation of monetary policy over the last several months took hold, and a large decline in inventories came to an end. The mission shared this view, and noted that domestic demand would also be supported by large investment projects planned by state-owned enterprises. Staff projections for 2002 include output growth of 3 percent, end-period inflation of 3 percent, and external current account deficit of 2.3 percent of GDP. The risk on this output projection is on the down side, mainly because the anticipated recovery in domestic demand may take longer than envisaged to materialize. These projections are broadly in line with official projections and those in surveys of private forecasts.

15. **There was agreement with the authorities on the current stance of monetary policy.** The level of the policy interest rate seems consistent with maintaining inflation within the 2–4 percent target band over the policy horizon, given the current output gap and expectations about domestic developments (a pick up in domestic demand) and the external environment (a recovery of global growth, a moderate increase in commodity prices including oil, and no further deterioration of the situation in the region). The risks around the central bank's baseline scenario appear to be well balanced.

16. **The authorities indicated that the large cuts in the policy interest rate since August 2000 had resulted in significantly lower lending rates for some, but not all, types of bank loans.** During this period, lending interest rates fell markedly for large loans (which make up most of the loan portfolio), but fell much less—and in some cases increased—for small loans (usually to small firms and individuals). Also, the interest rates charged on small loans showed a high dispersion across financial institutions. The authorities explained that over the last two years they have taken several steps to further enhance competition and increase transparency in financial markets, which should facilitate the response of lending rates to changes in the policy rate and reduce interest rate dispersion. These steps include, among others: (i) the issuance of new bank licenses; (ii) the authorization for savings and loan cooperatives to widen the variety of their credit operations; (iii) the requirements for banks to include all loan charges in a single interest rate figure, and to publish interest rates charged on consumer loans; and (iv) the publishing by the bank supervisory agency (SBIF) of information on interest rates charged by the various financial institutions on small loans.

17. **The authorities indicated the change in the definition of the policy interest rate from inflation-adjusted terms to nominal terms was part of a process of adjusting the implementation of monetary policy to an environment of low and stable inflation.** In particular, this change sought to: (i) reduce the volatility of short-term nominal interest rates and other nominal variables, including the exchange rate; (ii) foster the use of nonindexed contracts; and (iii) make it easier for investors to compare Chile's financial developments and policies with those of other countries. Since the move to a nominal policy interest rate, the volatility of nominal interest rates has declined and there has been some shift in the composition of bank deposits and loans toward nonindexed instruments (as of March 2002, 38 percent of bank deposits were inflation-indexed, 13 percent were exchange rate-indexed,

and the rest was nonindexed). As part of the process of reducing the scope of indexation, the central bank also stopped issuing inflation-indexed instruments for maturities shorter than one year, and started issuing two-year nonindexed instruments (as of March 2002, 54 percent of the central bank's paper was inflation-indexed, 25 percent was exchange rate-indexed, and the rest was nonindexed).

18. The authorities indicated that they had recently introduced the possibility for the central bank to enter into foreign exchange swaps with financial institutions. They explained that these operations were conceived as an additional tool for liquidity management, and specifically were not intended to be used for influencing the level of the exchange rate. Also, ensuring transparency, information on swap operations (if any) would be published in the central bank's bi-weekly economic and financial report.

19. **On the fiscal side, staff projects for 2002 a central government *structural* surplus of 0.7 percent of GDP, close to the official target.** The authorities are projecting slightly higher tax revenues than staff (on the basis of a higher GDP deflator), and thus they expect to achieve a structural surplus of 1 percent of GDP on current policies; they explained that they could adjust the level of government expenditure later in the year if needed for achieving their target. On current policies, staff projects that the central government *actual* balance would show a *deficit* of 1.5 percent of GDP, somewhat higher than last year, mainly reflecting higher capital expenditure. The authorities were resisting pressures to relax fiscal policy (by increasing government expenditure above planned levels) as a way of stimulating economic activity and reducing unemployment. They considered that the current approach to fiscal policy already allowed for automatic stabilizers to work, and that achieving their target for the structural surplus for a second year in a row was important to consolidate credibility of the new approach. In their view, relaxing fiscal policy at this stage could lead to an erosion of confidence in their commitment to sound fiscal policy, which could result in higher external borrowing costs for the private sector and thus offset any short-term direct impulse that could be obtained from additional government expenditure. They explained that they would continue addressing unemployment concerns through government-supported job programs, using resources already in the budget.[12] The staff was in agreement with this view.

20. The deficit of state-owned enterprises is projected to rise somewhat in 2002 (to 0.8 percent of GDP), reflecting an increase in investment expenditure which would be only partially offset by a reduction in current outlays resulting from the nonrecurrence of certain

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[12] Government-supported job programs (which in average during 2001 created employment for 1.7 percent of the labor force) aim at providing temporary jobs for unemployed household heads. The most important programs include direct job creation through the execution of public investment projects, and wage subsidies to foster creation of jobs in the private sector. The latter are expected to account for about one third of government-supported jobs in 2002.

wage payments made last year and from some efficiency gains. The central bank deficit is projected to rise moderately (to 1.1 percent of GDP), mainly reflecting lower government payment of interest on its debt to the central bank (as indicated in Appendix III, the government has some flexibility in deciding how much of the accrued interest on its debt to the central bank is paid and how much is capitalized).

21. Staff considers that current policies do not represent a risk for the public finances. The overall *net* debt of the public sector is low (projected at 15.3 percent of GDP for end-2002), and the government has had continued access to foreign financing, including at times of difficult access for emerging economies in general. Also, looking forward: (i) the central government's actual deficit should be expected to turn gradually into a surplus, to the extent that the current target for the structural balance is maintained (and there is convergence between the actual copper price and the reference copper price, and between actual output and estimated potential output); (ii) the deficit of the state-owned enterprises is limited, and most of them are profitable and thus unlikely to accumulate large debts that they would be unable to service; and (iii) the deficit of the central bank is projected to decline somewhat over the medium term, as the difference between domestic and foreign interest rates narrows.

22. The authorities confirmed their interest in having a **fiscal transparency ROSC** later this year. They continued to make progress in terms of transparency in the estimation of the structural balance by establishing a commission of experts (most of them from the private sector) to determine the copper reference price; each expert submits a projection for the average price of copper over the next ten years, and the reference price is calculated as the average of those projections (after excluding the highest and lowest projections). The authorities are in the process of setting up another commission, on estimation of the output gap. It would be important to make public the results of the work of this commission, and to regularly publish in detail the various accounting and cyclical adjustments used to derive the structural balance measure.

23. The authorities considered that a **capitalization of the central bank** was not a priority at present, as the current situation did not hamper the bank's ability to pursue its objectives. The mission acknowledged this point, but thought that the capitalization of the bank would contribute to increase transparency in the fiscal accounts.[13]

24. **The external current account deficit is projected to widen slightly**, to 2.3 percent of GDP, reflecting in part the envisaged pick up in domestic demand, but also the impact of

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[13] A hypothetical capitalization that eliminates the central bank deficit would lead, other things equal, to an equivalent weakening of the central government balance. This, however, would not imply a need for fiscal adjustment, as it would be logical to simultaneously lower the target for the central government's structural balance by a similar amount.

developments in Argentina (particularly a drop of tourism to Chile). This deficit is envisaged to be financed to a large extent by net foreign direct investment. International reserves would increase moderately, remaining broadly stable as a ratio to short-term external debt on a residual maturity basis.[14]

25. **Vulnerability to external shocks over the coming months appears to be limited given the strengths of Chile's policy framework and (financial and nonfinancial) corporate sector.** The public sector and the financial private sector have limited external debt servicing obligations and essentially no foreign exchange exposure. The nonfinancial private sector, which holds most of Chile's external debt (Table 6), has more significant financing needs, but enjoys also a strong capital base and does not appear to be illiquid, even though profitability is being affected negatively by the cyclical slowdown. Its foreign exchange exposure, in particular, has decreased significantly in recent years through increased financial hedging, as evidenced by a relatively small aggregate balance sheet loss resulting from the large depreciation in 2001.[15]

26. **If difficulties in neighboring countries were to expand and take a regional dimension, however, Chile would not escape unharmed.** Such a scenario would affect growth more severely than the crisis in Argentina, as exports to the region are significantly higher than those to Argentina, and a regional crisis would also be likely to adversely affect Chilean economic agents' expectations and weaken domestic demand. In addition, the exposure of the corporate sector through direct investments in all other Latin American countries is at about the same level as in Argentina. A regional crisis could also result in reduced net capital flows to Chile, but the flexible exchange rate has proven to be an effective adjustment mechanism, and, in the limit, the authorities could also use part of their ample international reserves to deal with a plausible-sized adverse shock without harsh consequences for the economy. Another source of strength is a sound banking system (see below), with a low level of dollarization. Also, the relatively effective bankruptcy regime would help minimize the output loss from individual companies' failure.

27. **The authorities noted that the nonfinancial corporate sector's increased resilience to external volatility had been induced, at least in part, by the flexible exchange rate regime.** They considered that the absence of an exchange rate anchor was providing the right incentives to manage foreign exchange exposure, while historically low

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[14] Even without exchange market intervention, international reserves can potentially vary due to interest earnings on reserves, changes in the foreign currency deposits at the central bank held by the financial institutions and the nonfinancial public sector, direct foreign exchange transactions of the central bank with the government or Codelco, and valuation changes.

[15] A background paper prepared for this consultation looks into these vulnerability issues.

interest rates were supporting fast growth in the local corporate bond market. The staff encouraged the authorities to continue developing their analysis of vulnerability in the nonfinancial private sector to complement their monitoring activities on the financial sector.

B. Financial Sector and Structural Issues

28. The mission shared the authorities' view that the **banking system** continued to be sound. The share of nonperforming loans remained low, loan provisioning seemed adequate, capital assets ratios were satisfactory, profitability was high, and stress tests indicated limited vulnerability to exchange rate, interest rate, and credit risk (Box 3). The authorities also indicated that the banking system's direct exposure to Argentina was low, as loans to clients in Argentina amounted to only 0.5 percent of total loans, and about half of those loans carried guarantees of Chilean firms which reportedly are in a strong financial position. Since the previous consultation, the authorities have advanced in terms of consolidated supervision of financial conglomerates, by requiring any individual or firm exercising control over a bank to submit to the supervisory agency (SBIF) information on their own financial situation. They have not made progress yet on providing staff of the SBIF with proper legal protection in the discharge of their responsibilities. The authorities have requested an **FSAP** to take place in coming months, with a view to discussing its findings in the context of the next Article IV consultation, and staff strongly supports these intentions.

29. **The mission restated staff support for Chile's open trade regime**, and the continued unilateral reduction of its uniform external tariff. The authorities considered that the free trade agreement with the European Union (which was expected to be soon ratified by Chile's congress) would boost trade flows and investment in Chile. Under the agreement, about 85 percent of Chilean exports to the European Union would enjoy zero tariff from the beginning, and this percentage would increase gradually to reach virtually 100 percent after ten years. The authorities also expected the negotiations on a free trade agreement with the United States to advance faster once the U.S. administration obtains Trade Promotion Authority. The mission encouraged the authorities to phase out the price-band scheme that places special tariffs on certain agricultural products, as these tariffs distorted resource allocation and generated a negative response from trading partners. The authorities indicated that this scheme was not conceived as a protection mechanism, but as a device to stabilize the domestic price of certain goods with highly volatile world prices resulting in part from subsidies and protection to industrial countries' producers. The mission noted that Chile's price-band scheme had a protectionist bias, as it allowed for increased import tariffs in the presence of "low" world prices but did not allow for import subsidies in the presence of "high" world prices. The authorities, however, considered that the price-band scheme was beneficial, and indicated that if Chile's appeal to a recent adverse WTO ruling on this scheme were to be rejected, they would likely use other mechanisms to achieve the same objectives.

30. The mission considered that the recent **labor reform** was likely to discourage hiring (in large part because it increased expected costs of firing workers). The authorities said that the reform was important in providing appropriate protection to workers, and that to the

Box 3. Chile's Banking System Soundness

The Chilean banking system continues to enjoy a reputation for soundness. Ratings agencies, for example, consider that this system is the strongest in Latin America and among the best regulated and supervised among emerging markets.[1] During the current Article IV consultation cycle, staff were able to examine more closely the Chilean banking system, including through stress tests conducted in late 2001 (see the background note prepared for this consultation). In advance of a planned FSAP, and in light of both the deceleration of growth and the external shocks that Chile has recently experienced, the staff would highlight the following information bearing on the soundness of the system:

Prudential indicators

- Capital-asset ratios. Capitalization has been adequate over the years, and in December 2001 the Basel risk-adjusted ratio was above 10 percent for every bank, and 12.7 percent for the system as a whole.
- Nonperforming loans. The proportion of the system's overdue loans has remained stable at low levels over the last few years, and stood at 1.6 percent in December 2001. Restated on the basis of the U.S. GAAP (which classifies the entire loan as nonperforming, not just the overdue portion), the estimated ratio would still have been moderate, below 3.9 percent.
- Provisioning. The ratio of loan-loss provisions to nonperforming loans has been at comfortable levels over recent years, and stood at 166 percent in December 2001.

Earnings measures

The Chilean banking system continues to generate healthy profits. The ratio of after-tax income to assets (ROA) increased in 2001, to 1.3 percent in December. The ratio of after-tax income to equity (ROE) also increased significantly in 2001, reaching 17.7 percent at end-year. Factors contributing to record profits last year include the reduction in interest rates (which permitted wider interest margins and generated a capital gain on securities' holdings), and the reduced requirement for constituting loan-loss provisions than in previous years.

Stress tests

In late 2001, staff conducted stress tests focused on banks' vulnerability to exchange rate, interest rate, and credit risk. Using the August 2001 balance sheets as a base, the tests estimated (for each bank) the simulated losses (or profits) that might result from each of the following assumed shocks:

- a 25 percent depreciation of the peso with respect to the U.S. dollar (similar to the depreciation experienced in the first ten months of 2001), which was applied to the net foreign exchange position of the banks;
- a sharp upward movement in the interest yield curve (similar to the exceptional change in interest rates that took place in Chile between June and September 1998), which was used to calculate the change in the net present value of future cash flows deriving from the banks' assets and liabilities, and the change in the earnings flows over a period of 12 months;
- an increase in nonperforming loans comparable to the average increase experienced in the wake of the Asian crisis (December 1997–June 2001), which was assumed to be fully provisioned.

The Basel capital ratio for each bank was adjusted for the effect of simulated losses (gains) resulting from each of these shocks, disregarding the potential for income to absorb part of the losses (i.e., income was implicitly assumed to be zero). In virtually all cases, banks would have continued to meet the minimum established in the Basel Accord. In the exchange rate test, about half of the banks benefited from the depreciation of the peso.

[1] See "The Chilean Banking System," by G. Lopez-Cortes, FitchRatings, May 2002, and "Latin American Roundup: Argentina and the Region," by C. Krossler, S&P, December 2001.

extent that workers valued this protection they would be willing to absorb at least part of the increased costs implicitly through lower wages than otherwise. They also emphasized that the new part-time contracts and labor-training contracts would enhance market flexibility, and indicated that some of these reforms were also useful in facilitating reaching bilateral trade agreements. The mission noted that the reform did not include the possibility of bilateral agreements between employers and employees to reduce restrictions on work schedules, and urged the authorities to make progress on this issue as soon as feasible to increase flexibility in the labor market.

31. The staff expressed the view that the marked increase in the **minimum wage**—both in real terms and in relation to the distribution of market wages—over the last few years had most likely made the minimum wage binding, which must be limiting job creation, especially under present conditions of weak economic activity. In this light, staff considered that the 2002 annual adjustment to the minimum wage (which was being discussed at the time of the mission, and became effective in June) needed to be modest, and preferably zero, at least for young workers for whom unemployment is particularly high and the minimum wage is more likely to be binding.[16] The authorities indicated that they were seeking a balance between the need to facilitate job creation and the need to provide some protection to unskilled workers, for whom an adjustment in the minimum wage serves to diminish the disadvantage they face in wage negotiations. In the event, the general minimum wage was raised by 5.4 percent, and the special minimum wage for young (and old) workers by 2.5 percent.

32. The authorities explained that they had started to work jointly with the private sector on several **structural reforms** aimed at enhancing efficiency and stimulating investment (the Pro-Growth Agenda). Among other objectives, these reforms would: (i) encourage the development of venture capital; (ii) improve regulation in the fishing, electricity, and telecommunications sectors; (iii) strengthen the institutional framework for the resolution of anti-monopoly cases; (iv) create special tribunals for tax, regulatory, and other economic disputes; (v) improve the tax environment for foreign investment by preventing double taxation; (vi) modify the country's bankruptcy law to shorten the period that productive assets affected by bankruptcy proceedings remain idle; and (vii) reduce bureaucratic red tape.

C. Medium-Term Outlook

33. **Staff consider that the chief medium-term issue confronting Chile today is the restoration of a high rate of economic growth.** Following very strong growth through most of the 1990s, growth has slowed markedly, from an average of 7.7 percent during 1990–97 to 2.4 percent during 1998–2001, with a projected 3 percent for this year. A significant part of

[16] Chile has a special minimum wage (below the general minimum wage, by about 13 percent at the time of the mission) for workers younger than 18 years and older than 65 years.

this deceleration is probably cyclical in nature, originating from a sequence of developments capable of depressing growth for a time: a sharp decline in terms of trade; the fallout from the Russia/LTCM crisis; a drought; political uncertainty around the electoral cycle; a slowdown in industrial country growth and associated further terms of trade decline; and a severe crisis in neighboring Argentina. Staff thus share the consensus view that a substantial gap between actual and "potential" output has developed in recent years, one symptom of which has been the persistently elevated level of unemployment.[17]

34. **However, the persistence of low output growth in recent years has led to some downward revisions of estimates of the growth of potential output as well, both for the last few years and for the medium term, from previous estimates of around 7 percent that had reflected the consensus through the late 1990s.** In recent years, the productive capacity of the Chilean economy is likely to have expanded at a slower rate than previously, since capital accumulation has slowed (though the investment/GDP ratio is still respectable), and the experience of a protracted period of high unemployment may have negatively influenced the formation of human capital. Looking ahead, potential output may also grow somewhat less rapidly than in the decade through the late-1990s, as the impulse effect of some past reforms inevitably winds down.

35. **In any case, a substantial acceleration of growth—to say 5 percent—should be within Chile's grasp.** Fundamental strengths that have underpinned Chile's growth in the past remain in place. Moreover, the economic policy regime has advanced further over the last several years, enhancing the environment for investments in physical and human capital. Growth will take a mainly privately-determined pattern. Certainly, part of the growth will arise in areas associated with natural resources; as in the past, growth in these ("traditional") areas is likely to be based also on innovation, technological advances, and productivity gains.[18] [19] The difference between moderate and fast growth will depend partly on policy initiatives, some of which are already well underway, such as education and capital markets

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[17] For example, the authorities have recently estimated an output gap of 4 to 5 percent.

[18] Several studies have shown that Chile's fast growth since the mid-1980s was supported by large productivity gains, including "The Golden Period for Growth in Chile: Explanations and Forecasts" by F. Gallego and N. Loayza (prepared for the conference "The Challenges of Economic Growth," Central Bank of Chile, November 2001), which estimates that total factor productivity's contribution to annual output growth was in the range of 2–3 percentage points for the period 1986–2000.

[19] One example is the mining sector, where production costs have been sharply lowered. More generally, the relationship between natural resources and growth, with a focus on Chile, was examined at a joint World Bank-Central Bank of Chile conference in January 2002, available at http://www.bcentral.cl/Estudios/Conferencias/2002RN/rrnn.htm).

reform, or are in their initial stages (such as the Pro-Growth Agenda described above). Other policy actions that staff considers would make a difference include measures to increase labor market flexibility, and further privatization or arrangements allowing the involvement of private capital in state-owned firms (e.g., in the state-owned oil and copper companies).

36. **Tables 7 and 8 depict an illustrative medium-term scenario, discussed with the Chilean authorities, with growth eventually converging to 5 percent, and supported over the medium term by both a modestly higher rate of capital accumulation and productivity**. In the next few years, growth will also benefit by a general improvement in the external environment (including a recovery of world growth and an improvement in the terms of trade reflecting mainly copper price recovery, in line with recent WEO projections), a strong supply growth in the copper sector (including in 2003 when a large mine expansion is expected to come on stream), and a gradual reduction in unemployment. The recent improvement in public sector saving would continue, reflecting mainly a strengthening of the actual balance of the central government, as the authorities hold the structural balance steady. Inflows of foreign saving would continue to play an important role, tending toward 2½ percent of GDP, but would be considerably less than during the 1996–98 peak. Foreign direct investment and bond financing would be the dominant form of net inflows.

37. **Chile's gross external debt is now fairly substantial, but would be sustainable under plausible assumptions.**[20] Most critically, it is reasonable to assume that growth of the Chilean economy will tend to be broadly similar to the real interest rates paid on foreign debt. Since debt of the public and financial sectors is expected to remain relatively small, the question of sustainability revolves largely around the individual and aggregate performance of the nonfinancial corporate sector; as noted earlier, this sector in the aggregate seems to be properly capitalized and not illiquid. The considerable increase in the value of external debt of the corporate sector since the mid-1990s reflected at first high domestic investment (reflected in Chile's large current account deficit before mid-1998); the subsequent more moderate increase has been associated more with accumulation of foreign assets. In part this phenomenon may be a one-off adjustment of portfolios, a type of diversification and internationalization not unexpected for growing companies located in a small economy with an open capital account.[21] In terms of ratios of debt to exports and to GDP, the recent rise in the former is also partly due to a decline in terms of trade (expected to be temporary, as discussed below), while the sharp increase in the latter is related to recent real depreciation (which by itself would be expected in due course to help widen the export base and thus enhance debt-servicing capability). In the staff's medium-term scenario, these two ratios

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[20] At end-2001, official reserves alone were more than US$14 billion, against gross external debt of about US$38 billion.

[21] Note that during this period foreign ownership of Chilean firms increased significantly.

would decline moderately over the period (to 134 percent and 47 percent, respectively, in 2007), as would the debt service ratio (following a hump in amortization payments in 2003).

38. **Regarding risks in the medium-term scenario, the staff considers that plausible negative shocks would not put solvency at risk, though they could induce a period of slower growth.** One risk relates to copper exports, as the significant price recovery now widely anticipated may not fully materialize during the projection period.[22] To put this risk in perspective, staff considered an extreme alternative scenario with zero price recovery and no policy response, the static effects of which would be (in 2005) a current account deficit larger by 1¼ percent of GDP, and a central government balance weaker by about 1 percent of GDP. Even then, however, Codelco and at least some private mining companies would cover costs, and so would be unlikely to experience payments difficulties. Moreover, a dynamic analysis would introduce some mitigating factors: (i) implementation of the government's target for its fiscal balance would in time likely imply a fiscal policy tightening; and (ii) external adjustment would also be facilitated through Chile's floating exchange rate regime. Staff also considered debt dynamics of a scenario in which output growth during 2003–07 stayed flat at 3 percent, rather than the 5.3 percent average of the baseline depicted in Tables 7 and 8. All else constant, the gross debt to GDP ratio would then still decline, but by half as much as in the baseline, settling at 52 percent of GDP, with official reserves converging to 22 percent of GDP, by the end of the projection period.

D. Other Issues

39. The authorities are seeking to strengthen **anti-money laundering** legislation. A bill already in congress, together with another to be sent over the coming weeks, proposes to: (i) extend the definition of money laundering to include activities associated with terrorism and arms trafficking (the current law only covers activities associated with drug trafficking); (ii) make it obligatory for financial (and some other) institutions to report transactions that could involve money laundering; (iii) provide legal protection to those reporting suspicious transactions; and (iv) create a specialized financial unit to analyze those reports. The authorities expressed interest in answering the Fund's voluntary anti-money laundering

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[22] Copper prices are notoriously difficult to predict. However, a background paper prepared for this consultation concludes that historically most copper price shocks have been temporary, albeit rather long-lived. Recent copper prices, near 70 U.S. cents/lb., have been the lowest in real terms in 70 years, but a complete return to the historical average of about 110 cents/lb. is not widely anticipated: the consensus is closer to 90 cents/lb., as in the staff's medium-term scenario. This view is based largely on estimates of the world market supply curve of copper, thought to have shifted downward in recent years, largely as the result of technical progress. (Indeed, copper production in Chile has enjoyed considerable reductions in costs, mitigating the negative effects of reduced copper prices.)

questionnaire, and indicated that they would send their response to staff over the coming weeks. Chile is a signatory of the **OECD anti-bribery convention** (to combat the bribery of foreign public officials in international transactions) but implementing legislation is still in congress, which is expected to discuss it within a few months.

40. The staff considers that Chile's economic data are broadly adequate for surveillance purposes. Chile is in full observance of the SDDS, and a ROSC Data Module completed last year provided a positive overall assessment of data dissemination practices and data quality. Recent significant improvements in economic data include the revision of the national accounts series (which, among other upgrades, changed the base year from 1986 to 1996), and the revision of the balance of payments series (to make it consistent with the fifth edition of the Fund's balance of payments manual). Chile is close to completing work on the International Investment Position that would meet the SDDS requirements with dissemination of these data scheduled for end-June 2002. The authorities continue working to enhance information on the financing items of the fiscal accounts, and to obtain reliable estimates for direct trade credits (which are missing from the official statistics on external debt). Prompt progress in these areas, as well as in improving the coverage of military transactions in the fiscal and external debt data, would enhance the usefulness of official statistics.

IV. Staff Appraisal

41. Chile's economic fundamentals remain sound and have improved through the evolution of the policy regime in recent years. Yet the country is operating in a difficult environment, for several years now coping with a sequence of negative shocks, most recently including the world economic slowdown, a further terms of trade decline, and spillovers from Argentina. No small economy could be expected to be immune to such developments, and they are largely responsible for the substantial slowdown in Chile's growth that has followed the very strong performance of most of the 1990s. Nevertheless, growth has continued, and recent shocks have been absorbed in an orderly fashion. Reflecting the economy's strong fundamentals and sound macroeconomic management, Chile was able to maintain favorable access to global finance even during last year's market drought, and the authorities did not need to raise—and in fact have been able to reduce—interest rates amid adverse external developments.

42. Early in 2001, the central bank began easing monetary policy in response to a weakening of domestic demand and reduced inflationary pressures. After midyear, this process had to pause, as pressures on the exchange rate arising outside Chile began to put the inflation target at risk. In the event, Chile "decoupled" from Argentina, and both actual and expected future inflation fell back. Thus, since early 2002 the authorities have reduced interest rates in an appropriate response to further signs of weak demand and very low inflation.

43. In 2001, the new fiscal framework had a solid start, as the authorities reached the new, ongoing target for the structural balance of the central government. The actual balance held steady, as the firming of the underlying government accounts was offset by the effects on revenue of lower copper prices and a widening output gap, reflecting the operation of the automatic stabilizers allowed under the targeting of the structural balance.

44. The staff fully supports the authorities' frameworks for fiscal and monetary policies, and Chile's floating exchange rate regime, and believe their plans for implementing these in 2002 are broadly appropriate. The current level of the policy interest rate seems consistent with maintaining inflation within the target band of 2–4 percent. The authorities will be alert to signs that policy might need to be adjusted in the short term, in either direction, to keep inflation inside the target band. Fiscal policy is geared toward maintaining the newly achieved central government surplus of 1 percent of GDP on a structural basis, likely to mean a moderate decline in the actual balance. The central bank balance will remain negative but broadly stable. The state-owned enterprises, which are essentially profitable, are expected to expand capital expenditure significantly this year, but their overall deficit will remain moderate.

45. Real GDP in 2002 is expected to grow by about 3 percent and inflation to stay inside the target band. The external current account deficit and other indicators of external vulnerability would remain at comfortable levels. These projections assume that demand strengthens fairly soon, in response to the easing of monetary policy, an ending of an inventory decumulation cycle, and with some push from greater investment expenditure by some public enterprises, as well as some further improvement in the external environment.

46. The authorities intend to participate in the fiscal transparency ROSC module, and they continue to take steps to enhance fiscal transparency. Beginning with the 2002 budget year, the reference price of copper is being determined by a committee of experts drawn mainly from outside the public sector. A new commission will provide key inputs for the estimation of the potential output measure also used in the fiscal target. Staff welcomes these steps and considers that a capitalization of the central bank would also add to fiscal transparency.

47. The banking system remains sound, as reflected by prudential indicators, earnings, and stress tests recently conducted by staff. The authorities have recently made progress in the area of consolidated supervision of financial conglomerates. To strengthen the supervisory framework further, it would be important to provide staff of the bank supervisory agency with proper legal protection in the discharge of their responsibilities. Staff supports the authorities' efforts to strengthen anti-money laundering legislation, and their request for an FSAP in the coming months, with a view to discussing its finding at the next consultation.

48. Chile has a very open trade regime and is commended for continuing to reduce unilaterally its uniform external tariff. The recent trade agreement with the European Union, and likely agreements with the United States and others, are welcome initiatives. It would be desirable that the authorities reevaluate the long-standing practice of using tariffs to hold the

domestic prices of certain agricultural goods within bands, both to improve resource allocation and to reinforce Chile's reputation as a country committed to open trade.

49. Unemployment has remained elevated and is being addressed mainly through government-supported job programs. The staff recognizes the need for such measures, at least on a temporary basis. Nevertheless, the persistence of high unemployment over a number of years raises the question of whether labor markets are operating as well as they might. In this context, staff has expressed concern over the extent of the cumulative increase in the minimum wage, as well as over the higher expected labor costs implied by the labor reform package. It would be important to use caution in future adjustments to the minimum wage and to look for ways to support labor market flexibility more generally.

50. The authorities are developing a range of initiatives to enhance growth prospects over the medium term. These are of an essentially microeconomic nature, and include encouraging the development of venture capital, strengthening the framework for resolving anti-monopoly cases and other economic disputes, and adjusting the regulation of several sectors. The staff encourages the authorities to press ahead in developing and implementing these reforms.

51. Chile's medium-term outlook remains favorable, with the main issue being the restoration of a high rate of growth. The slowing of growth in recent years is largely related to temporary factors. While the beneficial effects of some past reforms may be winding down, the country's fundamentals remain solid and in a number of respects have been improving in recent years, including in the development of sound frameworks for macroeconomic policies. The pace of growth over the medium term will depend partly on new policy initiatives, some now underway. Other possibilities which should be considered include bringing private capital into state-owned companies and increasing labor market flexibility. External payments sustainability will revolve largely around the performance of the nonfinancial private companies that owe most of Chile's external debt. At an aggregate level, debt sustainability seems assured, as it is likely that growth of the economy will tend to be broadly similar to the real interest rates paid on foreign debt, while the current account deficit remains moderate in the medium term. Assuming the consistent implementation of the macroeconomic policy and financial regulatory frameworks already in place, Chile should be able to cope with shocks that might plausibly arise in the years ahead.

52. The data received by the staff are timely and broadly adequate for surveillance purposes. Last year's ROSC data module provided a positive overall assessment of Chile's data dissemination practices and data quality, and since then the authorities have made progress in several areas. The authorities should persevere in these efforts, and it would be particularly useful to widen the coverage of fiscal and external statistics to fully capture military transactions, and to complete the estimation of direct trade credits to be included in the official short-term external debt statistics.

53. It is recommended that the next Article IV consultation with Chile be held on the standard 12-month cycle.

Table 1. Chile: Selected Economic Indicators

	1997	1998	1999	2000	2001	Proj. 2002
	(Annual percentage change)					
Production, prices, and trade						
Real GDP	6.6	3.2	-1.0	4.4	2.8	3.0
Real domestic demand	7.2	3.7	-5.7	5.9	-0.7	3.5
Consumption	6.5	4.3	-0.5	3.4	1.6	1.2
Investment	9.4	2.2	-19.6	14.0	-7.6	10.8
Fixed capital formation	10.5	1.9	-18.4	8.5	2.0	7.0
Consumer prices						
End of period	6.0	4.7	2.3	4.5	2.6	3.0
Average	6.1	5.1	3.3	3.8	3.6	2.6
Underlying inflation 1/	5.4	6.2	2.1	3.4	3.2	3.0
Real wages	2.4	2.7	2.4	1.4	1.6	...
Unemployment rate (average, in percent)	6.1	6.2	9.7	9.2	9.1	...
Exports (U.S. dollars)	7.5	-8.7	5.1	11.9	-3.8	5.1
Imports (U.S. dollars)	9.0	-4.8	-19.8	16.0	-4.0	6.1
Terms of trade	1.9	-4.7	5.7	5.5	-7.6	0.3
Real effective exchange rate (end period) 2/	9.8	-6.1	-6.2	2.5	-9.5	...
Money, credit, and interest rates						
Broad money (M3)	13.0	8.5	5.1	5.1	5.4	5.7
Credit to the private sector	18.0	11.2	3.0	10.7	6.7	7.9
Three-month interest rate 3/	13.4	16.4	10.7	10.8	7.2	...
Velocity of money (M1A)	12.2	12.3	11.8	12.5	11.4	11.4
	(In percent of GDP)					
Savings and investment						
Gross domestic investment	27.7	26.9	21.3	22.5	20.7	22.4
Public	4.8	4.8	4.0	3.5	3.7	4.9
Private	22.9	22.1	17.4	19.0	17.0	17.5
National savings	23.3	21.8	20.9	21.1	18.8	20.1
Public 4/	4.9	3.1	1.2	2.0	2.7	2.9
Private	18.4	18.8	19.7	19.1	16.1	17.1
External savings	4.4	5.1	0.4	1.4	1.9	2.3
Public sector						
Central government balance 5/	1.9	-0.1	-2.2	-0.9	-0.9	-1.5
State-owned enterprise balance	-1.0	-1.0	-0.1	-0.7	-0.4	-0.8
Central bank balance	-0.9	-1.0	-1.1	-0.9	-0.9	-1.1
Balance of payments						
Current account	-4.4	-5.1	-0.4	-1.4	-1.9	-2.3
Capital and financial account 6/	8.3	2.5	-0.5	1.7	1.3	3.5
Overall balance of payments	3.9	-2.6	-0.9	0.3	-0.6	1.2

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

1/ Excluding fuel and volatile food items, end-of-period.
2/ End of period. A decline indicates a depreciation of the peso.
3/ Nominal rates, in percent per annum, period average, on 90-day central bank promissory notes.
4/ Net of estimated deficit of the central bank.
5/ Using staff's presentation of the fiscal accounts. The official presentation of these accounts, as well as the estimated structural balance, are presented in Table 3.
6/ Includes errors and omissions.

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

	1997	1998	1999	2000	2001	Proj. 2002
I. Central Bank						
(Annual flows in millions of U.S. dollars)						
Net international reserves	3,209	-2,066	-683	198	-407	786
Medium- and long-term net foreign liabilities	0	0	-1	0	0	0
(Annual percentage change with respect to liabilities to the private sector)						
Net domestic assets	-359.8	209.4	91.9	-21.6	45.4	-49.6
Net credit to nonfinancial public sector	-40.7	30.6	82.2	20.1	34.6	33.5
Net credit to financial intermediaries	-116.5	-29.7	-66.0	-90.3	-35.3	-85.6
Central bank promissory notes	-108.5	73.7	5.2	-23.7	37.7	74.0
Other	-94.0	134.9	70.4	72.4	8.4	-71.5
Liabilities to private sector	14.6	-0.9	21.7	-4.9	9.3	8.2
II. Financial System						
(Annual flows in millions of U.S. dollars)						
Net international reserves	4,683	-1,160	1,720	-686	-2,144	2,066
Medium- and long-term net foreign liabilities	-161	-1,817	-3,645	197	-707	-746
(Annual percentage change with respect to liabilities to the private sector)						
Net domestic assets	-0.5	13.0	7.0	10.8	12.5	3.8
Credit to the private sector	11.7	4.1	2.0	6.5	4.8	5.7
Liabilities to private sector	16.3	9.7	15.7	9.5	10.1	8.7
Of which: pension funds	7.4	3.9	11.0	6.1	6.3	6.6
(In percent of GDP)						
Narrow money (M1A) 2/	9.6	8.6	10.2	10.1	10.5	10.7
Broad money	38.7	39.9	41.3	39.9	40.3	40.3
Liabilities to private sector 3/	84.6	88.3	100.8	101.9	108.3	111.5
Of which: pension funds	39.0	40.3	49.2	50.9	55.0	58.8
Credit to private sector	66.7	67.0	68.2	69.2	71.8	73.9
(Annual percentage change)						
Memorandum items:						
Growth of credit to private sector	15.0	5.8	3.5	9.7	7.0	8.6
Growth of credit to private sector, excluding pension funds	18.0	11.2	3.0	10.7	6.7	7.9
Inflation rate (CPI, end of period)	6.0	4.7	2.3	4.5	2.6	3.0
Narrow money (M1A)	16.6	-5.5	20.4	7.9	8.1	7.6
Broad money (M3)	13.0	8.5	5.1	5.1	5.4	5.7
(In percent: annual average)						
Interest rates (in real terms) 4/						
Commercial banks deposits	6.4	9.5	5.9	5.2	3.7	...
Commercial banks loans	8.8	11.9	8.2	7.5	6.3	...
90-day central bank promissory note (nominal)	13.4	16.4	10.7	10.8	7.2	...

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

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

2/ Defined as currency, demand deposits plus sight deposits.

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

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

Table 3. Chile: Summary Operations of the Central Government

(In percent of GDP)

	1997	1998	1999	2000	2001	Proj. 2002
			I. Staff Presentation			
Total revenue	**21.7**	**21.1**	**20.4**	**21.6**	**22.6**	**22.6**
Current revenue 1/ 2/	21.6	20.9	20.3	21.5	22.5	22.5
Tax revenue	16.3	16.3	15.6	16.4	17.2	17.6
Income taxes (excluding Codelco)	3.8	3.9	3.5	4.1	4.6	4.7
VAT	7.9	7.8	7.6	7.9	8.1	8.4
Excise taxes	1.9	2.0	2.2	2.2	2.4	2.4
Other	2.8	2.6	2.3	2.1	2.1	2.2
Copper income (Codelco) 2/	1.3	0.4	0.4	0.9	0.5	0.5
Other current revenue	3.9	4.3	4.3	4.2	4.8	4.4
Capital revenue	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure	**19.8**	**21.2**	**22.6**	**22.5**	**23.5**	**24.1**
Current expenditure 2/	16.4	17.6	18.8	19.1	20.0	20.0
Pensions	5.5	5.9	6.6	6.6	6.9	6.8
Of which : payment of recognition bonds	0.8	0.9	1.1	1.2	1.3	1.4
Wages	3.8	4.1	4.4	4.4	4.5	4.3
Purchases of goods and services	1.6	1.7	1.6	1.6	1.6	1.6
Interest payments	0.4	0.6	0.3	0.5	0.5	0.2
Transfers and other 2/	5.1	5.3	6.0	6.0	6.5	7.0
Capital expenditure 3/	3.4	3.6	3.7	3.4	3.5	4.1
Overall balance	**1.9**	**-0.1**	**-2.2**	**-0.9**	**-0.9**	**-1.5**
		II. Official Presentations: Actual (budget), Adjusted, and Structural Balances				
Actual balance, traditional budget presentation 4/	**1.8**	**0.4**	**-1.4**	**0.1**	**-0.3**	**-0.9**
Domestic financing	-1.3	-0.1	0.9	0.1	-0.4	0.0
External financing	-0.5	-0.2	0.5	-0.3	0.7	0.8
Adjusted balance (basis for structural balance) 5/	**1.8**	**0.0**	**-2.2**	**-0.8**	**-0.7**	**-1.1**
Estimated cyclical effect of output gap	0.7	0.4	-0.5	-0.4	-0.6	-0.9
Estimated cyclical effect of copper price gap	0.2	-0.7	-0.9	-0.4	-1.0	-0.9
Structural balance 6/	**0.9**	**0.3**	**-0.8**	**0.0**	**1.0**	**0.7**
Memorandum items:						
Deposits at Copper Stabilization Fund (flows)	0.1	-0.4	-0.6	-0.2	-0.7	-0.5
Central government employment, percent of total	2.5	2.5	2.6	2.7	2.8	...
Central government debt (official measure) 7/	13.8	12.5	13.4	13.1	15.1	16.6
Domestic debt 8/	9.6	9.4	9.6	9.6	10.6	11.6
External debt 7/	4.3	3.1	3.8	3.4	4.5	5.0

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

1/ Includes taxes paid and transfers made by the state-owned public enterprises.

2/ Includes amounts of CODELCO's off-budget transfers to the military (in recent years, 0.3-0.4 percent of GDP).

3/ Includes *net* lending (thus loan recovery is not included under capital revenue).

4/ Differs from staff's presentation in treatment of copper stabilization fund and certain privatization receipts. Official figures for balance, and its financing, through 2001.

5/ The authorities' adjustments here relate to copper stabilization fund and privatization receipts (as in staff treatment) and include also: shifting to an accrual treatment of pension "recognition bonds;" excluding net lending activity and other transactions judged not to affect government's net worth; incorporation of the quasi-fiscal activity implicit in the petroleum stabilization fund; and exclusion of certain one-time revenue windfalls.

6/ Reflects adjustments for revenue effects of output gap and copper price deviations from reference price.

7/ Excludes debt contracted by the armed forces, for which data are not available.

8/ Consists almost exclusively of debt owed to the central bank. Figures do not include pension "recognition bonds," which are estimated at 18 percent of GDP.

Table 4. Chile: Summary Operations of Other Public Sector Entities

(In percent of GDP)

	1997	1998	1999	2000	2001	Proj. 2002
			I. Central Bank			
Central bank balance	**-0.9**	**-1.0**	**-1.1**	**-0.9**	**-0.9**	**-1.1**
Net interest balance	-1.0	-1.0	-1.1	-0.9	-0.8	-1.1
Interest receipts (cash basis)	1.4	1.4	1.2	1.4	1.4	0.9
Interest payments	2.4	2.5	2.3	2.3	2.2	2.0
Operational result, net	0.1	0.0	-0.1	-0.1	0.0	-0.1
			II. Municipal Governments			
Overall balance 1/	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Revenue	1.9	1.9	2.1	2.0	...	...
Expenditure	1.8	2.0	2.1	2.1	...	...
			III. State-owned Enterprises (nonfinancial) 2/			
Current balance	**0.7**	**0.9**	**1.1**	**0.6**	**1.2**	**1.7**
Current revenue	11.7	10.3	10.8	13.1	14.4	13.8
Current expenditure	6.8	6.4	6.7	8.5	9.3	8.6
Taxes and transfers to central government	4.1	3.1	3.0	4.0	3.9	3.5
Capital balance	**-1.8**	**-1.9**	**-1.2**	**-1.3**	**-1.6**	**-2.5**
Of which: real investment expenditure	2.0	1.8	1.2	1.2	1.4	2.4
Overall balance	**-1.0**	**-1.0**	**-0.1**	**-0.7**	**-0.4**	**-0.8**
Memorandum items:						
Net debt of the consolidated public sector 3/ 4/	...	...	...	14.1	14.5	15.3
Domestic debt 3/ 5/	...	...	...	26.8	27.4	28.8
External debt 4/	-16.1	-13.4	-12.7	-12.7	-12.9	-13.5
Gross debt	5.5	6.7	7.5	6.9	8.5	8.8
Less: net international reserves	-21.6	-20.2	-20.2	-19.7	-21.4	-22.3

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

1/ Data for 2001 will be available at end-June 2002; figure shown is estimated based on legal budget constraint.
2/ Excludes Banco del Estado.
3/ Staff estimates.
4/ Excludes debt contracted by the armed forces, for which data are not available.
5/ Consists mainly of central bank debt. Excludes pension "recognition bonds," which are estimated at 18 percent of GDP.

Table 5. Chile: Balance of Payments

	1997	1998	1999	2000	2001	Proj. 2002
	(In millions of U.S. dollars)					
Current account	**-3,672**	**-4,014**	**-302**	**-1,072**	**-1,240**	**-1,568**
Trade balance	-1,396	-2,010	2,459	2,155	2,094	2,039
Exports, fob	17,902	16,353	17,194	19,246	18,505	19,449
Copper	6,647	5,197	6,026	7,285	6,746	7,050
Noncopper	11,256	11,155	11,167	11,961	11,759	12,398
Imports, fob	-19,298	-18,363	-14,735	-17,091	-16,411	-17,410
Financial services (net)	-2,597	-1,873	-2,219	-2,781	-2,742	-2,788
Other services and transfers (net)	320	-131	-542	-445	-592	-819
Capital account, incl. errors and omissions	**6,881**	**1,948**	**-381**	**1,270**	**833**	**2,355**
Foreign investment	5,740	1,328	4,526	-1,364	796	1,869
Chilean investment abroad	-2,105	-4,217	-7,221	-4,926	-5,304	-3,914
Direct investment	-1,867	-2,797	-4,855	-4,778	-3,791	-2,800
Portfolio investment	-238	-1,419	-2,366	-148	-1,513	-1,114
Foreign investment in Chile	7,845	5,545	11,747	3,562	6,100	5,783
Direct investment	5,243	4,955	9,251	3,674	4,762	4,281
Portfolio investment	2,602	590	2,496	-113	1,338	1,502
Medium- and long-term loans (net)	3,333	3,676	722	370	-415	-779
Disbursements	6,236	6,077	4,105	4,196	3,736	4,093
Amortizations	-2,903	-2,401	-3,384	-3,826	-4,151	-4,873
Other capital (net) 1/	-1,696	-1,747	-6,011	2,193	339	1,042
Public sector	-125	-264	-148	219	-133	0
Private sector	-1,570	-1,484	-5,862	1,974	472	1,042
Errors and omissions (net)	-496	-1,309	382	71	112	223
Overall balance of payments	**3,209**	**-2,066**	**-683**	**198**	**-407**	**786**
Reserve assets (increase -)	-3,209	2,066	683	-198	407	-786
Valuation adjustment	-842	217	-598	-167	-108	0
Change in official reserve stock (increase -)	-2,367	1,849	1,282	-31	515	-786
Memorandum items:						
Current account (percent of GDP)	-4.4	-5.1	-0.4	-1.4	-1.9	-2.3
Trade balance (percent of GDP)	-1.7	-2.5	3.4	2.9	3.2	3.0
External debt, all maturities (percent of GDP) 2/	32.3	40.0	46.8	49.2	56.9	57.8
Copper price (LME; U.S. cents per pound)	103.2	75.0	71.3	82.3	71.7	73.8
Copper exports (thousands of metric tons)	3,370.0	3,622.8	4,180.7	4,402.3	4,591.6	4,706.4
GDP (billions of U.S. dollars)	82.5	79.3	73.0	75.0	66.4	67.4
	(Annual change in percent)					
Copper export price (net of discount)	-5.6	-27.3	0.5	14.8	-11.2	2.0
Copper export volume	16.8	7.5	15.4	5.3	4.3	2.5
Noncopper export prices	-1.1	-8.1	-0.7	2.4	-11.6	-1.1
Noncopper export volume	7.3	7.8	0.8	4.5	11.2	6.6
Total export price	-3.0	-15.2	-0.3	6.8	-11.5	0.0
Total export volume	10.8	7.7	5.4	4.8	8.6	5.1
Total import price	-4.8	-11.0	-5.7	1.2	-4.2	-0.3
Total import volume	14.6	6.9	-14.9	14.6	0.2	6.4
Terms of trade	1.9	-4.7	5.7	5.5	-7.6	0.3

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

1/ Includes short-term flows and Chilean residents' holdings of medium- and long-term assets (other than equity) overseas.
2/ Does not include short-term direct trade credits.

Table 6. Chile: Indicators of External Vulnerability

(In percent; unless otherwise indicated)

	1997	1998	1999	2000	2001	Proj. 2002
Financial indicators						
Broad money (percent change)	13.0	8.5	5.1	5.1	5.4	5.7
Ratio of bank credit to GDP (percent)	55.4	58.5	59.2	60.2	61.6	63.0
90-day central bank promissory note (nominal) interest rate (averages) 1/	13.4	16.4	10.7	10.8	7.2	...
Share of foreign currency deposits in total deposits	3.7	6.9	9.9	11.8	14.4	15.7
Share of foreign currency loans in total credit (excluding pension funds)	8.3	9.1	8.6	9.5	11.0	11.0
Share of nonperforming loans in total loans 2/	1.0	1.4	1.7	1.7	1.6	...
Loan-loss provisions as percent of nonperforming loans 2/	147.6	131.2	152.7	145.7	166.0	...
Risk-based capital-assets ratio, end of period 3/	...	12.5	13.5	13.3	12.7	...
Return on bank capital	13.7	11.5	9.4	12.7	17.7	...
External indicators						
Exports, U.S. dollars (percent change)	7.5	-8.7	5.1	11.9	-3.8	5.1
Imports, U.S. dollars (percent change)	9.0	-4.8	-19.8	16.0	-4.0	6.1
Terms of trade (percent change)	1.9	-4.7	5.7	5.5	-7.6	0.3
REER (end of period, percent change)	9.8	-6.1	-6.2	2.5	-9.5	...
Exchange rate (pesos per US$, period average)	420.6	460.7	509.1	539.5	634.9	...
Current account (percent of GDP)	-4.4	-5.1	-0.4	-1.4	-1.9	-2.3
Capital account (percent of GDP) 4/	8.3	2.5	-0.5	1.7	1.3	3.5
Gross official reserves (in US$ billion) 5/	17.8	16.0	14.7	14.7	14.2	15.0
Central bank short-term foreign liabilities (in US$ billion)	0.0	0.0	0.0	0.0	0.0	0.0
Gross official reserves, months of imports of goods and services	9.4	9.9	8.1	8.3	7.6	7.3
Gross official reserves to broad money (M3)	58.3	51.9	50.6	52.4	54.8	55.2
Gross official reserves to short-term external debt 6/	496.4	385.2	367.8	230.3	220.1	206.0
Short-term foreign assets of commercial banks (in US$ billion) 7/	1.2	1.8	4.2	3.4	2.3	3.0
Short-term foreign liabilities of commercial banks (in US$ billion) 7/	0.8	0.9	0.3	0.4	1.0	0.4
Total external debt (percent of GDP)	32.3	40.0	46.8	49.2	56.9	57.8
Of which: public sector debt (percent of GDP) 8/	6.2	7.2	8.0	7.4	8.7	9.0
Total external debt to exports of goods and services	122.8	157.2	164.3	160.4	169.3	167.3
External interest payments to exports of goods and services	6.5	7.5	7.2	8.2	7.8	6.6
External amortization payments to exports of goods and services	13.3	11.9	16.3	16.7	18.6	20.9
Financial market indicators						
Stock market index (in US$; period average)	104.4	74.8	75.6	82.9	72.2	...
Sovereign long-term foreign-currency debt rating						
Moody's			Baa1 (6/29/95 to present)			
S&P			A- (7/11/95 to present)			

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

1/ The series starts in July 1997.

2/ Based on the official measure of nonperforming loans (recently, roughly half the level measured according to international norms).

3/ This indicator is not available before 1998.

4/ Includes errors and omissions.

5/ Gold valued at end-period market prices.

6/ Short-term external debt as measured by the central bank. Includes amortization of medium- and long-term debt falling due during the following year, but does not include direct trade credits.

7/ Refers to the commercial banking sector including the Banco del Estado de Chile.

8/ Includes private debt with public guarantee. Excludes debt contracted by the armed forces, for which data are not available.

Table 7. Chile: Balance of Payments—Medium-Term Projections

	2000	2001	2002	2003	2004	2005	2006	2007
			Projections					
	(In billions of U.S. dollars)							
Current account	-1.1	-1.2	-1.6	-1.4	-1.7	-2.1	-2.4	-2.6
Trade balance	2.2	2.1	2.0	3.0	3.3	3.4	3.4	3.5
Exports	19.2	18.5	19.4	22.3	24.3	26.5	28.2	29.9
Copper	7.3	6.7	7.1	8.7	9.4	10.3	10.7	11.2
Noncopper	12.0	11.8	12.4	13.6	14.9	16.2	17.4	18.7
Imports	-17.1	-16.4	-17.4	-19.3	-21.1	-23.2	-24.7	-26.3
Financial services (net)	-2.8	-2.7	-2.8	-3.4	-4.0	-4.3	-4.6	-4.9
Other services and transfers (net)	-0.4	-0.6	-0.8	-0.9	-0.9	-1.1	-1.2	-1.2
Capital account 1/	1.3	0.8	2.4	2.0	2.6	3.1	3.4	3.7
Foreign investment (net)	-1.4	0.8	1.9	3.7	3.0	3.9	3.7	3.1
Assets	-4.9	-5.3	-3.9	-4.0	-4.1	-4.2	-4.3	-4.4
Liabilities	3.6	6.1	5.8	7.7	7.1	8.1	8.0	7.5
Other capital flows	2.6	0.0	0.5	-1.7	-0.4	-0.8	-0.3	0.6
Medium- and long-term (net)	0.4	-0.4	-0.8	-1.7	-0.6	-1.0	-0.4	0.5
Disbursements	4.2	3.7	4.1	4.3	4.7	5.0	5.3	5.7
Amortizations	-3.8	-4.2	-4.9	-6.0	-5.3	-6.0	-5.7	-5.1
Other capital (net) 1/	2.3	0.5	1.3	0.0	0.2	0.2	0.1	0.1
Overall balance	0.2	-0.4	0.8	0.7	0.9	1.0	1.0	1.2
Reserve assets (increase -)	-0.2	0.4	-0.8	-0.7	-0.9	-1.0	-1.0	-1.2
Valuation adjustment	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Change in official reserve stock (increase -)	0.0	0.5	-0.8	-0.7	-0.9	-1.0	-1.0	-1.2
	(In months of imports of goods and services)							
Gross official international reserves 2/	8.3	7.6	7.3	6.9	6.7	6.6	6.6	6.6
Main assumptions								
Copper price (LME; U.S. cents per pound)	82.3	71.7	73.8	82.0	86.0	91.0	91.5	92.0
Volume of copper exports (thousand metric tons)	4,402	4,592	4,706	5,153	5,308	5,467	5,631	5,800
	(Annual change in percent)							
Copper export prices 3/	14.8	-11.2	2.0	12.3	5.5	6.5	0.8	0.8
Copper export volumes	5.3	4.3	2.5	9.5	3.0	3.0	3.0	3.0
Noncopper export prices	2.4	-11.6	-1.1	3.7	2.3	2.3	1.1	1.0
Noncopper export volume	4.5	11.2	6.6	5.9	7.0	6.3	6.3	6.3
Total export prices	6.8	-11.5	0.0	6.8	3.5	3.9	1.0	0.9
Total export volume	4.8	8.6	5.1	7.3	5.5	5.0	5.0	5.1
Total import price	1.2	-4.2	-0.3	1.9	2.4	2.5	1.3	1.1
Total import volume	14.6	0.2	6.4	8.9	6.4	7.5	5.4	5.3
Terms of trade	5.5	-7.6	0.3	4.8	1.1	1.4	-0.3	-0.2
Real GDP	4.4	2.8	3.0	5.5	6.0	5.0	5.0	5.0
LIBOR (in percent)	6.6	3.7	2.8	4.5	5.8	6.0	6.0	6.0
	(In percent of GDP)							
Gross domestic investment	22.5	20.7	22.4	23.1	23.4	23.4	23.7	23.8
Public sector	3.5	3.7	4.9	4.7	4.7	4.6	4.6	4.6
Private sector and inventory change	19.0	17.0	17.5	18.3	18.7	18.8	19.0	19.2
External current account balance	-1.4	-1.9	-2.3	-1.8	-2.1	-2.4	-2.5	-2.5
Gross national savings	21.1	18.8	20.1	21.3	21.3	21.1	21.2	21.3
Public sector 4/	2.0	2.7	2.9	3.2	3.7	4.3	4.8	5.3
Private sector	19.1	16.1	17.1	18.1	17.6	16.8	16.4	16.0

Sources: Data provided by the Central Bank of Chile; 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/ Chilean export price.

4/ Net of estimated deficit of the central bank.

Table 8. Chile: External Debt and Debt Service

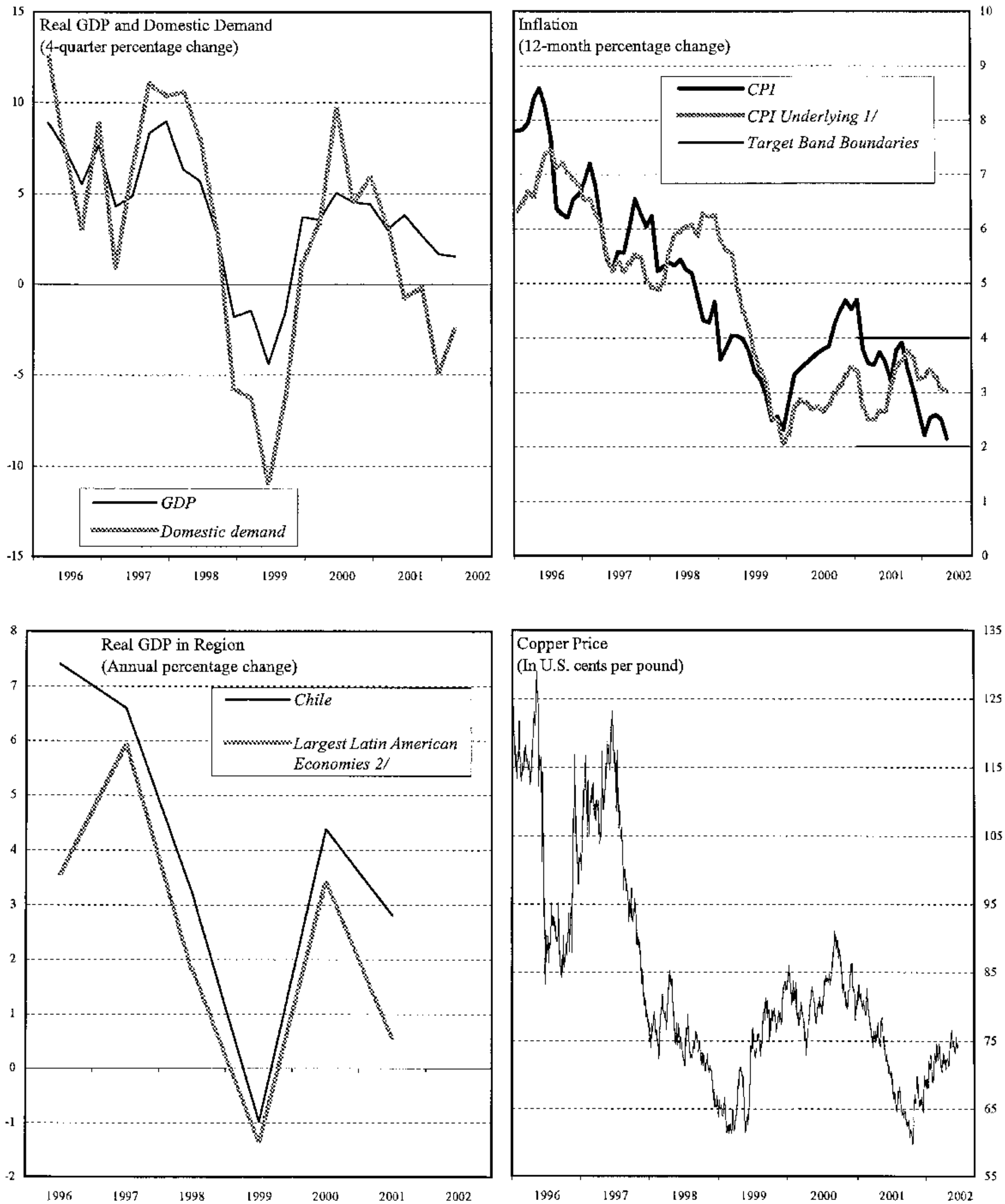
			Projections					
	2000	2001	2002	2003	2004	2005	2006	2007
			(In billions of U.S. dollars, end of period)					
Total debt outstanding 1/	**36.8**	**37.8**	**38.9**	**39.6**	**41.0**	**42.8**	**45.0**	**47.7**
Of which : external private debt	31.3	32.0	32.9	33.4	34.7	36.6	38.8	41.5
Medium- and long-term loans and bonds 2/	34.3	35.7	36.5	37.1	38.5	40.4	42.6	45.3
Short-term debt 1/ 2/	2.5	2.1	2.4	2.4	2.4	2.4	2.4	2.4
Short-term debt, residual maturity basis 1/	6.4	6.5	7.3	8.4	7.7	8.4	8.1	7.6
Total debt service	**5.7**	**8.3**	**6.4**	**8.6**	**8.5**	**9.4**	**9.3**	**8.9**
Amortization	3.8	4.2	4.9	6.0	5.3	6.0	5.7	5.1
Interest	1.9	4.2	1.5	2.6	3.2	3.4	3.6	3.8
IMF								
Credit outstanding	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repurchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
			(In percent of GDP)					
Total external debt, end-period 1/	49.2	56.9	57.8	53.3	50.5	48.6	47.4	46.7
Of which : external private debt	41.8	48.2	48.8	45.0	42.8	41.5	40.9	40.6
Interest payments on external debt	2.5	2.6	2.3	3.5	4.0	3.9	3.8	3.7
			(In percent of exports of goods and services)					
Debt-service payments	24.9	26.4	27.5	32.7	29.3	29.7	27.6	24.9
Of which : interest	8.2	7.8	6.6	9.9	11.1	10.8	10.6	10.5
IMF repurchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total external debt outstanding at year-end 1/	160.4	169.3	167.3	150.0	141.3	135.2	133.8	133.6
IMF credit outstanding	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:								
Net international reserves, percent of GDP	19.7	21.4	22.3	21.1	20.5	20.0	19.7	19.4
Net financial services payments, percent of GDP	3.7	4.1	4.1	4.6	5.0	4.9	4.9	4.8

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

1/ Excludes direct short-term trade credits.

2/ Original maturity basis.

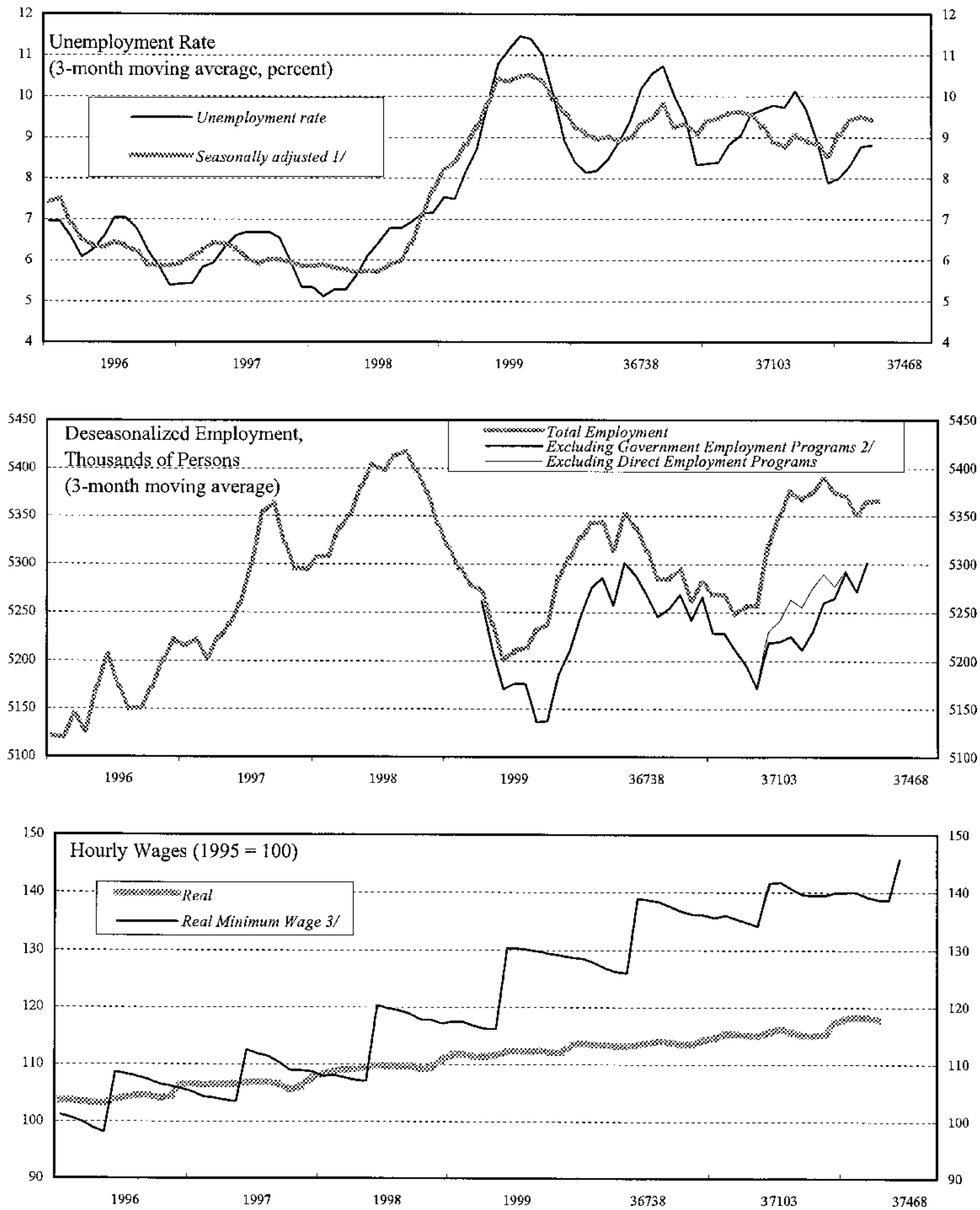
Figure 1. Chile: Selected Economic Indicators, 1996–2002



Sources: Central Bank of Chile; and London Metals Exchange.

1/ Excluding fuels and perishable agricultural products.
2/ Simple average of growth rates of Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.

Figure 2. Chile: Labor Market Developments, 1996–2002



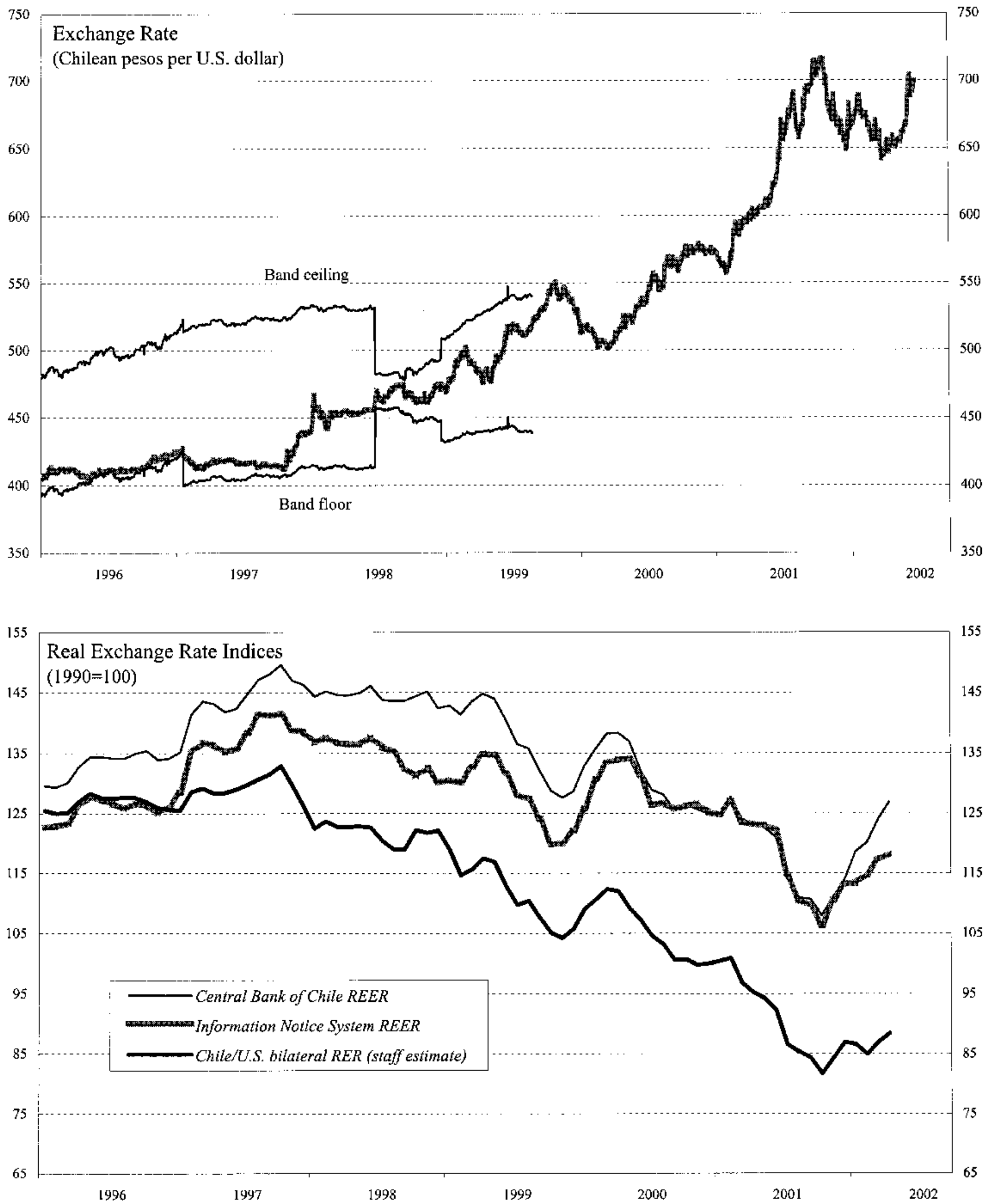
Source: Central Bank of Chile.

1/ INE deseasonalization.

2/ Government employment programs include direct creation of government jobs and the provision of wage subsidies for private sector jobs.

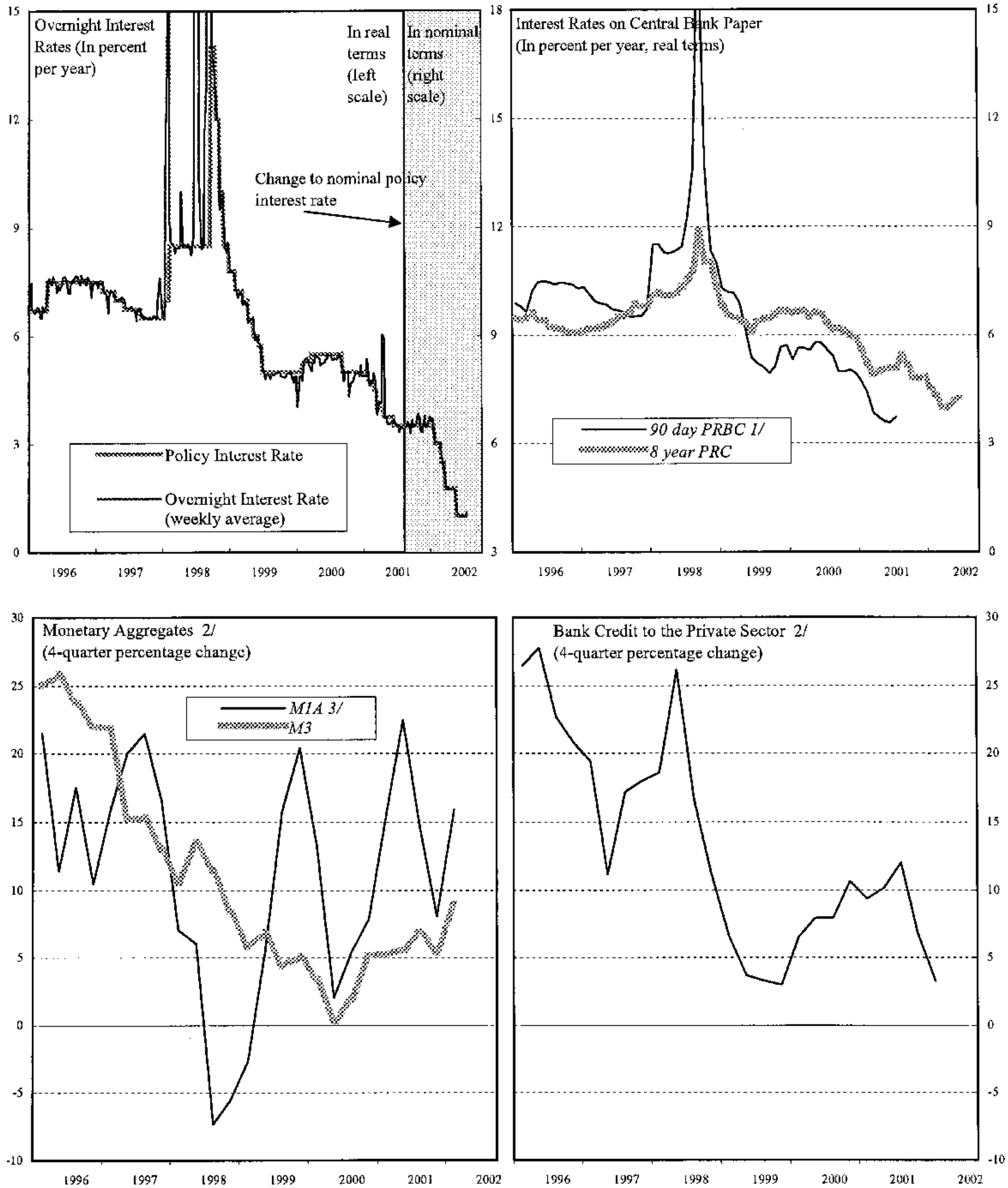
3/ June 2002 figure based on projected monthly inflation of 0.25 percent.

Figure 3. Chile: Exchange Rate Developments, 1996–2002



Sources: Central Bank of Chile; IMF's Information Notice System; International Financial Statistics; Fund staff estimates.

Figure 4. Chile: Financial Sector Indicators, 1996–2002



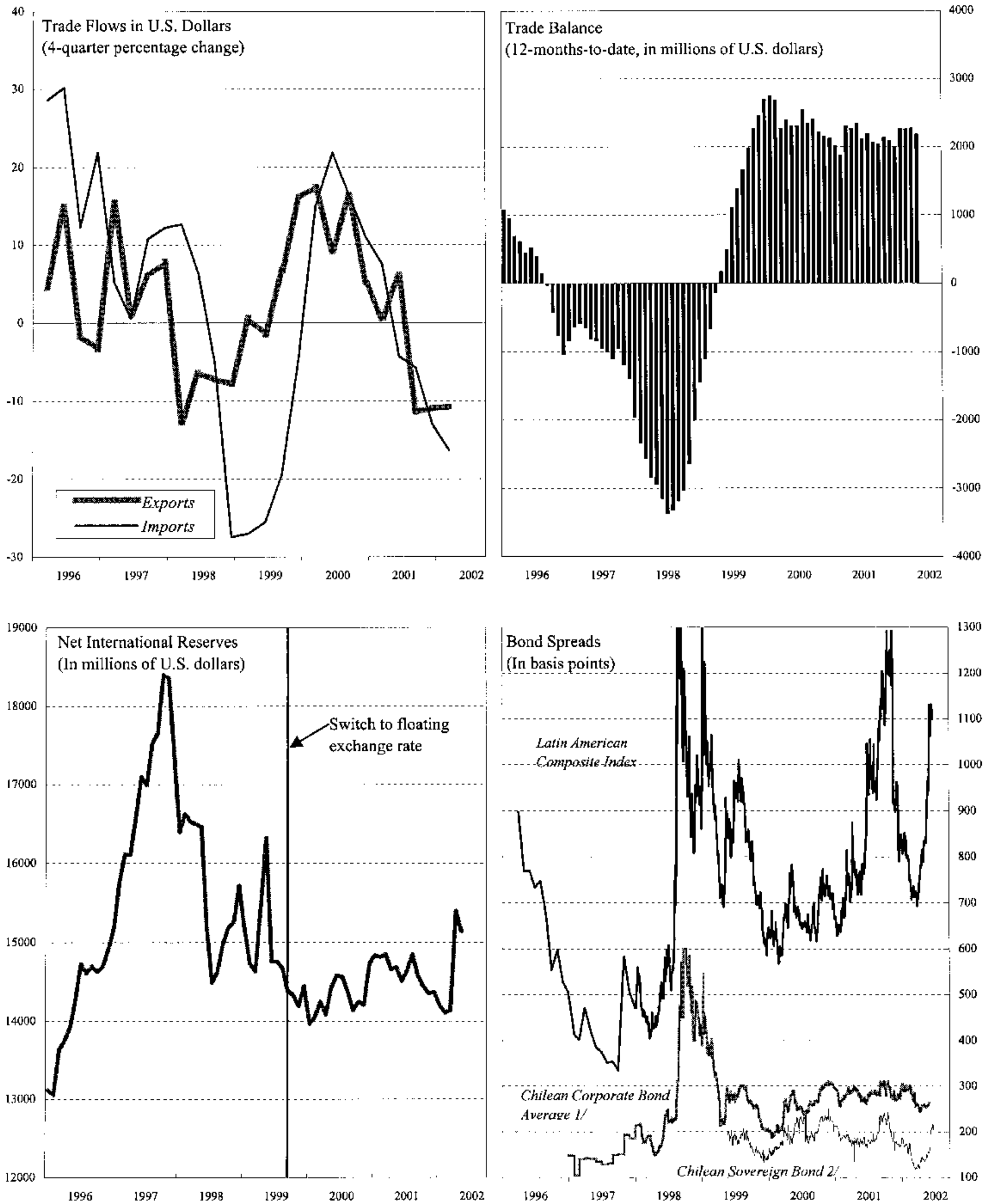
Source: Central Bank of Chile.

1/ Discontinued August 2001.

2/ Actual data through 2001. Preliminary data for Q1 2002.

3/ M1 plus sight deposits.

Figure 5. Chile: External Sector Indicators, 1996–2002



Sources: Central Bank of Chile; Bloomberg; and J.P. Morgan.

1/ Index refers to spread on five corporate bonds through March 1999, and thereafter to an average of 15 companies' bond spreads.

2/ Average spread on Chilean sovereign bonds issued April 1999 (matures 2009) and October 2001 (matures 2012).

Chile: Fund Relations
(As of May 31, 2002)

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

II. **General Resources Account**	**SDR Million**	**Percent Quota**
Quota	856.10	100.0
Fund holdings of Chilean pesos	574.45	67.1
Reserve tranche position	281.65	32.9

III. **SDR Department**	**SDR Million**	**Percent Allocation**
Net cumulative allocation	121.92	100.0
Holdings	24.41	20.0

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

V. **Financial Arrangements:**

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

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

VII. **Exchange Arrangements**: The exchange rate is permitted to float freely. On May 31 the interbank exchange rate was Ch$656 per U.S. dollar. Chile's exchange system is currently free of restrictions on the making of payments and transfers for current international transactions.

VIII. **Article IV Consultation:** The Executive Board concluded the 2001 Article IV consultation on July 16, 2001 (SM/01/185).

IX. **Technical Assistance:** In May 1997 a mission from the Fiscal Affairs Department (FAD) assisted the authorities in the evaluation of Chile's tax system. In June 1998 an FAD mission advised on the desirability of moving to a system of accrual accounting and budgeting. In June 1999 a mission from FAD and STA advised on public expenditure management, the implementation of accrual based accounting, and government finance statistical systems. In May 2000 a mission from STA advised on money and banking statistics. In March 2001, a mission from STA assessed the quality of national account statistics. In March–April 2001, a mission from STA assessed Chile's data dissemination practices against the IMF's SDDS. In April–May 2001, a mission from FAD advised on VAT administration issues, and a mission from STA advised on money and banking statistics (follow-up from May 2000 mission). In July 2001 an FAD mission advised on customs administration issues.

Chile: Financial Relations with the World Bank

The most recent Country Assistance Strategy (CAS) for Chile, covering the fiscal years 2002–05, was discussed by the Bank's Board in February 2002. The emphasis of the Bank's assistance program will be on sustaining economic growth and social progress, heightening inclusion—particularly of rural populations and vulnerable groups—and modernizing the state as the underpinning for the two previous objectives. It aims at focusing on areas of the Bank's comparative advantage, and actions that will deepen and sustain poverty reduction across the range of vulnerable groups. Moreover, and in view of the risks associated with the recent global economic slowdown and increasing regional uncertainties, the current program includes additional financing in support of structural reforms, and the use of a Deferred Draw Option among the Bank instruments, in order to provide maximum flexibility in managing risks. Though Chile is one of the best performers among the Bank's diverse middle-income borrowers, graduation is not foreseen as an immediate prospect.

The IFC is expected to help the private sector respond to slower growth and adverse effects of the global economic uncertainties and difficulties in Argentina, in support of the government's priorities, particularly growth and competitiveness. MIGA' support is expected to facilitate foreign direct investment in Chile and to counteract the adverse effects of the global and regional crisis.

There are currently five loans in Chile's operations portfolio, totaling US$374.53 million commitments. Three of these loans had already been approved when the present CAS was discussed: the ones in support of the Third Road Project (FY95), Second Municipal Development Project (FY99), and Higher Education Project (FY99). The remaining two, in support of the Public Expenditure Management Project and Lifelong Learning Project were approved in FY02. Additional lending for FY2002–FY06 is now expected to target watershed management, rural electrification/infrastructure, technology innovation, and local service delivery.

Chile: Financial Relations with the World Bank

(In millions of U.S. dollars)

	Commitments (Net of Cancellations)	Disbursements	Undisbursed
I. IBRD Operations (as of May 28, 2002)			
Fully disbursed loans	2,889.74	2,889.74	0.00
Loans in process of disbursement			
Agriculture	0.00	0.00	0.00
Education	221.20	57.64	163.56
Environment	0.00	0.00	0.00
Health	0.00	0.00	0.00
Municipal and urban	10.10	2.81	7.30
Public sector management	23.23	0.00	23.23
Transport	120.00	112.86	7.14
Water supply	0.00	0.00	0.00
Total loans	3,264.27	3,063.04	201.23
Repaid 1/	2,350.90		
Outstanding	913.37		

II. IFC Operations (as of December 31, 2001)

	IFC			
	Loans	Equity	Quasi Equity	Participation
Held	50.83	55.50	19.60	73.44
Disbursed	28.08	55.50	15.85	31.19
Approvals pending commitment	0.00	0.00	0.00	0.00

III. IBRD Loan Transactions (calendar year)

	Actuals			
	1999	2000	2001	2002 2/
Disbursements	43.28	48.38	38.59	13.71
Repayments	110.67	115.05	118.53	44.59
Net lending	-67.39	-66.67	-79.94	-30.88

Source: World Bank.

1/ Includes repayment from third parties.
2/ As of May 28, 2002.

Central Bank Balance

The Chilean central bank balance (financial outcome) as defined by staff—essentially the difference between the bank's interest earnings and interest payments—has been negative for some time, and fairly stable at close to 1 percent of GDP. This Appendix explains the nature and origin of the central bank deficits, and discusses the outlook.

These deficits are not the reflection of any sort of ongoing quasi-fiscal activity or central bank policy. Rather, they have two origins: (i) the particular structure (and scale) of the central bank's balance sheet; and (ii) the practice of the government making cash payments for only part of the interest due to the central bank, and capitalizing the rest.

The central bank's total assets and liabilities are large relative to the Chilean economy, with most assets denominated in foreign currency and most liabilities denominated in pesos or a widely used inflation-indexed unit of account (UF). This balance sheet structure resulted mainly from official help to commercial banks following a banking crisis in the early 1980s, and exchange market intervention during part of the 1990s. Official support to banks in the 1980s was channeled through the central bank, which issued promissory notes (mostly in UFs) to help banks, and in exchange received some commercial bank assets and government debt (mostly denominated in U.S. dollars). Also, for several years prior to the Asian crisis, the central bank engaged in sterilized intervention aimed at preventing an appreciation of the peso, which led to a large accumulation of international reserves and the issuance of central bank paper (in pesos and UFs) for significant amounts. As of end-2001, total central bank liabilities amounted to almost ten times the monetary base; international reserves and government debt (most of this in U.S. dollars) together accounted for 80 percent of the bank's total assets; and central bank promissory notes (to a large extent denominated in UFs or pesos) accounted for 75 percent of the banks' total liabilities. As the average interest rate on the bank's assets has been below the average interest rate on its liabilities, this has resulted in a net annual cost for the bank of about 0.5 percent of GDP in the last few years. **This is the first source of the central bank deficit.**

The government has some flexibility to decide how much of the accrued interest on its debt to the central bank to pay: there is a minimum interest payment of 2 percent, and the rest can be either paid by the government or capitalized by the central bank. In the staff's measure of the central bank balance, interest receipts from the government are measured on a cash basis, to be consistent with the amount registered as interest payments in the government's accounts. The difference between accrued interest and paid interest on the government debt to the central bank has been about 0.4 percent of GDP in the last few years. **This is the second source of the central bank deficit.**

Over the last few years, the central bank's net worth has been affected also by large net valuation adjustments, which are not included in the measure of central bank balance

(as this measure is designed to capture the effects of transactions, not valuation changes).[1] Given the currency mismatch between assets and liabilities, as well as the size of the central bank's balance sheet, large changes in the value of the U.S. dollar in terms of pesos (or UFs) lead to significant capital gains or losses for the central bank. In the last five years, valuation changes have averaged (in absolute value) about 1.3 percent of GDP. The real depreciation of the peso over the last few years has resulted in sizeable capital gains for the central bank (in 2001 equivalent to 2.8 percent of GDP). These valuation gains have contributed to moving the central bank net worth from negative 2.6 percent of GDP at end-1998, to a positive 0.6 percent of GDP at end-2001.[2]

Looking forward, and in the absence of a capitalization of the central bank (or a major restructuring of its balance sheet), the bank's balance is likely to continue showing a deficit, which would probably not be offset by valuation gains. A thorough analysis of this issue would require a detailed projection of the central bank balance sheet over a number of years, which is beyond the scope of this appendix.[3] Instead, the staff's conjecture above is based on a qualitative assessment that takes into account the broad characteristics of the central bank balance sheet. In principle, the interest rates on peso and UF instruments (the main components of the central bank's liabilities) could be expected to be equivalent to interest rates on U.S. dollar instruments (the main component of the central bank assets), corrected by expected depreciation (or appreciation) of the UF and the peso with respect to the U.S. dollar. Thus, one would expect that the central bank deficit (arising from interest flows) would be broadly offset by valuation gains (arising from exchange rate changes). However, the deficit is likely to be larger than valuation gains because: (i) interest rates on central bank promissory notes probably carry a country risk premium when compared with interest rates on international reserves and U.S. dollar-denominated government debt to the central bank (which accrues Libor plus 50 basis points), and while this risk premium may decline through time it is unlikely to disappear; (ii) the average maturity of central bank assets is shorter than the average maturity of its liabilities, and short-term interest rates would

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[1] The change in net worth is approximately equal to valuation changes, minus the central bank deficit (as measured by staff), plus the difference between accrued interest and paid interest on government debt to the central bank.

[2] In strict terms, net worth at end-2001 would still be negative (at 0.7 percent of GDP) if the central bank were to recognize in its books certain *deferred losses* (resulting from past help to the banking system) that now it carries as an asset (the law authorizes the central bank to recognize these losses gradually as it generates profits). Note also that the net worth refers to the book value of the assets and liabilities, rather than the discounted value of future earnings and payments.

[3] Such projection would need to separate explicitly the various types of assets and liabilities, and their respective returns. For instance, it would need to identify those liabilities (monetary base) and assets (deferred losses) which generate no interest.

in general be expected to remain below long-term rates; and (iii) the government is likely to continue paying only part of the interest accrued on its debt to the central bank, capitalizing the rest (this effect will decline gradually through time as the government amortizes its debt, a process to be completed in 2014).

Congress has recently authorized the government to change the denomination of its debt to the central bank, from US dollars to pesos. Staff understands that this operation is intended to leave the present value of future interest flows unaffected, and thus would not modify the staff's conjecture above. However, this operation would alter the currency composition of the central bank assets, reducing the "currency mismatch" between assets and liabilities, and thus reducing the magnitude of potential valuation gains and losses.

Chile: Statistical Issues

Monetary and real sectors

The central bank publishes comprehensive statistics on the real and monetary sectors on a bi-weekly basis. Data practices is these areas are adequate for surveillance purposes. New national accounts series, based on 1996 prices and beginning in that year, began to be published in early 2002.

Government finances and debt

The Ministry of Finance publishes on a quarterly basis detailed data on the central government and a summary of the accounts of the nonfinancial public sector. The annual report on public finances presents comprehensive information on the central government, municipalities, and public enterprises.

The use of the Copper Stabilization Fund is treated in the accounts of the government as an above-the-line item; withdrawals from the fund are registered as current revenues for the government, while deposits into the fund made by the state copper company (Codelco) do not appear in the government's accounts. (Data on the Copper Stabilization Fund, both stocks and flows, are published.)

The coverage of the government accounts is not complete, as it excludes the transfers made by Codelco to the armed forces, external financing obtained by the military (if any), and the military expenditure financed from these two sources. The accounts of certain publicly owned military factories are also not included. (Beginning with 2001, the amount of Codelco's transfers to the armed forces is published, but Chilean law does not allow the Ministry of Finance to publish information on the expenditures financed from this source.)

Publication of fiscal data focuses on above-the line flows; it would be useful to present more detailed data on the sources of public sector financing, with a more transparent correspondence to data for the monetary and external accounts. Beginning in 2002, data for below-the-line flows began to be published on a quarterly, rather than only annual, basis. It would be useful to publish central government operations data on a monthly basis.

Since mid-2001, central government debt statistics are published on a quarterly basis, with a lag of about four months. It would be useful to also publish statistics for the total debt of the consolidated public sector (such data are now under development; currently, the external debt of the consolidated public sector is published by the central bank).

Balance of payments and external debt

The central bank compiles balance of payments statistics on a quarterly basis, and publishes comprehensive statistics on the external sector on a bi-weekly basis. The process of reconciliation of data on short-term debt with the BIS has been completed. The central bank compiles and disseminates the International Investment Position, but information on the foreign assets held by the private sector includes only deposits in nonresident banks. Data on portfolio investment held by the private sector are in the process of being compiled.

Two main areas for improvement remain. First, it would be important to complete the estimation of direct trade credits, which currently are not included in the official short-term debt statistics. Second, coverage of the military sector in the external statistics is not necessarily complete. In particular, the accuracy of data on military imports is unclear, as those imports that do not pass through customs are estimated by the central bank. Also, if the military receives external credits, information on this may not be available to the central bank; therefore, such financing may not appear in the balance of payments or external debt statistics. Since the size of these omissions is unknown, their significance for surveillance purposes cannot be assessed.

Chile: Core Statistical Indicators

as of June 7, 2002

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance 1/	GDP/ GNP 2/	External Debt/ Debt Service 3/
Date of Latest Observation	6/6/2002	5/31/2002	5/2002	5/2002	5/2002	6/6/2002	5/2002	4/2002	Q1/2002	Q1/2002	Q1/2002	4/30/2002
Date Received	6/7/2002	6/7/2002	6/7/2002	6/7/2002	6/7/2002	6/7/2002	6/4/2002	5/23/2002	5/23/2002	5/22/2002	5/23/2002	6/7/2002
Frequency of Data 4/	D	M	M	M	M	D	M	M	Q	Q	Q	M
Frequency of Reporting 4/	D	O (twice monthly)	M	O (twice monthly)	O (twice monthly)	D	O (twice monthly)	O (twice monthly)	O (twice monthly)	Q	O (twice monthly)	M
Source of Update 5/	C	A	A	A	A	A	A	A	A	A	A	A
Mode of Reporting 6/	O (web site)	E	E	E	E	E	E	E	E	E	E	E
Confidentiality 7/	C	C	B	C	C	C	C	C	C	C	C	C
Frequency of Publication 4/	D	M	M	M	M	D	M	M	Q	Q	Q	M

1/ General government only (excluding municipal governments).

2/ Quarterly data at constant prices only.

3/ External debt only. General information on interest and amortization payments is available on a quarterly basis from the balance of payments. Detailed information on debt service payments is only available for missions.

4/ D-daily, M-Monthly, and Q-quarterly.

5/ A-direct reporting by central bank, ministry of finance, or other official agency; N-official publication or press release; P-commercial publication; and C-commercial electronic data provider.

6/ E-electronic transfer.

7/ A-for use by the staff only; B-for use of staff and the Executive Board, and C-for unrestricted use.

Statement by the IMF Staff Representative
July 19, 2002

This buff updates information presented in the staff report (SM/02/195). This additional information does not modify the thrust of the staff appraisal. Some of the information has resulted in a moderate downward revision of the staff's projection for output growth.

1. The monthly index of **economic activity** increased in April–May by 2.4 percent (year-on-year), bringing the rate of growth in the first five months of the year to 1.9 percent (year-on-year). **Unemployment** data for the period March–May indicate a seasonally-adjusted rate of just over 9 percent, essentially about the average level of the last several quarters. In the first six months of the year, **exports** declined by 5 percent (year-on-year) in U.S. dollar terms, while **imports** fell by 10 percent (partial information suggests that export volume expanded during this period, while the figure for imports reflects declines in both prices and volume). **Inflation** recently has been unexpectedly low, as both the headline and underlying price indices declined slightly in June, taking the 12-month rate of inflation down to 2.0 percent and 2.7 percent, respectively. Over the first six months of this year, both price indices grew by only 0.8 percent.

2. In financial market developments, the **peso weakened and international bond spreads increased** suddenly, though not severely, at mid-June. Over three trading days, June 19–21, the peso lost 4 percent, moving from 672 to almost 700 pesos per U.S. dollar. Subsequently, the exchange rate has tended to remain in the 690–700 pesos per U.S. dollar range. Also at mid-June, the spreads on sovereign bonds and on an index of corporate bonds jumped, both by about 45 basis points (compared with an increase of around 100 basis points in the EMBI+ index of sovereign spreads), reaching about 200 and 300 basis points, respectively. Subsequently, sovereign bond spreads have stayed close to 200 basis points, while the index of corporate spread widened further in the early days of July, to about 330 basis points. The **stock market** has weakened gradually, declining by more than 10 percent since end-May in domestic currency terms (the main Chilean index has continued to move rather closely with the U.S. Dow Jones index).

3. In terms of **policy developments**, the central bank **lowered its target policy interest rate** from 4 percent to 3¼ percent in its July monetary policy meeting. At that time, the policy council noted risks associated with recent declines in the world's major stock markets, and that the prospects for growth of Chile's trading partners had been affected by negative developments in several Latin American economies. The central bank also noted signs that output and domestic demand in Chile had expanded less than expected in the second quarter, and indicated that projections for growth over the coming quarters would need to be lowered. Overall, the central bank judged that the recent low level of inflation, the persistence of the output gap, and low rate of exchange rate pass-through would allow for a new monetary policy impulse to be consistent with inflation converging to the middle of the target band over the policy horizon.

4. On the basis of recent indicators, including developments in the external environment, the staff considers that the projection for output growth in the staff report for

- over -

this year and next, 3 percent and 5½ percent, respectively, are not as likely to materialize as a scenario involving a somewhat slower recovery of domestic demand and output. The revised staff projections are for growth of 2.6 percent for this year and 4.8 percent for 2003. The staff projection for inflation at end-2002 has also been revised downward, from 3.0 percent to 2.5 percent, for both headline and underlying CPI measures. These projections take into account this month's cut in the policy interest rate, which seems appropriate given the circumstances.

5. Regarding recent financial market developments, the staff considers that the drop in the peso and increase in bond spreads are noteworthy more for their suddenness and association with weaknesses in other emerging markets, than for their size. These movements have been moderate and needed to be viewed in a broader perspective, including Chile's floating exchange rate regime and absence of exchange market intervention during the period. For some 12 months now, the exchange rate has tended to remain in a range of about 650–700 pesos per U.S. dollar, always fluctuating but showing no strong direction or trend. Recent market exchange rates near 700 pesos per U.S. dollar are neither destabilizing nor likely to generate significant inflation. Regarding the rise in bond spreads over the last month, this followed a decline in spreads earlier this year, and the levels of these spreads remain relatively low by emerging market standards and manageable (including because of the low level of U.S. interest rates).

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 02/78
FOR IMMEDIATE RELEASE
July 31, 2002

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

IMF Concludes 2002 Article IV Consultation with Chile

On July 19, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Chile.[1]

Background

Chile's economic fundamentals remain sound and have improved through the evolution of the policy regime in recent years. Yet the country is operating in a difficult environment, for several years now coping with a sequence of negative shocks, most recently including the world economic slowdown, a further terms of trade decline, and spillovers from Argentina. Such developments are largely responsible for the substantial slowdown in Chile's growth that has followed the very strong performance of most of the 1990s. Nevertheless, growth has continued, and recent shocks have been absorbed in an orderly fashion. Reflecting the economy's strong fundamentals and the skilled implementation of the new frameworks for macroeconomic policy, Chile was able to maintain favorable access to global finance even during last year's market drought, and the authorities did not need to raise—and in fact have been able to reduce—interest rates.

Real GDP grew by 2.8 percent in 2001, as weakening domestic demand was offset by a strong expansion of net export volumes. With a substantial decline in Chile's terms of trade, however, the external current account deficit widened moderately, to about 2 percent of GDP. International reserves remained at comfortable levels, and the banking system sound. Notwithstanding a substantial depreciation of the Chilean peso in response to external factors,

[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.

inflation kept within the target band of 2 to 4 percent. The unemployment rate remained elevated in 2001, around 9 percent, compared to 6 percent before the 1998–99 recession.

In 2001, the authorities achieved their new, ongoing target for the structural balance of the central government (the actual balance held steady, with a deficit of about 1 percent of GDP, as a firming of the underlying government accounts was offset by the effects on revenue of lower copper prices and a widening output gap). Early in the year, the central bank began easing monetary policy in response to weakening domestic demand and reduced inflationary pressures. After midyear, this process paused, as pressures arising outside Chile induced substantial currency depreciation and raised concern about the inflation target. Noting exceptional circumstances, the central bank for a time intervened in the foreign exchange market, leaning against the wind but not targeting the exchange rate. Subsequently, the Chilean peso "decoupled" from developments in Argentina, and inflation risks subsided. Thus since early 2002 the authorities have been able to reduce interest rates in response to further signs of weak demand and very low inflation, while the peso has been broadly stable.

For 2002, real GDP is expected to grow by 2.6 percent and inflation to remain inside the target band. The central bank will continue to be ready to adjust the policy interest rate, if needed, in either direction, to keep inflation in 2003 also in the target band. Fiscal policy will remain geared to achieving a structural surplus of 1 percent of GDP for the central government. The external account deficit and other indicators of external vulnerability are envisaged to remain at comfortable levels. These projections assume that domestic demand will strengthen fairly soon, in response to the easing of monetary policy, ending of a cycle of inventory decumulation, and with some push from greater investment expenditures of certain public enterprises, as well as some further improvement in the external environment.

Several policy initiatives were introduced in 2001, in which remaining restrictions on external capital flows were eliminated, measures were introduced to develop domestic capital markets, and tax administration and tax law were changed to reduce tax evasion and tax avoidance. Regarding labor markets, an unemployment insurance scheme was adopted, and a wide-ranging package of labor law changes was approved. The problem of unemployment continued to be addressed mainly through government-supported job programs.

Chile has maintained a very open trade regime and has continued to reduce unilaterally its uniform external tariff rate, now down to 7 percent. In one area, however, a recent WTO panel has viewed critically the price-bands system applied to certain agricultural imports. A free trade agreement with the European Union is expected to be soon ratified by Chile's congress, and the authorities expect negotiations on an agreement with the United States to advance as well.

The Chilean authorities are now developing a range of initiatives to enhance growth prospects over the medium term. These are essentially of a microeconomic nature, and include among others: encouraging the development of venture capital, strengthening the framework for resolution of anti-monopoly cases and other economic disputes, and adjusting the regulation of several sectors.

Executive Board Assessment

Executive Directors commended the authorities for their adherence to a sound and consistent policy framework—based on exchange rate flexibility, inflation targeting, and achievement of a structural fiscal surplus—which in 2001 had helped maintain macroeconomic stability, continued access to capital markets, and moderate growth. This performance, in the face of an adverse external environment, is also a reflection of Chile's political stability, good governance, and credible institutions, which serve to reinforce the economic agenda of the authorities.

Directors considered that the authorities' objectives of promoting a recovery of domestic demand and moderate output growth this year are broadly appropriate, particularly in light of the still high level of unemployment and associated output gap. They agreed that regional uncertainties could adversely affect the outturn, but considered that the country continues to be well-placed to adjust to new adverse shocks in an orderly fashion.

Directors supported the authorities' fiscal stance of resisting pressures in favor of a stimulus, and holding steady the central government structural surplus. Adherence to the structural target would safeguard the public finances over time, while permitting the operation of automatic stabilizers.

Directors welcomed the authorities' efforts to enhance fiscal transparency through their planned participation in a fiscal Report on the Observance of Standards and Codes (ROSC). Directors considered that a capitalization of the central bank would also add to fiscal transparency, and some Directors recommended a more comprehensive definition of the fiscal balance—incorporating the rest of the general government.

Directors noted that the inflation-targeting framework combined with the floating exchange rate regime continues to serve Chile well. With inflation subdued, and in light of the output gap, they supported the recent lowering of the policy interest rate. At the same time, Directors observed that it would be essential for the authorities to adjust the monetary policy stance should inflationary pressures emerge. Directors welcomed the steps being taken to further enhance monetary instruments, and a few suggested a cautious approach in the possible use of foreign exchange swaps recently introduced for liquidity management purposes. Directors considered that the central bank's actions had been consistent with its announced policy of intervening in the foreign exchange market only in exceptional circumstances—as a key plank of the authorities' framework—and stressed the importance of continuing to adhere to this strategy in the difficult and uncertain external environment.

Directors noted that banking system indicators appear sound, as reflected by prudential and earnings ratios, as well as stress tests recently conducted by the staff. A few Directors suggested that there was scope for increased bank competition aimed at lowering interest spreads, particularly on small business loans. They welcomed the progress being made in the area of consolidated supervision of financial conglomerates, as well as the efforts to strengthen anti-money laundering legislation, and the authorities' request for a Financial Sector Assessment Program in the coming months. Some Directors considered that strengthening the supervisory framework further would also require providing staff of the bank supervisory agency with proper legal protection.

Directors were of the view that Chile’s medium-term outlook remains favorable, noting that the slowing of growth in recent years is related in part to temporary factors. However, some Directors cautioned that global and regional factors, and the still weak domestic demand and business confidence could continue to complicate the recovery. Directors welcomed the government’s initiative to work closely with the private sector on the pro-growth agenda, and observed that growth should be boosted over the medium term by the range of proposals which the authorities are developing. These proposals aim to foster a deeper venture capital market for small and innovative firms, strengthen the framework for resolving anti-monopoly and other economic disputes, and improve regulation. Directors encouraged the authorities to press ahead with these reforms. A few Directors also recommended consideration of bringing private capital into state-owned companies.

Directors noted that a faster rate of growth would help tackle the still high rate of unemployment. They recognized the temporary need for measures such as government-supported job programs, but also noted that the persistence of high unemployment suggests that labor markets are not sufficiently flexible, or operating adequately. In this connection, Directors suggested that greater attention be placed on education and job training for low-skilled workers, and on other ways of enhancing labor market flexibility more generally. Several Directors expressed concern over the extent of the cumulative increase in the minimum wage, as well as over the possible higher labor costs implied by the recent labor reform package. Some Directors considered that wage and labor market developments, while creating rigidities in the economy, were adequate in the context of the country’s social and economic objectives.

Directors commended Chile for its open trade regime and for continuing to reduce unilaterally the country’s uniform external tariff, and welcomed the recent trade agreement with the European Union as part of initiatives to diversify the economy. Some Directors recommended that the authorities reevaluate the longstanding practice of using tariffs to hold domestic prices of certain agricultural goods within bands, and it was also suggested that efforts to phase them out would be assisted by the elimination of distortions in the agricultural policies of some industrial countries.

Directors recognized that the data received by the staff are timely and broadly adequate for surveillance purposes, recalling the positive overall assessment in last year’s ROSC data module, and noting that since then the authorities have made progress in several areas. They urged the authorities to persevere in these efforts, and in particular to widen the coverage of fiscal and external statistics in the context of the forthcoming ROSC on fiscal transparency.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2002 Article IV Consultation with Chile is also available.

Chile: Selected Economic Indicators

	1997	1998	1999	2000	Est. 2001	Proj. 2002
Real economy (annual percentage change) 1/						
Real GDP growth	6.6	3.2	-1.0	4.4	2.8	2.6
Unemployment (in percent)	6.1	6.2	9.7	9.2	9.1	…
Change in consumer prices (end of period)	6.0	4.7	2.3	4.5	2.6	2.5
Money and credit (year-end percentage change) 1/						
Broad money (M3)	13.0	8.5	5.1	5.1	5.4	5.7
Bank credit to the private sector	18.0	11.2	3.0	10.7	6.7	7.9
Three-month interest rate 2/	13.4	16.4	10.7	10.8	7.2	…
External sector (in percent of GDP) 1/						
Trade balance	-1.7	-2.5	3.4	2.9	3.2	3.2
Current account balance	-4.4	-5.1	-0.4	-1.4	-1.9	-2.1
Capital account balance 3/	8.3	2.5	-0.5	1.7	1.3	3.3
Overall balance of payments	3.9	-2.6	-0.9	0.3	-0.6	1.2
Gross official reserves (in percent of short- term external debt) 4/	496.4	385.2	367.8	230.3	220.1	206.0
External debt 5/	32.3	40.0	46.8	49.2	56.9	57.8
Real effective exchange rate (in percent change) 6/	9.8	-6.1	-6.2	2.5	-9.5	…
Terms of trade (annual percentage change)	1.9	-4.7	5.7	5.5	-7.6	0.3
Copper price (U.S. cents per pound)	103.2	75.0	71.3	82.3	71.7	73.8
Public finances (in percent of GDP)						
Central government balance	1.9	-0.1	-2.2	-0.9	-0.9	-1.5
State-owned enterprise balance	-1.0	-1.0	-0.1	-0.7	-0.4	-0.8
Central bank balance	-0.9	-1.0	-1.1	-0.9	-0.9	-1.1
Memorandum items:						
Central government balance (official presentation) 7/	1.8	0.4	-1.4	0.1	-0.3	-0.9
Structural balance (official presentation)	0.9	0.3	-0.8	0.0	1.0	0.7

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

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

Statement by Guillermo Le Fort, Alternate Executive Director for Chile
July 19, 2002

Overview

1. Let me begin by conveying my authorities' appreciation to the staff for the very useful policy and technical discussions held in Santiago and for their hard work during the consultation process. Since my authorities agree with the bulk of the staff report, this Buff statement will limit itself to restating some policy views for emphasis and noting areas where some differences may exist.

2. A long period of continuous growth averaging almost 7 percent a year ended in 1999, when adverse external shocks and contagion from the Asian crisis led Chile into its first recession in 17 years. Recovery was prompt to appear but then lost momentum. GDP growth fell to 2.8 percent in 2001, and a similar rate is expected for 2002. Growth is expected to accelerate in 2003, along with the global recovery, but recently, doubts about the strength of the global economy and fears of renewed financial turbulences and regional instability have dampened this optimism. Nonetheless, the domestic factors that should favor higher growth are improving as expected: The macroeconomic policy stance has been eased, the structural reform program is advancing, and a significant output gap has developed, making room for a period of accelerated non-inflationary growth while aggregate demand recovers.

3. Domestic demand has been depressed by worsening terms of trade, weaker investor confidence, diminished net external financing, and by associated the real depreciation of the peso which is having a contractionary wealth effect in the private sector because of its net liability exposure in foreign currency. But the private sector's exposure to exchange rate risk has been gradually reduced and better distributed by more active use of the hedging markets, while the wealth effect of the peso depreciation on output is balanced by its relative price effect that expand export volumes and contract imports.

4. Chile has managed to weather the external shocks well. Export volumes continue growing at fast rates, and GDP, capital formation, and even employment are expanding, although more slowly than in the pre-1999 period. This compares well with Chile's experience in earlier global slowdowns, and with the effects of the present slowdown on other open economies. Sound macroeconomic policies and financial strength, and Chile's ample diversification of its export markets, have helped reduce the vulnerability to shocks, especially to those specific to countries or regions. But an open economy cannot evade the effects of a global slowdown or a generalized aversion to emerging market risks. To counter shocks and stimulate recovery, the authorities have executed a well-defined rules-based policy framework, including an explicit fiscal target, inflation targeting, and a floating exchange rate system, while moving forward with their structural and social reform programs.

Demand Management Policies

5. Chile's fiscal policy is based on an explicit target for the central government structural balance, set at a surplus of 1 percent of GDP. The authorities' commitment to macroeconomic stability is reflected by their rapid actions to reach this target. Starting from a structural deficit of 1 percent of GDP in 1999, the fiscal position improved steadily until the target was reached in 2001. From then on the implementation of the fiscal rule, under an unvarying tax burden, should permit real public spending to increase in line with the trend growth of potential output (currently estimated between 4 and 5 percent). This replaces the harmful stop-and-go pattern, characteristic of cyclical fiscal outlays, with a steady one, more favorable for a medium-term strategy for social policies.

6. My authorities' adherence to their fiscal target in the face of weak aggregate demand has exposed them to the criticism of those favoring a more active counter-cyclical fiscal policy. But even though the tightening of the fiscal stance may have temporarily reduced domestic demand before the target was reached in 2001, since then the fiscal automatic stabilizers have been allowed to operate fully. At the same time, this rule-based fiscal policy has increased the confidence of the financial markets, giving Chile the lowest sovereign spread in the region and one of the lowest among all emerging market economies. The benefits of this reduced financing cost accrue also to private investment. My authorities consider that this broad, long-lasting effect of the fiscal consolidation on financing costs is more significant than a narrow and temporary effect of an expansionary fiscal stance on aggregate demand.

7. To respond to the slowdown of activity and higher unemployment rate, the composition of public spending has been modified while keeping the total within the limits imposed by the rule. These changes include accelerating labor-intensive public investment projects and a program of employment subsidies. Taken together, their effect has been the creation of additional direct employment estimated, at its seasonal peak, between 2 and 3 percent of the labor force.

8. Monetary policy is based on a symmetric 2 to 4 percent annual inflation target range, with a focus on the center (3 percent). Inflation has continuously met the target range, but headline inflation is presently at the lower boundary, while core inflation has now fallen to just below 3 percent. This low inflation has made room to alter the policy mix by easing monetary policy and making it more counter cyclical, favoring the future convergence of inflation towards the central target. The interest rate used as monetary policy's operational target has been lowered by a total of 475 basis points since the end of 2000, and the last cut --75 basis points--, took place only a week ago. Less than half of these rate cuts occurred under the former policy regime, whose operational target was the inflation-adjusted interbank overnight rate. Currently the target is set at the equivalent nominal rate, which is at the all-time low of 3.25 percent, annual rate in pesos. The reduction in the policy rate is justified by the fall of forecast inflation below the 3 percent target, and is not linked to the level of the exchange rate, as clearly shown by the recent rate cut made despite the depreciation.

9. Market interest rates have decreased in parallel with the policy rate, but the reduction has been generalized only for deposit rates, while peso-lending rates have been particularly slow

to fall. This partly reflects the temporary effects of changing the denomination of monetary policy's operational target from "inflation-adjusted" to "nominal". This change will facilitate Chile's integration with international financial markets, and has already stabilized short-term nominal interest rates. Nevertheless, it has not yet run its course in the development of nominal financial intermediation, where a large spread between lending and deposit rates still prevails in pesos. The central bank is fostering the development of a financial market for peso instruments, including deepening the market for central bank peso notes and further extending the longer end of their maturity range, currently at two years.

10. The floating of the peso is an essential element of Chile's policy framework, and interventions in the currency market are reserved for exceptional circumstances, such as the steep peso depreciation in mid 2001 associated with the emergence of the Argentine crisis. After a significant recovery, the peso has once again depreciated in recent weeks in response to the regional as well as global financial turbulence, but given the speed and magnitude of the depreciation my authorities have seen no need for intervention and expect these pressures to be transitory as in the previous episode. But it is important to note that the ability to intervene remains intact, with the central bank maintaining a high net asset position in foreign exchange.

11. The fundamentals for the Chilean peso remain strong, based on sustained productivity and export volume growth, a low current account deficit and a strong liquidity position. Net international reserves remain comfortably high, hovering around US$15 billion, equivalent to more than two times Chile's short-term external debt at residual maturity. The volatility and strong correlation with regional currencies displayed by the peso at times of financial turmoil do not represent fundamentals. Chile's regional trade and investment ties do not justify a strong linking of the Chilean peso with regional currencies, as empirically shown by the peso's decoupling from regional asset prices that took place in late 2001, as the previous episode faded away. The correlations between Chile's peso and regional currencies seem strong only when markets are in turmoil, but this is not the normal condition of markets.

12. These episodes of peso volatility show, once more, that macro financial policies must take account of this important source of risk, and that adequate instruments must be available to preserve macroeconomic and financial stability. My authorities consider especially important to protect banking institutions by limiting their exposure to the market and credit risks, caused by volatile behavior of the exchange rate and capital flows.

Structural Policies

13. Progress in structural reforms advances at strong pace. Last year, the gradual deregulation of Chile's forex market was completed with the elimination of all remaining restrictions on foreign exchange operations. Efforts to develop an external market for peso-denominated instruments continue in spite of the drying up of international financial markets. The first phase of the capital market reform was successfully completed: by increasing the scope for voluntary savings; by eliminating the capital gains tax on actively traded stocks and on newly issued stock of emerging companies, during the first three years of trading; by reducing from 35 percent to 4 percent the tax rate on interest receipts in the local market for non-resident

investors; and by several initiatives to increase the flexibility of the operations of pension funds and other institutional investors.

14. The privatization of water and sewage companies paved the way to private investment and competition, and the government is now trying to encourage private participation in the few companies still in public hands. The single external tariff rate will reach 6 percent in less than six months, without quota limits; a free trade agreement has been concluded with the European Union, and others are being negotiated with the United States and Korea.

15. The long-lasting practice of keeping the domestic prices for three traditional agricultural products within bands should be viewed as a compensatory action. The limits are designed to offset the distortions caused by the industrial countries' agricultural policies in the international markets of these products. Limits apply to a small number of products, and the price support that they provide is moderated and kept under review, taking account of current and impending market developments. It provides a much-needed cushion against the effects of volatile international market behavior in Chilean regions, where economic activity and employment critically depend on these traditional crops. My authorities continue to look for alternatives: they are requesting liberalization of these sectors in multilateral and bilateral trade negotiations, and fostering the development of substitute crops or activities in the regions affected. There has been very little progress in this respect in trade agreements, and finding substitute products has been complicated by increasing protectionist barriers in the form of anti-dumping and other measures applied to the exports of regions adjacent to those favored by the bands.

16. Discussions have been held with private sector representatives on a broad agenda for promoting growth. This agenda would include numerous initiatives for increasing growth and efficiency by adjusting the regulatory system. The main goals are to further promote Chile's international integration, to foster the development of new segments of the local capital market, to create incentives for technological development and the use of new technologies, to improve laws aimed to defend competition and resolve economic disputes, to increase incentives for private investment and labor market flexibility, to expand the access to higher education, and to improve the incentives created by the regulations governing the electricity and fishing sectors.

17. The second stage of the capital market reform aims to further advance the development of the equity market and increase financing for innovative projects, *inter alia* with tax incentives and by simplifying the capital gains tax, changing regulations to favor agreements among stockholders and the solution of conflicts through arbitration, and developing a centralized system for guarantees.

18. To foster incentives for private sector Research and Development, the system of patents and licenses and the system of technological funds will be upgraded. Economy-wide use of information technology will be promoted through greater use of the Internet for business transactions and for providing public services. This will include the use of the recently approved "electronic signature", of the system of electronic invoices being developed by the internal revenue service, and of electronic transactions for public sector purchases, to be authorized under a new law. The government is also making progress with the simplification of

administrative procedures, shortening and limiting the time taken for their completion and using the Internet to issue certificates.

19. The institutions for resolving conflicts involving competition will be improved, and a new competition tribunal will be created with members of high standing and an independent technical staff. The system for dealing with general economic conflicts will be modified by introducing specialized tribunals. This will avoid lengthy procedures and high costs to the economy. The legal framework governing bankruptcies will be adjusted to minimize the time during which assets are idled, increase the incentives to entrepreneurship by giving another chance to entrepreneurs experiencing a non-fraudulent bankruptcy, and find better solutions to disputes between creditors.

20. It should be noted that the rapid increase in the minimum wage, mentioned in paragraph 31 of the staff report, took place until the year 2000, and since then, minimum wage adjustments have been in line with increases in average private sector wages. It should be recognized, however, that there are important challenges to increase the flexibility of the labor market, including limiting the effects of indexation and modifying the regime for severance payments.

21. Laws concerning labor reform and unemployment insurance were passed last year, enabling Chile to meet international labor standards important for completing free trade agreements being negotiated. There is no evidence that these reforms have affected the demand for labor, or that a secular labor-substitution effect is present in the demand for productive factors in Chile. Nonetheless, my authorities admit that many rigidities affect Chile's labor markets, and are considering various initiatives, such as special training contracts, flexible labor contracts (permitting part-time work, flexible time, work at home, temporary employment), and systems to promote participatory wages. In addition, employment creation programs will be focus on private employment and, as the economy recovers, the existing employment subsidies for heads of households will be gradually transformed in labor training programs for the young. A system for certifying workers' labor skills, obtained by experience and on-the-job training is also under consideration; as well as improving the system of protection against unemployment by adding voluntary savings to complement the present unemployment insurance system.

22. Fishing sector regulations will be reformed by updating the technical norms used to manage species conservation, and by a long-term plan for developing the sector which will give continuity to the regulation of fishing quotas, define by law the participation permitted to industrial and traditional fishing activity within the global quota for each species, protect the smaller traditional fishermen, financing the regulatory system and fishing research with license and permit fees, and simplify the transfer of fishing quotas among firms.

23. Reforms in the electrical sector are aimed at increasing the reliability of supply during droughts and other shocks, while minimizing the costs to consumers. Given the technologies presently available, it will be important to promote interconnections between the two national electric systems and with those of neighboring countries. This will require reworking the regulations for tolls on transmission and making the electricity market more transparent in

transactions of generation and distribution. The additional competition created by the interconnection should be followed by a gradual deregulation.

24. International integration and investment are being promoted by means of tax exemption mechanisms that would provide incentives to international firms to use Chile as its base for regional investments. In the same line, the pending implementation of the six bilateral international tax agreements already signed, and the negotiation process of several others, will be accelerated. Finally, to favor fix capital investment, tax incentives will be given through provisions for the accelerated depreciation of new assets.

Social Policies

25. In education, the government's efforts to create equal opportunities have been directed at increasing the access to financing for university education, which is restricted for those without physical capital, since human capital cannot be used as collateral. Instead of relying on direct or subsidized financing, the new program seeks to increase access to private bank lending at regular market rates by providing guarantees that are linked to conditions of career advancement. In addition, there is a direct subsidy for university education, consisting of scholarships based on merit and need that cover both the living expenses and tuition costs of higher education.

26. A new health initiative will provide a wide coverage health plan aimed at giving universal access to a carefully defined set of essential medical services. The financing of the well-focused subsidy will require some increase in indirect taxes. This new scheme carries markedly improved incentives for public health providers. Their spending and budgeting, which have traditionally been independent from the actual provision of services, will be determined from now on by the demand they serve. Under the new system the demand for health services is the one subsidized, although the subsidy cannot be used outside the public health system. Autonomy will be given to individual public providers of health services in adapting their organizations to the new demands and conditions.

27. My authorities reaffirmed their commitment to foster transparency on attaining SDDS status last year. They have now requested a fiscal ROSC and an FSAP, and have already begun the publication of Chile's international investment position. They also expect to resolve, with staff's help, a number of pending methodological issues in fiscal accounting, including the treatment of the activities of public enterprises, the future payment of pensions through recognition bonds, and advances in implementing the accounting rules of the latest edition of the Manual on Public Finance Statistics or the approaches used in OECD countries.

28. To conclude, my authorities consider all of these to be significant advances that contradict the view that the momentum of reforms is "running down." Chile continues to make significant advances in implementing policies aimed at fostering stability and stimulating growth, and the prolongation of the present period of sluggish growth is mostly the result of continuing global and regional difficulties.