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Chile: 2003 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 2003 Article IV consultation with Chile, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **June 13, 2003,** with the officials of Chile on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on July 25, 2003.** 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 **August 18, 2003,** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its August, 18, 2003 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

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

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

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CHILE

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the
2003 Consultation with Chile

Approved by Charles Collyns and Juha Kähkönen

July 25, 2003

- **Discussions.** A staff team held discussions in Santiago during June 2–13. The team met with the ministers of finance and economy, the president of the central bank, other senior officials in the government, central bank, and supervisory agencies, and representatives of the private sector, labor, and the academic community.

- **Team.** E. Kalter (Head), S. Phillips, M. Espinosa, R. Luzio, and M. Villafuerte (all WHD); and M. Singh (ICM). The team worked closely with a parallel fiscal ROSC mission, led by A. Cheasty (FAD). The Executive Director for Chile, Mr. Le Fort, attended many of the key meetings.

- **Previous consultation.** At the conclusion of the 2002 consultation on July 19, 2002 (published as Country Report No. 02/155), Directors supported the macro policy framework and noted that strong fundamentals had allowed Chile to manage external shocks and pursue a credible countercyclical policy. They encouraged the authorities to press ahead with their "Pro-Growth Agenda" and recommended increased labor market flexibility. To enhance fiscal transparency, Directors suggested recapitalizing the central bank and widening coverage of statistics.

- **Effectiveness of Fund policy advice.** Recognizing Chile's sound policy record, Fund policy advice has focused on further enhancing the policy framework and on policy implementation issues. On fiscal policy, the focus has been on improving transparency, and the Chilean authorities have made considerable progress in this area, making use of Fund technical advice. The staff has generally supported the authorities' approach on monetary policy. On reform issues, the dialogue has concentrated on strengthening financial supervision, streamlining the trade regime, and enhancing later market flexibility. There also has been a useful exchange of views on vulnerability analysis.

- **An accompanying Selected Issues volume** includes staff papers on: the role of institutions; exports and growth; the domestic capital market; and monetary policy transmission. Shorter notes examine: the macropolicy framework; public sector finances; the external position and potential financing vulnerabilities; the state of the banking system and recent failure of a financial company; cases of distress among foreign-owned corporations; and development of financial benchmarks.

- Chile has accepted the obligations of Article VIII and maintains an exchange system free of restrictions on current transactions. Chile participates in the New Arrangements to Borrow. Chile subscribes to the Fund's Special Data Dissemination Standard, and its metadata are posted on the Fund's Data Standards Bulletin Board. A statistics ROSC was completed for the 2001 consultation, and a fiscal ROSC for this consultation. An FSAP mission is planned for late 2003.

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EXECUTIVE SUMMARY

Recent developments

Chile's sound macro-policy framework and strong fundamentals have largely insulated the country from the regional financial crisis and permitted continued growth. During 2001–02, the economy decelerated along with the world economy, but grew faster than most countries in the region as it enjoyed favorable access to external financing and was able to pursue countercyclical macro policies. Monetary policy was eased in 2002, with a view to keeping inflation from dropping below the target band. Automatic fiscal stabilizers were allowed to operate, as the authorities met their structural balance target.

Recent reform efforts have focused on ambitious measures to modernize the public administration, increase government transparency, and reinforce the financial system. The "Pro-Growth Agenda" defined in early 2002 has also advanced, and the authorities have further increased the transparency of macroeconomic policies and statistics.

Economic outlook

In the baseline scenario, GDP growth accelerates to 3⅓ percent this year and 4½ percent in 2004, as recovery of demand—prompted by improved regional confidence, better terms of trade and low real interest rates—takes up slack capacity. As the output gap closes over the medium term, the actual government balance would converge to the structural balance target, a surplus of 1 percent of GDP. Inflation would remain around 3 percent. The authorities indicated that they had a similar view of the outlook, emphasizing that performance over the next few years would depend substantially on global economic conditions.

Policy discussions

Staff supported the authorities' macro-policy framework and targets:

- The inflation targeting framework has anchored inflation expectations. The current monetary stance is well balanced.
- Adherence to the structural fiscal balance target would provide adequate assurance of sustainability. Recent actions to raise taxes and reduce expenditure plans are appropriate to ensure that the fiscal objectives are achieved in 2003–04.

Staff commended the authorities' recent actions to further increase the transparency and credibility of macro policies, including their plans to implement the GFSM 2001 standard. Staff encouraged the authorities' interest in institutionalizing a fiscal policy rule and recapitalizing the central bank, which would help enhance fiscal transparency and credibility, while safeguarding confidence in monetary policy independence.

I. Background

1. **Chile has long stood out among developing countries for its pioneering economic reforms and for its success in raising real per capita income.** Among emerging markets, Chile has also distinguished itself in avoiding a financial crisis for nearly 20 years and, more generally, for the stability of its growth and inflation rates.

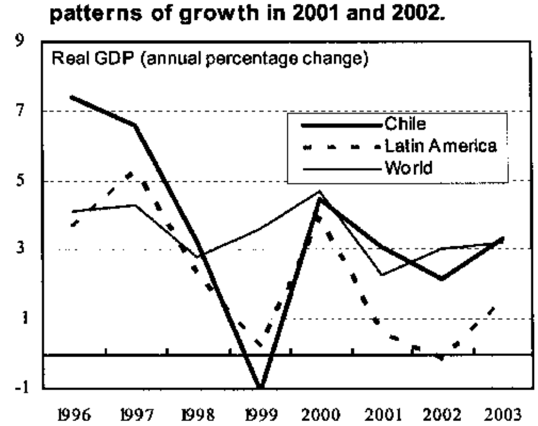
2. **The Chilean political and institutional framework has promoted a broad-based consensus in favor of market-oriented policies and the need for policy discipline.** Constitutional arrangements have promoted stability of governments and coalition-building, and have curtailed incentives for fiscal indiscipline.[1] The executive has dominant power in setting the fiscal stance, while monetary policy is set by an independent central bank. In other areas, however, economic policy action requires a substantial consensus-building effort, particularly as the center-left government coalition now half-way through its six-year term has only a slight legislative majority.

3. **Recent scandals involving several public institutions have revealed some institutional weaknesses and prompted reform efforts.** A private financial company (Inverlink) failed largely because of its corrupt practices, but systemic effects were avoided. Political fallout from the scandals has been significant, as the government nearly lost its congressional majority (after a number of representatives lost voting rights), and the heads of the central bank and securities regulatory body resigned under pressure. However, these incidents have served as catalysts to a series of reforms to increase transparency and accountability of the operation of the public and financial sectors.

II. Recent Economic and Policy Developments

4. **Chile's macro-policy framework and strong fundamentals have insulated the country from the regional financial crisis and permitted continued growth, albeit at a lackluster pace.** Application of a policy framework involving inflation targeting and setting fiscal policy to meet an objective for the government's structural balance has meant that automatic stabilizers have been allowed to operate, with some room for countercyclical policies.

Economic activity has mirrored global patterns of growth in 2001 and 2002.



5. **During 2001–02, the Chilean economy mirrored the decelerating growth pattern of the world economy,** but was able to grow faster than many other countries in its region, as it

[1] Selected Issues, "The Role of Institutions in Chile."

enjoyed continued access to external financing on favorable terms and was able to pursue countercyclical macro policies.

6. **Economic activity has turned up since mid–2002, but the output gap remains wide.**[2] Domestic demand has begun to recover strongly, driven by a pickup in consumption in the context of lower interest rates, and improvements in the terms of trade and in the labor market (Figure 1, Table 1). Moreover, recent increases in copper prices have encouraged mining companies to step up production and contributed to an acceleration of exports (Figure 2). However, the unemployment rate has remained elevated—around 9 percent according to the official measure, but several points higher in the University of Chile's survey—although both employment and labor force participation have picked up (Figure 3).

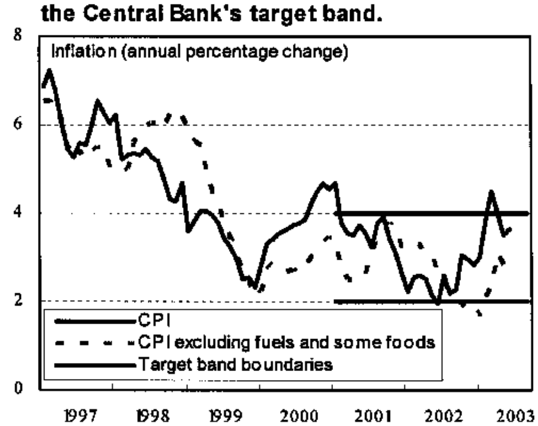
Indicators of Economic Activity, 2001-03

	2001	2002	2002 Q1	2002 Q2	2002 Q3	2002 Q4	2003 Q1
(Percent change from corresponding period of previous year; unless otherwise indicated)							
Real GDP	3.1	2.1	1.2	1.5	2.6	3.3	3.5
Real domestic demand	2.1	1.9	-0.9	-0.4	4.2	4.8	3.4
Fixed capital formation	2.5	1.4	-0.8	3.7	0.3	2.5	0.6
Net exports (contribution to growth)	0.9	0.3	2.1	1.9	-1.7	-1.3	0.3
Copper export volume	4.3	-3.0	2.6	3.5	-17.2	-0.7	2.7
Noncopper export volume	14.0	4.3	3.7	7.7	5.0	2.5	8.5
Import volume	0.2	0.2	-7.6	3.2	1.9	3.8	6.0
Employment (percent growth)	0.3	1.1	2.2	1.0	0.3	0.9	3.1
Unemployment rate (average, percent)	9.1	8.9	9.2	9.1	8.7	8.9	8.7

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

7. **Inflation has stayed under control.** The 12–month inflation rate has remained inside the 2–4 percent target band, with only brief stays near the upper and lower boundaries. The continued output gap, a significant drop in import prices, and slowing wage growth (to about 4 percent) have contributed to this inflation performance.

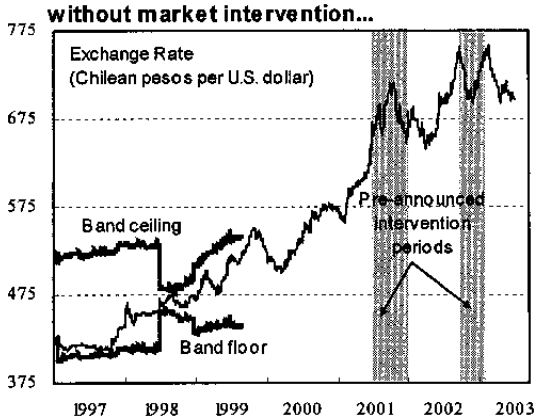
Inflation has generally remained within the Central Bank's target band.



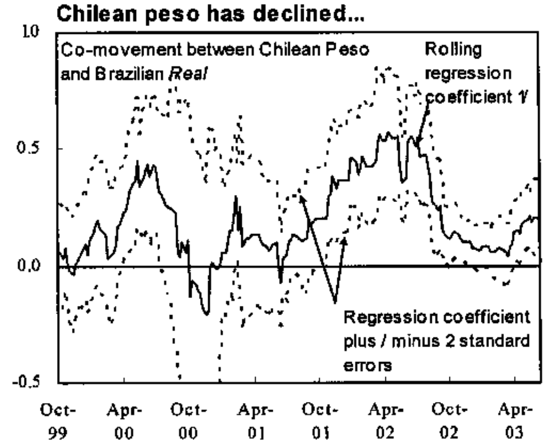
[2] This output gap has accumulated gradually over recent years, as actual output has grown more slowly than potential output. Recent estimates—based on a combined production function approach and the Hodrick-Prescott filter—indicate that output is now around 5 percent below its potential level. However, output gap estimates are subject to significant uncertainty.

8. **The peso's volatility increased during 2001–02 reflecting turbulence in the region.** At the height of market concern about Brazil last October, the central bank announced a special four-month window of potential exchange market intervention.[3] The design of the potential intervention package was similar to the one applied in 2001 (amid concern about Argentina). In the event, the authorities did not intervene in the spot market but did issue US$1.4 billion in dollar-indexed debt (equivalent to about 10 percent of gross reserves).[4]

The exchange rate has fluctuated recently without market intervention...



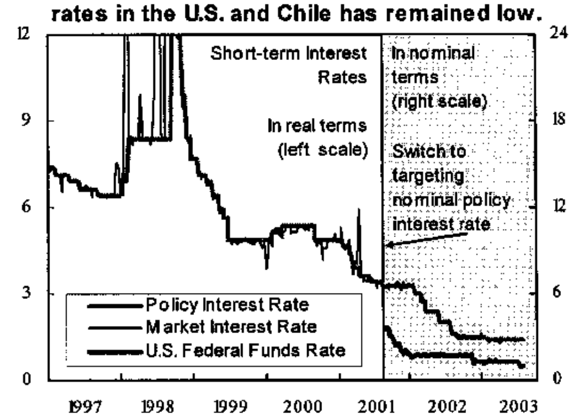
...and the apparent impact of Brazil on the Chilean peso has declined...



1/ Regression of weekly change in Chilean peso/US$ exchange rate against change in Brazilian real/US$ rate, in rolling 20-week samples.

9. **Consistent with the inflation targeting framework, monetary policy has been eased since early 2002.** The central bank cut its policy interest rate steeply over the first half of 2002, aiming to prevent inflation from dropping below the target band. In January 2003 the bank again lowered its policy rate—to 2¾ percent—citing the favorable evolution of labor costs and low foreign inflation. Since then it has held the policy rate steady. The reduction in interest rates has fueled a recovery of consumer credit and mortgage activity (Figure 4, Table 2).[5]

...while the differential between interest rates in the U.S. and Chile has remained low.



[3] The exchange rate policy is zero intervention—outside exceptional circumstances—which prohibits spot market transactions and holds steady the bank's stock of dollar-indexed debt.

[4] The dollar-indexed debt has an original maturity of two to five years.

[5] Selected Issues "Retail Bank Interest Rate Pass-through in Chile."

10. **Automatic fiscal stabilizers have been allowed to operate, as the authorities have met their structural balance target (Table 3).** In 2002, the *structural balance* of the central government was held steady, close to the targeted surplus of 1 percent of GDP. The *actual balance* (before adjusting for revenue effects of output and copper price gaps)[6] widened to a deficit of 1.4 percent of GDP, from 0.9 percent of GDP in 2001. The central bank's deficit was again broadly steady, close to 1 percent of GDP.[7] Gross public debt ratios rose slightly, while net debt declined as currency depreciation raised the value of international reserves.

Fiscal Indicators, 1999-2003
(In percent of GDP)

	1999	2000	2001	2002	Proj. 2003
Central government balance					
Balance, traditional staff presentation	-2.1	-0.8	-0.9	-1.4	-1.2
Adjusted (basis for structural) balance	-2.2	-0.8	-0.7	-1.2	-0.9
Structural balance	-0.8	0.1	0.9	0.7	0.8
Central bank balance	-1.1	-0.9	-0.8	-1.1	-0.9
Public enterprises					
Current balance	1.1	0.6	1.2	1.0	1.1
Overall balance	-0.1	-0.7	-0.4	-0.8	-1.0
Consolidated govt.-central bank debt					
Gross debt	35.7	36.3	36.9	37.3	...
Net debt 1/	9.4	10.6	9.4	8.3	...
Gross debt, unconsolidated					
Central government	13.9	13.9	15.4	15.9	15.6
Central bank	35.5	35.6	34.6	32.2	...
Public enterprises	5.3	5.0	5.3	6.6	7.0

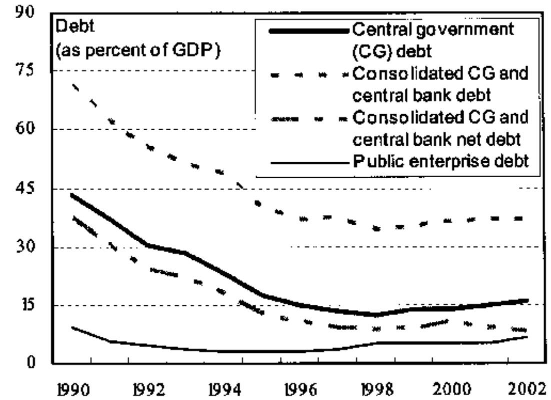
Sources: Ministry of Finance; Central Bank of Chile; and Fund staff estimates and projections.
1/ Net of liquid financial assets, the bulk of which are international reserves.

[6] The copper price gap is the difference between the actual copper export price and the average price of copper over the medium term (as determined by an expert panel).

[7] The authorities do not consider the overall balance of public enterprises a reflection of fiscal policy, though they do report comprehensive statistics on this sector (Table 4). Staff agrees that consolidation of this data with the central government is not required, in light of the overall profitability and limited quasi-fiscal activity of the public enterprises.

11. **The authorities have increased the transparency of fiscal policy further.** In response to analysts' questioning, since late 2002 the authorities have stepped up their efforts to explain the structural balance rule, issued a new report covering the debt and liquid assets of the entire public sector, and begun an enhanced schedule of fiscal data releases. They have also moved to institutionalize some of the transparency-enhancing steps taken in the last few years, and participated in a fiscal ROSC.[8] In consultation with an IMF technical assistance mission, they developed a phased plan for implementing the new GFS and have committed to publishing revised statistics along these lines early next year.

Fiscal discipline has allowed debt to remain at low levels.



12. **Most vulnerability indicators are at comfortable levels (Table 5), although corporate external refinancing needs remain a potential concern.**[9] Official reserves, at US$16 billion (24 percent of GDP), are double the economy's short-term external debt at residual maturity, and also exceed the public sector's entire stock of exchange rate-linked liabilities. While the external debt/GDP ratio has risen to 60 percent, mainly reflecting real depreciation, most of this debt is owed by the private sector, roughly two-thirds of that by foreign-owned companies. Rolling over this debt dominates Chile's external financing needs.

Vulnerability Indicators, 1999-2003
(In percent; unless otherwise indicated)

	1999	2000	2001	2002	Proj. 2003
Financial system					
Foreign currency deposits / total deposits	9.9	11.6	13.8	14.9	14.7
Net short-term foreign assets of commercial banks, US$ bill.	3.9	2.9	1.3	0.1	0.1
Nonperforming loans / total loans	1.7	1.7	1.6	1.8	...
Risk-based capital-assets ratio	13.5	13.3	12.7	14.0	...
Balance of payments					
Current account / GDP	0.1	-1.0	-1.7	-0.8	-0.9
Short-term external debt / GDP	5.5	8.8	9.8	11.8	10.6
Memorandum item:					
Official reserves / short-term external debt (ratio)	3.7	2.3	2.1	1.8	2.1

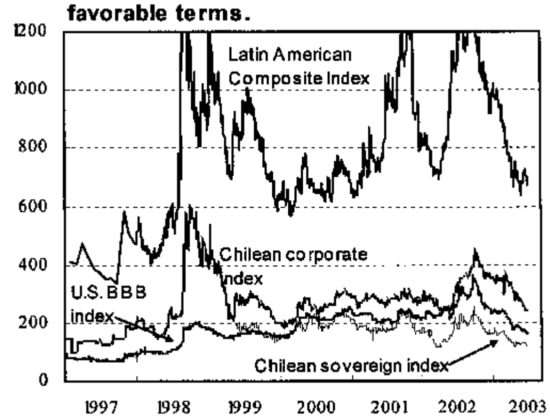
Sources: Central Bank of Chile; and Fund staff estimates and projections.

[8] Further information on these steps is contained in the fiscal ROSC.

[9] Recently, S&P reaffirmed a positive outlook on the A- sovereign foreign currency rating. However, Fitch took its local currency rating down to A+, mainly on growth concerns.

13. **The sovereign and most leading corporates have retained access to external debt financing on favorable terms.** The main exception was a large foreign-owned electric company involved in Argentina and Brazil, which faced spreads above 1000 bp for a time, but this episode did not generate significant spillovers.[10] The government raised US$1 billion early this year, at a spread below 200 basis points. However, private FDI inflows have remained at low levels since mid–2001.

Access to financing has been available on favorable terms.



14. **Recent reform efforts have focused on ambitious measures to modernize the public administration, increase government transparency and reinforce the financial system** (Annex I—Reform Agenda).[11] The "Pro-Growth Agenda", a set of microeconomic reforms agreed with business leaders in 2002, has also advanced, though less quickly.[12]

III. Economic Outlook

15. **The mission presented a baseline scenario with growth accelerating to 3⅓ percent this year and 4½ percent in 2004**, as recovery of demand—prompted by improved regional confidence, better terms of trade, and low real interest rates—takes up slack capacity. Growth would peak at 5½ percent in 2006, above the projected growth of potential output. The sizable output and copper export price gaps would gradually close over the medium term, bringing the actual government balance in line with the structural balance target of a 1 percent of GDP surplus. Headline inflation would remain around 3 percent. The authorities indicated that they had a broadly similar view of the outlook for both actual and

[10] Selected Issues, "Distress Among Chile's Foreign-owned Corporates: The Cases of *Enersis* and *AES Gener*."

[11] Measures to modernize public administration and increase government transparency include civil service and campaign finance reforms; banning cabinet ministers from serving as directors of public enterprises; and new procurement procedures. The government is also proposing reforms to make the financial system more secure, including electronic trading and custody of securities, and information sharing among regulatory agencies, while the central bank has already implemented new security procedures.

[12] The measures included in the Pro-Growth Agenda would address various constraints on growth, including by reducing regulatory uncertainty in electricity provision and fishing, the creation of independent tax, competition defense and economic courts, and the modernization of the bankruptcy framework.

potential output, while noting that performance over the next few years would depend substantially on the state of the world economy.

Medium-Term Baseline Scenario, 2002-2008

	2002	2003	2004	2005	2006	2007	2008
Real GDP Growth (in percent)	2.1	3.3	4.5	5.2	5.5	5.0	4.8
Potential output (percent growth) 1/	*3.7*	*3.7*	*3.7*	*3.8*	*4.0*	*4.2*	*4.5*
Output gap (level, in percent) 1/	*-4.5*	*-4.8*	*-4.0*	*-2.7*	*-1.2*	*-0.4*	*-0.1*
Government balance / GDP							
Balance, traditional staff presentation	-1.4	-1.2	-0.7	-0.2	0.1	0.3	0.4
Adjusted (basis for structural) balance	-1.2	-0.9	-0.1	0.4	0.7	0.9	0.9
Structural balance	0.7	0.8	1.0	1.0	1.0	1.0	1.0
Government gross debt/GDP	15.9	15.6	14.5	13.0	11.3	9.6	8.0
Current account/ GDP	-0.8	-0.9	-1.1	-1.3	-1.7	-2.1	-2.4
Gross external debt/GDP	60.8	60.5	57.9	56.0	54.8	54.1	53.8
Terms of trade (percent change)	1.9	2.5	4.0	4.2	0.8	0.2	0.1

Sources: Central Bank of Chile; Ministry of Finance; and Fund staff projections.
1/ Figures are consistent with Ministry of Finance's working estimates of potential output, in advance of annual update of official figures (to be drawn from expert panel's medium-term forecasts).

16. **Growth of potential output is expected to rise modestly over the medium term, based on current reform initiatives, faster capital accumulation, and a rise in labor participation rates.**[13] The sound macro-policy framework, stable institutional arrangements and open economy provide a favorable environment for investment. In addition, the state modernization and pro-growth agendas should help to increase economic efficiency and reduce growth bottlenecks. Nevertheless, potential growth would remain considerably below the rate achieved prior to the East Asian crisis (7½ percent on average during 1990–96).

17. **The current account deficit would widen gradually over the medium term, as improving terms of trade partially offset the effect of growing domestic demand (Tables 6 and 7).** Net international reserves would be broadly stable, while external debt to GDP would decline somewhat but remain above 50 percent in 2008, and total government debt would decline to just under 10 percent of GDP.

18. **Downside risks to this scenario in the near term include slower recovery of the world economy and of copper prices.** Consistent with the authorities' macro policy framework, such shocks would be moderated through an accommodative monetary stance and weaker outcomes for the exchange rate, domestic demand, and the fiscal balance. Over a medium-term horizon, if growth of potential output and copper export prices turned out less than expected, the structural balance rule would require policy to fully offset the impact on

[13] Part of the projected recovery in potential growth is due to the projected cyclical recovery in actual output with the associated rise in capital accumulation.

the fiscal accounts. Effects of such shocks also would be borne by the foreign owners of many Chilean firms, including in the mining sector (see Section E for a discussion of additional potential vulnerabilities).

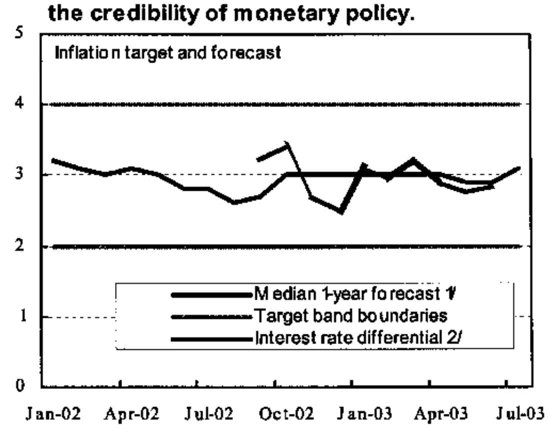
IV. Policy Discussions

A. Monetary and Exchange Rate Policy

19. **The authorities indicated that Chile's inflation targeting framework has successfully anchored inflation expectations and increased the economy's resilience to external shocks while maintaining price stability.** Weakness of domestic demand in late 2001 and early 2002 had required a further significant interest rate decline, in order to respect the lower limit of the target band, leaving the real interest rate significantly below its steady state level. The economy's response has been satisfactory, and the subsequent pickup in demand, output, and employment raises the question of when to begin phasing out—what the authorities recognize to be—a quite accommodative monetary stance.

20. **The mission agreed that the current monetary stance is appropriate in light of the still-tentative recovery in Chile and in the global economy.** A substantial output gap remains, labor market conditions are still slack, and industrial country prospects continue to be uncertain. Indeed, the authorities consider the target band's lower limit of 2 percent as an important defense against world deflation risks. The authorities stressed that the monetary policy stance is based on inflation projections over a one- to two-year horizon and that their strong track record of meeting the inflation target has helped to stabilize inflation expectations within the target band. In this context, they stand ready to adjust policy—in either direction—as necessary to keep inflation inside the target band.

Indicators of inflation expectations reflect the credibility of monetary policy.



1/ Median forecast from survey conducted by central bank.
2/ Differential between nominal and inflation-indexed 5-year public debt.

21. **The central bank is increasing the already high level of transparency and credibility of its conduct of monetary policy:**

- The bank already publishes its inflation forecast and *intends to start publishing its inflation forecasting models.*[14]
- Various data, such as official reserves and trade flows, are now *released more frequently, and distributed electronically.* Also, the publication lag for bank policy meeting minutes was cut to 45 days, and policy votes will now be made public

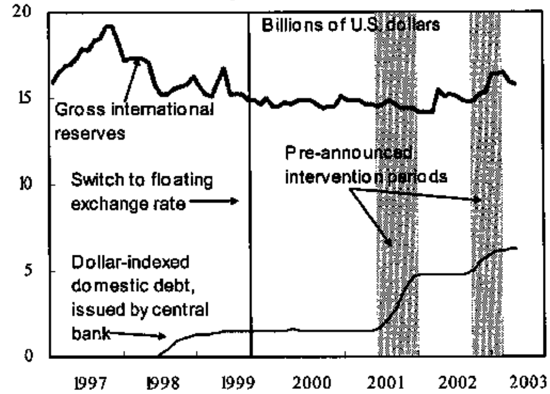
[14] Selected Issues, "Chile's Macroeconomic Policy Framework—An Overview and Update."

immediately.

- The authorities explained that they had *tightened internal security* and taken other steps to reduce the risk that confidential information would again be subject to insider manipulation.
- The bank's credibility is reflected in the *low and stable interest differentials* on its new benchmark instruments.

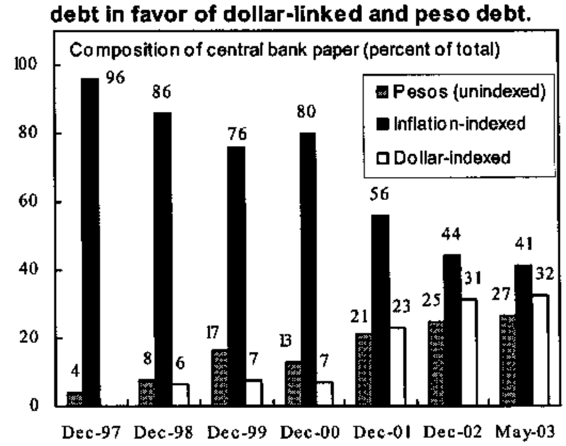
22. **It was agreed that the floating exchange rate regime had served Chile well, and the new central bank president reaffirmed the policy of confining intervention to announced periods of exceptional circumstances.** In the two such periods to date, the authorities had avoided targeting the exchange rate and intervened in amounts that did not threaten the bank's foreign exchange position. The authorities emphasized that they had refrained from intervention during some recent episodes of peso weakness and that intervention could be helpful when exchange rate movements were not justified by fundamentals.[15] They explained that their decision to intervene through the issuance of dollar-indexed debt had been taken to preserve the benefits of the bank's holdings of liquid foreign assets. The staff stressed the importance of continuing to avoid short-term issues of such debt and remaining transparent about such operations.

Episodes of exchange market intervention have used mainly dollar-indexed debt.



23. **Public debt management policy is giving increased attention to the development of financial markets.** The central bank has led this effort, in view of the central government's low level of domestic debt. In this context, since September 2002, the bank has configured its debt issues in forms specifically designed to deepen—and promote the liquidity of—the market for peso-denominated, fixed-income instruments. Specific actions that the central bank initiated include: increasing the relative importance and average maturity of peso issues; adopting

The central bank has reduced inflation-linked debt in favor of dollar-linked and peso debt.



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[15] The central bank has published a detailed explanation of its rationale for recent intervention episodes.

international standards for these instruments, including the use of "bullet" payments; and creating benchmarks for debt markets by establishing a yield curve for low-risk instruments. These developments build on earlier actions by the central bank to shift its liability structure away from inflation-indexed debt in favor of both peso and dollar-indexed debt.[16]

24. **The mission recommended recapitalizing the central bank to reduce its operational deficit.**[17] Staff suggested that a recapitalization of the bank could help improve fiscal transparency and safeguard public confidence in the effective independence of monetary policy. The authorities indicated interest in such a recapitalization, adding that such an approach could improve ownership of their fiscal policy rule because the surplus target (designed in part to offset the bank's quasi-fiscal deficit) could be confusing to the market. However, substantial analytical work remains to determine the size of the needed capitalization (which depends, inter alia, on considerations of the optimal size and structure of the central bank's balance sheet).

B. Fiscal Policy

25. **The authorities are taking steps to ensure adherence to the fiscal target in 2003 and 2004.** They had recently determined that an adjustment of about 1 percent of GDP would be needed to achieve the objective in 2004 reflecting, in part, declines in tariff revenue resulting from recent trade agreements. The mission supported the authorities' proposal to accomplish this by a mix of spending cuts and VAT and excise tax increases.[18] The authorities noted that in Chile the VAT was a less regressive tax than import tariffs.

26. **The authorities expressed some interest in institutionalizing a fiscal policy rule.** By reducing discretion in setting the fiscal stance, the structural balance rule has boosted credibility and helped to preserve the effectiveness of monetary policy. So far, this innovative rule has been a hallmark commitment of President Lagos' government. The mission suggested a range of ways in which the rule could be institutionalized, such as formalizing procedures for measuring the structural balance, requiring budgets to be prepared with reference to such a measure, or requiring that each new government declare some form of verifiable medium-term fiscal target. The authorities indicated they would consider such possibilities but that, in any case, consensus regarding the need for prudent fiscal policy within Chile was the essential ingredient to sustain its practice.

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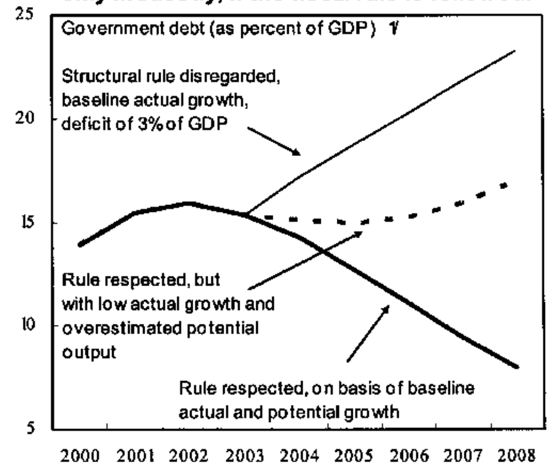
[16] The greater issuance of peso-denominated debt is part of the bank's "nominalization" strategy, begun in 2001, when the bank switched its operational target from an inflation-indexed interest rate to a simple nominal interest rate (see SM/02/195; 6/27/02).

[17] Broadly speaking, the bank's losses can be traced to support given to banks in the 1980s and purchases of reserves (and costly sterilization) during the 1990s. Part of the (cash basis) deficit also reflects the capitalization of interest on old government debt to the bank.

[18] The VAT increase, from 18 to 19 percent, recently has been approved by congress.

27. **The mission agreed that adherence to the structural balance target would provide adequate assurance of sustainability.**[19] Baseline projections assuming that the structural balance target is maintained show the government debt ratio declining from an already low level. Since potential output estimates tend to be uncertain[20], inaccurate assumptions regarding the size of the output gap or the length of the business cycle are a possibility, but would be unlikely to trigger a rapid rise in the government debt ratio, even in a low-growth context, because of the quite low cyclical component of government revenue and spending. In contrast, the sustainability of government debt is sensitive to deviations from the structural balance target. The sustainability of the public finances is confirmed by standardized exercises based on historical shocks (Table 8).[21]

Debt ratios would decrease, or increase only modestly, if the fiscal rule is followed.



1/ See Selected Issues for details and other sensitivity analysis.

28. **The recent fiscal ROSC concluded that Chile has achieved a high level of fiscal transparency in many areas, following steps taken in the last few years.** The new public debt report has greatly facilitated analysis, and when issued last October seemed to have quickly contributed to a decline in Chile's cost of borrowing. The mission welcomed the authorities' plans to publish information on off-budget military expenditure and contingent liabilities, and to report comprehensively on public-private partnerships (e.g., concessions to build and operate roads).

29. **The authorities reaffirmed their commitment to continue to enhance transparency in fiscal statistics, and in particular to move toward the new *System of Government Finance Statistics (GFS).*** A recent FAD/STA mission provided technical

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[19] Selected Issues, "Public Sector Finances in Chile: Balance Sheets, Financing Needs, and Sustainability," which examines also the central bank and public enterprise sector.

[20] The use of expert panels to estimate the structural balance (i.e., to estimate the output gap and the copper price gap) has increased the transparency and credibility of fiscal policy. The authorities indicated they would continue this new practice.

[21] Critical to these results is the healthy structure of the public sector balance sheet, including minimal short-term or floating interest rate debt. The public sector—and especially the central bank—balance sheet would weaken with a *currency appreciation* due to the positive net foreign asset position.

assistance and agreed with the authorities on a new approach, following the new GFS to the extent possible. The authorities explained that they would be ready to publish data on this basis early next year.[22]

C. Financial Sector

30. **The mission's assessment—in advance of an FSAP mission planned for later this year—is that Chile's financial system remains sound, although recent events have highlighted potential weaknesses in the regulatory system.** Indicators of banking vulnerability (Table 5) are broadly stable and the system fared well in extensive stress tests conducted in late 2001.[23] A recent Moody's report concluded that banks experienced no significant indirect effects from the fall of the Inverlink company early this year.

31. **The authorities agreed that the Inverlink case pointed to the need for actions to strengthen some potential weaknesses in the financial regulatory framework.** After the mission, the authorities sent to congress proposals to establish (i) more regulatory discretion in denying a bank license; (ii) more regulatory control over banks' subsidiaries; (iii) better coordination and information sharing among the financial supervisory agencies; and (iv) modernization of financial transactions.

32. **The mission expressed concern that although capital markets in Chile continue to be fairly deep, liquidity in the equity and corporate debt markets remained low.**[24] The authorities agreed that the 2000 corporate governance reform and the capital markets reform and elimination of remaining capital controls in 2001 had not yet substantially altered the landscape. The authorities noted that the market for domestic bond issues was enhancing financing opportunities for corporates. In addition, recently submitted "Capital Markets II" legislation aims at deepening capital markets, including through venture capital markets.

D. Structural Policy Issues

33. **Recent trade agreements with the European Union and the United States should have a positive impact on growth (Box 1).** The new agreements ensure access to markets and eliminate tariff escalation clauses affecting products with high value added, and should also promote the establishment of Chile as a regional hub of multinational corporations. Prior to these agreements, Chile already had a liberal trade regime (highest rank

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[22] It was agreed that staff would initiate the presentation of data on this basis; see Annex II.

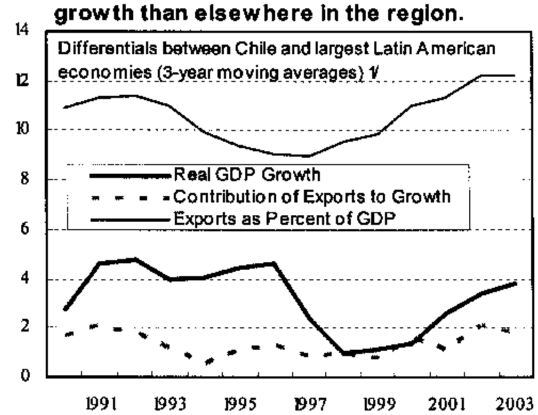
[23] Selected Issues, "An Update on the Chilean Banking System."

[24] Selected Issues, "Capital Markets and Corporate Financing in Chile."

on the Fund's scale). On the Chilean side, the main change will be that tariffs will decline from 6 percent to zero, which is expected to cause only limited trade diversion.[25]

34. **Chile's rich endowment of natural resources can continue to provide a basis for growth, particularly if accompanied by adequate human capital accumulation.**[26] The mission noted that resource-based exports had fueled growth through sustained increases in productivity and technological dynamism that has spilled over to other parts of the production chain and led to the generation of new export products. However, increased efforts were still needed, particularly in improving education achievement levels, which have come up short in international attainment tests. The authorities noted significant progress in educational attainment in recent years and believed that higher inclusiveness of the Chilean system explains the relatively low scores. They mentioned several efforts under way to improve the quality of education, including an increased focus on pre-school education and redesign of the standardized admission tests. The World Bank is assisting in the design of programs to better match labor force skills with the needs of a knowledge-based economy.

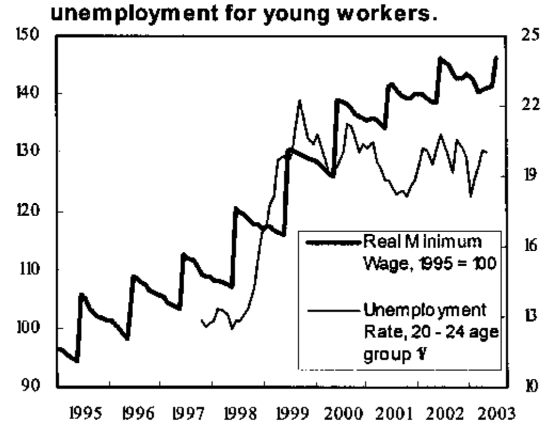
Exports have contributed more to Chile's growth than elsewhere in the region.



1/ Simple average of Argentina, Brazil, Colombia, Mexico, Peru, and Venezuela. Forecast for 2003.

35. **The mission suggested that prospects for employment, investment and growth might also be helped through increased flexibility in labor markets (Box 2).** The authorities affirmed their intention to submit legislation to congress introducing the possibility of bilateral agreements between employers and employees to reduce restrictions on work schedules, which should also facilitate the use of the part-time and labor-training contracts introduced in the 2001 labor reform. The mission acknowledged that this would be an important initiative to make labor markets more flexible, and encouraged the authorities to explore the issue of dismissal costs,

Large increases in the minimum wage have coincided with high unemployment for young workers.



1/ Deseasonalized.

[25] The agreement with the U.S. also limits Chile's potential ability to implement restrictive measures on capital flows in the future; however, this requires no change to current policies and was not regarded as a relevant constraint by the authorities.

[26] Selected Issues, "Export Specialization and Economic Growth in Chile."

which appear high in international perspective, and to limit increases in the minimum wage, particularly for young workers. The authorities indicated that they are looking for ways to reduce dismissal costs without jeopardizing workers' rights. They noted that a recent IDB-sponsored study found that the fall in employment in recent years had been mainly cyclical but was aggravated by rigidity in wage setting and by the level of minimum wage (which had been raised steeply during 1998–2000). In that context, the government and congress recently agreed on a 4 percent increase in the minimum wage for the private sector, an expected 1 percent rise in real terms.

E. External Sustainability and Vulnerability

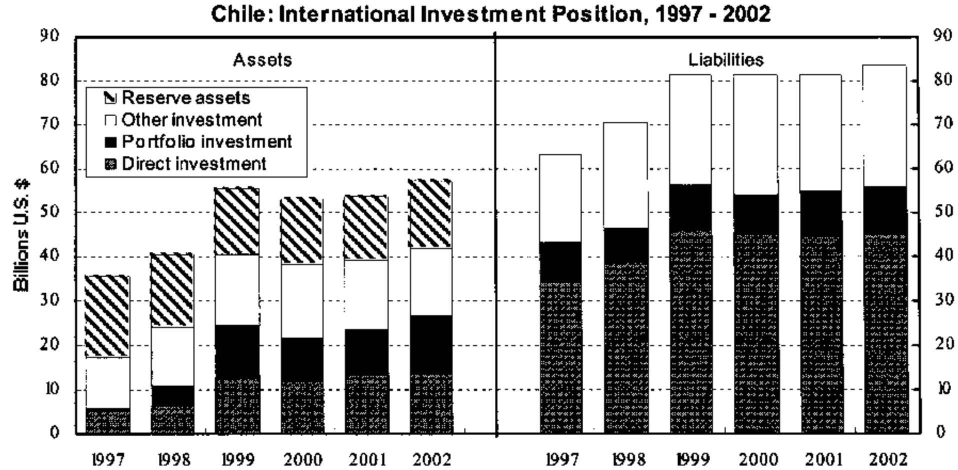
36. **Chile's external position remains strong on the basis of a consistent and credible policy framework.** The earlier-noted strengths of the balance sheets of the public and banking sectors are especially important in this assessment, as is the proven capacity to adjust smoothly via the floating exchange rate. The country's institutional framework and consensus on macro policies make it likely that policymakers would be able to respond appropriately to adverse shocks.

37. **In recent years, potential vulnerability concerns have focused on the non-financial private sector.** This sector is responsible for the bulk of Chile's external debt and refinancing needs and a majority of its external debt used a floating interest rate. The authorities noted that available information has been limited but that they have stepped up their monitoring and data development of the corporate sector, as part of their larger project to develop a Financial Stability Report. They looked forward to the further insights that would come from their participation in the FSAP mission.

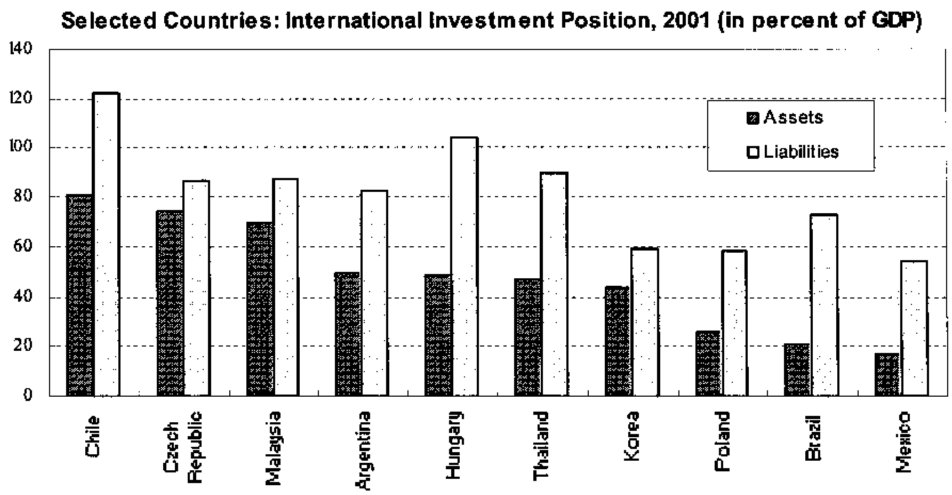
38. **Chile's gross external financing requirements (which largely reflect the financing needs of the nonfinancial corporate sector) are sizable—in excess of 10 percent of GDP in 2003 and 2004—but are nearly twice covered by the official liquid reserves.** This suggests that Chile could withstand a severe loss of access to foreign finance, even before taking into account the reduced financing requirements that would result from the expected policy response to such a shock. Debt sustainability analysis, considering a set of potential shocks calibrated on Chile's past experience, also yields favorable results, particularly taking into account the size of the export base, as well as the risk-sharing provided by foreign ownership (Table 9).

39. **The strength of Chile's external position was confirmed by new information on Chile's foreign assets and liabilities (International Investment Position (IIP) data):**

- A marked increase in Chile's external debt since 1997 has been accompanied by *rising ownership of foreign assets*—indeed, there has been no deterioration in the net international investment position.



- Compared to other emerging markets, Chile stands out for the *large size of both its international assets and liabilities relative to GDP, as well as in having relatively low international leverage* (i.e., a low share of debt in its external liabilities). The authorities emphasized that large foreign assets and liabilities should be expected for a relatively small but open economy offering a stable investment environment.



- *The private sector has liquid foreign assets of almost 10 percent of GDP,* broadly equal to its own short-term external debt.

Liquid Foreign Assets Compared with 2003 External Financing Needs (percent of GDP)

	Liquid Foreign Assets at end-2002	Short-term External Debt (by residual maturity) at end-2002
Public sector	23.1	1.6
Private sector	9.1	10.2
Memorandum:		
Gross external financing requirement (projection for 2003)		11.5
Current account deficit (projection for 2003)		0.9
Public domestic debt linked to US$		9.3

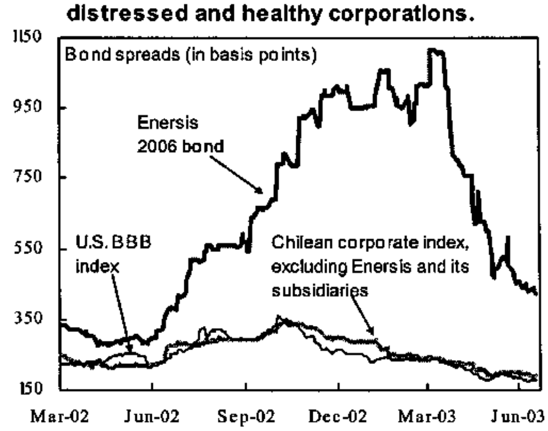
Sources: Central Bank of Chile; Fund staff estimates.

40. **External vulnerability in Chile comes down to the performance of individual corporations, and possible contagion from distressed companies, including in many cases the behavior of the parent company.** The mission viewed the case of *Enersis*—the large private electric company accounting for a significant part of Chile's external financing needs—as a stress test particularly relevant to Chile's circumstances of heavy foreign participation, and uniquely informative as the first example in years of a sizable Chilean-resident company experiencing distress:

- After Enersis began to experience financial distress last year[27], it was *the company's foreign parent—rather than the Chilean government—that came to its aid.*

- Though Enersis might have been seen as a flagship "Chilean" company, it was clear that *investors' perceptions of Chile and Chilean companies more generally were not significantly affected during Enersis' period of distress.*

Bond markets have differentiated between distressed and healthy corporations.



- Looking forward, the Enersis case points to the *importance of considering links to corporates' foreign parents, and the financial condition of those parents, in assessing vulnerability.*

The authorities emphasized that the recent resolution of Enersis' situation supports their view that the financial problems of private enterprises are best handled by the market, in the context of a stable and well-established legal framework.

F. Other Issues

41. **The authorities indicated that they would consider including collective action clauses (CACs) in any future sovereign bond issues.** Though CACs do not seem relevant to Chile's situation, the authorities felt that their use should be considered, given recent evidence from other countries that CACs were essentially costless.

42. **The mission welcomed Chile's recent moves to participate in international efforts to combat bribery, money laundering, and the financing of terrorism:**

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[27] Enersis' troubles arose not on account of its operations in Chile, but rather through its investments in other countries in the region.

- Chile is a signatory of the *OECD anti-bribery convention.* A new law to combat bribery of foreign officials was approved in October 2002.

- The Chilean authorities responded comprehensively to the *Fund's voluntary anti-money laundering questionnaire*. A bill to strengthen anti-money laundering legislation is now in congress, and in June of this year was approved in general by the senate.

- Chile has signed the *1999 United Nations Convention for the Suppression of the Financing of Terrorism*, and the senate has ratified this agreement.

V. Staff Appraisal

43. **The recent performance of the Chilean economy has largely followed that of the global economy, as Chile has successfully resisted contagion from neighboring countries' difficulties.** Application of a sound policy framework, including inflation targeting and setting fiscal policy to meet the government's structural balance target, has meant that automatic stabilizers have been allowed to operate. Behind this success, the Chilean political and institutional framework has promoted a broad consensus in favor of market-oriented policies and policy discipline.

44. **Economic recovery is now expected to gather momentum**. Growth should accelerate in the short term as slack capacity is taken up. Moreover, potential output growth should gradually increase in the medium term on account of both higher capital accumulation and productivity growth, provided the authorities are successful in pushing ahead with their administrative and growth reform agenda. As both output and copper export prices recover over the medium term, the actual government balance would converge to the structural balance target of a 1 percent of GDP surplus. Headline inflation would remain around 3 percent.

45. **Chile's inflation targeting framework has successfully anchored inflation expectations and increased the economy's resilience to external shocks while maintaining price stability.** The current accommodative monetary stance is appropriately balanced in light of the still tentative recovery in Chile and in the global economy. The policy interest rate will in time need to rise toward a neutral level but for now reflects an appropriate balance of the risks. Staff supports the central bank's forward-looking approach to adjusting the monetary policy stance—in either direction—as necessary, to keep inflation inside the target bands.

46. **The floating exchange rate regime adopted several years ago is an essential part of the macroeconomic policy framework and continues to serve Chile well.** Consistent with announced policy, intervention is confined to declared exceptional circumstances when exchange rate movements are not justified by fundamentals, and conducted transparently. Critically, there is no exchange rate target and the rate has remained flexible even during the

two intervention episodes in recent years. The strong liquid foreign asset position of the central bank is a source of strength for Chile, helping to lower borrowing costs on international markets.

47. **The authorities' efforts to foster capital market development are further reducing vulnerabilities and should help to broaden capital market access by mid-sized companies**. Steps to encourage development of an international market for peso-denominated instruments, and better hedging opportunities, are also positive developments.

48. **The authorities' interest in recapitalizing the central bank is welcome.** It would safeguard public confidence in the effective independence of monetary policy, and it would also help to increase fiscal transparency.

49. **The government's recent actions to raise certain taxes, while also adjusting expenditure plans, are an appropriate response to ensure that the fiscal objective is achieved.** In particular, the VAT increase replaces revenues lost from the reduction of the less progressive import tariffs. Sustaining fiscal discipline is essential, and the authorities are encouraged to explore ways to ensure that fiscal policy will continue to be set in a coherent medium-term framework, perhaps by institutionalizing aspects of the new practice of structural balance targeting. Staff strongly agrees with the authorities that public consensus regarding the need for the structural rule within Chile is the essential ingredient to sustain its practice, which would be aided by its continued transparent and successful application.

50. **Staff commends the authorities for the transparency of monetary and fiscal policies.** Fiscal transparency has been significantly enhanced in the last few years, as documented in the fiscal ROSC, and staff welcomes the authorities' intention to unify their fiscal statistics following the GFSM 2001 standard. The inflation targeting framework and the policy on exchange market intervention are quite transparent, and the central bank this year took further steps to maximize transparency.

51. **Since the 2002 consultation, atypical public corruption charges emerged and were met by a broad set of reforms**. The prompt response of the Chilean authorities—and of Chilean society—to the unexpected developments speaks well of the country's institutions, including policymakers' ability to recognize issues and build consensus to confront them. The authorities are determined to remain vigilant, following through with recent reforms and avoiding complacency.

52. **Recent years have demonstrated Chile's capacity to adjust smoothly to adverse external and domestic shocks.** In addition to the well-known strengths of the public sector and the banking system, the corporate sector remains strong. Chile's external debt and refinancing needs—mainly associated with the corporate sector—remain sizable, but are twice covered by liquid international reserves. New information on the corporate sector's substantial foreign assets is reassuring, as are most of the implications of the high degree of foreign ownership. Existing vulnerabilities arise largely from the performance of individual private companies. Staff welcomes the authorities' forthcoming FSAP participation, and their work to develop a Financial Stability Report.

53. **Having met recent challenges of maintaining stability amid a difficult environment, Chile now faces the essential task of returning to sustained economic growth and relatively low unemployment.** The authorities have developed a sensible structural reform agenda, which would address various constraints to growth. The authorities' plans for capital market development should also enhance growth prospects, as will the recent trade agreements with some of Chile's largest partners. Taking a longer view, Chile's continued development can be expected to be supported by its endowment of natural resources and efforts at enhancing its human capital. While the recent pickup in employment is encouraging, staff urges the authorities to move ahead on their commitment to enhance labor market flexibility, and to consider other steps, such as introducing a more differentiated minimum wage structure, that could lower unemployment.

54. **Chile's data are of good quality, timely, and adequate to conduct surveillance effectively**. Most of the shortcomings identified in previous consultations have now been rectified, and the authorities are committed to further improvements in the coming months.

55. **It is proposed that the next Article IV consultation with Chile take place on the standard 12–month cycle**.

Box 1: Integration to the World Economy and the Recent Trade Policy Strategy

The application of an early and aggressive trade liberalization process, followed by (gradual) financial integration has helped Chile to sustain relatively high growth rates and to weather recurrent financial crises in the region. As shown in the Figure on page 17, Chile's positive growth differential against other Latin American countries is partly related to the consistently higher contribution of exports to GDP growth and the significantly larger export share (as percent of GDP). Moreover, the balance between trade and financial integration reduces the country's vulnerability by facilitating adjustment to financial and current account shocks.

The trade policy strategy has recently focused on negotiation of several trade agreements. In addition to continuous reduction in its uniform tariff level to 6 percent in 2003, Chile has subscribed to several trade agreements aimed at ensuring the access to foreign markets. In addition, those accords should boost economic growth through the elimination of tariff escalation clauses that affect products with higher value added, the establishment of regional hubs of multinational corporations, and more efficient resource allocation. Trade diversion costs should be limited since more than 80 percent of Chile's imports will be exempted from the already low uniform tariff of 6 percent. In the last year, Chile has concluded negotiations for free-trade agreements with the European Union (EU), the United States (US), South Korea, and the European Free Trade Association (EFTA).

Agreement with the EU. Under this agreement about 85 percent of Chilean exports to the EU will enjoy zero tariffs from the outset, and this share would increase to 96 percent after four years and to 100 percent after 10 years. An important feature is the phase out of tariff escalation clauses that have hindered the diversification of Chilean exports to the EU (agro-industrial exports were facing up to a 40 percent tariff). A general equilibrium model from "Sustainable Impact Assessment" SIA-Chile, cited in BCCH's Monetary Policy Report (January 2003) estimated the potential *direct* impact of the agreement on Chilean exports and GDP at 3.2 percent and 0.5 percent, respectively. However, these estimates are static and conservative since they do not consider other channels, such as better resource allocation; reduced transaction costs; lower uncertainty on policies and a better business climate, all of which would tend to motivate investment in physical and human capital and productivity-enhancing technological exchanges.

Agreement with the U.S. This includes trade, a dispute resolution mechanism, services, investment, and sections on environment and labor standards. The agreement on trade consolidates the market access conditions for Chilean exports (including GSP conditions) and aims at the elimination of all tariffs in a maximum period of 12 years, including on agricultural and textile products. All escalation tariffs on Chilean exports will be gradually phased out. On capital flows, the agreement states that foreign investors would be able to protest any future restrictive measures by the Chilean government only a year after their implementation. Estimates by the Chilean Ministry of Foreign Relations (with the same limitations described above), suggest potential positive impacts of the trade agreement on Chilean exports and GDP of at least 16 percent and 2 percent, respectively.

Box 2: Labor Market Issues and Initiatives to Increase Flexibility

The unemployment rate in Chile has remained high since the 1998–99 recession. Over the last 12 months, there has been a strong growth in the number of employed workers, accompanied by an increase in labor market participation. However, most of the increase in employment came from the categories of self-employed and non-remunerated family member workers and in the services sector. The lack of a broader-based growth of employment may reflect a still-tentative economic recovery, but it also might signal a reluctance of firms to sign formal or more permanent labor contracts. Such a reluctance might be explained by:

- **Statutory job protection costs** remaining among the highest from an international perspective (Heckman, et. al., 1999). The 2001 labor reform increased dismissal costs in cases where dismissal is deemed unjustified or "anti-union" by the labor court.
- **High minimum wage** and **rigidities in wage-setting**. Some studies (Beyer, 2000; Maloney and Nuñez, 2001; Bravo and Contreras, 2001) have shown that the minimum wage in Chile (following steep increases in the late 1990s) is "binding," with detrimental effects on employment, particularly on young workers and workers with lower skills. In addition, and as documented in an IDB-sponsored study on unemployment in Chile, nominal wages are highly indexed and contracts tend to be negotiated for the following two years.
- **Statutory rigidities in the setting and distribution of work schedules**.
- **Limit on fixed-term employment contracts:** up to one year only.
- **Limited legal causes of dismissals,** and expensive compensation for unjustified dismissals.

Recent discussions on labor market flexibility in Chile have centered on the setting of work schedules. As part of the Pro-Growth Agenda, the authorities are preparing legislation to introduce the possibility of **allowing bilateral agreements between employers and employees to reduce restrictions on work schedules**, which would also facilitate the use of the part-time and labor-training contracts introduced in the 2001 labor reform and increase female labor participation.

Regarding the minimum wage, there have been suggestions **to create new special minimum wage categories** (currently, there are such categories for workers under 18 and over 65 years of age) for workers by age (in particular, under 24), and by training and/or experience. However, the government has been concerned that introduction of additional special minimum wages would only generate substitution toward cheaper labor. Another alternative is the establishment of **"participatory" wages** linked to firms' production level or profits (a basic wage, plus profit sharing).

There has been **limited discussion on reducing the relatively high dismissal costs**. An alternative to consider would be extension of the length of fixed-term contracts.

Box 3: Aspects and Implications of the Central Bank's Balance Sheet

The balance sheet of the Central Bank of Chile (BCCh) has four essential features:

- **Large size.** Assets and liabilities together total about 70 percent of GDP. Assets are mainly international reserves and (old) central government debt; liabilities are mainly domestic debt.

- **Strong liquidity position.** Liquid international reserves dominate the bank's assets, while its liabilities are mostly medium-term paper.

- **The BCCh is "long in dollars."** Exchange rate-linked assets far exceed exchange rate-linked liabilities. At end-2002, the net foreign position was + 23 percent of GDP.

Components of Central Bank Net Debt at end–2002 (percent of GDP)

Assets		Liabilities	
Foreign-denominated		Foreign-denominated (or indexed)	
International reserves	23.9	Foreign liabilities	0.0
Government debt	9.1	Government deposits	0.7
		US$-indexed paper	9.3
Peso-denominated		Peso-denominated	
Government debt	0.7	Government deposits	0.3
		Peso paper:	21.5
		o/w: inflation-indexed:	9.3

- **An ongoing operating deficit.** This deficit arises from (i) the structure of the balance sheet (in turn related to past support to banks and sterilized exchange market intervention) and ii) the government choosing to exercise its option to capitalize interest on certain old debt to the central bank. In recent years, the staff's cash-basis measure of the BCCh's deficit has been close to 1 percent of GDP (about 0.5 percent GDP on an accrual basis).

The size and structure of the bank's balance sheet have several implications:

- **An "insurance" role.** When adverse shocks strike Chile and weaken the peso, the position of the BCCh improves (e.g., a 10 percent depreciation raises net worth by more than 2 percent of GDP).

- **Benchmarking.** The bank's substantial domestic debt constitutes a critical mass that can be used to establish risk-free benchmarks.

- **Transparency.** The bank's losses and capital position tend to complicate analysts' view of the public sector finances, since the losses are not reflected in the government accounts. Transparency will improve when central government statistics are shifted from a cash to an accrual basis, in line with the new GFS.

- **Confidence.** Public confidence in the future independence of monetary could be influenced by the bank's capital position. To date, however, negative debt dynamics have not emerged, and in fact the bank's deficit has been relatively stable.

PRO-GROWTH, CAPITAL MARKETS, AND STATE REFORM AGENDAS: DESCRIPTION AND STATUS OF MAIN REFORMS

(as of June 18, 2003)

I. REGULATORY ISSUES

Reform	Description	Status
Electricity Law	Aims at improving the system of transmission charges (and their distribution between electricity generators and consumer) to foster the expansion of transmission systems and inter-connections. The law would also improve the mechanism to set the prices charged by generating companies to avoid political manipulation.	Proposal submitted to congress.
Fishing Law	The first part of the Law extended (previously temporary) fishing rights for 10 years and eliminated the link between those rights and specific fishing vessels, thereby reducing uncertainty and promoting investment in the sector. The second part of the law would extend fishing rights for an additional 15 years, and would deal with fishing quotas for small fisheries.	First law published in late-2002. Second part being discussed by congress.
Telecommunications Sector Regulation	Setting uniform and transparent access fees between all telecommunication companies. The only change that might be achieved is the determination of fees among mobile companies.	Strong opposition to this draft law.
Tax Courts	Creation of 16 independent and specialized tax courts. Free from hierarchical and administrative control of the internal revenue service (SII). Creation of specialized tribunals at the Court of Appeals level.	Proposal submitted to congress.
Anti-Trust Court	Its objective is to reinforce the existing institutional framework and accelerate the resolution of conflicts. The new court will replace the Anti-monopoly Resolution Commission, which has ad-honorem members. The new court would benefit from increased autonomy, quasi-permanent members, and a permanent supporting staff.	Approved by the Chamber of Deputies.
Economic Courts	Establishment of independent and specialized courts to deal with economic issues.	Under study.
Investment Platform Law	Establishes a special regime to avoid double taxation on foreign enterprises based in Chile to invest abroad.	Law already published.
Bankruptcy law	Aimed at modernizing the current bankruptcy framework by making bankruptcies part of an administrative process rather than a judicial process. It should increase the overall economy's efficiency by making bankruptcies a "normal" result of a capitalist system.	Under study.

II. CAPITAL MARKETS REFORM

Reform	Description	Status
Capital Market Reform II	Reforms can be grouped into several categories:	Draft law submitted to congress.
	i) incentives for the development of venture capital, including the creation of a guarantee system through Corfo and the IDB and capital gains tax exemptions;	

	ii) reduction of transaction costs for small companies;	
	iii) improvements in corporate governance laws (for example allowing the SVS to limit transactions among connected parties and to request pertinent information from corporations' majority share holders to assess their solvency;	
	iv) financial incentives to boost voluntary private pension savings (similar to U.S. 401-K plans);	
	v) regulation, coordination and modernization changes in the financial system (for example, allowing the SBIF more discretion over banks' subsidiaries and in denying bank licenses, establishing mechanisms to share information among the three supervisory agencies, and introducing immaterialization and electronic trading of assets.	

III. STATE REFORM

Reform	Description	Status
Civil Service Regime	Changes remuneration and career development for (non-managerial) civil servants, including by strengthening of performance-based incentives. Reduces the number of political appointments to line jobs in government (*exclusiva confianza* positions) from around 3,500 to 400 by extending the civil service regime to the lowest ranking of those positions and by creating a labor system for the senior executive service (*alta dirección pública*), including a rationalization of their remuneration schemes and the designation process. Rationalizes remunerations to higher-ranked officials not included under the senior executive service system (ministers, vice-ministers, intendents, governors). Creates a National Direction of Civil Service (under the authority of the Ministry of Finance) in charge of human resources policy in the public sector.	Approved by congress.
Campaign Finance	Sets limits on electoral spending; increases transparency and control of campaign financing; makes some state funding available to parties and candidates.	Approved by congress.
Public Procurement Law	Aims at increasing the transparency of government contracts for the purchase, rent, and lease of goods. Requires government institutions to formulate and publish annual contracting plans. Establishes an electronic procurement and information system to be managed by a Procurement Directorate. Creates a Public Procurement Court to rule on associated challenges and conflicts.	Law already published.
Administrative Procedures Law	Sets maximum terms for the issuance of bureaucratic permits and certificates ("silencio administrativo"), reducing uncertainty for private firms and discretion by public officials.	Approved by congress.
Military supplies	Elimination of tax exemptions on imports by the armed forces, excluding munitions, parts and fuel.	Proposal submitted to congress.
Budget Commission	The special bicameral budget commission will work permanently to evaluate the execution of the government's budget.	Approved by congress.

IV. LABOR MARKET ISSUES

Reform	Description	Status
Bilateral agreements to make work schedules more flexible (*adaptabilidad pactada*)	Introduction of the possibility of bilateral agreements between employers and employees to reduce restrictions on work schedules, which should also facilitate the use of the part-time and labor-training contracts introduced in the 2001 labor reform.	Draft law under preparation.
Certification of Labor Competencies	Creation of a national system of labor competencies' certification. This system would reduce information asymmetries by standardizing information on labor competencies.	Draft law under preparation.
Voluntary Savings for Unemployment	A complement to the unemployment insurance system for middle- and high-wage earners.	Draft law under preparation.
Temporary workers	Regulation of firms providing temporary workers and the relationship between subcontracted workers and hiring companies.	Under discussion in congress. Strong discrepancies.

V. SOCIAL ISSUES

Reform	Description	Status
AUGE (health) Plan	Comprehensive reform to the health system aimed at improving the use of resources by the public health system, explicitly guaranteeing access to health services for the most common and costly pathologies, and overhaul of the financing mechanisms of public and private health care. As a result, health-service providers would adapt better to the demand structure through a reallocation of resources among health units.	Draft laws being discussed by congress.
Student Loans System for Private Universities	Aims at establishing student loans with government guarantees in private universities. This reform will be accompanied by a system to secure the quality of higher education through better qualification processes.	Proposal submitted to congress.
Chile Solidario	Targeting of social policies toward the extremely poor, to eradicate extreme poverty by 2006.	Under discussion in congress.

Developments in Fiscal Accounting and Statistics

In recent years, issues of fiscal accounting and statistics have received increased attention in Chile:

- As the authorities recognized some shortcomings of Chile's traditional official statistics and budget presentation, they also noted limitations of the Fund's (former) standard on fiscal statistics, in particular its use of a cash rather than accrual basis.

- In 2001, the authorities introduced a new measure, the "*adjusted balance*," as a policy indicator, but kept the traditional government balance measure for budget and statistical purposes.

The resulting multiplicity of fiscal balance measures—the traditional Chilean and Fund staff measures, and the authorities' new adjusted balance—risked creating confusion, or even perceptions of non-transparency.

Against this background, the authorities announced their intention to bring their measure of the government balance in line with current international standards. They sought to align Chile's fiscal accounts with the new *System of Government Finance Statistics (GFS 2001)*, which emphasizes accrual accounting and capturing changes in net worth. A joint FAD-STA mission visited Santiago in January 2003 and agreed with the authorities on a methodology to unify the presentations of Chilean fiscal statistics, and also helped develop a strategy for gradual full implementation of the new GFS.

It is planned that the new, unified fiscal presentation will be used uniformly in the Chilean budget documents and official statistics, in the derivation of the targeted structural balance, and in Fund staff reports on Chile. The authorities indicated that beginning next year they would publish figures for the 2003 fiscal outturn in the new framework, as well as a historical time-series, and also prepare future budgets consistent with it. Subsequently, it will be possible to use the unified presentation as the basis for Fund fiscal analysis.

Annex Table 1 presents Chile's fiscal accounts in the unified framework. This table may be compared to the traditional presentation shown in Table 3. Annex Figure 1 shows the derivation of the unified balance from the budget balance, the Fund's traditional balance, and the adjusted balance.

Table 1. Chile: Central Government Prototype Presentation

(In percent of GDP)

	1997	1998	1999	2000	2001
Revenue	21.6	21.1	20.3	21.6	22.0
Tax revenue	16.3	16.4	15.6	16.4	16.8
Income taxes (excluding Codelco)	3.8	3.9	3.5	4.1	4.5
VAT	7.9	7.8	7.6	7.9	7.9
Excise taxes	1.9	2.0	2.2	2.2	2.3
Oil price stabilization mechanism	0.0	0.1	0.0	0.0	0.0
Other	2.8	2.6	2.3	2.1	2.1
Other revenue	5.3	4.7	4.7	5.2	5.2
Copper income (Codelco)	1.3	0.4	0.4	0.9	0.5
Other non-tax revenue	3.9	4.3	4.3	4.2	4.7
Expense	17.3	18.6	20.2	20.6	20.5
Compensation of employees	3.8	4.1	4.4	4.4	4.4
Pensions and other	4.7	5.0	5.6	5.6	5.6
Purchases of goods and services	1.6	1.7	1.6	1.6	1.5
Interest payments	1.7	2.0	1.7	1.7	1.6
Interest on debt	0.8	1.1	0.8	0.9	0.8
Interest on recognition bonds	1.0	0.9	0.9	0.8	0.7
Oil price stabilization mechanism	0.1	0.0	0.2	0.5	0.0
Current transfers and other	4.9	5.2	5.9	5.9	6.3
Capital transfers	0.4	0.5	0.8	1.0	1.1
Gross operating balance	**4.3**	**2.5**	**0.2**	**0.9**	**1.4**
Net acquisition of non-financial assets	**2.8**	**2.9**	**2.8**	**2.2**	**2.2**
Acquisition of nonfinancial assets	2.9	2.9	2.8	2.2	2.3
Disposal of nonfinancial assets	0.1	0.1	0.0	0.0	0.0
Net lending/borrowing (surplus/deficit)	**1.5**	**-0.4**	**-2.6**	**-1.3**	**-0.8**
Adjustments	--	--	--	--	--
Overall balance	1.5	-0.4	-2.6	-1.3	-0.8

Sources: Ministry of Finance; and Fund staff estimates.

Steps in moving to the unified fiscal presentation

Chile has good fiscal data, but the official statistics and budget presentation diverge from the Fund standard (both the former GFS standard, and the new GFS 2001). Notable differences involve: the treatment of the copper stabilization fund; certain privatization receipts; and transfers to the armed forces from the state-owned copper company (as detailed in Annex Figure 1).

Since 2001, the authorities set fiscal policy, however, with reference to their *adjusted balance*. This measure shares the Fund staff's treatment of the copper stabilization fund and privatization receipts, but it goes further, particularly in incorporating accrual features. For instance, payment of Chile's pension recognition bonds is treated as amortization of previously accumulated debt, while implicit accrued interest on this debt is added to the accounts, as expense (Annex Figure 1). This treatment is an advance toward isolating the "permanent" deficit elements relevant to the calculation and interpretation of a structural balance.[1] The adjusted balance also incorporates quasi-fiscal flows related to the oil price stabilization mechanism.

The new, unified fiscal balance is similar to the adjusted balance, but with two further adjustments. The adjusted balance is already closely in line with the net lending/borrowing (overall balance) concept defined by the new GFS. However, two further amendments would be made:

- **The authorities will identify previously secret off-budget transfers to the armed forces, and associated off-budget expenditure, and include these in the fiscal balance.** These flows were not included in Chile's traditional budget balance, and Fund staff previously were able to incorporate only estimates in their presentation. Bringing these flows into the fiscal presentation tends to have only a small (net) effect on the government balance.

- **The government interest bill on its debt to the central bank would be shown on an accrual basis, rather than on the cash basis used so far.** The government is permitted the option of capitalizing part of the interest on its old debt to the central bank. The traditional cash-based presentations of both the authorities and the Fund staff do not show this capitalized interest. Under the new GFS, the capitalized portion (averaging around 0.4 percent of GDP in recent years) of interest on this debt would need to be shown as interest expense.

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[1] The authorities have defined their structural balance target using the adjusted balance as a base, from which adjustments are made for the effects on revenue of the gap between actual and potential output, and between current and longer-run copper export prices.

A phased introduction of the new GFS

The unification of the fiscal presentation is a first step in the authorities' phased plan for introducing the new GFS:

- The unified presentation is GFS-compliant, in the sense that the format and classifications will be in line with the new GFS from the time of the presentation of the 2003 fiscal outturn. Also, Chile's recent enhancement of its debt statistics will permit the new version of the government operations table (flow data) to be supplemented with partial balance sheets (stock data).

- Next, full-accrual fiscal numbers will be adopted as the main source of fiscal data. These are already being produced by the Comptroller General but with some lags and small gaps.

- Finally, complete balance sheets will be produced for components of the public sector, as complex issues of valuation and depreciation expense get resolved.

Annex Figure 1. Chile—Shifting to a Unified Fiscal Presentation

Traditional (Official) Budget Balance

▼

Adjustments to traditional balance
- -- move (all) privatization receipts below the line
- -- include actual copper flows, unadjusted for copper stabilization fund
- -- include estimation of Ley Reservada off-budget transfers to armed forces
- -- move loan recovery from revenue to (negative) expenditure (net lending)

▼

Traditional Fund Staff Presentation of Central Government Balance

▼

Adjustments to traditional Fund presentation
- -- switch recognition bonds from cash to accrual (i.e., include interest bill above the line, and move payments of bonds below the line)
- -- move net lending below the line (only if no change in government net worth)
- -- include net impact of petroleum stabilization fund
- -- exclude one-time windfalls

▼

Adjusted Balance (*Balance ajustado*)

▼

Adjustments to *Balance ajustado*
- -- switch government interest bill to central bank from cash to accrual
- -- include actual Ley Reservada off-budget transfers (i.e., replace estimate)

▼

Unified Presentation of Central Government Balance

Chile—Fund Relations
(As of April 30, 2003)

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	474.06	55.37
Reserve tranche position	382.04	44.63

III. **SDR Department**	**SDR Million**	**Percent Allocation**
Net cumulative allocation	121.92	100.00
Holdings	27.86	22.85

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 June 27, the interbank exchange rate was Ch$ 697.23 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 2002 Article IV consultation on July 19, 2002 (SM/02/195).

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. In October 2002, a mission from MAE and WHD advised on nominalization and interest rate pass-through. In January 2003, a joint FAD/STA mission advised on fiscal statistics.

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$303.16 million in commitments. Two of these loans had already been approved when the present CAS was discussed: the ones in support of the Second Municipal Development Project (FY99), and Higher Education Project (FY99). The remaining three, in support of the Public Expenditure Management Project (FY02), Lifelong Learning Project (FY02), and Science for the Knowledge Economy (FY03) fall under the present CAS. Additional lending for FY2004–06 is now expected to target urban transport, rural infrastructure services, and social protection.

Chile: Financial Relations with the World Bank

(In millions of U.S. dollars)

	Commitments (Net of Cancellations)	Disbursements	Undisbursed
I. IBRD Operations (as of June 30, 2003)			
Fully disbursed loans	2,934.22	2,934.22	0.00
Loans in process of disbursement			
Agriculture	0.00	0.00	0.00
Education	246.46	90.02	156.44
Environment	0.00	0.00	0.00
Health	0.00	0.00	0.00
Municipal and urban	10.10	5.74	4.36
Public sector management	23.23	2.90	20.33
Transport	75.52	74.40	1.12
Water supply	0.00	0.00	0.00
Total loans	3,289.52	3,107.32	182.25
Repaid 1/	2,576.12		
Outstanding	713.40		

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

	IFC			
	Loans	Equity	Quasi Equity	Participation
Held	77.33	44.10	77.49	70.04
Disbursed	36.48	44.10	73.74	49.89
Approvals pending commitment	50.00	2.00	13.00	53.00

III. IBRD Loan Transactions (calendar year)

	Actuals			
	2000	2001	2002	2003/2
Disbursements	48.38	38.59	29.69	28.27
Repayments	115.05	118.53	202.33	48.17
Net lending	-66.67	-79.94	-172.54	-19.90

Source: World Bank.

1/ Includes repayment from third parties.
2/ As of June 30, 2003.

Chile: Statistical Issues

Monetary and real sectors

The central bank publishes comprehensive statistics on the real and monetary sectors on a bi-weekly basis. STA is providing assistance to improve the quarterly national accounts and has recently helped to improve the classification of the monetary accounts (by financial instrument, liquidity, and economic sector) and to expand the institutional coverage of the monetary statistics. STA will publish in the September 2003 issue of *International Financial Statistics* revised time series based on the new methodology, beginning with data for December 1997.

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. Beginning in early 2003, central government operations data are also published on a monthly basis. The annual report on public finances presents comprehensive information on the central government, municipalities, and public enterprises.

Beginning in late 2002, the quarterly report on central government debt was supplemented by a broader twice-yearly debt report, including also the debt of the central bank and public enterprise sector. It would be useful to add to these new data information on the currency composition of public enterprise debt, and information on the maturity of central bank debt (though the latter is published already, in the central bank's annual report).

The authorities are in the process of a broad enhancement and revamping of public sector statistics, in general along the lines of GFSM 2001 (see Annex II). Accordingly, beginning in early 2004, they will shift to a new presentation, and this will resolve a number of fiscal statistics issues. Thus, from early 2004, the official statistics will no longer give special treatment to the Copper Stabilization Fund.[1] It is also expected that from early 2004 considerably more detailed data will be published on the financing of the central government, and that this will permit a more transparent correspondence of fiscal data to the monetary and external accounts data.

Coverage of fiscal statistics is being widened to include off-budget military expenditure and the off-budget transfers received by the military from the state-owned copper company. In early 2003, a a new law permitted the Ministry of Finance to publish these flows, which will be included in the new fiscal statistical presentation set to begin in early 2004. Coverage of the military's financing flows and debt stock will remain incomplete, however. Also, the accounts of certain publicly-owned military factories are still not reported.

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[1] Formerly, withdrawals from this fund were registered as current revenue for the government, while deposits into the fund made by the state-owned copper company did not appear in the government's accounts.

Balance of payments and external debt

The central bank continues to compile balance of payments statistics on a quarterly basis, and to publish comprehensive statistics on the external sector on a bi-weekly basis. In 2003, the bank increased the frequency of its reporting of official reserves, exports and imports to a weekly basis, and also shortened the data release lags to 7 days.

In 2002, the central bank began to publish the International Investment Position, with the new series beginning in 1997.

Until 2003, official debt statistics did not include direct trade credits.[2] The bank has now completed estimation of such credits, and publication will begin in September 2003. The process of reconciliation of data on short-term debt with BIS data has been completed.

A remaining area for improvement is the coverage of the military sector in the external statistics. 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. As noted above, a law approved in early 2003 will permit the government to release previously confidential data on the off-budget portion of military expenditure, and it is expected that these data can be used to complete the coverage of imports by the military. However, complete information on military external financing and debt will still not be available.

[2] The data did include direct trade credits that had been sold off to banks.

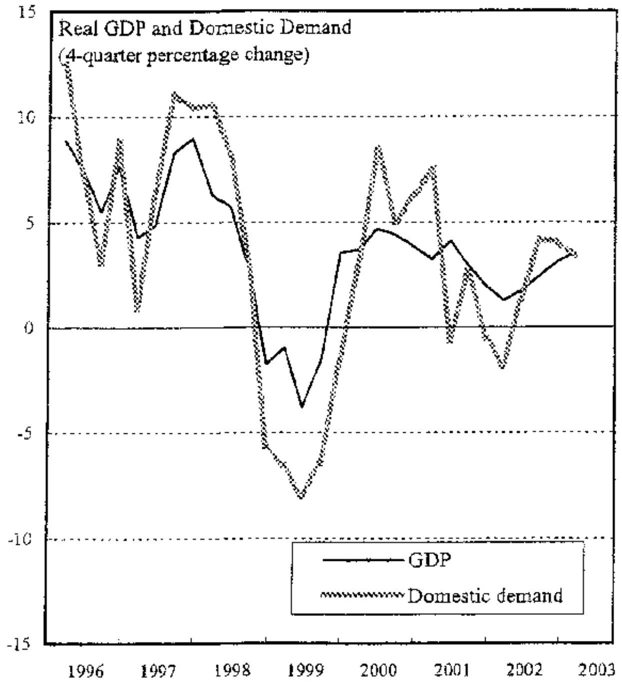
Chile—Core Statistical Indicators
As of July 17, 2003

	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	7/16/03	7/7/2003	6/2003	7/7/2003	7/7/2003	7/4/2003	6/2003	6/2003	Q1/2003	12/2003	Q1/2003	3/31/2003
Date Received	7/17/03	7/14/2003	7/4/2003	7/14/2003	7/14/2003	7/4/2003	7/2/2003	6/30/2003	5/23/2003	3/20/2003	5/23/2003	6/8/2003
Frequency of Data 4/	D	W	M	W	W	D	M	W	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	A	C	C
Frequency of Publication 4/	D	M	M	M	M	D	M	M	Q	Q	Q	M

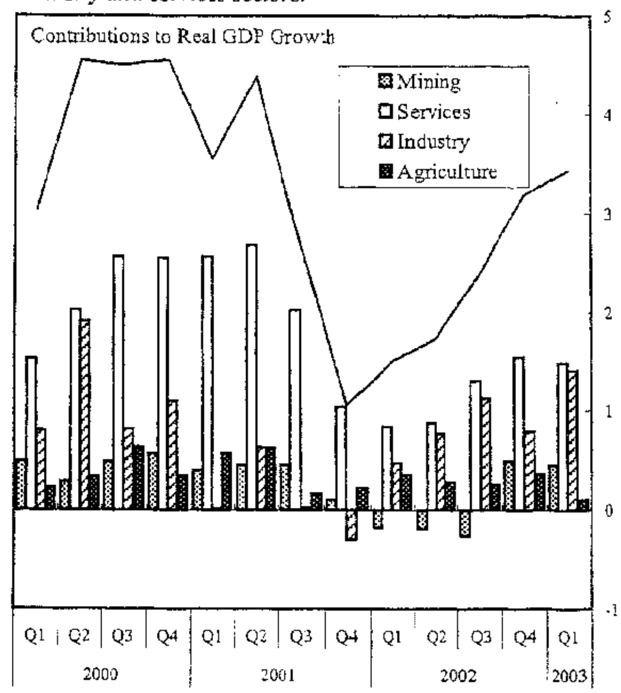
1. General government only (excluding municipal governments).
2/ Quarterly data at constant prices only.
3/ External debt only. General information on interest and amortization payments is available on a quarterly basis from the balance of payments. Detailed information on debt service payments is only available for missions.
4/ D-daily, W-Weekly, 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 unrestrictive use.

Figure 1. Chile: Selected Economic Indicators, 1996–2003

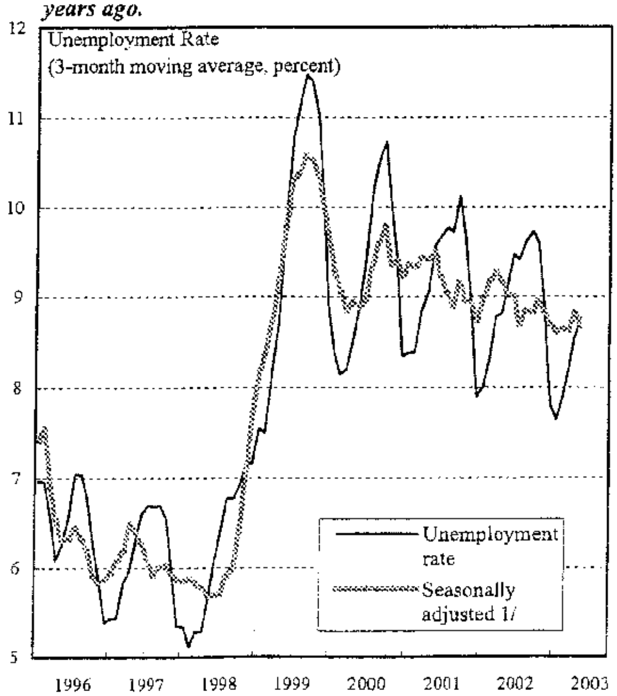
Demand and economic activity have picked up since mid-2002...



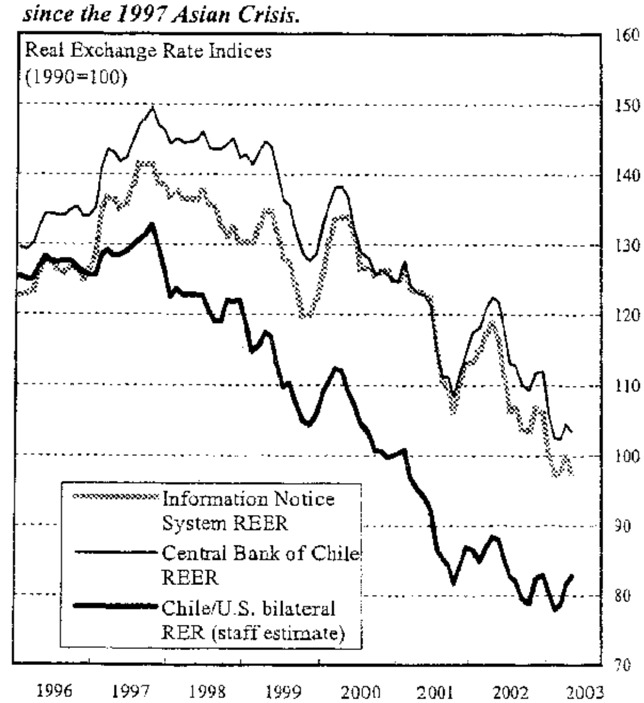
...with the largest contributions coming from the industry and services sectors.



Unemployment has slowly declined from its peak four years ago.



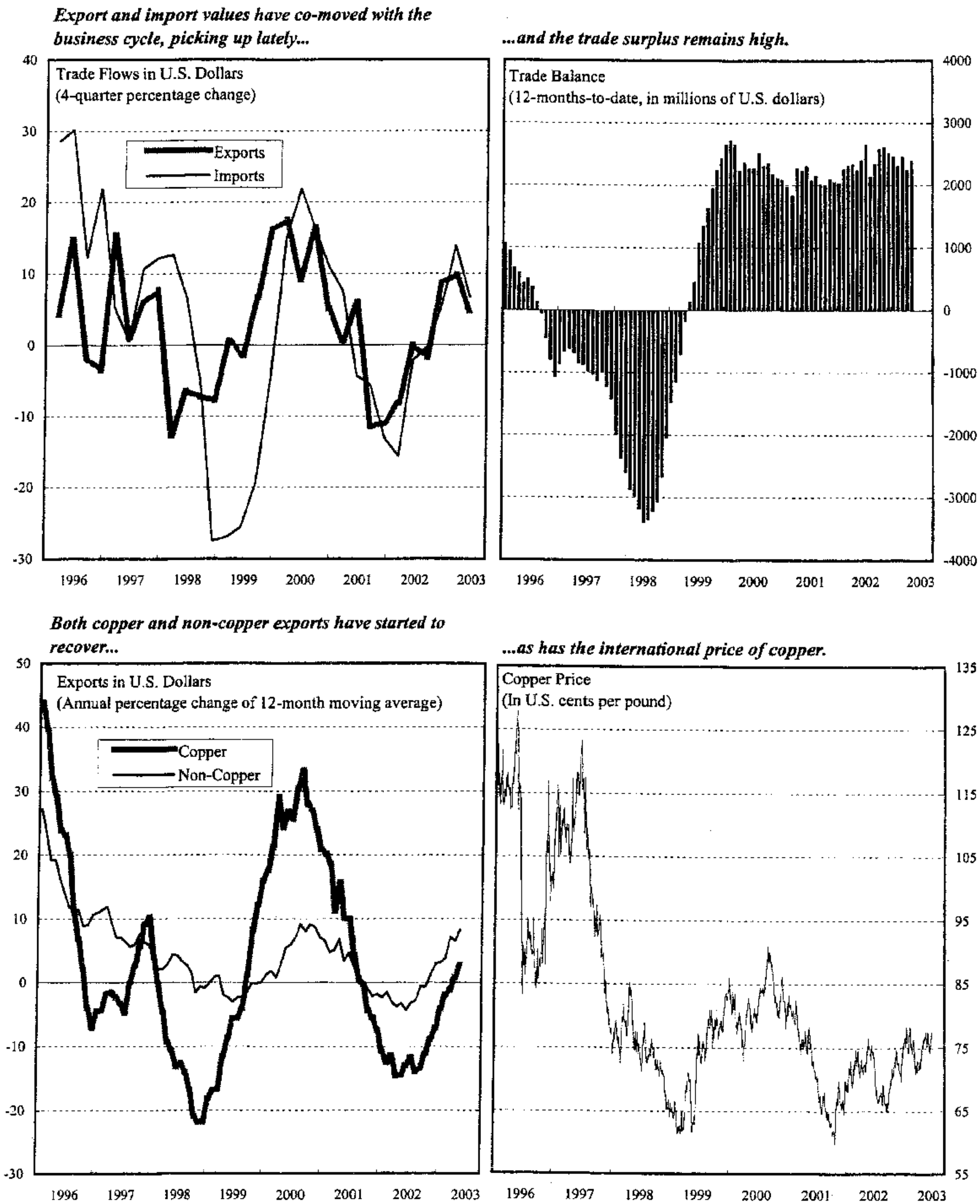
The real exchange rate has continued to depreciate since the 1997 Asian Crisis.



Sources: Central Bank of Chile; *Instituto Nacional de Estadisticas;* IMF's Information Notice System; Fund staff estimates.

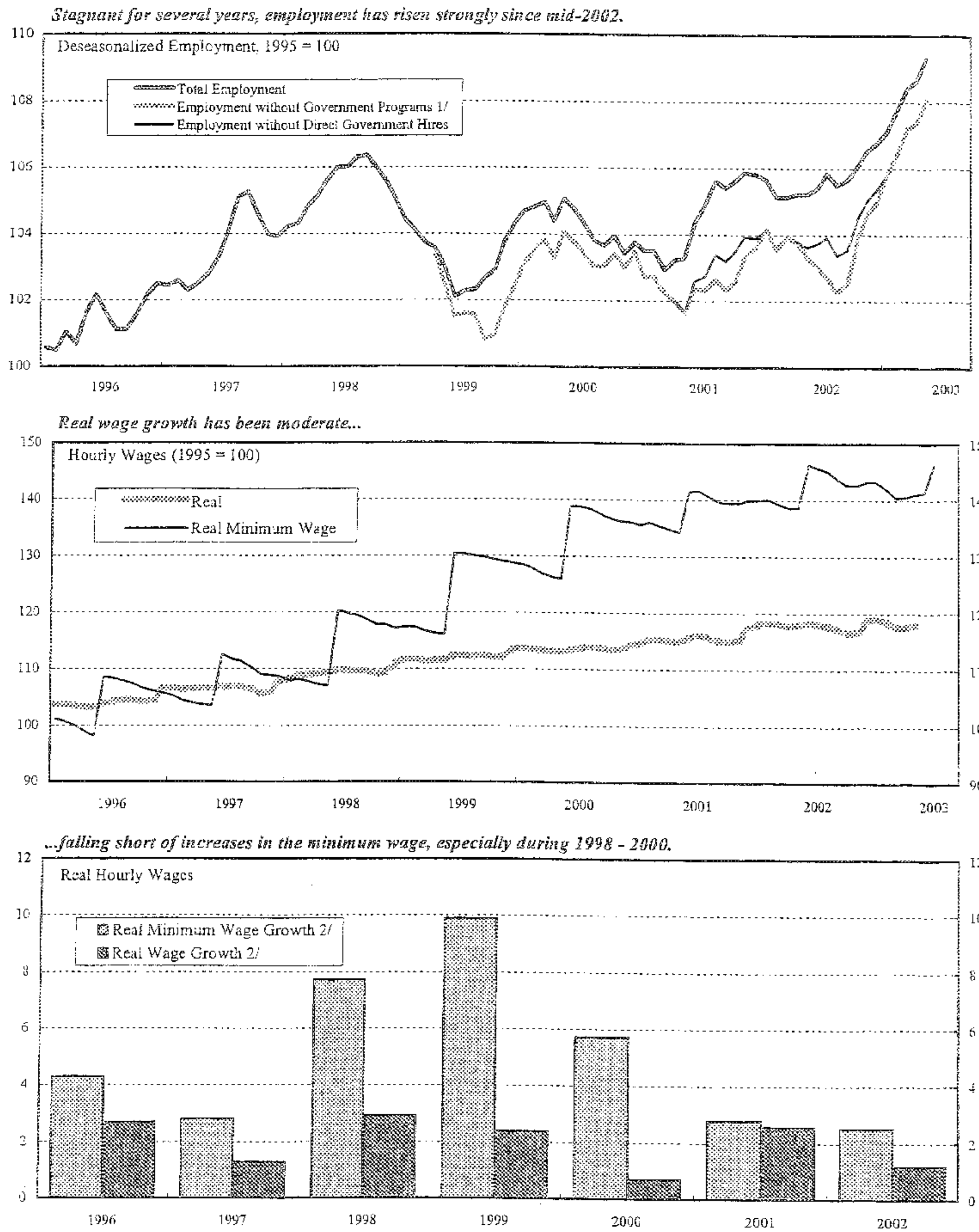
1/ Deseasonalization by *Instituto Nacional de Estadisticas*

Figure 2. Chile: External Sector Indicators, 1996–2003



Sources: Central Bank of Chile; London Metals Exchange.

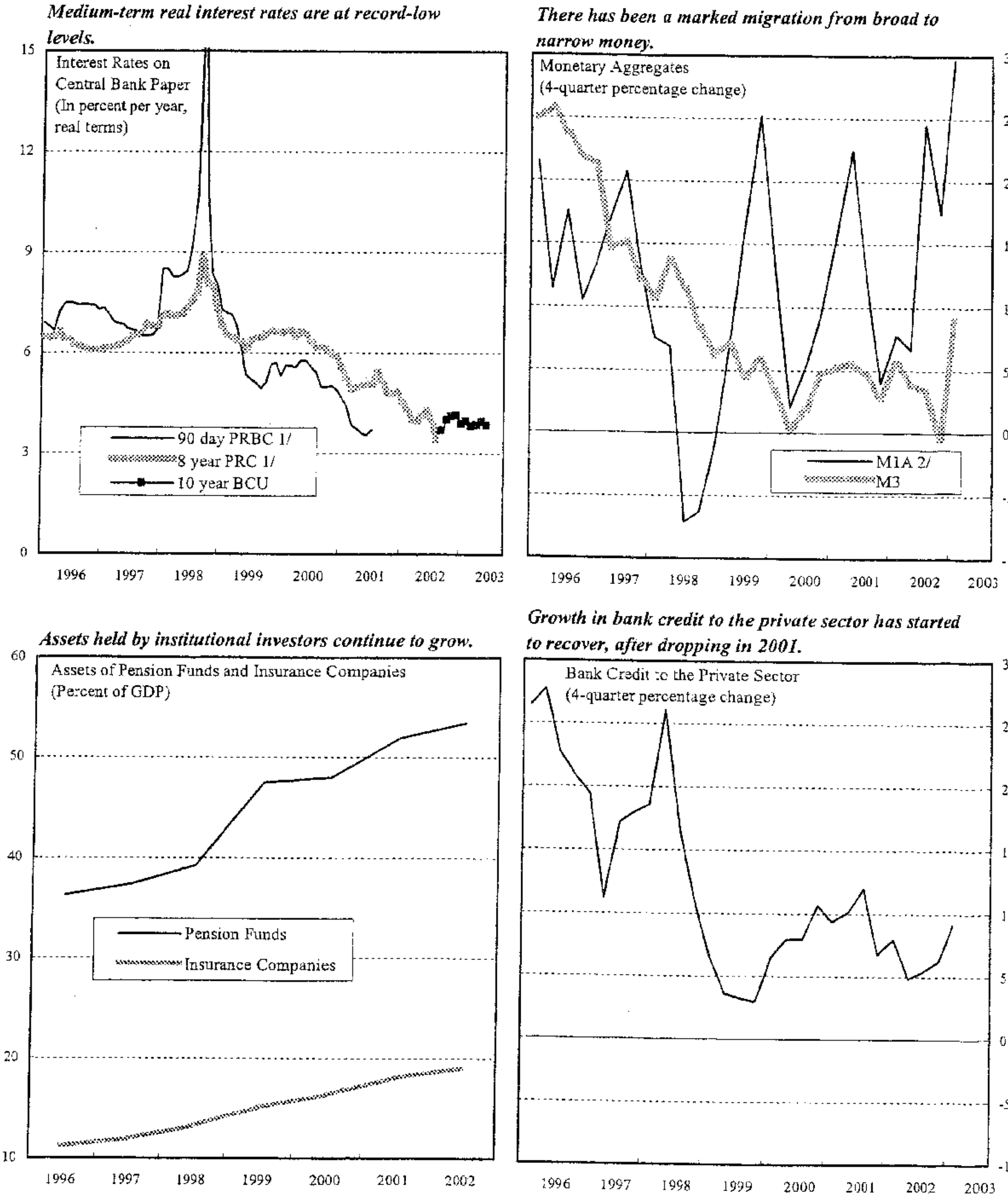
Figure 3. Chile: Labor Market Indicators, 1996–2003



Source: *Instituto Nacional de Estadísticas* .

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

Figure 4. Chile: Financial Sector Indicators, 1996–2003



Source: Central Bank of Chile; *Superintendencia de Valores y Seguros; Superintendencia de AFP.*

1/ PRBC discontinued August 2001, PRC discontinued September 2002.

2/ M1 plus sight deposits.

Table 1. Chile: Selected Economic Indicators

	1998	1999	2000	2001	2002	Projections 2003	Projections 2004
	(Annual percentage change)						
Production, prices, and trade							
Real GDP	3.2	-0.8	4.2	3.1	2.1	3.3	4.5
Real domestic demand	3.7	-5.8	5.7	2.1	1.9	4.2	5.6
Consumption	4.3	-0.7	3.8	2.7	1.8	4.6	4.9
Investment	2.2	-19.5	12.1	0.3	2.3	2.9	7.6
Fixed capital formation	1.9	-18.2	7.7	2.5	1.4	2.9	7.7
Consumer prices							
End of period	4.7	2.3	4.5	2.6	2.8	3.3	3.1
Average	5.1	3.3	3.8	3.6	2.5	3.4	2.9
Underlying inflation (end pd.) 1/	6.2	2.1	3.4	3.2	1.7	2.8	3.0
Real wages (period average)	2.7	2.4	1.4	1.6	2.0	...	...
Unemployment rate (average, in percent)	6.2	9.7	9.2	9.1	8.9	...	...
Exports (U.S. dollars)	-8.7	5.1	11.9	-3.9	-0.7	10.4	13.3
Imports (U.S. dollars)	-4.8	-19.8	16.0	-4.0	-3.6	10.5	12.2
Terms of trade	-4.5	5.6	5.1	-7.9	1.9	2.5	4.0
Real effective exchange rate (end pd.) 2/	-6.1	-6.2	2.5	-9.5	-6.4	...	
Money, credit, and interest rates							
Broad money	8.4	6.0	4.7	2.9	-0.5	8.7	7.5
Credit to the private sector	11.2	3.0	10.7	6.7	5.1	8.3	...
Three-month interest rate 3/	16.4	10.7	10.8	7.2	3.9	...	...
Velocity of money (M1A)	12.3	11.8	12.5	11.7	10.9	10.9	...
	(In percent of GDP)						
Savings and investment							
Gross domestic investment	26.9	21.1	21.8	21.9	21.9	21.8	22.0
Public	4.8	4.0	3.5	3.6	4.0	4.0	4.0
Private	22.1	17.2	18.4	18.3	17.9	17.8	18.0
National savings	22.0	21.2	20.8	20.1	21.1	20.9	20.9
Public 4/	3.1	1.2	2.0	2.6	1.7	2.5	3.3
Private	18.9	20.0	18.8	17.5	19.4	18.4	17.6
External savings	4.9	-0.1	1.0	1.7	0.8	0.9	1.1
Public sector							
Central government balance							
Actual balance, staff presentation 5/	-0.1	-2.1	-0.8	-0.9	-1.4	-1.2	-0.7
Adjusted (basis for structural) balance 6/	0.0	-2.2	-0.8	-0.7	-1.2	-0.9	-0.1
Structural balance 7/	0.1	-0.8	0.1	0.9	0.7	0.8	1.0
Central bank balance (cash basis)	-1.0	-1.1	-0.9	-0.8	-1.1	-0.9	-0.5
State-owned enterprise balance	-1.0	-0.2	-0.8	-0.4	-0.9	-1.0	-1.1
Balance of payments							
Current account	-4.9	0.1	-1.0	-1.7	-0.8	-0.9	-1.1
Capital and financial account 8/	2.2	-1.1	1.5	0.9	1.1	1.1	1.6
Overall balance of payments	-2.8	-1.0	0.4	-0.9	0.3	0.2	0.5
External debt							
Gross external debt 9/	40.0	46.8	48.7	55.7	60.8	60.5	57.9
Public	7.2	8.0	7.4	8.4	10.8	11.5	11.7
Private	32.8	38.9	41.3	47.3	50.0	49.1	46.2

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

1/ Excluding fuel and volatile food items.
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/ Staff's former presentation, to be replaced by measure closer to GFSM 2001.
6/ Authorities' measure. See Table 3.
7/ Includes adjustments for effects on revenue of output gap and copper price fluctuations.
8/ Includes errors and omissions.
9/ Excludes direct short-term trade credits.

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

	1998	1999	2000	2001	2002	Proj. 2003
			I. Central Bank			
			(Annual flows in millions of U.S. dollars)			
Net international reserves	-2,066	-683	198	-421	199	146
Medium- and long-term net foreign liabilities	0	0	0	0	0	0
			(Annual percentage change with respect to liabilities to the private sector)			
Net domestic assets	108.1	81.1	-14.5	33.8	69.2	-24.0
Net credit to nonfinancial public sector	34.1	93.8	20.1	34.6	51.8	18.9
Net credit to financial intermediaries	-33.2	-75.3	-90.3	-61.8	-63.5	11.7
Central bank promissory notes	82.3	6.0	-21.6	38.5	2.0	-49.0
Other	24.9	56.6	77.4	22.4	78.9	-5.6
Liabilities to private sector	-3.1	38.9	-4.9	9.3	7.2	5.3
			II. Financial System			
			(Annual flows in millions of U.S. dollars)			
Net international reserves	-1,160	1,720	-686	-2,166	-57	180
Medium- and long-term net foreign liabilities	-1,817	-3,645	197	-453	638	-264
			(Annual percentage change with respect to liabilities to the private sector)			
Net domestic assets	9.3	6.4	10.8	11.3	8.7	7.6
Credit to the private sector	4.2	2.0	6.5	4.8	4.0	6.5
Liabilities to private sector	9.7	16.1	9.3	8.7	4.9	11.2
Of which : pension funds	4.0	11.1	6.1	6.3	5.1	6.0
			(In percent of GDP)			
Narrow money (M1A) 2/	8.3	10.2	10.3	9.9	11.1	11.4
Broad money	39.6	41.3	39.7	38.1	35.9	36.2
Liabilities to private sector 3/	88.0	100.9	101.8	103.9	103.8	106.9
Of which : pension funds	40.3	49.2	51.0	53.5	55.7	57.4
Credit to private sector	67.0	68.3	69.3	69.9	70.8	71.8
			(Annual percentage change)			
Memorandum items:						
Growth of credit to private sector	5.8	3.5	9.7	7.0	5.9	9.6
Growth of credit to private sector, excluding pension funds	11.2	3.0	10.7	6.7	5.1	8.3
Growth of consumer credit	-3.0	-3.5	2.7	4.4	15.3	14.0
Inflation rate (CPI, end of period)	4.7	2.3	4.5	2.6	2.8	3.3
Narrow money (M1A)	-6.3	25.2	9.3	4.0	17.4	11.4
M3 (central bank defintion)	11.1	11.6	8.9	3.3	6.1	9.1
Broad money (M3 less pension funds' time deposits)	8.4	6.0	4.7	2.9	-0.5	8.7
			(In percent: annual average)			
Interest rates						
Commercial bank deposits (in real terms) 4/	5.4	4.5	5.0	2.1	2.2	...
Commercial bank loans (in real terms) 4/	11.9	8.2	7.5	6.3	4.1	...
90-day central bank promissory note (nominal)	16.4	10.7	10.8	7.2	3.9	...

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)

	1998	1999	2000	2001	2002	Staff Projection 2003	2004
I. Traditional Staff Presentation							
Total revenue	21.1	20.4	21.6	22.0	21.4	21.5	22.0
Current revenue 1/ 2/	21.0	20.3	21.6	21.9	21.3	21.5	21.9
Tax revenue	16.3	15.6	16.4	16.8	16.7	16.6	16.8
Income taxes (excluding Codelco)	3.9	3.5	4.1	4.5	4.4	4.5	4.5
VAT	7.8	7.6	7.9	7.9	8.3	8.4	8.6
Excise taxes	2.0	2.2	2.2	2.3	2.3	2.3	2.3
Other	2.6	2.3	2.1	2.1	1.7	1.4	1.4
Copper income (Codelco) 2/	0.4	0.4	0.9	0.5	0.5	0.8	1.0
Other current revenue	4.3	4.3	4.2	4.7	4.1	4.1	4.1
Capital revenue	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure	21.1	22.5	22.4	22.9	22.8	22.7	22.7
Current expenditure 2/	17.6	18.8	19.0	19.4	19.3	19.1	19.1
Pensions	5.9	6.6	6.6	6.7	6.7	6.5	6.5
Of which: payment of recognition bonds	0.8	1.0	1.0	1.1	1.1	1.1	1.1
Wages	4.1	4.4	4.4	4.4	4.4	4.2	4.2
Purchases of goods and services	1.7	1.6	1.6	1.5	1.6	1.6	1.6
Interest payments	0.6	0.3	0.5	0.5	0.3	0.5	0.5
Transfers and other 2/	5.2	5.9	5.9	6.3	6.4	6.4	6.4
Capital expenditure 3/	3.6	3.7	3.4	3.4	3.5	3.6	3.6
Overall balance	-0.1	-2.1	-0.8	-0.9	-1.4	-1.2	-0.7
II. Authorities' Presentations: Traditional, Adjusted, and Structural Balances							
Actual balance, traditional budget presentation	0.4	-1.4	0.1	-0.3	-0.8	-0.9	-0.6
Adjusted balance (basis for structural balance) 4/	0.0	-2.2	-0.8	-0.7	-1.2	-0.9	-0.1
Estimated cyclical effect of output gap	0.6	-0.5	-0.4	-0.6	-0.9	-1.0	-0.8
Estimated cyclical effect of copper price gap	-0.7	-0.9	-0.4	-1.0	-1.0	-0.7	-0.3
Structural balance 5/	0.1	-0.8	0.1	0.9	0.7	0.8	1.0
Memorandum items:							
Deposits at Copper Stabilization Fund (flows)	-0.4	-0.6	-0.2	-0.6	-0.6	-0.3	-0.1
Central government employment, percent of total	2.5	2.6	2.7	2.8	...	...	...
Central government debt (official measure) 6/	12.5	13.8	13.7	15.0	15.9	15.6	14.5
Domestic debt 7/	9.3	9.8	10.1	10.5	10.1	9.4	8.7
External debt 6/	3.2	4.0	3.7	4.6	5.8	6.2	5.8

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

1/ Includes taxes paid and transfers made by the state-owned public enterprises.
2/ Includes staff estimates of off-budget income from Codelco and off-budget military expenditure.
3/ Includes *net* lending (thus loan recovery is not included under capital revenue).
4/ The 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.
5/ Reflects adjustments for revenue effects of output gap and copper price deviations from reference price.
6/ Excludes debt contracted by the armed forces, for which data are not available.
7/ Consists almost exclusively of debt owed to the central bank.

Table 4. Chile: Operations of Other Public Sector Entities

(In percent of GDP)

	1998	1999	2000	2001	2002	Staff Projection 2003	2004
			I. Central Bank				
Central bank balance (cash basis)	**-1.0**	**-1.1**	**-0.9**	**-0.8**	**-1.1**	**-0.9**	**-0.5**
Net interest balance	-1.0	-1.1	-0.9	-0.8	-1.0	-0.9	-0.5
Interest receipts (cash basis)	1.4	1.2	1.4	1.3	0.8	0.8	1.1
Interest payments	2.5	2.3	2.3	2.1	1.8	1.7	1.5
Operational result, net	0.0	-0.1	-0.1	0.0	-0.1	-0.1	-0.1
			II. Municipal Governments				
Overall balance 1/	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Revenue	1.9	2.1	2.0	2.1	...	...	...
Expenditure	2.0	2.1	2.1	2.0	...	...	...
			III. State-owned Enterprises (nonfinancial) 2/				
Current balance	**0.9**	**1.1**	**0.6**	**1.2**	**1.0**	**1.1**	**1.0**
Current revenue	10.3	10.8	13.1	14.0	13.5	13.7	13.5
Current expenditure	6.4	6.7	8.5	9.0	8.9	9.0	9.0
Taxes and transfers to central government	3.1	3.0	4.0	3.8	3.6	3.6	3.5
Capital balance	**-1.9**	**-1.2**	**-1.3**	**-1.6**	**-1.9**	**-2.1**	**-2.1**
Of which : real investment expenditure	1.8	1.2	1.2	1.3	1.8	2.2	2.2
Overall balance	**-1.0**	**-0.1**	**-0.7**	**-0.4**	**-0.8**	**-1.0**	**-1.1**

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

1/ Estimate for 2002 and projections for 2003 and 2004 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. Does not include pension liabilities.

Table 5. Chile: Indicators of External Vulnerability

(In percent; unless otherwise indicated)

	1998	1999	2000	2001	2002	Proj. 2003
Financial indicators						
M3 (central bank definition, percent change)	11.1	11.6	8.9	3.3	6.1	9.1
Broad money (M3 *less* pension funds' time deposits, percent change)	8.4	6.0	4.7	2.9	-0.5	8.7
Ratio of bank credit to GDP (percent)	58.5	59.3	60.3	60.0	60.4	60.5
90-day central bank promissory note (nominal) interest rate (averages) 1/	16.4	10.7	10.8	7.2	3.9	...
Share of foreign currency deposits in total deposits	6.9	9.9	11.6	13.8	14.9	14.7
Share of foreign currency loans in total credit (excluding pension funds)	9.1	8.6	9.5	11.0	11.1	11.1
Share of nonperforming loans in total loans 2/	1.5	1.7	1.7	1.6	1.8	...
Loan-loss provisions as percent of nonperforming loans 2/	131.2	152.7	145.7	146.3	129.5	...
Risk-based capital-assets ratio, end of period 3/	12.5	13.5	13.3	12.7	14.0	...
Return on bank capital	11.5	9.4	12.7	17.7	14.4	...
External indicators						
Exports, U.S. dollars (percent change)	-8.7	5.1	11.9	-3.9	-0.7	10.4
Imports, U.S. dollars (percent change)	-4.8	-19.8	16.0	-4.0	-3.6	10.5
Terms of trade (percent change)	-4.5	5.6	5.1	-7.9	1.9	2.5
REER (end of period, percent change)	-6.1	-6.2	2.5	-9.5	-6.4	...
Exchange rate (pesos per US$, period average)	460.7	509.1	539.5	634.9	688.9	...
Current account (percent of GDP)	-4.9	0.1	-1.0	-1.7	-0.8	-0.9
Capital account (percent of GDP) 4/	2.2	-1.1	1.5	0.9	1.1	1.1
Gross official reserves (in US$ billion) 5/	16.0	14.7	15.1	14.4	15.4	15.5
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	9.9	8.1	8.5	8.3	8.1	7.2
Gross official reserves to broad money	51.9	50.6	53.9	57.1	67.1	66.0
Gross official reserves to short-term external debt 6/	385.2	367.8	229.7	214.8	180.1	210.7
Short-term foreign assets of commercial banks (in US$ billion) 7/	1.8	4.2	3.4	2.4	1.4	1.4
Short-term foreign liabilities of commercial banks (in US$ billion) 7/	0.9	0.3	0.4	1.1	1.3	1.3
Total external debt (percent of GDP)	40.0	46.8	48.7	55.7	60.8	60.5
Of which: public sector debt (percent of GDP) 8/	7.2	8.0	7.4	8.4	10.8	11.5
Total external debt to exports of goods and services	156.3	162.5	156.6	168.5	181.1	172.4
External interest payments to exports of goods and services	7.4	7.2	8.9	8.3	7.3	5.0
External amortization payments to exports of goods and services	12.0	15.9	17.9	18.8	26.0	20.6
Financial market indicators						
Stock market index (in US$; period average)	74.8	75.6	82.9	72.2	61.4	...
Sovereign long-term foreign-currency debt rating 9/						
Moody's	Baa1 (June 1995 to present)					
S&P	A- (1995 to present; positive outlook since 2002)					

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

1/ The series starts in July 1997.
2/ 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 armed forces, for which data are not available.
9/ Ratings are only shown for the dates on which they were revised by the rating agencies.

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

				Projections					
	2000	2001	2002	2003	2004	2005	2006	2007	2008
			(In billions of U.S. dollars)						
Current account	-0.8	-1.2	-0.6	-0.6	-0.8	-1.1	-1.6	-2.1	-2.6
Trade balance	2.1	2.1	2.5	2.8	3.3	3.7	3.4	3.1	2.9
Exports	19.2	18.5	18.3	20.3	23.0	25.2	26.8	28.4	30.1
Copper	7.3	6.7	6.3	7.0	8.4	9.5	9.9	10.3	10.8
Noncopper	11.9	11.7	12.1	13.3	14.5	15.7	16.9	18.1	19.3
Imports	-17.1	-16.4	-15.8	-17.5	-19.6	-21.5	-23.4	-25.2	-27.2
Financial services (net)	-2.8	-2.8	-2.5	-2.7	-3.1	-3.7	-3.9	-4.1	-4.5
Other services and transfers (net)	-0.1	-0.5	-0.5	-0.7	-1.1	-1.1	-1.0	-1.1	-1.0
Capital account 1/	1.1	0.6	0.8	0.8	1.2	1.9	2.5	3.0	3.6
Foreign investment (net)	0.6	3.2	-0.4	-1.2	-0.4	-0.4	-0.4	-0.3	-0.4
Assets	-3.2	-2.8	-3.7	-5.7	-4.7	-4.9	-5.2	-5.4	-5.7
Liabilities	3.8	6.0	3.3	4.5	4.3	4.5	4.8	5.1	5.3
Other capital flows	0.5	-2.6	1.2	2.0	1.7	2.3	2.8	3.3	4.0
Medium- and long-term (net)	0.1	-0.2	-0.6	0.6	0.6	1.0	1.2	1.4	1.8
Disbursements	4.3	4.1	5.2	5.6	4.0	5.9	6.5	6.0	6.5
Amortizations	-4.2	-4.2	-5.8	-5.0	-3.4	-4.9	-5.3	-4.5	-4.7
Other capital (net) 1/	0.4	-2.4	1.8	1.4	1.0	1.4	1.6	1.9	2.2
Overall balance	0.3	-0.6	0.2	0.1	0.4	0.8	0.9	1.0	1.0
Reserve assets (increase -)	-0.3	0.6	-0.2	-0.1	-0.4	-0.8	-0.9	-1.0	-1.0
Valuation adjustment	-0.2	-0.1	0.8	0.0	0.0	0.0	0.0	0.0	0.0
Change in official reserve stock (increase -)	-0.2	0.7	-1.0	-0.1	-0.4	-0.8	-0.9	-1.0	-1.0
			(In months of imports of goods and services)						
Gross official international reserves 2/	8.5	8.3	8.1	7.2	6.8	6.6	6.4	6.3	6.3
Main assumptions									
Copper price (LME; U.S. cents per pound)	82.2	71.7	70.8	74.9	81.6	86.2	87.1	88.0	88.9
Volume of copper exports (thousand metric tons)	4,402	4,592	4,453	4,694	5,114	5,426	5,589	5,756	5,929
			(Annual change in percent)						
Copper export prices 3/	14.8	-11.2	-4.2	5.8	10.9	6.2	1.1	1.1	1.1
Copper export volumes	5.3	4.3	-3.0	5.4	8.9	6.1	3.0	3.0	3.0
Noncopper export prices	2.2	-13.2	-0.8	4.9	2.0	2.8	1.0	1.1	1.0
Noncopper export volume	5.6	14.0	4.3	5.1	7.5	5.5	6.3	6.0	5.9
Total export prices	6.7	-11.6	-2.1	5.0	4.9	3.9	1.0	1.1	1.1
Total export volume	4.9	8.7	1.4	5.2	8.0	5.7	5.1	4.9	4.9
Total import price	1.5	-4.0	-3.9	2.4	0.9	-0.2	0.2	0.9	0.9
Total import volume	13.9	0.2	0.2	6.9	11.2	9.9	8.5	7.0	6.7
Terms of trade	5.1	-7.9	1.9	2.5	4.0	4.2	0.8	0.2	0.1
Real GDP	4.2	3.1	2.1	3.3	4.5	5.2	5.5	5.0	4.8
LIBOR (in percent)	6.6	3.7	1.9	1.3	2.8	5.2	5.5	5.5	5.5
			(In percent of GDP)						
Gross domestic investment	21.8	21.9	21.9	21.8	22.0	22.0	22.0	22.1	22.4
Public sector	3.5	3.6	4.0	4.0	4.0	3.9	3.9	3.9	3.9
Private sector and inventory change	18.4	18.3	17.9	17.8	18.0	18.1	18.2	18.3	18.5
External current account balance	-1.0	-1.7	-0.8	-0.9	-1.1	-1.3	-1.7	-2.1	-2.4
Gross national savings	20.8	20.1	21.1	20.9	20.9	20.7	20.3	20.0	19.9
Public sector 4/	2.0	2.6	1.7	2.5	3.3	3.7	4.0	4.2	4.2
Private sector	18.8	17.5	19.4	18.4	17.6	17.0	16.3	15.8	15.7

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 losses of the central bank.

Table 7. Chile: External Debt and Debt Service

	2000	2001	2002	2003	2004	2005	2006	2007	2008
				Projections					
	(In billions of U.S. dollars, end of period)								
Total debt outstanding 1/	**36.5**	**38.0**	**40.4**	**42.1**	**44.2**	**46.6**	**49.5**	**52.7**	**56.4**
Of which: external private debt	31.0	32.3	33.2	34.1	36.2	38.6	41.5	44.7	48.4
percent change	9.4	4.3	2.9	2.8	5.9	6.8	7.4	7.8	8.3
Of which: external public debt	5.5	5.8	7.2	8.0	8.0	8.0	8.0	8.0	8.0
Medium- and long-term loans and bonds 2/	33.9	36.0	38.1	39.8	41.8	44.3	47.1	50.4	54.1
International organizations	1.5	1.4	1.2	1.0	0.8	0.5	0.4	0.2	0.1
Official lenders	1.6	1.7	1.8	1.6	1.4	1.3	1.2	1.1	1.0
Private creditors	30.8	32.8	35.1	37.2	39.6	42.5	45.6	49.1	53.1
Private financial institutions	15.8	16.2	16.7	18.0	19.9	21.9	24.3	26.8	29.5
Other	7.9	8.0	7.9	7.1	5.9	4.8	3.4	2.1	1.0
Bonds	7.1	8.6	10.4	12.1	13.9	15.8	17.9	20.1	22.6
Short-term debt 1/ 2/	2.5	2.1	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Short-term debt, residual maturity basis 1/	6.6	6.7	8.5	7.4	5.7	7.2	7.6	6.8	7.0
Total debt service	**6.2**	**6.1**	**7.4**	**6.2**	**5.3**	**8.1**	**8.7**	**8.2**	**8.6**
Amortization	4.2	4.2	5.8	5.0	3.4	4.9	5.3	4.5	4.7
Interest	2.1	1.9	1.6	1.2	1.9	3.2	3.5	3.7	3.9
IMF									
Credit outstanding	0.0	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	0.0
	(In percent of GDP)								
Total external debt, end-period 1/	48.7	55.7	60.8	60.5	57.9	56.0	54.8	54.1	53.8
gross change (in percent)	4.3	14.4	9.2	-0.4	-4.4	-3.2	-2.2	-1.2	-0.5
gross change of nominal stock (in percent)	6.9	4.3	6.2	4.3	4.8	5.6	6.1	6.6	7.1
GDP growth (in US$)	2.6	-8.8	-2.7	4.7	9.6	9.1	8.5	7.9	7.6
GDP growth (real)	4.2	3.1	2.1	3.3	4.5	5.2	5.5	5.0	4.8
Of which: external private debt	41.3	47.3	50.0	49.1	47.4	46.4	45.9	45.9	46.2
Of which: external public debt	7.4	8.4	10.8	11.5	10.5	9.6	8.9	8.2	7.6
Interest payments on external debt	2.8	2.8	2.4	1.7	2.5	3.8	3.8	3.8	3.7
	(In percent of exports of goods and services)								
Debt-service payments	26.8	27.1	33.3	25.6	19.3	26.8	27.0	23.8	23.6
Of which: interest	8.9	8.3	7.3	5.0	7.0	10.5	10.7	10.7	10.7
IMF repurchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total external debt outstanding at year-end 1/	156.6	168.5	181.1	172.4	160.4	154.5	153.0	153.5	154.8
IMF credit outstanding	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Net international reserves, percent of GDP	20.2	21.1	23.1	22.3	20.9	20.1	19.6	19.1	18.8
Net financial services payments, percent of GDP	3.7	4.0	3.8	3.8	4.0	4.5	4.4	4.2	4.2

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

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

Table 8. Chile: Public Sector Debt Sustainability Framework, 1998-2008

(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
					I. Baseline Medium-Term Projections						
Public sector debt 1/	12.5	13.8	13.7	15.0	15.9	15.6	14.5	13.0	11.3	9.6	8.0
o/w foreign-currency denominated	11.0	12.4	12.5	13.9	15.1	14.7	13.7	12.3	10.7	9.1	7.6
Change in public sector debt	-0.7	1.2	0.0	1.3	0.9	-0.3	-1.1	-1.6	-1.7	-1.7	-1.6
Identified debt-creating flows	0.3	3.2	0.7	1.7	1.9	-0.3	-0.5	-1.0	-1.1	-1.1	-1.0
Primary deficit	-0.6	1.8	0.4	0.4	1.1	0.6	0.2	-0.3	-0.6	-0.7	-0.8
Revenue and grants	21.1	20.4	21.6	22.0	21.4	21.5	22.0	22.5	22.8	23.0	23.1
Primary (noninterest) expenditure	20.5	22.2	22.0	22.4	22.5	22.2	22.2	22.2	22.2	22.2	22.3
Automatic debt dynamics 2/	0.9	1.4	0.4	1.3	0.8	-1.0	-0.6	-0.7	-0.5	-0.4	-0.2
Contribution from interest rate/growth differential 3/	0.0	0.1	-0.7	-0.5	-0.5	-0.6	-0.6	-0.7	-0.5	-0.4	-0.2
Of which contribution from real interest rate	0.4	0.0	-0.1	-0.1	-0.2	-0.1	0.0	0.0	0.1	0.2	0.2
Of which contribution from real GDP growth	-0.4	0.1	-0.5	-0.4	-0.3	-0.5	-0.6	-0.7	-0.7	-0.5	-0.4
Contribution from exchange rate depreciation 4/	0.9	1.3	1.0	1.8	1.3	-0.4	0.0	0.0	0.0	0.0	0.0
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2-3)	-1.0	-2.0	-0.7	-0.4	-1.1	0.0	-0.6	-0.6	-0.6	-0.6	-0.6
Public sector debt in percent of revenues 1/	59.4	67.4	63.5	68.3	74.3	72.5	66.1	57.7	49.5	41.8	34.7
Gross financing 5/	1.6	4.0	2.7	2.9	3.4	3.5	2.9	2.7	1.8	2.1	1.5
in billions of U.S. dollars	1.3	2.9	2.0	1.9	2.2	2.4	2.2	2.2	1.6	2.1	1.6
Key Macroeconomic and Fiscal Assumptions											
Real GDP growth (in percent)	3.2	-0.8	4.2	3.1	2.1	3.3	4.5	5.2	5.5	5.0	4.8
Average nominal interest rate on public debt (in percent) 6/	5.1	2.7	3.6	3.7	2.1	3.6	3.7	3.8	4.0	4.4	4.9
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	3.2	0.2	-0.8	-0.4	-1.3	-0.7	0.1	0.1	1.2	1.6	2.2
Nominal appreciation (increase in US dollar value of local currency, in percent)	-7.2	-10.2	-7.9	-12.5	-8.9	2.7	0.0	0.0	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	1.9	2.4	4.4	4.1	3.4	4.4	3.6	3.7	2.8	2.7	2.7
Growth of real primary spending (deflated by GDP deflator, in percent)	9.2	7.5	3.1	5.0	2.7	1.7	4.5	5.3	5.6	5.1	4.8
					II. Stress Tests						
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2007					15.9	13.6	11.3	9.1	7.1	5.2	3.5
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004					15.9	16.5	16.2	14.5	12.8	11.0	9.4
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004					15.9	16.4	16.3	14.6	12.8	11.0	9.3
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004					15.9	18.0	19.7	17.8	16.0	14.1	12.4
5. Combination of 2-4 using one standard deviation shocks					15.9	16.6	17.0	14.6	12.0	9.5	7.1
6. One time 30 percent real depreciation in 2003 7/					15.9	23.5	22.1	20.2	18.2	16.3	14.6
7. 10 percent of GDP increase in other debt-creating flows in 2003					15.9	25.6	24.1	22.1	20.0	18.1	16.2
8. Impact on **debt-to-GDP ratio** if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04					15.9	20.0	23.7	21.7	19.7	17.7	15.9
8a. Impact on **debt-to-revenue ratio** if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003					74.3	117.5	139.1	96.6	86.3	77.1	69.0

Historical Statistics for Key Variables (past 10 years)	Historical Average	Standard Deviation
Primary deficit	-0.7	1.9
Real GDP growth (in percent)	6.0	3.8
Nominal interest rate (in percent) 6/	4.1	0.9
Real interest rate (in percent)	-2.2	3.8
Inflation rate (GDP deflator, in percent)	6.3	4.3
Revenue to GDP ratio	20.5	1.7

1/ Refers to general government gross debt.

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

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

4/ The exchange rate contribution is derived from the denominator in footnote 2/ as $\alpha\varepsilon(1+r)$.

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

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

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

Table 9. Chile: External Debt Sustainability Framework, 1998-2008
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
I. Baseline Medium-Term Projections											
External debt	40.0	46.8	48.7	55.7	60.8	60.5	57.9	56.0	54.8	54.1	53.8
Change in external debt	7.6	6.8	1.9	7.0	5.1	-0.3	-2.7	-1.9	-1.2	-0.7	-0.3
Identified external debt-creating flows (4+8+11)	5.5	0.1	-0.8	6.9	7.9	1.2	-3.7	-4.3	-3.5	-2.7	-2.1
Current account deficit, excluding interest payments	3.1	-2.5	-1.7	-1.0	-1.6	-0.9	-1.4	-2.5	-2.1	-1.7	-1.3
Deficit in balance of goods and services	3.1	-2.3	-2.0	-1.7	-2.3	-2.3	-2.3	-2.5	-2.0	-1.5	-1.2
Exports	25.6	28.8	31.1	33.1	33.6	35.1	36.1	36.2	35.8	35.3	34.8
Imports	28.7	26.5	29.1	31.4	31.2	32.8	33.8	33.7	33.8	33.8	33.6
Net non-debt creating capital inflows (negative)	-0.9	-3.0	-0.2	0.5	5.6	3.1	0.5	-0.8	-0.8	-0.8	-0.7
Net foreign direct investment, equity	4.0	8.5	-0.5	4.5	1.7	1.2	2.1	2.0	1.9	1.8	1.7
Net portfolio investment,equity	-3.1	-5.5	0.7	-5.0	-7.3	-4.3	-2.6	-1.2	-1.1	-1.0	-1.0
Automatic debt dynamics 1/	3.2	5.5	1.2	7.4	3.8	-1.0	-2.8	-1.0	-0.5	-0.2	-0.1
Contribution from nominal interest rate	1.9	2.1	2.5	2.5	2.3	1.7	2.5	3.8	3.8	3.8	3.7
Contribution from real GDP growth	-1.1	0.4	-2.0	-1.5	-1.2	-1.9	-2.5	-2.8	-2.8	-2.5	-2.4
Contribution from price and exchange rate changes 2/	2.4	3.0	0.7	6.4	2.8	-0.8	-2.9	-2.1	-1.5	-1.5	-1.4
Residual, incl. change in gross foreign assets (2-3)	2.1	6.8	2.7	0.1	-2.8	-1.5	1.0	2.4	2.3	2.1	1.9
External debt-to-exports ratio (in percent)	156.3	162.5	156.6	168.5	181.1	172.4	160.4	154.5	153.0	153.5	154.8
Gross external financing need (in billions of U.S. dollars) 3/	7.6	4.9	5.8	8.0	8.4	8.0	6.6	8.4	9.1	8.9	9.6
in percent of GDP	9.6	6.7	7.7	11.7	12.6	11.5	8.6	10.0	10.1	9.1	9.1
Key Macroeconomic and External Assumptions											
Real GDP growth (in percent)	3.2	-1.0	4.4	2.8	2.2	3.3	4.5	5.2	5.5	5.0	4.8
Exchange rate appreciation (US dollar value of local currency, change in percent)	-8.7	-9.5	-5.6	-15.0	-7.8	-2.9	1.3	0.0	0.0	0.0	0.0
GDP deflator in US dollars (change in percent)	-6.9	-7.1	-1.5	-11.5	-4.7	1.4	5.0	3.7	2.8	2.7	2.7
Nominal external interest rate (in percent)	5.6	4.8	5.5	4.8	4.0	3.0	4.6	7.2	7.4	7.4	7.4
Growth of exports (US dollar terms, in percent)	-6.8	3.7	10.7	-3.1	-1.2	9.6	12.6	9.6	7.2	6.2	6.1
Growth of imports (US dollar terms, in percent)	-2.4	-15.0	12.8	-1.8	-3.2	10.1	12.8	9.0	8.7	7.8	7.0
II. Stress Tests for External Debt Ratio											
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, at	40.0	46.8	48.7	55.7	60.8	56.3	54.2	53.6	52.9	51.9	50.8
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004					60.8	63.6	63.0	61.0	59.7	59.0	58.8
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004					60.8	63.8	65.0	63.2	62.1	61.5	61.4
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004					60.8	67.1	73.9	72.2	71.2	70.8	70.8
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004					60.8	66.1	69.3	67.2	65.9	65.1	64.9
6. Combination of 2-5 using one standard deviation shocks					60.8	73.6	88.4	85.7	84.0	83.1	82.7
7. One time 20 percent nominal depreciation in 2003					60.8	73.7	70.8	69.0	68.0	67.5	67.4

Historical Statistics for Key Variables (past 10 years)	Historical Average	Standard Deviation	Average 2003-08
Current account deficit, excluding interest payments	0.5	2.1	-1.6
Net non-debt creating capital inflows	2.4	2.2	-0.1
Nominal external interest rate (in percent)	6.1	1.1	6.2
Real GDP growth (in percent)	5.9	3.9	4.7
GDP deflator in US dollars (change in percent)	2.3	10.0	3.1

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

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

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

Statement by the IMF Staff Representative
August 18, 2003

This statement updates information presented in the staff report. This additional information does not modify the thrust of the staff appraisal.

1. **Recent economic information has been consistent with the staff's projections for output, inflation and the external accounts:**

- **Economic activity.** The latest monthly index of economic activity showed an increase of 2½ percent in May 2003 (year-on-year). For January-May 2003, this index was 3.2 percent higher than for the same period in 2002.
- **Unemployment.** In the second quarter, the unemployment rate was steady at 8.6 percent seasonally-adjusted; employment was 3.9 percent higher (year-on-year).
- **Primary exports and imports.** Upward revisions to the outlook for both copper export and oil import prices this year are expected to increase the values of exports and imports by broadly similar amounts. Exports and imports have shown steady growth in the first seven months of the year, increasing by 9.8 and 12.6 percent (year-over-year), respectively.
- **CPI Inflation.** The 12–month inflation rate fell back to the middle of the target band in July, at 3.1 percent, the core inflation measure fell to 2.5 percent. Monthly inflation for the last four months has been zero or slightly negative, countering the sizable March increase of 1.2 percent.

2. **Financial market conditions remain stable, with the most notable development being the strong advance of the stock market:**

- **Stock market.** The stock index is up almost 10 percent in the last month (more than 35 percent since end–2002).
- **Exchange rate.** The nominal exchange rate remains steady, at about 700–710 pesos per dollar, where it has been for the last several months.
- **Country risk.** The sovereign spread continues to be stable, at around 125 basis points.
- **Banking.** A license to open a bank was granted to a large retail company. Retailers have recently entered the banking industry, aiming to capitalize on their experience with the consumer sector. Such entry is expected to increase banking competition.

3. **Recent policy developments include the following:**

- **Monetary policy.** The central bank decided to maintain its policy interest rate at 2.75 percent at its August 12 meeting. The bank noted lower-than-expected economic growth in the second quarter, reflecting higher oil prices and regional factors that affected some manufactures. The bank continues to expect a pickup in the economic recovery in the second half of the year, supported by the current monetary policy stimulus and stronger growth in Asia and the United States.

- **Free trade agreement.** The United States-Chile trade agreement was approved by the U.S. Congress on July 31, and Chile's congress has begun reviewing it. The trade agreement is expected to be approved promptly and to take effect on January 1, 2004.
- **Labor market.** As part of a government initiative to ensure the protection of workers' rights, the administration submitted to the congress a law that would increase the number of labor courts, move compensation disputes to separate courts, and lower paperwork requirements. Despite these efforts, the Chilean Workers Union called a one-day nationwide strike (the first since 1986) for August 13 to protest the minimum wage and to demand equal input in the design of labor policies. However, workers' participation in the strike seems to have been limited.

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

IMF Concludes 2003 Article IV Consultation with Chile

On August 18, 2003, the Executive Board concluded the Article IV consultation with Chile.[1]

Background

Chile's sound policy framework and strong fundamentals have shielded the country from the regional financial crisis and permitted continued, though moderate, growth. The pace of Chilean growth has largely followed that of the global economy, as Chile has successfully resisted contagion from neighboring countries' difficulties. In the context of inflation targeting, monetary policy has played an important countercyclical role, while the government's fiscal structural balance rule has allowed automatic stabilizers to operate.

Economic activity has turned up since mid–2002, with a recovery of domestic demand prompted by lower interest rates, better terms of trade, and improved consumer confidence as employment picked up after several years of stagnation. The unemployment rate remains elevated, however, and is declining only slowly from its 1999 peak. Given a still sizable output gap, inflation has stayed inside the 2–4 percent target band, with very brief exceptions, and indicators of inflation expectations confirm the credibility of the inflation targeting framework.

Monetary and fiscal policies have followed their rules-based frameworks. The central bank has maintained the accommodative stance it adopted during the first part of 2002. The low policy interest rate has kept inflation from dropping below the target band, as it was successfully transmitted to commercial rates, fueling a recovery of consumer credit and mortgage activity. The

[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.

Chilean peso fluctuated considerably in 2002, reflecting turbulence in the region. At the height of market concern about Brazil last October, the central bank announced a temporary window of potential exchange market intervention; in the event, intervention was less than the announced limits. Fiscal policy continued to aim at a structural surplus of 1 percent of GDP, which, in the context of a sizeable output gap, allowed for a modest widening of the actual deficit (to around 1½ percent of GDP).

For 2003 and 2004, recovery is expected to gather momentum as slack capacity is taken up, while inflation remains close to 3 percent. Over the medium term, potential output growth should gradually increase on account of both higher capital accumulation and productivity growth, on the basis of recent and planned reforms. As demand recovers, the modest current account deficit will widen, but only slowly, since the terms of trade are expected to improve. As both output and copper export prices recover over the medium term, the actual government balance is projected to converge to the structural balance target.

The authorities have made progress in implementing the Pro-Growth Agenda formulated early last year. Further reform efforts have focused on ambitious measures to modernize the public administration, increase monetary and fiscal policies transparency, and reinforce the financial system. Chile also has concluded negotiations for free-trade agreements with South Korea and the United States, and such an agreement with the European Union is now in force.

Executive Board Assessment

Executive Directors commended the Chilean authorities for implementing a sound policy framework, based on inflation targeting, exchange rate flexibility, and a prudent target for the structural fiscal balance. They considered that these policies, in conjunction with other strong fundamentals, such as transparent institutions, an open trade regime, and sound banking and financial regulatory systems, have allowed Chile continued stability and economic growth in 2002.

Directors recognized that Chile's inflation targeting framework has successfully anchored inflation expectations and increased the economy's resilience to external shocks while maintaining price stability. They supported the current accommodative monetary stance, in light of the still tentative recovery in Chile and the global economy, and advised the authorities to stand ready to adjust the monetary policy stance in either direction in order to keep inflation inside its target band. They commended recent initiatives to strengthen monetary policy transparency and supported the authorities' interest in recapitalizing the central bank, which would further consolidate confidence in the independence of monetary policy and allow for a better understanding of the authorities' fiscal policy rule.

Directors observed that the floating exchange rate regime has helped the economy adjust smoothly to adverse shocks. They noted that the peso had remained flexible even throughout an episode of exceptional volatility in late 2002, during which the central bank chose to intervene in the markets.

Directors supported the central bank's decision to deepen the market for peso-denominated debt, though they suggested a cautious approach to issuing dollar-indexed debt and continuing to avoid issuing such debt at short maturities. Some Directors urged the inclusion of collective action clauses in future external debt issues, stressing the positive signal that such action would transmit to other emerging market economies, given Chile's strong position in international financial markets.

Directors underscored the importance of sustained fiscal discipline and supported the government's commitment to meeting its structural surplus target of 1 percent of GDP, consistent in the current environment with a small actual deficit. They viewed recent actions to raise taxes and lower expenditure as appropriate to achieve the fiscal objective, and in particular endorsed the recent VAT rate increase as a means to replace the tariff revenue forgone through recent trade agreements and finance additional outlays associated with social programs.

Directors noted that the structural balance rule had improved the credibility of the fiscal policy framework and the effectiveness of monetary policy. Looking forward, they agreed that reinforcing the public consensus regarding the need for the structural balance rule would be essential to sustaining it. Several Directors encouraged the authorities to consider formalizing elements of the structural balance target, including its level or procedures for measuring the balance, though others thought that greater formalization would be unnecessarily constraining.

Directors commended the authorities for the transparency of fiscal policies, as documented in the recent fiscal ROSC. They welcomed the authorities' plan to further improve transparency by presenting information on off-budget expenditures, contingent liabilities, and public-private partnerships, as well as reformulating the fiscal statistics using the 2001 Government Finance Statistics standards.

Directors endorsed the broad set of public sector reforms taken this year, including those to rationalize remuneration in the civil service, place limits on and increase the control of campaign finance, and increase the transparency of procurement procedures. They considered these reforms an appropriate response to weaknesses that had recently come to light in public governance, and urged the authorities to remain vigilant in monitoring their effectiveness. They also welcomed the authorities' efforts to improve the financial regulatory framework through legislation submitted to congress that would strengthen bank regulatory controls, exchange of information among supervisory agencies, and modernize financial transactions, and supported the authorities' intention to participate in an FSAP later this year. They commended Chile's continued efforts to combat money laundering and the financing of terrorism.

Directors considered the sizable external debt and refinancing needs of the corporate sector one possible source of vulnerability, but recognized that the central bank's liquid international reserves and the corporate sector's significant foreign assets offered assurance against instability in financial markets. A few Directors suggested that the global economic slowdown and the volatility of international capital flows was having a serious effect on Chile's well-managed economy, reinforcing the importance of greater surveillance of advanced economies.

Directors highlighted that the main challenge for Chile is to return to higher, sustained growth and to reduce unemployment. They emphasized the importance of enhancing progress to date in addressing constraints to growth and investment through regulatory, capital market, and social sector reforms, including those in the Pro-Growth Agenda. In this regard, they noted the importance of proposed steps to broaden capital market access and promote financial stability, including measures to promote venture capital, reduce transactions costs, and improve corporate governance.

Directors also noted that recent trade agreements, including with some of Chile's largest partners, should enhance growth prospects. They considered that Chile's endowment of natural resources would best serve the process of economic development when combined with a further enhancement of human capital. Though encouraged by recent growth of employment, they urged the authorities to move ahead on their commitment to make work schedules more flexible, and to consider other steps, such as introducing a more differentiated minimum wage structure, that would lower unemployment.

Directors recognized that the data received by the Fund are of good quality, timely, and adequate for surveillance purposes. They welcomed that most of the data shortcomings identified in previous consultations have been addressed.

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.

Chile: Selected Economic Indicators

	1998	1999	2000	2001	2002	Proj. 2003
Real economy (annual percentage change) 1/						
Real GDP growth	3.2	-0.8	4.2	3.1	2.1	3.3
Unemployment (in percent)	6.2	9.7	9.2	9.1	8.9	...
Change in consumer prices (end of period)	4.7	2.3	4.5	2.6	2.8	3.3
Money and credit (year-end percentage change) 1/						
Broad money (M3)	8.4	6.0	4.7	2.9	-0.5	8.7
Bank credit to the private sector	11.2	3.0	10.7	6.7	5.1	8.3
Three-month interest rate 2/	16.4	10.7	10.8	7.2	3.9	...
External sector (in percent of GDP) 1/						
Trade balance	-2.6	3.3	2.8	3.0	3.8	4.0
Current account balance	-4.9	0.1	-1.0	-1.7	-0.8	-0.9
Capital account balance 3/	2.2	-1.1	1.5	0.9	1.1	1.1
Overall balance of payments	-2.8	-1.0	0.4	-0.9	0.3	0.2
Gross official reserves (in percent of short-term external debt) 4/	385.2	367.8	229.7	214.8	180.1	210.7
External debt 5/	40.0	46.8	48.7	55.7	60.8	60.5
Real effective exchange rate (in percent change) 6/	-6.1	-6.2	2.5	-9.5	-6.4	...
Terms of trade (annual percentage change)	-4.7	5.9	4.8	-7.9	1.9	2.5
Copper price (U.S. cents per pound)	75.0	71.3	82.2	71.7	70.8	74.9
Public finances (in percent of GDP)						
Central government balance	-0.1	-2.1	-0.8	-0.9	-1.4	-1.2
State-owned enterprise balance	-1.0	-0.2	-0.8	-0.4	-0.9	-1.0
Central bank balance (cash basis)	-1.0	-1.1	-0.9	-0.8	-1.1	-0.9
Memorandum items:						
Central government balance (official presentation) 7/	0.4	-1.4	0.1	-0.3	-0.8	-0.9
Structural balance (official presentation)	0.1	-0.8	0.1	0.9	0.7	0.8

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 do not include 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, Executive Director for Chile
August 18, 2003

Key points

- *The core message of these excellent reports is that Chile is among the most solid emerging market economies, distinguished by its sound macroeconomic policy framework and strong institutions that have allowed growth to exceed the regional average, yet considerably below the rapid expansion rates of the previous decade.*

- *Growth in 2004 and beyond should pick up as global conditions improve, although economic prospects on how long it will take to close the still sizable output gap remain uncertain.*

- *The structural fiscal surplus kept at one percent of GDP allows the automatic stabilizers to operate fully, and together with the anchoring of inflationary expectations and the floating exchange rate, have made room for a significant monetary stimulus.*

- *The open trade strategy, including Chile's recent trade agreements, and the continuous diversification of the natural resource dominated export base, are the cornerstone of Chile's development strategy, just as education and effective social policies are key complements for its success.*

- *Despite episodes of international financial turmoil and the global growth slowdown, Chile's international investment position has improved since 1997. Over the last year, sovereign and corporate spreads have continued to narrow.*

- *Several measures were taken to enhance transparency and accountability aimed at improving the country's macroeconomic policy framework, and in response to corruption scandals and financial fraud involving private firms and public institutions.*

- *The banking system has high capitalization, healthy profitability, low credit risk, and adequate provisioning. The results of stress testing exercises suggest that capital adequacy requirements continue to be fulfilled even under sizable shocks and unlikely scenarios.*

1. My Chilean authorities express their sincere appreciation to the staff for their efforts and insights during the very useful policy discussions and for the excellent set of reports. At the outset, I would like to report my authorities' consent to the Fund's publication of these documents. The core message of these reports is that Chile is among the most solid emerging market economies, distinguished by its sound macroeconomic framework and high level of fiscal transparency, and its serious commitment to pursue structural reforms while preserving

macroeconomic stability. Chile's strength is a compound of several elements: a consistent macroeconomic policy framework, a very open trade regime, sound institutional arrangements, a robust and stable financial sector, and a solid aggregate external position. All of these elements play important roles in Chile's development strategy, which has already substantially increased real *per capita* income and significantly improved the economy's resiliency to external shocks. Some uncertainties remain concerning the Chilean economy's short-term prospects, but given the strength of its policy framework and institutional arrangements, Chile is very well positioned to return to faster growth in the medium-term.

Background and Recent Developments

2. Slow positive growth has characterized Chile's economy in recent years, and the continued delay of the expected return to the higher growth rates closer to those of the 1990s is mostly due to unfavorable external conditions. After the slowdown of 2001, Chile's growth rate began to accelerate in the second half of 2002, but has failed to gather the expected momentum. Given the heterogeneity of the signals coming from sectoral and domestic and external demand indicators, it is difficult at this stage to predict how long it will take to close the still sizable output gap. A look at the components of aggregate demand shows consumption playing a major role in the growth upturn of the last three quarters, while fixed capital investment and real exports have yet to show a significant sustained impulse. A pick-up of domestic spending might be encouraged by the improvement of the terms of trade, which have been showing signs of an incipient recovery, albeit from very low levels. The official forecast is for moderate growth of 3 to 4 percent this year, accelerating to over 4 percent in 2004.

3. Strong fundamentals, gradually built up by means of sustained economic reforms and a sound macroeconomic framework, have improved the Chilean economy's resilience to adverse shocks. But even Chile's strong fundamentals cannot be expected to insulate this very open and financially integrated small economy from events occurring in the world economy. The staff has stressed the effects of unfavorable regional conditions on the dynamism of Chile's domestic economy. Nonetheless, Chile's strong fundamentals and the diversification of its export markets have cushioned these regional effects, *inter alia* by redirecting Chilean exports to markets outside the region. Nevertheless, the effects of the tepid recovery of global trade and economic activity after the downturn in 2001 on Chile's terms of trade and foreign financing cannot be easily offset. It is estimated that the value of exports in 2002 would have been 30% higher had the 1998 export prices prevailed. Clearly, these elements far outweigh the regional shocks as a factor constraining the recovery of domestic economic growth.

4. Against this background, the dynamic behavior of Chilean employment during the first half of 2003 has been a bright spot, even though the decline in the unemployment rate has been mostly offset so far by an elastic response of the labor force to new employment opportunities. The dynamism in employment has not been transmitted to wages or prices. The nominal increase in wages has considerably softened while inflationary pressures remain subdued, as shown by the latest monthly CPI inflation rate (-0.1 percent in July) and by the 12-month core inflation rate's decline to 2.5 percent, below the mid-point of the target range. A significant amount of productive capacity remains unused, making the accommodative stance of monetary

policy appropriate at the present juncture, as it was recently confirmed by the Central Bank's board.

Macroeconomic Framework

5. My authorities emphasized that a key element of Chile's economic success is the internal consistency among its economic policies. Monetary policy set by an independent Central Bank is focused on attaining a symmetric inflation target within a 2 percentage point wide band centered on 3 percent. This policy enjoys strong credibility, as shown by the alignment in the middle of the target band of several estimates of inflationary expectations. A free-floating exchange rate, with intervention limited to exceptional circumstances, gives monetary policy ample room for maneuver. In this case, the credibility of the inflation target plays a key role, limiting the exchange rate pass through and eliminating concerns related to the "fear of floating." Given the importance of preserving the strong credibility of monetary policy, my authorities sympathize with the staff's suggestion about recapitalizing the Central Bank, at the same time underlining that current conditions have not dampened public confidence in the independence of the monetary institution and its ability to fulfill its tasks.

6. The Chilean inflation targeting framework has taken a more technically advanced form in recent years, once inflation was brought down to a rate comparable to that of developed countries and the *peso* was allowed to float. Inflationary uncertainty in the early 1990s was much more prominent in limiting the forecasting horizon, and the newly independent Central Bank had to build its credibility on the basis of fulfilling successive annual inflation targets, while strengthening domestic capital and financial markets, opening the capital account, and slowly liberalizing the exchange rate system. There were also disinflation opportunities that the Central Bank was able to use advantageously. As international experience demonstrates, the path to a freely floating exchange rate that allows the development of a totally independent monetary policy is fraught with difficulties not easy to avoid.

7. The government is committed to an intertemporal fiscal policy target, in the form of a structural surplus equivalent to 1 percent of GDP, and in fact the structural fiscal balance has steadied around this target. The authorities' commitment to the fiscal target is reflected in the recently approved 1 percent increase in the VAT, to offset the increased spending caused by new social programs and by some structural reductions in tax revenues resulting from recent and prospective trade agreements.

8. One of the most important features of the structural balance rule (SB rule) is that it imposes fiscal discipline at every stage of the business cycle, even during upturns, when more simple rules fail. This avoids pro-cyclical policies and allows automatic stabilizers to operate throughout the cycle. The staff has noted that while keeping fiscal policy from becoming pro-cyclical, the SB rule has a rather limited direct countercyclical effect. Indirectly, however, the solid public sector financial position resulting from low levels of net public debt, and the fiscal rule and its credibility, reduce external financing costs and create substantial room for the operation of a countercyclical monetary policy. This, together with the highly credible

monetary policy and the floating exchange rate, has made possible the significant monetary stimulus that is currently in place.

9. Chile is one of the few emerging markets economies that can count with countercyclical macroeconomic policies that contribute to stabilize economic activity. This additional room for policy maneuver has been earned by building-up credibility through the consistent implementation of sound policies, but still subject to a delicate balance, given the constraints imposed by volatile external financing conditions. Therefore, the political pressures to intensify the use of macroeconomic policy for speeding up the recovery even at the cost of missing targets and commitments should continue to be resisted, considering that over stretching counter-cyclical policies entail the risk of a capital account shock that could wipe-off the room for policy maneuvering.

Trade Regime

10. Chile's open trade regime is the cornerstone of its development strategy. It is based on a unilateral trade liberalization process that by January 2003 reduced the uniform tariff rate to 6 percent and was complemented by a policy of "open regionalism" which seeks bilateral or multilateral free trade agreements with all its trading partners. Several significant agreements were reached since the last Article IV consultation, with the European Union, the Republic of Korea, EFTA, and most recently with the United States, complementing other agreements already in place, mostly with countries in the Western Hemisphere. My authorities are convinced that this incremental openness to trade creates significant opportunities for export development and will result in a sizable increase in Chile's productive potential. Nonetheless, it is important to emphasize the rather conservative approach that was used in the medium-term growth forecasts and the output gap calculation associated to the fiscal rule, underestimating the likely direct and indirect effects of these free trade agreements on potential output.

11. As noted by the staff, the natural resource content of the Chilean export basket does not represent a barrier to long-term growth. The continuing trade diversification process and the steady increase in technological content of the export base are additional guarantees of the strategy's success. Comparative advantages are dynamic, and experience shows that Chile's sound policies and stable legal framework provide appropriate incentives to encourage development of new export sectors and for long term export growth. In addition, the initiatives contemplated under the Pro-Growth Agenda are an appropriate complement for this export-led growth strategy. In particular, the Agenda's social policies, contribute through improvements in the quality of education, and access to health services and basic social infrastructure, which also support technological innovation and assimilation that are essential for sustained export-led growth. My authorities share the staff's views that education is a key to the success of the strategy, noting that the government is working to improve the quality of education, already among the best in Latin America, to bring it closer to OECD standards. At the same time, my authorities underline the considerable advances in terms of coverage achieved by the Chilean educational system over the last few years, to the point where currently 75% of all university students come from households in which the parents do not have tertiary education. Many of the observed weaknesses in the quality of education can be attributed to the relatively recent expansions of the system's coverage.

Governance and Institutional Arrangements

12. A continuous effort to increase the transparency and accountability of macroeconomic policy has allowed reaching quite high standards on these issues, as presented in the ROSC on Fiscal Transparency included among the reports for this consultation. Recent improvements in this area include the issuing of the public debt report (on a semi-annual basis), the financial issues report presented with the Budget, additional efforts to improve the public's understanding of the SB rule, and the plans to publish fiscal data on the new GFS basis early next year. Regarding the transparency of monetary policy, the Central Bank has shortened the lag for the publication of the minutes of Monetary Policy Meetings, and the voting results of the policy decisions are immediately made public in press briefings following each meeting. The Central Bank has also reduced the lags or increased the frequency in the publication of statistics for monetary aggregates, international reserves, external trade and domestic economic activity, all of these available through electronic means.

13. Last May, the Governance Group of the World Bank Institute published its latest biannual research on Governance Indicators, in which they examine indicators for 199 countries and territories. They again ranked Chile 19th on "Control of Corruption," close to the average of OECD countries. This positive report comes at a special moment for the Chilean society, which has recently been shaken by corruption scandals involving private firms and public institutions. The Chilean authorities have taken these issues very seriously. Such cases are very rare, and the Chilean society has a low tolerance for corruption. Thus, investigations were immediately launched, and the rules and regulations were adjusted to prevent their recurrence.

14. A more important outcome of these events was to catalyze a political consensus for a series of reforms aimed at strengthening institutions and reducing the probability of recurrence of similar cases. These reforms were proposed and rapidly approved by Congress, including *inter alia* a Civil Service Regime Reform, which will reduce the number of political appointments in the public sector, from 3.500 to 400 individuals, increase the transparency of the remuneration system of the public sector, and strengthen the performance based incentive system; a Campaign Finance Reform, to increase the transparency and control of campaign financing; and a Public Procurement Reform, to increase the transparency of relations between the government and its providers of goods and services.

The Financial Sector

15. A robust and stable financial sector is another pillar of the Chilean economy. The banking system has capitalization levels well above the Basel standards, healthy rates of profitability, low credit risk, and adequate provisioning. The recent small decline in the banking system's profits is partly explained by some bank mergers, which have resulted in a one off increase in provisioning and overhead expenses; and by the cyclical position of the economy, causing a slight increase in non-performing loans to 1.9 percent of total loans. The banking system remains subject of a strong supervisory and regulatory framework, whose quality is widely acknowledged, as the staff rightly points out.

16. During last year's Article IV Consultation, Directors suggested that there was room for increased bank competition aimed at lowering interest rate spreads, particularly for small business loans. The authorities wish to report that recent evidence confirms increasing competition in various segments of the credit market, and particularly for smaller-sized loans. New banks have been entering into this business, covering specific market niches, and this trend is expected to continue in the near term. In addition, the consolidation of the successful nominalization of monetary policy has increased the transparency of the transmission of monetary policy actions to the nominal rates normally used for short-term loans to consumers and small enterprises. And finally, analyses by the staff and the Central Bank indicate that the behavior of Chilean spreads is not atypical and that market power does not seem to play a major role in the Chilean banking industry. At the same time, it appears that external conditions remain important determinants of the cost of credit in the domestic market.

17. Concerning the banking system's vulnerability to potential shocks, stress test exercises have been performed by both the staff and the Superintendence of Banks and Financial Institutions (SBIF), suggesting that capital adequacy requirements would still be met even after large and unlikely shocks. As the staff points out, perhaps the most significant new SBIF regulation is the one that allows banks to use their own portfolio risk models for loan provisioning, a change in the direction of the Basel II Committee's recommendation.

18. The liquidity squeeze created by the Corfo-Inverlink fraud case represented a real-life stress test for the banking system, as well as for the Central Bank in its role of safeguarding the stability of the payment system. According to a recent Moody's report, the banks experienced no significant indirect effects, and the Central Bank's liquidity injections were adequate, as shown by the behavior of the market interbank rate during the stress period. This shock highlighted the need to strengthen financial controls in certain institutions, as well as to pass regulations aimed at modernizing the transaction system and custodial practices.

19. My authorities also have some important advances to report in this area. The most notable is the comprehensive modernization of the payment system achieved by adopting real time gross settlement for electronic fund transfers and new regulations for netting payment systems. This system will substantially reduce the risks connected with payment systems and should go on line during the first quarter of next year. The Capital Market II reform proposal recently submitted to Congress includes a strengthening of several mechanisms for control, sanction, and coordination, in accordance with the lessons of the Corfo-Inverlink episode. The core of the Capital Market II reform proposal, however, comes from the framework provided by the Pro-Growth Agenda, which includes legal initiatives aimed at boosting the risk capital industry to support the private sector development of innovative projects. The reform proposal also includes stronger mechanisms for voluntary savings, and improvements to the laws on corporate governance, bringing them into conformity with international standards. The proposed modifications for corporate governance will come as a complement of the 2000 law on initial public offering, aimed at protecting minority shareholders' rights.

20. The standardization of domestic public debt instruments, and the revision of norms for issuing and trading them, are aimed at increasing the liquidity of the domestic fixed-term market, and facilitating Chile's integration into the international capital markets by increasing

the participation of foreign investors in its domestic financial markets. In this connection, it is worth noting — as recognized by the staff— that Chile was already making important advances toward integration in the international capital markets during the 1990s, when capital inflow restrictions were still in place. Paradoxically, since 2001 and after the full elimination of the capital account restrictions, the pace of integration to world capital markets has slowed down, underscoring the important role played by external conditions in the process of international financial integration.

The External Position

21. The staff's assessment of Chile's external position is very comprehensive. In line with ongoing work at the Central Bank in preparation of a Financial Stability Report, it goes far beyond the required external debt sustainability analysis, by taking into account the liquidity available to deal with gross external financing requirements, and making a preliminary analysis of Chile's international investment position. The overall results underscore the strength of Chile's aggregate external position.

22. Sovereign and corporate spreads have continued to narrow, almost to record lows, in spite of the financial challenges faced by two electricity conglomerates that have restructured their liabilities. This shows markets being able to differentiate clearly between "country" risk and individual corporate problems. Thus, my authorities do not believe that these problems illustrate "the potential downside of international diversification". On the contrary, the cases of Enersis and AES Gener show that while private financial risks exist, they can be effectively dealt with by the private sector using existing institutional arrangements.

23. Despite all the turmoil in international financial markets and the slowdown in economic growth, Chile's international investment position improved since 1997 and this trend is expected to continue as the external current account deficit is projected to remain small in coming years. On private external debt and the financial needs of the private sector, it should be noted that about two-thirds of this debt is hedged, and that the external refinancing needs of the corporate sector, are seen by my authorities as a natural outcome of the strategy of financial integration to the world economy. Chile has followed a strategy of gradual openness of the capital account — which was completed in 2001— with the objective of reaping the benefits of financial integration including the consolidation of the economy's macro-financial fundamentals. This strategy has been especially cautious in controlling associated risks but as shown by the experience of small advanced economies, the increasing levels of both external assets and liabilities, *inter alia* external debt by the private sector, is inevitable as financial integration with the rest of the world advances.

24. Finally, my authorities look forward to Chile's participation in the FSAP, which is expected to begin with a mission later this year and which should conclude in time for Chile's next Article IV Consultation. They consider this a key exercise in developing an adequate diagnostics and appropriate policies directed at further strengthening Chile's financial system.