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Chile: 2005 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Chile

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with Chile, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 27, 2005, 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 13, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 29, 2005 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Chile.

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

Selected Issues Paper

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

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

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INTERNATIONAL MONETARY FUND

CHILE

Staff Report for the 2005 Article IV Consultation

Prepared by Staff Representatives for the
2005 Consultation with Chile

Approved by José Fajgenbaum and Michael Hadjimichael

July 13, 2005

- ***Discussions***. A staff team held discussions in Santiago during May 16–27, 2005. The team met with the Minister of Finance; the Minister of Economy and Energy; the Minister of Cooperation and Planning; the President of the Central Bank; other senior officials; advisors to the main presidential candidates; and representatives of the private sector and the academic community.
- ***Team.*** The staff team comprised Gilbert Terrier (Head), Christopher Faulkner-MacDonagh, Meral Karasulu (all WHD), Gustavo Adler (EP-FIN), and Oya Celasun (RES). An STA mission comprised of Ethan Weisman (Head) and Isabel Rial overlapped with the mission. José Fajgenbaum (WHD) took part in the concluding discussions. Mr. Eduardo Lopez-Escobedo, Senior Advisor to the Executive Director, attended the main meetings.
- ***Previous consultation.*** At the conclusion of the 2004 Article IV consultation, on August 4, 2004, Directors commended the Chilean authorities for their continued implementation of sound policies, centered on a prudent fiscal rule, a successful inflation targeting framework, and trade integration. They noted that these policies, together with a robust financial system, have led to sustained economic growth and have contributed to a marked reduction in poverty. Directors welcomed the authorities' public debate on policies to sustain higher rates of economic growth while reducing income inequality. Directors also welcomed the authorities' intention to follow the recommendations of the Financial System Stability Assessment to improve the efficiency of the financial system and further enhance AML/CFT legislation. The staff report was published as IMF Country Report No. 04/291.
- ***Relations with the Fund.*** Chile has accepted the obligations of Article VIII, sections 2, 3, and 4 and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. Chile subscribes to the Fund's Special Data Dissemination Standard. The FSSA including ROSCs on Monetary and Financial Policy Transparency, Banking Supervision, and Securities Regulation was published on August 18, 2004. An update to the ROSC on Fiscal Transparency is being circulated to the IMF Executive Board separately.
- ***Selected Issues Papers.*** The companion Selected Issues paper comprises four chapters: (i) Addressing the Long-Run Shortfalls of the Chilean Pension System; (ii) Experience with Public-Private Partnerships; (iii) Competition in the Banking Sector: A Cross-Country Comparison; and (iv) Perspectives on Chile's Private External Debt.

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Executive Summary

- ***Chile's adherence to a sound and consistent policy framework has helped foster macroeconomic stability and economic growth.*** In recent years, this policy framework has been based on prudent fiscal policies in the context of the structural surplus rule, a successful inflation targeting framework, and trade and financial openness.

- ***The government is firmly committed to the structural surplus rule.*** The accounts of the central government are projected to register an overall surplus of 2¼ percent of GDP in 2005, to be used mostly to prepay debt. The 2006 budget, to be approved by year-end by the current administration, will continue to abide by the fiscal rule. The authorities intend to introduce draft legislation in congress to further entrench fiscal responsibility.

- ***Inflation expectations are well anchored near the middle of the target range.*** The core inflation rate has risen in recent months, reflecting the gradual closing of the output gap and the second-round effects of higher energy prices. Headline CPI inflation is projected to be at the middle of the target range in 2005.

- ***The central bank plans to continue gradually withdrawing monetary stimulus.*** It has appropriately started to raise interest rates, and further increases will likely be needed, depending on developments in inflation and the closing of the output gap.

- ***The central bank is moving ahead with plans to reduce its yearly deficits.*** The joint retirement of dollar-linked debt and reduction in foreign reserves will go some way toward reducing the yearly deficits. The central bank and the central government are also working together toward an agreement on a methodology for the government to cover the central bank's yearly deficits.

- ***In the financial sector, progress in reforms awaits the approval of the Capital Markets Reform II draft law by Congress.*** This approval remains critical to help ensure a well-sequenced implementation of the FSAP recommendations.

- ***The authorities and staff agreed that structural policies should focus on a comprehensive approach to ensure strong and sustained medium term growth.*** This will require further increasing human capital, while simultaneously continuing to improve income distribution. Significant progress has been made toward achieving Chile's Millennium Development Goals.

- ***All the main candidates in the December 2005 presidential elections broadly support maintaining the current macroeconomic framework.*** The new government is scheduled to take office in March 2006.

I. Background

1. ***Chile's adherence to a sound and consistent policy framework over the past two decades has helped foster macroeconomic stability and poverty reduction.*** This policy framework has been based on prudent fiscal policies, a gradual move to inflation targeting, and trade openness. During the 15-year period that ended in 1997, Chile's rate of economic growth averaged 6½ percent a year, per capita income more than doubled, and poverty rates were cut in half. While economic growth slowed significantly during 1998–2003, to 2¾ percent a year on average, reflecting in part the regional financial crisis, the sharp improvement in the terms of trade that started in mid-2003 contributed to a strong economic rebound in 2004. The economic recovery has continued into 2005.

2. ***Upon taking office in 2000, the current administration introduced a key fiscal innovation—the structural surplus rule, while the central bank completed the transition to a full-fledged inflation-targeting framework***. Under the rule, fiscal policy is, for the first time, anchored to a target—a cyclically-adjusted surplus of 1 percent of GDP in the accounts of the central government. The rule has worked well, in very different macroeconomic environments, providing effective countercyclical stimulus to the economy over the cycle. The inflation targeting framework has been successful at keeping inflation low—2¾ percent a year on average during 2000–04, while allowing the peso to float freely.

3. ***Progress has been made in several areas since the last Article IV consultation, in line with the views of Executive Directors.*** The fiscal stance has remained prudent; higher revenue from the increase in copper prices has been sterilized; and the overall surplus of the government used to selectively prepay debt. Also, the proposal to introduce a royalty in the mining sector was modified and care was taken to ensure that the recently-introduced mining fee does not negatively impact foreign investment. In the financial sector area, steps have been taken to further improve risk management in the banking system and reduce risks in the insurance industry, but the recapitalization of the central bank still has not taken place. Prompt passage of the Capital Market II draft law by Congress would help ensure progress in the reforms aimed at strengthening regulation and supervision of the securities industry.

4. ***Congressional and presidential elections are scheduled for December 2005, with a new administration taking office in March 2006.*** Political consensus in Chile on the macroeconomic framework remains very strong. All the main candidates have reaffirmed their commitment to fiscal prudence, inflation targeting, and trade openness. Policies to maintain strong economic growth and further reduce income inequality are expected to dominate the political debate, with emphasis on the issues of health, education, and support to small and medium-sized enterprises.

II. Recent Developments

5. ***A strong external environment has helped spur Chile's economic growth in 2004 and early 2005 (Box 1).*** Robust growth in the global economy, including Asia—which absorbs one third of Chile's total exports, has helped boost mineral export prices, particularly copper, Chile's main export commodity.[1] During 2004 and in early 2005, Chile's year-on-year rate of economic growth has been around 6 percent, with a strong recovery in private investment, particularly in mining, telecommunication, transportation, and construction. In recent months, the recovery has also been supported by an increase in consumption, driven by improved labor market prospects and continued strength in consumer borrowing. The rebound in the terms of trade, a mining export boom (16 percent in volume terms), and a strong performance of nontraditional exports have resulted in a current account surplus of 1½ percent of GDP in 2004—an improvement of 3 percentage points from 2003.[2]

6. ***Monetary policy has remained supportive, with low pressure on inflation during most of 2004.*** The Chilean peso has continued to float freely and, reflecting the improvement in Chile's terms of trade, it has appreciated sharply against the U.S. dollar since mid-2003. This has contributed to low inflation, with the 12-month rate of increase in the CPI remaining below the 2–4 percent

Figure 1. GDP and Determinants of Growth
Contributions to Real GDP growth, by selected components

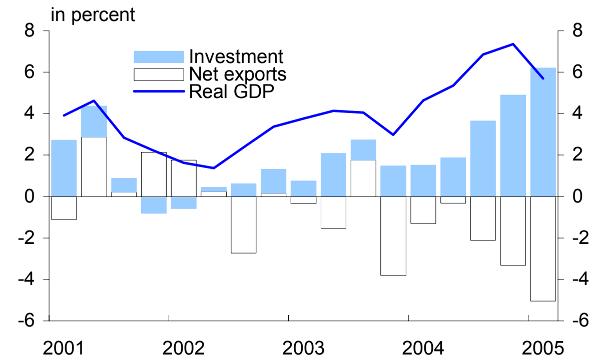


Figure 2. Unemployment Rate

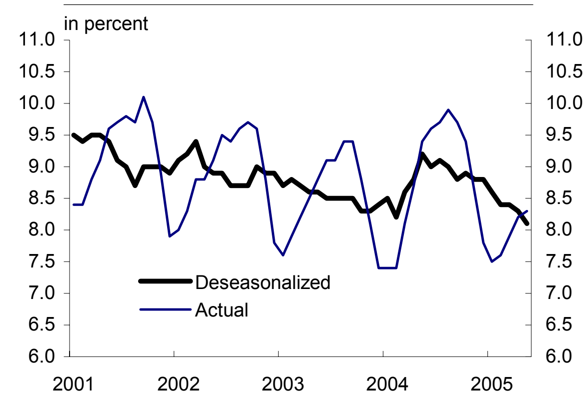
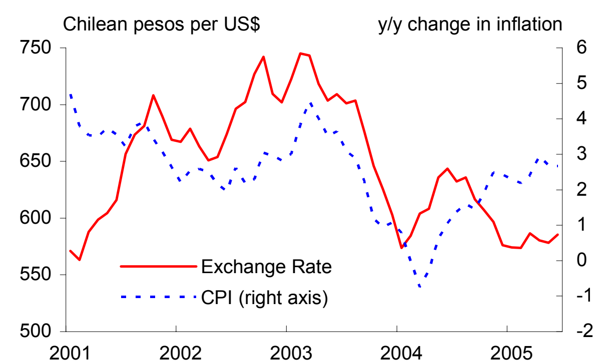


Figure 3. Exchange Rate and Inflation



[1] Chile is the world's largest copper producer, with one third of global supply. Copper accounts for 10 percent of its GDP and 35–45 percent of exports of goods.

[2] The contribution of net exports to real GDP growth in the most recent quarters has been negative, however, reflecting a sharp increase in imports in volume terms.

BOX 1. DEVELOPMENTS IN 2004 AND EARLY 2005

GDP growth. Real GDP grew by 6.1 percent in 2004. After registering a strong rise during the last quarter of 2004 (7¼ percent on a year-on-year basis), the rate of economic growth is estimated to have moderated to just over 6 percent during January–May 2005.

Inflation. The 12-month headline inflation rate was 2.4 percent in December 2004, edging up to 2.7 percent by June (with 12-month core inflation at 2.4 percent). Wage growth moderated in recent years, averaging 3½ percent in 2004, but has recently inched up slightly, to 4¾ percent in May.

Employment. Employment grew by 3.3 percent during 2004 and by 4.3 percent during the 12-month period ended in May 2005. Although strong economic growth encouraged more workers to return to the labor market, the unemployment rate has declined from 9.2 percent in May 2004 (seasonally adjusted) to 8.1 percent in May 2005.

Current account balance. Boosted by improved terms of trade, the current account registered a surplus of 1½ percent in 2004. Copper prices have hovered at around US$1.50 a pound in the first half of 2005, up from US$1.30 in 2004 and US$0.81 in 2003. Nonmining exports also performed strongly in 2004, rising by 11½ percent in volume terms.

Gross international reserves. At end-June 2005, reserves amounted to US$16¾ billion (16½ percent of GDP and over 120 percent of short-term external debt).

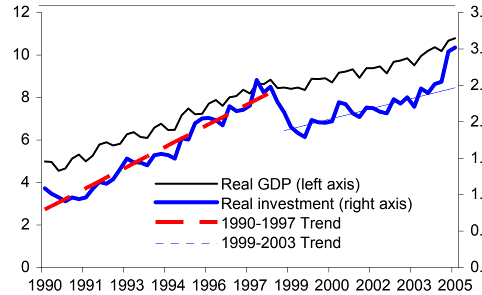
Public sector accounts. The overall balance of the central government registered a surplus of 2¼ percent of GDP in 2004. The quasi-fiscal deficit of the central bank narrowed slightly, from 0.8 percent of GDP in 2003 to 0.7 percent in 2004.

Exchange rate. During 2004, the Chilean peso appreciated against the U.S. dollar in the first half of the year, but reversed this change in the second half. So far in 2005, it has remained broadly stable.

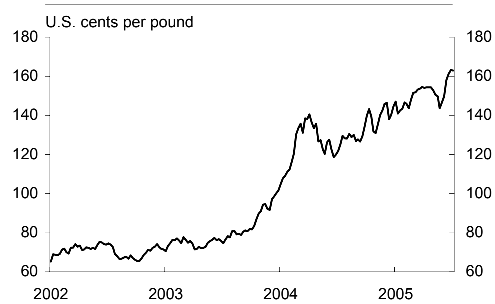
Sovereign spreads. Chile's sovereign spreads remain the lowest in the region, at 60 basis points on June 30. In March 2005, Fitch upgraded Chile's sovereign long-term foreign currency rating to A, following a similar upgrade by S&P in January 2004.

Real GDP and Real Investment

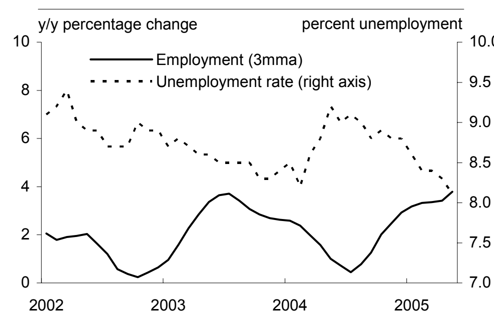
(in trillions of 1996 pesos)



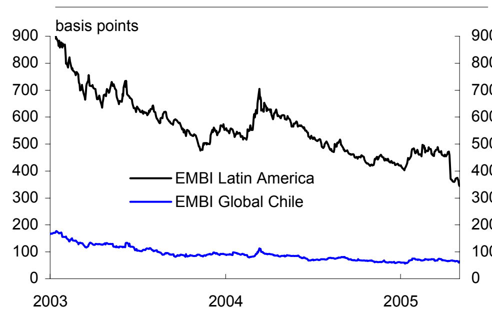
Copper Prices



Labor Market Developments



Country Risk



inflation target band of the central bank during most of 2004. In the context of a still weak economic recovery, the monetary authorities eased their policy stance in late 2003 and early 2004. Later in the year, with the economic recovery well under way and with inflation forecasts moving above the center of the target band, the central bank initiated a tightening cycle. Since September 2004, it has raised its policy rate on seven occasions, by a total of 175 basis points, to 3½ percent in mid-July 2005. Nevertheless, monetary conditions still remain supportive, with the policy rate only moderately positive in real terms.

7. ***Consistent with the structural surplus rule, the position of the central government improved sharply in 2004, and is expected to remain strong in 2005.*** The overall balance of the central government shifted from a deficit of ½ percent of GDP in 2003 to a surplus of 2¼ percent in 2004. The government used most of the surplus to prepay debt—a total of US$2 billion in 2004 and early 2005, including US$½ billion to multilaterals and US$1¼ billion on a central bank loan extended at the time of the 1980s banking crisis.

III. Report on the Discussions

8. ***Chile's return to a strong macroeconomic performance testifies to the importance of consistent policy frameworks and solid institutions.*** There was full agreement between the staff and the authorities that the overall policy framework had contributed to the return of sustained economic growth. Macroeconomic policy implementation has centered on well-established rules and institutions, reinforced in recent years by strict adherence to the structural surplus rule, the sound implementation of the inflation targeting framework, and a floating exchange rate regime. These policies, in the context of increasing trade integration and a robust financial system, have helped provide counter-cyclical stimulus to the economy while ensuring effective resilience to external shocks. There was agreement also that one of the main tasks ahead would be to continue to improve the efficiency of the economy in order to sustain high rates of economic growth and reduce poverty further.

A. Short-Term Economic Outlook

9. ***The authorities and staff concurred that the short-term outlook remained very positive.*** Sentiment in the business community was generally bullish, with many participants considering that the long-anticipated economic recovery was well-entrenched. The authorities estimated that, in the context of a favorable global environment, real GDP growth would be in the range of 5¼–6¼ percent in 2005

Selected Economic Indicators, 2003-2005
(in percent; unless otherwise indicated)

	2003	2004	Proj. 2005
Real GDP Growth	3.7	6.1	5½-6
CPI Inflation (end of period)	1.1	2.4	2.9
Current Account/GDP	-1.5	1.5	0.3
Reserves (US$ billions)	15.9	16.0	13.1

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

and 5½ percent in 2006—broadly in line with the staff forecast and that, on that basis, the output gap would close in 2007. They considered that the pick-up in domestic demand, particularly investment, would help support economic activity in 2005, while the impact of net foreign demand would tail off. Domestic investment was projected to rise by ½ percentage point of GDP, to 22¼ percent of GDP, while consumption would also pick up, boosted by higher incomes, an increase in employment, and strong consumer lending. A possible source of weakness was a build-up in inventories observed over the preceding three quarters, which could signal a somewhat weaker-than-anticipated growth in domestic demand in the second half of this year.

10. ***There was agreement also that, although some external risks could weigh negatively on growth, these were limited in 2005.*** There was the risk that high oil prices could lead to a slowdown in global demand and in Chilean exports. Existing global imbalances could also lead to disorderly adjustments that would affect negatively the world economy. However, in the short run, strong copper demand from Asia was likely to keep prices at a high level, or perhaps even higher than projected at the time of the mission.[3] The authorities thought that the risks from regional political or economic instability would pose few difficulties, as past experience had shown that Chile was able to attract foreign investment even when unfavorable sentiment prevailed in some countries of the region.

11. ***A source of concern was the supply of regional gas, including from Argentina.*** During the first five months of 2005, actual exports of gas from Argentina to Chile fell to about 75 percent of contractual levels, with significant and unpredictable daily variations. However, the authorities noted that about three fourths of Chilean firms that use gas in the production process had already converted their plants to use alternative sources of energy when needed. In addition, new hydroelectric plants have come into production or are under construction. Therefore, the direct impact of gas cuts on domestic output was expected to be small—amounting at most to ¼ percent of GDP in 2005. However, there were also indirect effects on production costs in the economy, associated with the shift from gas to more costly alternatives.

12. ***Chile has built important safeguards against potential vulnerabilities.*** Total public debt (including central bank debt) has declined from 41½ percent of GDP in 2001 to 35 percent in 2004, and public external debt has dropped to about 10 percent. Private external debt has also fallen significantly as a share of GDP in recent years, from about 48 percent in 2001–02 to 36 percent at end-2004.[4] Although external debt is mostly denominated in foreign currencies, net exposures to exchange rate fluctuations remain limited, with about 40 percent of private external debt originating in the tradable good

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[3] Copper prices have further increased in recent weeks, from US$1.45 a pound in late May to around US$1.65 a pound in late June, with world copper inventories reportedly at a 31-year low.

[4] An accompanying *Selected Issues Paper* analyzes the private external debt position from an international perspective.

sectors. Moreover, in the nontradable good sectors, financial hedging against currency risks has increased in recent years and is available at relatively moderate costs. The central bank has built important buffers against external risks, with gross official reserves amounting to US$16 billion at end-2004, equivalent to 17 percent of GDP and covering more than 110 percent of debt maturing during the year.

B. Fiscal Policy under the Structural Surplus Rule

13. ***The authorities and staff agreed that the structural rule, in place since 2000, has served Chile well.*** The rule aims at maintaining a cyclically-adjusted surplus of 1 percent of GDP in the accounts of the central government. Under the rule, the government saves all copper revenues from the state copper company CODELCO above a long-term reference price for copper. Other central government revenue is smoothed over the business cycle, using an estimate of potential output. With the help of two independent panels of experts, the government estimates structural revenue adjusted for the long-term price of copper and potential GDP (Box 2). Central government expenditures are set in the budget law, so that the difference between *structural* revenue and *actual* expenditure is equal to 1 percent of GDP.

BOX 2: THE ROLE OF THE TWO INDEPENDENT PANELS OF EXPERTS

- ***Composition.*** Each year, the Finance Ministry assembles two independent panels of experts. Each panel is composed of 12–14 members who are widely regarded as experts in their fields. The Finance Ministry has been careful to ensure that the panels have a balanced representation, particularly the potential output panel, where there is generally a wide dispersion of views.

- ***Consultation.*** The panels are consulted each year prior to the preparation of the budget. To ensure transparency, the information requested from the panels is specific, and all information is published on the website of the Budget Office immediately after the panels have met.

- ***Copper price panel.*** The Finance Ministry asks this panel to provide a ten-year forecast of copper prices, and the reference price is set as the arithmetic average of the forecasts (excluding two most extreme estimates). For 2005, the long-term reference copper price was set at US$0.93 a pound.

- ***Potential output panel.*** From the panel, the ministry requests growth forecasts of: (i) labor force; (ii) real investment; and (iii) total factor productivity. Officials compute an average of these forecasts (excluding the two most extreme values) and use them to estimate the output gap from a production function. At the suggestion of the expert panel, officials have made successive improvements to the production function estimates.

14. ***The structural surplus rule constitutes a useful tool for policy making in terms of budget preparation, benchmark for spending and revenue targets, and transparency (Box 3).*** In recent years, this rule has served as the primary pillar of fiscal policy. The rule allows the government to run deficits when economic growth is below trend—during 2000-03, the deficit averaged ⅔ percent of GDP a year—and to accumulate surpluses when the external environment is favorable and economic growth strong. In 2004, the central government registered an overall surplus of 2¼ percent of GDP, and it is projected to register surpluses averaging 1¾ percent of GDP in 2005–06.

BOX 3. THE FISCAL RULE, A USEFUL TOOL FOR POLICIES

- ***Budget preparation.*** At the time of the budget preparation, the rule provides useful *ex-ante* guidance for setting spending plans. Revenue projections are based on the long-run copper price and projected output levels, with reliance on the two panels of experts.
- ***Benchmark for spending and revenue targets.*** During the year, the spending target is actively used to constrain fiscal policy. In January and June, the Budget Office updates revenue and spending forecasts and, if needed, takes steps to raise revenue or cut spending.
- ***Spending adjustments***. The rule includes few adjustments, which aids in transparency but makes it stricter. For example, there are no adjustments for changes in inflation or exchange rates. However, some flexibility exists to shift the savings under one expenditure line to other lines. The rule also includes a small contingency fund (¼ percent of GDP) to expand emergency employment programs or increase capital expenditure by up to 10 percent over budgetary allocations, while remaining within the 1 percent structural surplus limit.
- ***Transparency.*** The fiscal rule has helped promote fiscal transparency and compliance with international standards. In particular, in recent years the authorities have brought greater transparency and discipline to military spending—including spending previously treated in off-budget accounts. At present, most government operations, including extra-budgetary operations, are treated according to the 2001 *Government Financial Statistics Manual*.

15. ***The authorities were planning to introduce a draft law in congress to formalize some aspects of the rule, including with respect to future pension liabilities.*** The initiative would seek the creation of two funds to be included in the structural surplus rule: (i) one to allow for employment spending during periods of high unemployment; and (ii) another one to build resources for future pension payments. Regarding future pension payments, the authorities agreed with the staff that the coverage of the pension system had fallen short of the original goals of the reform. In particular, many workers are not participating in the pension system long enough to qualify for a minimum pension.[5] As a result, they are running

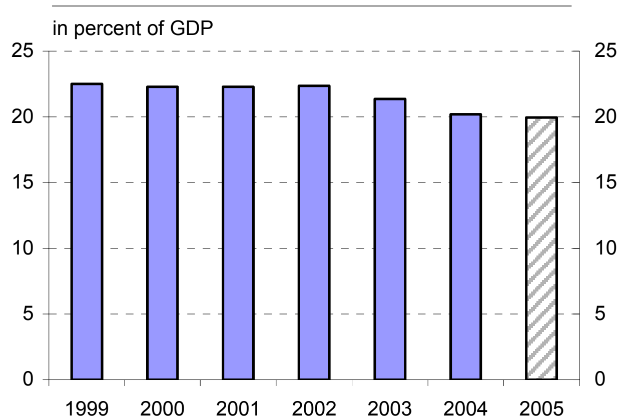
[5] See the accompanying *Selected Issues Papers* on "Addressing the Long-run Shortfalls of the Chilean Pension System". To qualify for a minimum pension, workers must contribute at least twenty years.

the risk that they will reach old age with insufficient savings to fund an adequate pension. The authorities' objective would thus be to pre-fund a government account that would gradually help mitigate the future costs of old-age programs. Staff encouraged the authorities to design this mechanism in such a way that it does not discourage workers from contributing to their own retirement accounts. The draft law would also aim at strengthening the internal audit of the government and require future governments to publish an annual estimate of the structural budget balance.

16. ***Based on their experience with the fiscal rule, the authorities thought that some adjustments could be made in the future to strengthen counter-cyclical policies.*** They noted that it was conceivable that the 1 percent of GDP level of the structural surplus could be changed at some point in the future, particularly if the definition of the fiscal accounts were to be broadened to include the quasi-fiscal deficit of the central bank. The authorities also noted that there was still a pro-cyclical bias in revenue and spending because the estimates of structural revenue used to establish the expenditure level did not seem to fully smooth out the swings in income tax and VAT collections over the business cycle. They noted that, by capturing the cyclicality of revenue better, they would be able to follow the practice in several OECD countries, under which expenditure is allowed to rise during economic downturns, in part to make room for unemployment benefit payments. Such a change would help provide an additional component to existing counter-cyclical policies. Staff also suggested that the definition of copper-related operations in the copper price adjustor could be broadened to include, inter alia, corporate tax payments by private mining companies and the proceeds from the recently-introduced fee on mining activity.[6]

17. ***Fiscal projections point to a central government surplus equivalent to 2¼ percent of GDP in 2005.***[7] Revenue projections take into account the steady increase in tax collections registered in recent months, particularly income taxes and VAT receipts, reflecting higher corporate profits, a sharp increase in domestic demand, and improvements in tax administration. As a percent of GDP, expenditure has been declining in recent years, from 22½ percent in 1999–2000 to 20¼ percent in 2004, despite increases in

Figure 4. Central Government Expenditure



[6] The law, approved by congress in May 2005, introduces a 3–5 percent fee on the operating profits of large mining companies, with expected annual proceeds of US$100–$150 million. This fee does not apply to investments undertaken under the preferential tax treatment for foreign investors (*D.L. 600*).

[7] In line with WEO projections, the staff's fiscal projections assume an average price of copper of US$1.41 a pound in 2005.

social spending averaging 4 percent a year in real terms (Figure 4). The mission took the view that, in 2005, it would be important to avoid permanent increases in spending and to keep the rate of expenditure growth to a moderate level (the budget already assumes a 5½ percent increase in expenditure in real terms). It thus strongly encouraged the authorities to save any excess tax revenue. The authorities expected the preparation of the budget for 2006 to be finalized by September, and indicated that it would be consistent with the fiscal rule, even though it would be implemented by the next administration. On the basis of projected WEO copper prices, the balance of the central government would show a surplus of around 1½ percent of GDP in 2006.

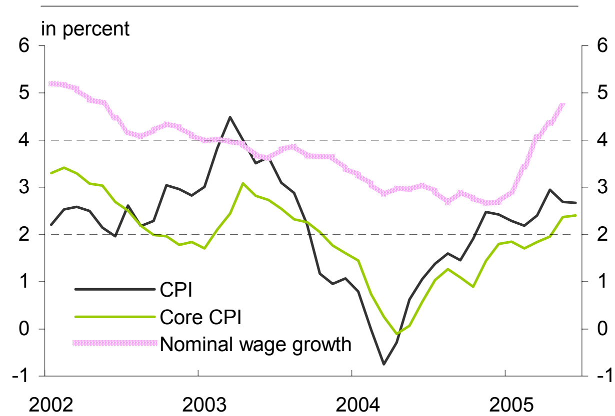
18. ***The authorities intend to use the strength of the fiscal position to consolidate their debt management strategy.*** They plan to continue using the forthcoming surpluses to retire debt and replenish the Copper Stabilization Fund (the Debt Sustainability Analysis is presented in Appendix IV). The Finance Ministry has been coordinating the issuance of new public debt with the central bank, with a view to establishing government benchmarks in the long-term segment of the market while the central bank focuses on short- and medium-term issues. During the remainder of 2005, the government does not plan to issue new bonds in the international markets, but it is considering placing a ten-year peso-denominated issue locally. It also plans to participate in the Euroclear trading system, with a view to facilitating the access of international investors to the domestic market.

C. A Sound and Credible Monetary Policy Framework

19. ***Implementation of the inflation targeting framework has been successful in reducing inflation and anchoring expectations.*** Under this framework, the central bank aims at keeping expected CPI inflation within the 2–4 percent target range over a 12-24 month horizon. Although the 12-month rate of headline inflation trailed below the lower end of the central bank's target range during most of 2004, it has returned well within the target range since end-2004. In recent months, core inflation has also returned within the target band and inflation expectations have been close to the mid-range of the target band.

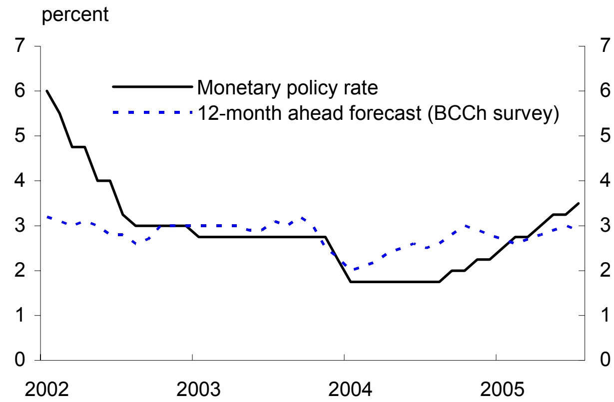
20. ***The staff enquired whether the below-target inflation outturn in 2004 reflected an undershooting bias in policy decisions.*** The authorities stressed their commitment to a symmetric treatment of the lower and upper ends of the target range and observed that, in recent years, the monetary policy response has been broadly appropriate. Specifically, they noted that, in the face of downward pressures on prices in late 2003-early 2004, the central bank had decisively cut its policy rate by a total of 100 basis points. They attributed the sharp

Figure 5. Twelve-Month CPI and Wage Increases



drop in headline inflation, below the target band during most of 2004, to the earlier appreciation of the peso, a reduction of margins in the retail sector, and a slower increase in unit labor costs. The determined cut in the policy rate had helped bring inflation within the target range, while providing support to the economy. In September 2004, when it had become clear that the inflation forecast had returned well within the target range over the 12–24 month horizon, the central bank began gradually raising its policy rate. By that time, the pick up in economic activity also justified withdrawing monetary stimulus. These actions have helped keep inflation expectations well anchored near the middle of the 2–4 percent target range.

Figure 6. Monetary Policy Rate



21. ***There was agreement that the gradual withdrawal of monetary stimulus should continue.*** The monetary authorities noted that the policy rate remained below its neutral level and indicated that they planned to continue reducing the stimulus gradually. They recognized that there was some uncertainty about the actual level of the neutral rate, but interpreted the recent increase in underlying inflation as an indication that a neutral policy stance would require further tightening. The staff noted that the still benign price pressures, firmly anchored expectations, and high credibility of the central bank suggested a measured approach to tightening, particularly given the uncertainties about the level of the neutral rate. The authorities generally agreed and stressed that the next moves in interest rates would depend on developments in inflation and the closing of the output gap.

22. ***Staff shared the central bank's view that the inflation target band of 2–4 percent remained appropriate***. Staff enquired whether the low rates of inflation registered during 2004 warranted consideration of a lower target range. Central bank officials thought that the 2-4 percent target range was appropriate for Chile, for a series of reasons. First, in emerging market countries, there tends to be a relatively high upward measurement bias in price indices because, typically, large relative price changes result in pronounced variations in the composition of the consumption baskets. Second, the target range provides a buffer for adjustments in relative prices, given the downward rigidity in nominal wages associated in part with still-widespread wage indexation. Third, setting the target at too low a level carries risks of entering into deflation. The authorities also noted that changing the target range could undermine the credibility of the central bank and weaken the nominal anchor value of the target. The staff fully agreed with the central bank that the inflation target range should be kept at the 2–4 percent level. Central bank officials are in the process of developing a full-fledged dynamic stochastic general equilibrium (DSGE) model to complement their current set of macro-econometric forecasting models. Staff welcomed the central bank's efforts

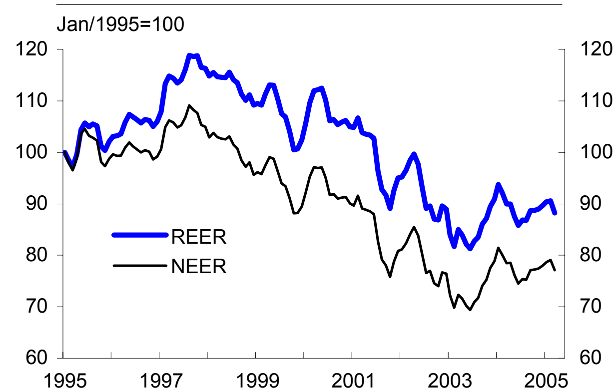
toward further enhancing its forecasting framework and, in that context, its plans to deepen its understanding of the transmission mechanism.

23. ***The central bank is moving ahead with its plan to reduce its yearly deficits***. Since November 2003, after a comprehensive evaluation of the benefits and costs of holding international liquidity, it has embarked on a program to gradually redeem its stock of dollar-denominated bonds while simultaneously reducing its stock of gross international reserves.[8] The U.S. dollar debt stock has been cut by about US$1 billion, to US$5 billion, and the central bank plans to reduce it further by US$2½ billion during the remainder of 2005. The joint retirement of dollar-linked debt and reduction in foreign reserves is projected to help narrow further the deficit of central bank to about ½ percent of GDP in 2005. The authorities were confident that the associated reduction in gross international reserves was well anticipated by the market and would therefore have no adverse impact on financial stability.

24. ***The gradual recapitalization of the central bank awaits finalization of an agreement on a new methodology with the government.*** While previously the authorities had envisaged that the government would recapitalize the central bank upfront, the government now plans to cover the central bank's yearly deficits. To this end, discussions are ongoing between the central bank and the government on a definition of these deficits and on a mechanism to compensate for them. Staff stressed that an appropriate mechanism should help ensure that the annual payments are transparently registered in the fiscal accounts and do not impair the institutional independence of the central bank while gradually helping rebuild its capital.

25. ***The authorities reiterated their commitment to a flexible exchange rate.*** They noted that, since the Chilean peso has been floating freely, it has displayed more volatility than in the past, reflecting in part developments in the external terms of trade and in the major currencies. However, the economy had adapted well to this new situation and the market for financial hedges had grown rapidly. Furthermore, upward pressures on the peso had moderated in the course of the past year, reflecting in part high public sector saving

Figure 7. International Competitiveness
Real and nominal effective exchange rate, INS



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[8] At end-June 2005, gross international reserves amounted to US$16¾ billion and central bank debt liabilities to US$21½ billion.

(effectively sterilizing part of the improvement in the terms of trade), an increase in the foreign assets of pension funds, and financial intermediaries' investments abroad to take advantage of arbitrage opportunities. In real effective terms, the peso has appreciated by about 10 percent since mid-2003, following a depreciation of close to 29 percent from early 1998 to mid-2003—suggesting that competitiveness remains appropriate. In addition, wage increases in the industrial sector have been moderate in recent years, averaging 1¼ percent a year in real terms over the past three years. In the authorities' view, a stronger increase in nominal wages in recent months and the reduction in official working hours (from 48 hours to 45 hours) that became effective in early 2005 have been accompanied by large productivity gains, leaving unit labor costs broadly unchanged. However, they recognized that the recent pick up in nominal wage increases would need to be kept under close scrutiny, to ensure that it does not lead to pressure on inflation.

D. Financial Sector Issues

26. ***The Chilean banking sector is robust, with strong profits and a low level of impaired assets.*** Capital adequacy is 13½ percent and the ratio of nonperforming loans to total loans has remained low, at 1¼ percent in May 2005, with a provisioning rate of over 160 percent. Consumer lending has begun to moderate, with the 12-month rate of growth down from 37 percent in December 2004 to 23 percent in May 2005. Despite this relatively rapid increase in consumer lending, bank supervisors were confident that the risk classification and provisioning procedures remained adequate. They also noted that the increase registered during 2004–05 was taking place after several years of virtually flat consumer lending, and from a low base. The growth of this high-margin market contributed to an increase in banks' return on equity to 19 percent in the 12-month period ended in April 2005.

27. ***Although competition in the banking sector has intensified with the entrance of niche players, staff analysis suggests that there is further room for competition in the sector***.[9] Cross-country comparisons show that the profitability of Chilean banks is above what can be explained by macroeconomic and banking sector characteristics in Chile. Although regulatory barriers to entry are low, competition from other non-bank financial intermediaries still plays a small role and the restrictions on the investments of private pension funds (the largest institutional depositors) remain in place, both of which appear to have contributed to high bank profitability.

28. ***Progress in the implementation of the 2004 FSAP recommendations awaits the approval of the Capital Market Reform II draft law by Congress.*** The FSAP stressed the need for greater competition in financial services, modernization of the securities markets infrastructure, and reforms of the segmented financial oversight organization to enhance efficiency and risk management. The recent change in regulations that allow banks and

[9] See the accompanying *Selected Issues Paper* on Competition in the Chilean Banking Sector.

corporates to trade call and put options is a further step toward implementing the FSAP recommendations. Many FSAP recommendations, including netting arrangements for derivatives, and institutionalizing the Committee of Superintendents, are to be addressed in the comprehensive Capital Markets Reform II law (CMII). However, this draft law has so far stalled in Congress, in part because of the difficulty to secure consensus on technically complex financial issues. The mission noted that prompt approval of the draft law was critical to help ensure a well-sequenced implementation of FSAP recommendations. The authorities reiterated their hope that the law could be approved in the coming months.

29. ***In the pension and insurance sectors, progress on further reforms has been limited.*** In late 2004, the authorities prepared proposals aimed at introducing more competition among private pension funds and a risk-based approach in the management of their investments. The debate on these issues is still ongoing, and the authorities noted that they needed more time to build consensus. In the insurance sector, the annuities market plays a unique role in Chile as the natural continuation of the pension fund system during retirement. To help minimize the contingent liabilities of the government associated with the guarantees that it provides on the minimum annuity performance, the mission called for vigilant supervision of the insurance market. The officials noted that the update in mortality tables to fully reflect higher life expectancies and the associated increase in provisioning requirements are expected to help reduce default risks, but that improvements to credit risk regulations were still pending.

30. ***Domestic capital market activity is buoyant, with new bond issues of US$2–3 billion a year.*** Chilean long-term interest rates are broadly in line with long-term rates in mature markets, at around 2½ percent for 10-year inflation-adjusted bonds. The market for financial hedges has grown rapidly in recent years, enhanced by an increase in the supply of foreign exchange rate hedges by pension funds.[10] To further enhance the development of the financial market, the staff suggested to gradually phase out the stamp tax and the retention tax on lending by non-residents. The authorities agreed that these taxes introduced distortions, but did not see room to reduce them in the near future because of the large associated tax collections.

31. ***In the area of AML/CFT, the Financial Intelligence Unit (FIU) became fully operational in May 2005***. In November 2004, it was accepted as an Egmont member and, in April 2005, MFD provided training to its staff. New legislation, enhancing the ability of the FIU to obtain information, is expected to be approved by Congress during 2005. GAFISUD is in the process of assessing the regulatory oversight of its members for cash remittances, and the mission encouraged the authorities to participate in this project.

[10] Pension funds are required to hedge a proportion of their assets abroad, above a certain threshold. At end-2004, about 55 percent of their assets abroad were covered by forward contracts.

E. Laying the Ground for Strong and Equitable Medium-Term Growth

32. ***The authorities and staff agreed that structural policies should focus on a comprehensive approach to medium-term growth.*** The mission noted that implementation of the government's Pro-Growth Agenda had helped deepen the reform efforts and promote total factor productivity growth. The authorities, as well as most players in the political spectrum, recognized that it would only be possible to sustain strong long-term growth by further increasing human capital, while simultaneously continuing to improve income distribution. Significant progress has been made toward achieving Chile's Millennium Development Goals (Table 9).

Income distribution, Education, and Health

33. ***Chile has significantly reduced poverty in the past two decades.*** Reflecting the impact of high economic growth and the implementation of well-targeted social programs, poverty rates have been reduced from 38½ percent in 1990 to 19 percent in 2003. The government has introduced a series of programs aimed at supporting the poor, including *Chile Solidario,* a program to support the most vulnerable groups, with transfers to beneficiaries tied to clearly articulated, step-by-step, self-help programs. The program has already incorporated about 160,000 families (the target is to reach 225,000 families) with a success rate of 70 percent in achieving individual program targets. However, income distribution remains highly concentrated. In 2003, the richest 20 percent of the population accounted for 56½ percent of all factor income received by households, or 14½ times more than the lowest quintile.[11] According to official data, this figure is reduced by about half (to 7½ times) once the value of all government transfers is accounted for.

Figure 8. Poverty Rate, 1990-2003

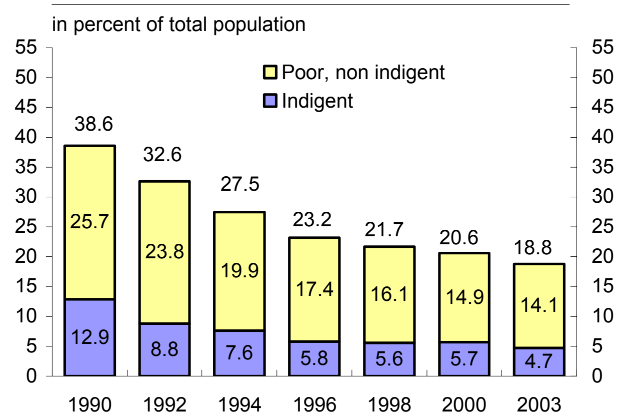
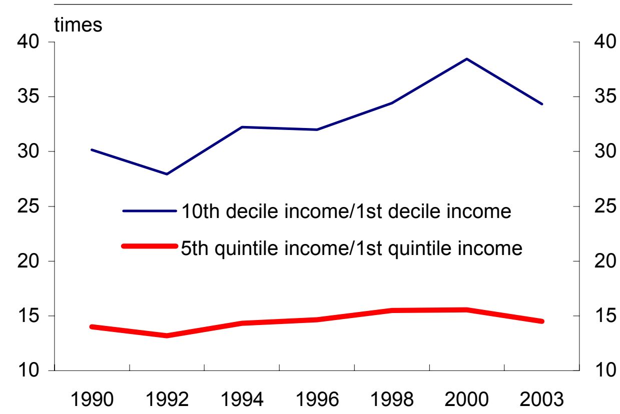


Figure 9. Income Gap, 1990-2003 1/



Source: Ministry of Planning (MIDEPLAN), Encuesta CASEN.
1/ Income gap, based on autonomous income (excludes monetary transfers), is measured as the ratio of incomes in the two groups.

34. ***The authorities underscored the***

[11] In addition, the richest 10 percent of the population earns 35 times more than the lowest decile of the population.

importance of improving education as a key step toward equitable growth, and highlighted the recent reforms in this area. The government is seeking to improve pre-school coverage for low income groups by extending the voucher subsidies to the most vulnerable 40 percent of the population in 2005. With respect to access to primary and secondary education, sizeable improvements have been made over the last decade, but the quality of education remains uneven and relatively low, as shown by international assessments of student knowledge. To give better-performing schools an incentive to take on low-income students and reduce socio-economic stratification, the government plans to substantially increase the value of vouchers for students from vulnerable groups. The authorities agreed with the staff that there was a need also to improve incentives to teachers, including by allowing greater pay differentiation according to performance. The government is taking steps to improve access to tertiary education for low income families. Although such access has improved over the last decade, only around 15 percent of students from low income families go to the university, less than half the national average. In 2005, the government introduced a new student loan program targeted at 9,000 low income students attending public and private universities.

35. ***The government is also pressing ahead with reforms in the health care sector.*** To help improve targeting and better match payments with the severity of illnesses, the government introduced the *AUGE* plan in 2001. Under this plan, the authorities provide an incentive structure to encourage doctors to treat priority diseases that have the largest impact on patients and their families. At present, 25 conditions are covered, and this number will rise gradually to 56 in 2007. Over the long-term, the reform establishes a cap on total spending, to limit pressures to expand the program. Officials forecast that, by 2007, the *AUGE* plan would cost the equivalent of ¾ percent of GDP (up from ¼ percent in 2005), but they also anticipate that some of these costs will be offset by saving from improvements in care and incentives to treat those diseases that are the most costly to society.

Business Environment, Research and Development, and Labor Markets

36. ***Chile provides a stable institutional and legal environment for business, but there is room to increase innovation efforts as a way to diversify the economy***. The authorities noted that investment in R&D is equivalent to about ½ percent of GDP, while developed countries spend over 2 percent of GDP on average (and innovative countries over 3 percent of GDP). A recent report of Congress has shown that there is little coordination between the private sector and the scientific community, research activities are generally biased toward basic research, and private sector participation in financing and conducting R&D is low.[12] Also, in comparison with other Latin American countries, Chile's share of high-technology exports as a percent of total manufacturing exports is relatively low (Figure 10). The authorities planned to send a draft law to Congress to create a special fund to finance

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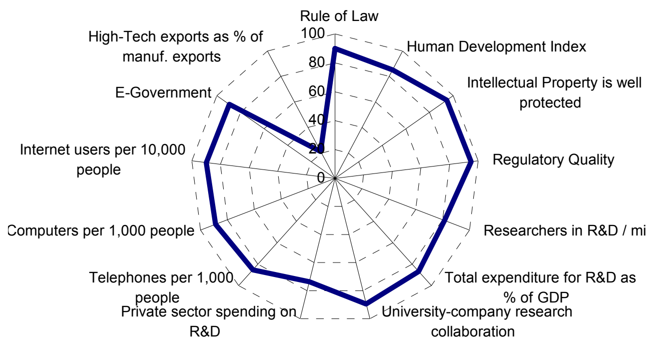
[12] "*Ciencia y Tecnologia-Indicadores de la Situacion Chilena,"* Biblioteca del Congreso Nacional de Chile, Serie Estudios, Anio XIV, Numero 304, December 2004.

innovation activities with the proceeds from the recently-introduced fee on mining activity.[13] This would increase the public resources devoted to R&D by about 50 percent. In addition, the draft law envisages the creation of a National Innovation Council, formed by the government, members of the scientific community, and the corporate sector, to design a strategy and mechanisms for allocating the resources of the fund.

Figure 10. Relative Position of Chile vs. Latin American Countries

Percentile ranking of Chile relative to other LA economies.



Source: World Bank Knowledge for Development Indicators.

37. ***The staff took the view that Chile could benefit from further standardization and streamlining of businesses procedures and a more flexible labor market.*** Administrative procedures for business creation generally remain cumbersome, particularly at the municipal level, and information about applicable regulations varies across jurisdictions and is not easily available. The authorities noted that the central government had initiated a voluntary pilot program ("*Ventanilla de Tramites Municipales*") providing technical support to municipalities to improve administrative procedures. Also, the bankruptcy law was revised in 2004 to help improve liquidation procedures and reduce liquidation costs, and the Senate is currently discussing proposals to introduce outside arbitration between firms and creditors to avoid costly liquidation processes. In the labor area, several studies have shown that Chile exhibits significant labor market inflexibility, in part as a result of still widespread practices of inflation-indexed wage contracts, binding minimum wages for low-skilled workers, high severance payments, and cumbersome rules for worker dismissal. However, the authorities were not considering any new specific initiatives in this area in the near future.

Electricity Regulation

38. ***To help address the impact of gas cuts from Argentina, the government has introduced a series of reforms aimed at securing uninterrupted energy supply in the coming years.*** Electricity tariffs for regulated consumers were increased by 12–15 percent in June 2005, following increases in generation prices (node prices) of about 30 percent. The authorities explained that a recently-approved revised energy law (*Ley Corta II*) introduces significant changes to the regulatory framework to provide incentives for investment and diversification by: (i) establishing bidding mechanisms for long-term supply contracts between electricity-generating and distributing companies that set fixed long-term prices,

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[13] To smooth out spending by the newly created fund, government transfers to this fund would be computed on the basis of long-term copper prices.

reducing uncertainty for investments in generation; (ii) excluding gas supply cuts from the conditions that can be invoked as "*force majeure*", thus providing incentives for generating companies to seek alternative sources of energy; (iii) widening the band around unregulated prices, to allow a faster reaction of regulated prices to large shocks and to increase the pass-through of generation costs, reducing risks to electricity-generating companies; and (iv) allowing the introduction of price incentives to consumers for reducing electricity consumption during peak periods.

Trade Policy

39. ***The mission commended the authorities for their continued progress toward trade liberalization.*** Beside their active participation in the Doha round, the authorities have finalized several bilateral free trade agreements (FTAs) in recent years, including with the United States, the European Union, and Korea. At end-2004, Chile's external tariff rates averaged only 2.1 percent, with half of total exports and over one third of imports realized with countries with which it had signed an FTA. In June 2004, a "trans-Pacific" trade pact was agreed upon with Singapore, New Zealand, and Brunei, which will effectively eliminate tariffs on 90 percent of the goods traded between the countries. In recent weeks, a second round of negotiations on a bilateral free-trade agreement took place with China, and a second round of negotiations is also expected to take place in the near future with India.

IV. Staff Appraisal

40. ***The Chilean authorities are to be commended for their skilled management of the economy.*** Sound macroeconomic policies have helped entrench low inflation and sustained growth, while contributing to a significant reduction in poverty, and Chile plays a regional leadership role in terms of political stability and economic reform. The authorities are taking advantage of the favorable global environment to strengthen the fiscal position and further open the economy, while gradually removing monetary stimulus. On the basis of current projections for the global economy, the Chilean outlook remains strong for 2005 and 2006, with internal demand gradually replacing the impulse from net exports.

41. ***The authorities' strict adherence to the structural surplus rule, as well as the decision to use most of the fiscal surpluses to prepay debt, are commendable.*** Staff considers that the structural surplus rule has served Chile well, and the authorities' strong commitment to the rule in times of high copper prices has helped entrench the rule further. Staff would recommend that the authorities save any tax collections in excess of budgetary projections in 2005.

42. ***In the future, it will be important to preserve the main aspects of the rule, while accumulating resources to cover future liabilities.*** Staff supports the authorities' intention to establish a fund to prepare for future social programs and encourages the authorities to design it in a way that does not deter workers from contributing to their own retirement accounts. With respect to the plans to address the yearly deficits of the central bank, it will be

important to define the coverage of these deficits appropriately, to ensure a gradual recapitalization of the bank.

43. ***With the high credibility of the central bank, Chile's inflation-targeting framework has been effective in bringing inflation down to low levels.*** In recent months, the central bank has appropriately been taking steps toward gradually removing monetary stimulus and has reaffirmed its intention to continue tightening as needed. Despite the closing of the output gap, cost pressures have generally remained limited, reflecting in part the still high unemployment rate. However, the recent increase in nominal wages will have to be kept under close scrutiny to ensure that it does not lead to pressure on inflation.

44. ***The financial sector is strong, but delays have been registered in the adoption of reforms.*** Prompt approval of the Capital Market II draft law by Congress would help make headway in several areas which are key to the further development of the financial market. It will be important also to implement the reforms needed in the areas of insurance supervision and the pension regime and, over time, to phase out the stamp and retention taxes.

45. ***Chile has taken prompt action to address the issues raised by shortages in the supply of gas.*** A revised energy law was recently approved, aimed at adjusting electricity prices, promoting a steady flow of investments into the sector, and encouraging energy savings. The staff commends the authorities and Congress for taking immediate action to adjust electricity prices and reorient electricity generation.

46. ***Chile is benefiting from its sustained emphasis on free trade.*** Tariff rates have fallen to very low levels, including with the signing of free trade agreements with the European Union, the United States, and Korea in recent years. Further steps are now being taken with several countries, including in Asia, toward new free trade agreements.

47. ***The authorities' emphasis on promoting strong medium-term growth and reducing income inequality is well advised***. The government recognizes that the synergies between income redistribution and growth are strongest in the area of education. To that effect, it is promoting pre-schooling on a universal basis, providing education subsidies to low-income households, and enhancing financing for tertiary education. The authorities' intention to increase funding for research and development is welcome, provided appropriate mechanisms are designed to ensure an efficient allocation of resources.

48. ***A still relatively high unemployment rate remains a challenge.*** In recent months, employment has grown steadily and unemployment has declined, but it remains relatively high. The authorities' programs have gone some way toward reducing unemployment, and it is expected that continued economic growth will help ensure a more pronounced reduction in the unemployment rate. Introducing more flexibility in the labor market in the medium term would be important to ensure a sustained reduction in unemployment.

49. ***Chile's medium term outlook remains favorable***. Public debt ratios are low, and private external debt has declined significantly as a share of GDP in recent years. The level of this debt does not give rise to concern because it is at relatively long terms and financial hedging is available. Maturing debt is more than covered by the stock of gross foreign reserves.

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

Table 1. Chile: Selected Economic Indicators

	2000	2001	2002	2003	2004	Projections 2005	2006
	(Annual percentage change, unless otherwise specified)						
National accounts and employment							
Real GDP	4.5	3.4	2.2	3.7	6.1	5½-6	5.5
Total domestic demand	6.0	2.4	2.4	4.8	7.9	8.9	6.2
Consumption	3.6	2.9	2.5	3.9	5.2	7.5	5.7
Investment	14.0	0.8	2.2	7.8	16.1	12.6	7.4
Fixed	8.9	4.3	1.5	5.7	12.7	11.7	10.0
Inventories 1/	1.2	-0.8	0.2	0.5	1.0	0.5	-0.5
Net exports 1/	-1.3	1.0	-0.2	-1.0	-1.8	-3.2	-1.0
Consumer prices							
End of period	4.6	2.7	2.9	1.1	2.4	2.9	3.0
Average	3.8	3.6	2.5	2.8	1.1	2.6	3.1
Unemployment rate	9.2	9.2	9.0	8.5	8.8	8.2	8.1
Employment growth (end of period)	-0.5	1.8	1.0	2.6	3.3	2.6	1.6
Money, credit, and interest rates							
Broad money 2/	5.3	4.9	3.3	2.3	11.7	...	...
Credit to the private sector	12.1	8.1	9.6	11.4	14.8	...	...
Three-month interest rate 3/	10.8	7.2	3.9	2.8	1.8	...	...
Terms of trade	5.0	-7.2	3.9	8.5	21.9	5.1	-5.5
Real effective exchange rate (EOP)	2.5	-9.5	-6.3	2.1	-1.3	...	...
	(In percent of GDP)						
External Debt and Balance of Payments							
Gross external debt	49.4	56.2	60.2	58.7	46.4	46.2	45.2
Public	8.0	8.9	10.7	12.6	10.5	9.5	9.1
Private	41.4	47.3	49.5	46.0	35.9	36.7	36.2
Current account balance	-1.2	-1.6	-0.9	-1.5	1.5	0.5	-0.7
Exports of goods and services	31.0	32.7	33.5	36.1	40.4	42.9	39.7
Imports of goods and services	-29.1	-31.2	-31.0	-32.1	-31.4	-34.9	-33.9
Net income and transfers	-3.1	-3.1	-3.4	-5.5	-7.5	-7.4	-6.5
Foreign direct investment, net	1.2	3.8	3.3	3.4	7.1	5.1	4.1
Portfolio investment, net	0.8	0.2	-3.4	-2.9	-3.6	-1.1	-1.6
Other investments, net (inc. reserve assets)	-0.8	-2.4	1.0	1.0	-4.9	-4.4	-1.8
Savings and investment							
Gross domestic investment	21.9	22.1	21.7	22.0	21.7	22.3	22.3
Public	2.7	2.6	2.6	2.3	2.1	2.3	2.2
Private	19.1	19.5	19.1	19.7	19.6	20.0	20.2
National savings	20.6	20.6	20.7	20.6	23.2	22.8	21.3
Public 4/	2.7	2.8	2.0	2.5	4.8	5.2	4.5
Private	18.0	17.8	18.7	18.0	18.4	17.7	16.8
External savings	1.2	1.5	1.0	1.4	-1.5	-0.6	1.0
Public sector finance							
Public sector net debt	10.8	10.9	11.0	13.1	11.0	8.7	8.5
Public sector gross debt	40.6	41.5	42.4	40.0	35.1	32.7	32.5
Central government gross debt	13.7	15.0	15.7	13.1	10.9	9.8	9.5
Central government balance	-0.6	-0.5	-1.2	-0.4	2.2	2.3	1.4

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

1/ Contribution to growth.
2/ Excluding time deposits of private pension funds.
3/ Nominal rates, in percent per annum, period average, on 90-day central bank promissory notes.
4/ Gross saving of the general government sector, including the deficit of the central bank.

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

						Projections 1/	
	2000	2001	2002	2003	2004	2005	2006
I. Central Government Accounts							
Overall balance	**-0.6**	**-0.5**	**-1.2**	**-0.4**	**2.2**	**2.3**	**1.4**
Total revenue	21.7	21.8	21.1	20.9	22.4	22.2	20.9
Taxes	16.5	16.6	16.7	16.0	15.9	16.4	16.5
Income on assets	0.5	0.7	0.6	0.6	0.4	0.4	0.4
Social contributions	1.4	1.4	1.5	1.4	1.4	1.4	1.4
Grants	0.2	0.3	0.2	0.2	0.1	0.1	0.1
Transfers from public enterprises	1.8	1.3	1.2	1.7	3.7	3.3	1.7
Other	1.2	1.4	0.9	1.0	0.8	0.6	0.8
Total expenditure	22.3	22.3	22.4	21.4	20.2	20.0	19.5
Consumption	6.2	6.2	6.1	5.8	5.8	5.6	5.4
Social benefits	5.6	5.6	5.5	5.3	4.9	4.7	4.9
Subsidies and grants	5.9	5.7	5.9	5.6	5.2	5.5	5.3
Interest payments	1.2	1.2	1.2	1.2	1.0	0.9	0.8
Other	0.2	0.2	0.2	0.2	0.1	0.0	0.0
Gross investment	2.2	2.2	2.2	2.0	1.8	2.0	1.9
Defense	1.7	1.7	1.6	1.4	1.4	...	...
Non-defense	0.5	0.6	0.6	0.6	0.4	...	...
Net capital transfers	1.0	1.1	1.2	1.3	1.3	1.3	1.3
Assumptions for staff WEO forecast:							
Real GDP growth	4.5	3.4	2.2	3.7	6.1	5½-6	5.5
Copper price (U.S. cents per pound)	82.3	71.7	70.8	80.7	129.9	140.6	122.5
II. Structural Balance and Authorities' Forecast 2/							
Structural balance	0.1	0.9	0.5	0.8	1.0	1.0	1.0
Overall balance	-0.6	-0.5	-1.2	-0.4	2.2	2.2	0.9
Revenue	21.7	21.8	21.1	20.9	22.4	22.4	20.6
Expenditure	22.3	22.3	22.4	21.4	20.2	20.2	19.7
Assumptions:							
Real GDP growth	4.5	3.4	2.2	3.7	6.1	5.9	5.2
Copper price (U.S. dollars per pound)	82.3	71.7	70.8	80.7	129.9	139.3	103.9

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

1/ The staff projections reflect the economic assumptions for the WEO forecast.
2/ The 2005 figures are based on the June update to the budget, and the 2006 figures are from the December 2005 budget forecast.

Table 3. Central Government Spending, 1996-2004
(by GFSM functional classification, in percent of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	Average 1996-99	Average 2000-04
Total expenditure	**19.6**	**19.6**	**20.7**	**22.5**	**22.3**	**22.3**	**22.4**	**21.4**	**20.2**	**20.6**	**21.7**
Defense & public safety	2.5	2.6	2.8	3.0	2.9	3.0	2.9	2.7	2.7	2.7	2.8
Defense	1.5	1.5	1.6	1.7	1.7	1.7	1.6	1.4	1.4	1.6	1.6
Public safety	1.0	1.1	1.1	1.3	1.2	1.3	1.3	1.3	1.3	1.1	1.3
Non-defense	17.1	17.0	17.9	19.5	19.4	19.3	19.5	18.7	17.5	17.9	18.9
General public services	1.4	1.3	1.3	1.4	1.4	1.5	1.5	1.5	1.4	1.4	1.4
Economic & cultural affairs	2.9	3.0	3.0	3.2	3.1	2.8	2.9	2.8	2.6	3.0	2.8
Economic affairs	2.8	2.9	2.9	3.1	3.0	2.7	2.8	2.7	2.4	2.9	2.7
Cultural affairs	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Social & environmental protection	12.8	12.7	13.6	14.9	14.9	15.1	15.0	14.4	13.5	13.5	14.6
Social protection	7.3	7.0	7.4	7.9	7.9	7.9	7.8	7.4	6.8	7.4	7.5
Education	2.8	2.9	3.3	3.8	3.7	3.9	4.0	3.8	3.7	3.2	3.8
Health	2.4	2.4	2.6	2.8	2.8	3.0	3.0	3.0	2.8	2.6	2.9
Housing	0.2	0.2	0.2	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Environmental protection	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1

Source: Ministry of Finance: DIPRES.

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

	2000	2001	2002	2003	2004	Projections 2005	2006
I. Central government							
Balance	-0.6	-0.5	-1.2	-0.4	2.2	2.3	1.4
Total revenue	21.7	21.8	21.1	20.9	22.4	22.2	20.9
of which: intragovernmental receipts 1/	1.2	1.1	1.1	1.0	1.0	1.0	0.9
Total expenditures	22.3	22.3	22.4	21.4	20.2	20.0	19.5
of which: intragovernmental transfers 1/	1.2	1.1	1.1	1.0	1.0	1.0	0.9
Current	19.1	18.9	18.9	18.1	17.0	16.7	16.4
Capital	3.2	3.4	3.5	3.3	3.2	3.3	3.1
II. Municipalities 2/							
Balance	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Total revenue	3.3	3.3	3.3	3.1	2.9	2.8	2.7
of which: intragovernmental receipts 1/	1.2	1.1	1.1	1.0	1.0	1.0	0.9
Total expenditures	3.3	3.2	3.3	3.1	2.9	2.7	2.7
of which: intragovernmental transfers 1/	1.2	1.1	1.1	1.0	1.0	1.0	0.9
Current	2.8	2.8	2.8	2.7	2.5	2.3	2.3
Capital	0.6	0.4	0.4	0.4	0.4	0.4	0.4
III. Central bank							
Balance	-1.5	-1.2	-1.2	-0.8	-0.7	-0.5	-0.3
Net operating balance	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0
Net interest balance	-1.5	-1.1	-1.2	-0.8	-0.6	-0.5	-0.3
IV. Public enterprises (non-financial)							
Balance	0.6	1.0	-0.3	-0.4	1.0	1.2	0.5
Total revenue	11.2	11.0	11.6	10.7	14.4	13.3	12.6
Total expenditures	10.6	10.1	11.9	11.2	13.4	12.1	12.1
Current	9.0	9.1	9.8	9.5	11.6	10.0	9.8
Capital	1.6	0.9	2.1	1.7	1.8	2.2	2.3
Memorandum: Public enterprise transfers							
From central government	0.1	0.1	0.1	0.1	0.1	0.2	0.2
To central government and municipalities	1.8	1.3	1.2	1.7	3.7	3.3	1.7

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

1/ Intergovernment transfters between central and local governmental units
2/ On a cash basis.

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

	2000	2001	2002	2003	2004	Proj. 2005
Financial indicators						
M3 (percent change)	8.4	7.0	8.3	-1.8	19.3	...
less pension funds' time deposits (annual percentage change)	5.3	4.9	3.3	2.3	11.7	...
Bank credit to GDP	72.4	72.9	75.1	76.4	77.5	...
90-day central bank promissory note (nominal) interest rate (avg.)	10.8	7.2	3.9	2.8	1.8	...
Share of foreign currency deposits in total deposits	11.3	14.0	12.8	13.2	11.4	...
Share of foreign currency loans in total credit	11.6	13.7	14.5	10.3	10.0	...
Share of nonperforming loans in total loans 1/ 2/	1.7	1.6	1.8	1.6	1.2	1.2
Loan-loss provisions as percent of nonperforming loans 1/ 2/	145.7	146.4	129.5	133.2	165.5	158.0
Risk-based capital-assets ratio, end of period 2/	13.3	12.7	14.0	14.1	13.6	13.5
Return on bank capital 2/	12.7	17.7	14.4	16.7	16.7	19.0
External indicators						
Exports of goods, U.S. dollars (annual percentage change)	11.9	-4.9	-0.5	18.4	48.8	13.9
Imports of goods, U.S. dollars (annual percentage change)	16.0	-3.9	-3.9	14.0	27.8	20.5
Terms of trade (annual percentage change)	5.0	-7.2	3.9	8.5	21.9	5.1
REER (end of period, percent change)	2.5	-9.5	-6.3	2.1	-1.3	...
Exchange rate (pesos per US$, period average)	539.5	634.9	688.9	691.4	609.5	...
Current account (percent of GDP)	-1.2	-1.6	-0.9	-1.5	1.5	0.5
Gross official reserves:						
In US$ billions 3/	15.1	14.4	15.4	15.9	16.0	13.1
In months of imports of goods and services	-8.3	-8.1	-8.8	-8.1	-6.5	-4.4
As a percent of broad money	44.5	45.4	48.5	43.0	34.0	...
As a percent of short-term external debt 4/	147.6	144.8	134.4	125.4	115.6	96.2
Short-term foreign assets of commercial banks (in US$ billions) 5/	4.3	2.8	1.8	1.6	1.3	...
Short-term foreign liabilities of commercial banks (in US$ billions) 5/	0.4	1.1	1.3	2.4	2.3	...
Total external debt (percent of GDP)	49.4	56.2	60.2	58.7	46.4	46.2
Of which: public sector debt	8.0	8.9	10.7	12.6	10.5	9.5
Total external debt to exports of goods and services	159.6	172.0	179.5	162.8	114.9	107.8
External interest payments to exports of goods and services	8.1	7.6	6.4	4.8	3.4	3.3
External amortization payments to exports of goods and services	18.2	20.1	28.8	23.7	22.1	14.2
Financial market indicators						
Stock market index (in US$; period average) 6/	667.9	589.8	483.1	600.6	832.3	...
Sovereign long-term foreign-currency debt rating (end of period)						
Moody's	Baa1	Baa1	Baa1	Baa1	Baa1	Baa1
S&P	A-	A-	A-	A-	A	A
Fitch Ratings (rating upgrade: March 28, 2005 to A)	A-	A-	A-	A-	A-	A

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

1/ Official measure of non-performing loans.
2/ Data as of April 2005.
3/ Gold valued at end-period market prices.
4/ As measured by the central bank; includes amortization of medium and long-term debt falling due during the following year.
5/ Refers to the commercial banking sector including the Banco del Estado de Chile.
6/ Morgan-Stanley Capital International index (Dec/1987=100).

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

						Projections					
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
(In billions of U.S. dollars)											
Current account balance	**-0.9**	**-1.1**	**-0.6**	**-1.1**	**1.4**	**0.5**	**-0.7**	**-1.2**	**-1.1**	**-1.0**	**-0.9**
Trade balance	2.1	1.8	2.4	3.5	9.0	8.8	6.5	5.5	5.0	5.1	5.2
Exports	19.2	18.3	18.2	21.5	32.0	36.5	35.7	36.2	37.1	38.7	40.4
Copper	7.3	6.5	6.3	7.8	14.4	15.8	14.0	13.4	13.0	13.0	13.0
Non-copper	11.9	11.7	11.9	13.7	17.7	20.7	21.7	22.8	24.1	25.7	27.4
Imports	-17.1	-16.4	-15.8	-18.0	-23.0	-27.7	-29.2	-30.7	-32.1	-33.6	-35.2
Net services	-0.7	-0.8	-0.7	-0.6	-0.6	-0.7	-0.3	-0.3	-0.4	-0.4	-0.5
Net income	-2.9	-2.5	-2.8	-4.6	-8.1	-8.8	-8.0	-7.5	-6.7	-6.4	-6.3
Net transfers	0.6	0.4	0.6	0.6	1.1	1.2	1.1	1.2	1.0	0.8	0.7
Financial account balance	**0.9**	**1.1**	**0.6**	**1.1**	**-1.4**	**-0.5**	**0.7**	**1.2**	**1.1**	**1.0**	**0.9**
Foreign investment (net)	0.9	2.6	2.2	2.5	6.7	5.2	4.4	4.5	4.5	4.6	4.6
Direct Investment Abroad	-4.0	-1.6	-0.3	-1.9	-0.9	-0.8	-0.4	-0.4	-0.6	-0.6	-0.7
Direct Investment in Chile	4.9	4.2	2.5	4.4	7.6	5.9	4.8	4.9	5.0	5.2	5.3
Portfolio investment (net)	0.6	0.1	-2.3	-2.1	-3.4	-1.2	-1.7	-2.0	-2.1	-2.5	-2.6
Financial Derivatives	0.0	-0.1	-0.1	0.1	-0.1	0.1	0.0	0.0	0.0	0.0	0.0
Reserves Assets (change)	-0.3	0.6	-0.2	0.4	0.2	-2.9	-0.7	-0.2	0.0	0.1	0.2
Change in official reserves (increase -)	*-0.2*	*0.7*	*-1.0*	*-0.5*	*-0.2*	*2.9*	*0.7*	*0.2*	*0.0*	*-0.1*	*-0.2*
Other (inc. errors and omissions)	-0.3	-2.1	1.0	0.2	-4.7	-1.7	-1.2	-1.0	-1.1	-1.2	-1.3
(In months of imports of goods and services)											
Gross official international reserves 1/	-8.3	-8.1	-8.8	-8.1	-6.5	-4.4	-4.1	-3.8	-3.7	-3.5	-3.4
(Annual change in percent)											
Copper export prices 2/	14.8	-13.8	0.0	18.4	58.8	8.3	-12.8	-11.1	-8.3	-4.5	-4.6
Copper export volume	5.4	4.3	-3.6	4.0	16.1	2.1	2.0	7.0	6.0	5.0	5.0
Agricultural exports volume	3.7	6.0	11.4	9.4	11.3	9.0	7.0	6.5	6.5	5.5	5.5
Industrial exports volume	5.4	17.2	4.2	7.8	14.5	7.4	6.0	5.5	5.0	5.0	5.0
Total export prices	6.6	-12.3	-1.1	11.4	30.2	8.5	-3.3	-3.6	-1.9	0.2	0.8
Total export volume	4.9	8.4	0.7	6.3	15.4	4.0	4.3	6.2	5.5	4.8	4.7
Total import price	1.9	-5.5	-4.6	2.7	7.0	0.3	0.7	1.6	0.2	-0.3	1.8
Total import volume	13.6	1.8	1.2	10.2	19.7	20.0	7.5	4.9	5.1	5.7	4.3
Terms of trade	5.0	-7.2	3.9	8.5	21.9	5.1	-5.5	-4.0	-1.3	0.3	0.1
Real GDP	4.5	3.4	2.2	3.7	6.1	5½-6	5.5	4.2	4.5	4.5	4.5
(In percent of GDP)											
Current Account Balance	-1.2	-1.6	-0.9	-1.5	1.5	0.5	-0.7	-1.1	-1.0	-0.8	-0.7
Gross national savings	20.6	20.6	20.7	20.6	23.2	22.8	21.3	19.6	19.8	20.4	21.1
Public sector 3/	2.7	2.8	2.0	2.5	4.8	5.2	4.5	4.4	4.3	4.0	3.9
Private sector	18.0	17.8	18.7	18.0	18.4	17.7	16.8	15.0	15.5	16.4	17.0
Gross domestic investment	21.9	22.1	21.7	22.0	21.7	22.3	22.3	20.9	20.9	21.2	21.7
Public	2.7	2.6	2.6	2.3	2.1	2.3	2.2	2.1	2.1	2.1	2.0
Private	19.1	19.5	19.1	19.7	19.6	20.0	20.2	18.7	18.8	19.2	19.7
Total external debt (end of period)	49.4	56.2	60.2	58.7	46.4	46.2	45.2	45.4	44.5	43.2	41.6
Memorandum items:											
Copper price (LME; U.S. cents per pound) 4/	82.3	71.7	70.8	80.7	129.9	140.6	122.5	108.9	99.8	95.3	90.7
Copper exports (thousand metric tons)	4,442	4,630	4,432	4,772	5,572	5,628	5,686	6,084	6,449	6,772	7,111

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

1/ Gold at market valuation. End-year stock of reserves in relation to imports of the following year.
2/ Chilean export price index up to 2004; projections for 2005 onwards derived from WEO assumptions.
3/ Net of estimated losses of the central bank.
4/ WEO assumptions.

Table 7. Chile: External Debt and Debt Service Projections

						Projections					
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
(In billions of U.S. dollars, end of period)											
Total external debt outstanding 1/	37.2	38.5	40.5	43.1	43.7	47.0	48.6	50.6	52.5	54.7	56.8
Of which: Private	31.2	32.4	33.3	33.8	33.8	37.3	38.8	40.7	42.5	44.6	46.7
percent change	*8.3*	*4.0*	*2.8*	*1.4*	*0.1*	*10.4*	*4.1*	*4.7*	*4.5*	*5.0*	*4.7*
Of which: Public	6.0	6.1	7.2	9.3	9.8	9.7	9.7	9.9	10.0	10.1	10.1
Medium- and long-term	31.0	33.2	34.9	35.9	36.0	38.7	40.3	42.2	43.9	45.9	47.8
Public sector	5.0	5.3	6.3	7.9	9.1	8.9	9.0	9.2	9.2	9.3	9.4
Of which: central government	2.5	3.0	3.6	4.6	4.7	4.5	4.6	4.8	4.8	4.9	5.0
Private sector	26.0	27.9	28.6	28.0	26.9	29.8	31.3	33.0	34.7	36.5	38.4
Financial sector	1.3	1.5	2.6	3.1	3.8	3.5	3.5	3.5	3.5	3.5	3.5
Non-financial sector	24.8	26.4	26.0	24.9	23.1	26.3	27.8	29.5	31.1	33.0	34.9
Short-term 1/	6.2	5.3	5.7	7.2	7.6	8.6	8.6	8.7	8.9	9.2	9.4
Residual maturity basis	10.2	9.9	11.4	12.6	13.9	13.7	12.4	12.8	11.8	11.4	10.3
Total debt service	6.1	6.2	8.0	7.5	9.7	7.7	5.9	5.4	4.2	4.5	2.6
Amortization	4.2	4.5	6.5	6.3	8.4	6.2	4.5	4.3	3.3	3.7	1.8
Interest	1.9	1.7	1.4	1.3	1.3	1.5	1.3	1.2	0.9	0.7	0.8
(In percent of GDP)											
Total external debt	49.4	56.2	60.2	58.7	46.4	46.2	45.2	45.4	44.5	43.2	41.6
Gross change (in percent)	3.8	13.7	7.1	-2.5	-21.0	-0.4	-2.1	0.2	-2.0	-2.8	-3.7
Gross change of nominal stock (in percent)	7.0	3.7	5.1	6.3	1.4	7.6	3.4	4.1	3.7	4.3	3.9
Of which: private debt	8.3	4.0	2.8	1.4	0.1	10.4	4.1	4.7	4.5	5.0	4.7
Of which: public debt	0.5	1.7	17.5	29.0	6.0	-1.7	0.8	1.7	0.7	1.1	0.3
Interest payments on external debt	2.5	2.5	2.1	1.7	1.4	1.4	1.2	1.1	0.8	0.6	0.6
(In percent of exports of goods and services)											
Debt-service payments	26.3	27.7	35.2	28.4	25.5	17.6	13.8	12.5	9.5	9.5	5.4
Of which: interest	8.1	7.6	6.4	4.8	3.4	3.3	3.1	2.7	2.0	1.6	1.6
Total external debt outstanding 1/	159.6	172.0	179.5	162.7	114.9	107.8	113.9	116.2	117.3	116.7	116.4
(In percent of GDP)											
Memorandum items:											
Gross international reserves	20.1	21.0	22.8	21.6	17.0	12.9	11.6	11.0	10.4	9.8	9.2
Net financial services payments	-3.8	-3.7	-4.2	-6.3	-8.6	-8.6	-7.5	-6.7	-5.7	-5.1	-4.6
GDP (billions of U.S. $) 2/	75.2	68.6	67.3	73.4	94.1	101.7	107.4	111.5	118.0	126.6	136.5
percent change	*3.0*	*-8.8*	*-1.9*	*9.1*	*28.2*	*8.1*	*5.6*	*3.8*	*5.8*	*7.3*	*7.9*

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

1/ Original maturity basis; end of period basis.

2/ At current prices and exchange rates.

Table 8. Social and Demographic Indicators

GDP (2004)		**Poverty rate (2003)**	18.8
Chilean pesos (billions)	57,357	Indigent	4.7
U.S. dollars (billions)	94.2	Poor, not indigent	14.1
Per capita (U.S. dollars)	6,057		
Population and Country Information (2003)		**Health (2002)**	
Total (in millions)	15.4	Population per physician	909
Urban population (in percent of total)	85.6	Population per hospital bed	370
Area (thousand sq. km.)	756.1		
Density (per sq. km)	20.3		
Annual rate of growth, 1996-2003	1.3		
Population characteristics (2003)		**Access to electricity**	
Life expectancy at birth (years)	75.8	Percent of population (2000)	99
Crude birth rate (per thousand)	18.8	Urban (1996)	99
Crude death rate (per thousand)	5.7	Rural (1996)	75
Infant mortality rate (per thousand births, 1998)	10.3		
Mortality rate (ages 1-4, per thousand, 1998)	0.5		
Income distribution (2003)		**Access to safe water (2003)**	
Percent of total income received:		Percent of population	95
By richest 10 percent of households	41.2	Urban	100
By poorest 20 percent of households	3.9	Rural	59
Gini coefficient	0.57		
Distribution of labor force, in percent of total (2004)		**Education (2003)**	
Agriculture and fishing	11.9	Adult literacy rate (2002)	96
Mining	1.2	Gross enrollment rates, percent of the age group	
Industry	12.9	Primary education	99
Construction	7.0	Secondary education	93
Services, Public Utilities, and Trade	67.0	Tertiary education	38

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

Table 9. Millennium Development Goals

	1990	1995	2001	2002	2003	2004	2015 Target
Goal 1: Eradicate extreme poverty and hunger							
Population below $1 a day (in percent of population)	3.5	...	2.0	...	1.8	...	1.0
Poverty gap at $1 a day (in percent of total population,)	...	...	0.5	...	...	...	...
Percent of income or consumption held by poorest 20 percent	4.4	...	3.3	3.3	4.5	...	...
Prevalence of child malnutrition (in percent of children under 5)	...	0.9	0.8	0.8	...	...	0.5
Pop. below min. of dietary energy consumption (in percent of total)	8.0	5.0	4.0	...	...	...	4.0
Goal 2: Achieve universal primary education							
Net primary enrollment ratio (in percent of relevant age group)	87.7	87.3	88.8	...	...	...	100.0
Percentage of cohort reaching grade 5 (in percent)	...	100.0	101.2	...	...	...	100.0
Youth literacy rate (in percent of ages 15-24)	98.1	98.5	98.9	99.0	...	...	100.0
Goal 3: Promote gender equality							
Ratio of girls to boys in primary and secondary education (in percent)	101.0	100.3	99.6	96.1	...	...	100.0
Ratio of young literate females to males (in percent of ages 15-24)	100.4	100.4	100.3	100.3	...	...	100.0
Share of women employed in the nonagricultural sector (in percent)	36.2	36.2	36.6	...	...	...	...
Proportion of seats held by women in national parliament (in percent)	...	8.0	...	10.1	10.1	9.5	...
Goal 4: Reduce child mortality							
Under 5 mortality rate (per 1,000)	19.0	14.0	12.0	12.0	...	...	12.7
Infant mortality rate (per 1,000 live births)	18.0	12.0	10.0	7.8	...	...	5.3
Immunization, measles (in percent of children under 12 months)	82.0	97.0	99.0	95.0	...	...	97.0
Goal 5: Improve maternal health							
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	...	31.0	17.0	...	...	7.8
Births attended by skilled health staff (in percent of total)	...	99.5	99.8	99.8	...	...	100.0
Goal 6: Combat HIV/AIDS, malaria and other diseases							
Prevalence of HIV, female (in percent of ages 15-24)	...	...	0.1	...	...	...	0.05
Contraceptive prevalence rate (in percent of women ages 15-49)	...	...	...	...	...	...	...
Number of children orphaned by HIV/AIDS	...	...	4100	...	...	...	...
Incidence of tuberculosis (per 100,000 people)	...	...	20.0	18.0	18.0	...	...
Tuberculosis cases detected under DOTS	...	79.0	97.0	112.1	112.1	...	...
Goal 7: Ensure environmental sustainability							
Forest area (in percent of total land area)	21.0	...	20.7	...	...	...	...
Nationally protected areas (in percent of total land area)	...	18.9	18.9	18.9	18.7	18.8	...
GDP per unit of energy use (PPP $ per kg oil equivalent)	4.5	5.7	6.2	...	...	...	...
CO2 emissions (metric tons per capita)	2.7	3.1	3.9	...	...	...	...
Access to an improved water source (in percent of total population)	90.0	...	93.0	...	...	...	95.0
Access to improved sanitation (in percent of total population)	97.0	...	96.0	...	...	...	...
Access to secure tenure (in percent of total population)	...	...	...	...	...	...	...
Goal 8: Develop a Global Partnership for Development							
Youth unemployment rate (in percent of labor force ages 15-24)	13.1	11.5	18.8	21.6	21.1	...	...
Fixed line and mobile telephones (per 1,000 people)	67.0	141.2	568.1	658.6	658.6	...	...
Personal computers (per 1,000 people)	9.4	33.2	106.5	119.3	119.3	...	...

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

Chile—Fund Relations
(As of May 31, 2005)

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

II.	***General Resources Account***	**SDR Million**	**Percent Quota**
	Quota	856.10	100.00
	Fund holdings of Chilean pesos	609.37	71.18
	Reserve tranche position	246.73	28.82

III.	***SDR Department***	**SDR Million**	**Percent Allocation**
	Net cumulative allocation	121.92	100.00
	Holdings	35.46	29.08

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

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 July 11, 2005, the interbank exchange rate was Ch$584.7 per U.S. dollar. Chile's exchange system is free of restrictions on the making of payments and transfers for current international transactions.

VIII. ***Article IV Consultation:*** The Executive Board concluded the 2004 Article IV consultation on August 14, 2004. The staff report was subsequently released as Country Report No. 04/291.

IX. ***Technical Assistance:*** In October 2002, a joint MFD/WHD mission advised on nominalization and interest rate pass-throughs. In January 2003, a joint FAD/STA mission advised on fiscal statistics. In late 2003 and early 2004, an FSAP mission (joint Fund-Bank) assessed the Chilean financial system. In late 2004, an STA mission advised on fiscal statistics and in February 2005 another STA mission advised on national account statistics. In April 2005, MFD provided training to the FIU staff on AML/CFT issues. An STA mission overlapped with the Article IV mission to assist with the implementation of GFSM 2001.

Chile—Financial Relations with the World Bank

The most recent Country Assistance Strategy (CAS) for Chile, covering Fiscal Years 2002-06, was discussed by the Executive Board of the Bank in February 2002. The CAS calls for selectively focusing on areas in which the government felt that the Bank could be instrumental in ensuring the successful implementation of its initiatives. To that aim, the strategy proposed to diversify the forms of financial assistance by providing direct financing through regular investment and policy-based lending, as well as contingent financing. A new CAS is planned for the fourth quarter of FY06.

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

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

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

There are currently six investment loans in Chile's operations portfolio, totaling US$330.7 million in commitments. One of these loans, the Higher Education Project (FY99), had already been approved when the present CAS was discussed. The remaining five loans, in support of Public Expenditure Management (FY02), Lifelong Learning (FY02), Science for the Knowledge Economy (FY03), Social Protection TA Loan (FY04), and Infrastructure for Territorial Development (FY05) are covered by the current CAS. A Social Protection Adjustment Loan DDO in the amount of US$200 million, also approved in FY04, has been fully disbursed. The FY06 program includes the first of two Programmatic Development Policy Loans for the Santiago Urban Transport (DPL1) and the accompanying TA loan, and the Tertiary Education Finance for Results Project. These loans were approved by the Executive Board of the Bank on July 5, 2005.

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

	Commitments (Net of Cancellations)	Disburs-ments	Undis-bursed
	I. IBRD Operations (as of June 15, 2005)		
Fully disbursed loans	**3218.5**	**3218.5**	**0.0**
Loans in process of disbursement	**330.7**	**171.5**	**159.2**
Agriculture	0.0	0.0	0.0
Education	246.5	156.0	90.5
Environment	0.0	0.0	0.0
Health	0.0	0.0	0.0
Municipal and urban	0.0	0.0	0.0
Public sector management	23.2	13.1	10.1
Social protection	10.7	2.4	8.3
Transport	50.3	0.0	50.3
Water supply	0.0	0.0	0.0
Total loans	**3549.2**	**3390.0**	**159.2**
Repaid 1/	**3053.4**		
Outstanding	**495.8**		

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

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

III. IBRD Loan Transactions (calendar year)

	2001	2002	2003	2004	2005 2/
Disbursements	38.6	29.7	37.5	258.7	14.3
Repayments	118.5	202.3	172.7	240.6	13.8
Net lending	-79.9	-172.6	-135.2	18.1	0.5

Source: World Bank.

1/ Includes repayment from third parties.
2/ As of May 31, 2005.

Chile—Statistical Issues

Chile's economic and financial data are of good quality, timely, and adequate for surveillance purposes. Chile has subscribed to the SDDS in May 1996 and met all specifications by end-March 2000.

Monetary and real sectors

The central bank publishes comprehensive statistics on the real and monetary sectors on a bi-weekly basis. Following technical assistance from STA, new and more comprehensive GDP series were published by the central bank in March 2005. Also, STA has recently helped to improve the classification and sectorization, and to expand the institutional coverage of the monetary accounts. The improved monetary statistics were published starting with the July 2003 issue of *International Financial Statistics*; and revised time series based on the new methodology are now available for the period since December 1997.

Without prior notice, the National Statistical Institute (INE) changed the CPI weightings of the telecommunications sector in April, resulting in a downward revision to core CPI. In response to criticism, INE announced that it would submit any future proposed changes to the Ministry of Finance and the Central Bank, seeking approval.

Government finances

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

More progress is expected by end-2005. The authorities expect to produce estimates for the consumption of fixed capital and apply accrual and cash accounting using the System of Information for the Financial Management of the Public Sector. This will permit the compilation of opening and closing balance sheets covering the central government, municipalities and public corporations.

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

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

Balance of payments and external debt

The central bank compiles balance of payments and external debt statistics on a quarterly basis, and publishes selected statistics on the external sector on a weekly basis. Beginning in 2002, the central bank has been publishing the International Investment Position consistent with the balance of payments.

However, the coverage of the military sector in the external statistics is not complete. In particular, the accuracy of data on military imports needs to be verified, as imports that do not go through customs are estimated by the central bank. Also, if the military receives external credits, information on this may not be available to the central bank; therefore, such financing may not appear in the balance of payments or external debt statistics. Published data on military expenditure are outdated.

CHILE: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

AS OF JUNE 30, 2005

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]	Memo Items:	
						Data Quality – Methodological soundness[7]	Data Quality Accuracy and reliability[8]
Exchange Rates	06/29/2005	06/30/2005	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	06/23/2005	06/30/2005	M	TM	M		
Reserve/Base Money	06/23/2005	06/30/2005	M	TM	M	LO, LO, LO, LO	LO, LO, LO, NA
Broad Money	06/23/2005	06/30/2005	M	TM	M		
Central Bank Balance Sheet	06/23/2005	06/30/2005	M	TM	M		
Consolidated Balance Sheet of the Banking System	05/31/2005	06/23/2005	M	M	M		
Interest Rates[2]	06/29/2005	06/30/2005	D	D	D		
Consumer Price Index	05/2005	06/03/2005	M	TM	M	O, LO, O, O	LO, O, LO, NA
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q4/2004	3/25/2005	Q	Q	Q	O, LNO, O, O	LO, NA, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	4/2005	06/16/2005	M	TM	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	3/2005	06/30/2005	A	A	A		
External Current Account Balance	Q1/2005	05/24/2005	Q	TM	Q	LO, LO, LO, LO	O, O, LO, O
Exports and Imports of Goods and Services	06/23/2005	06/30/2005	M	TM	M		
GDP/GNP	Q1/2005	05/24/2005	Q	TM	M	O, O, O, O	LO, O, LO, NA
Gross External Debt	04/2005	06/07/2005	M	TM	M		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).
[7] Reflects the assessment provided in the data ROSC published on July 30, 2001 and based on the findings of the mission that took place during March 28 – April 11, 2001 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), not observed (NO), or not available (NA).
[8] Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

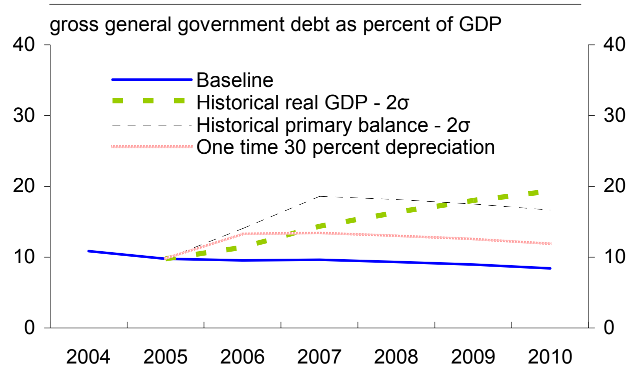
Chile—Debt Sustainability Analysis (DSA)

1. ***This appendix assesses Chile's gross debt sustainability.*** Public debt appears sustainable under the stress test scenarios, but private external debt remains sensitive to foreign exchange rate shocks. However, the presence of natural hedges in the export sector and access to financial hedges in the nontradable sector mitigates the risks to external debt sustainability.

2. ***Most external vulnerability indicators have improved in 2004, reflecting strong economic growth and favorable external conditions.*** Strong economic activity, together with the strengthening of the Chilean peso against the U.S. dollar have helped reduce external debt from 58¾ percent of GDP at end-2003 to 46½ percent at end-2004. Over the same period, total public debt has been reduced from 40 percent of GDP to 35 percent. Debt prepayments by the central government has also helped reduce the external public debt-to-GDP ratio by over 2 percentage points, to 10½ percent at end-2004. Private external debt ratios have also improved significantly, at 36 percent of GDP at end-2004 (down from 46 percent at end-2003).

3. ***Under the medium-term baseline scenario, the fiscal prudence—as embedded in the structural surplus rule—would lead to a further decline in the already low government debt-to-GDP ratio***.[1] Reflecting the persistence of high copper prices in near future, the overall balance of the central government is projected to register surpluses of around 1¼ percent of GDP a year on average over the forecast horizon. Gross central government debt would decline from 9¾ percent of GDP in 2005 to 8½ percent by 2010 (Figure 1). Computations made at the time of the 2004 budget suggest that the stock of central government debt would be eliminated between 2012 and 2030. In most of the bounds tests, which assume significant shocks, the debt stock would remain low and not exceed 20 percent of GDP. Furthermore, the current forecast of the overall balance remains comfortably above any level needed to stabilize the debt ratios (Table 1).

Figure 1. Public debt sensitivity to shocks
Baseline (staff forecast) and shocks to historical averages



[1] A small amount of the *debt of the armed forces,* estimated at 0.5 percent of GDP, is not published, and therefore not included in the stock of public debt. The stock of the *recognition bonds* issued by the government in recognition of the pension liabilities incurred under the old public pension regime was equivalent to 13¾ percent of GDP by end-2004. The recognition bonds are not included in the debt stock, but their amortization is included.

4. ***At end-2004, the stock of central bank debt was equivalent to 23¾ percent of GDP.*** This stock, held entirely by domestic residents, is broadly offset by international reserves (the net debt of the central bank was equivalent to only 1½ percent of GDP). Computations including the debt of the central bank show that total public debt would decline from 35 percent of GDP in 2004 to just under 29 percent in 2010.

5. ***Under the baseline scenario, external debt would remain contained over the medium-term, but it remains sensitive to large swings in the foreign exchange rate.*** Under the baseline scenario, the external debt ratio would fall slightly, from 46¼ percent of GDP in 2005 to 41½ percent in 2010 (Figure 2). Under a sizeable interest rate shock or lower-than-projected GDP growth, the external debt ratio would remain below 50 percent of GDP in the medium term. However, a one time depreciation of 30 percent would bring the external debt ratio to about 65 percent. Although sensitivity to exchange rate risk remains substantial, there are mitigating factors to external debt sustainability. About 40 percent of the private sector external debt is held in the tradable goods sector where revenue is naturally hedged; another 25 percent is held by financial institutions, where regulations have ensured careful management of exposures to currency movements; and there is increasing use of financial hedges in the non-tradable goods sectors.

Figure 2. External debt sensitivity to shocks

Baseline (staff forecast) and shocks to historical averages

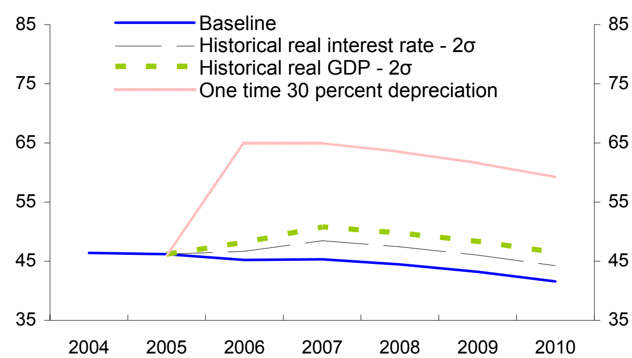


Table DSA1. Public Sector (Central Government) Debt Sustainability Framework, 2000-2010
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2000	2001	2002	2003	2004			2005	2006	2007	2008	2009	2010	
								I. Baseline Projections						**Debt-stabilizing primary balance 11/**
Public sector debt 1/	13.7	15.0	15.7	13.1	10.9			**9.8**	**9.5**	**9.6**	**9.3**	**9.0**	**8.4**	**-0.3**
o/w foreign-currency denominated	12.4	13.9	14.7	11.9	9.1			8.9	8.6	8.7	8.5	8.1	7.6	
Change in public sector debt	-0.1	1.3	0.8	-2.6	-2.3			-1.1	-0.2	0.1	-0.3	-0.4	-0.5	
Identified debt-creating flows (4+7+12)	0.5	1.3	1.5	-3.2	-4.4			-3.2	-1.9	-1.7	-1.7	-1.6	-1.7	
Primary deficit	0.3	0.0	0.7	-0.1	-2.6			-2.7	-1.9	-1.8	-1.6	-1.3	-1.3	
Revenue and grants	23.8	23.9	23.3	23.0	24.3			24.0	22.7	22.3	22.6	21.7	20.7	
Primary (noninterest) expenditure	24.0	23.9	24.0	22.9	21.7			21.3	20.8	20.5	21.1	20.4	19.4	
Automatic debt dynamics 2/	0.3	1.3	0.7	-3.0	-1.8			-0.5	-0.1	0.0	-0.2	-0.3	-0.3	
Contribution from interest rate/growth differential 3/	-0.7	-0.5	-0.4	-0.8	-1.1			-0.5	-0.1	0.0	-0.2	-0.3	-0.3	
Of which contribution from real interest rate	-0.2	0.0	-0.1	-0.3	-0.4			0.1	0.4	0.4	0.2	0.1	0.0	
Of which contribution from real GDP growth	-0.6	-0.4	-0.3	-0.5	-0.7			-0.6	-0.5	-0.4	-0.4	-0.4	-0.4	
Contribution from exchange rate depreciation 4/	1.0	1.7	1.2	-2.2	-0.7			...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	-0.6	0.0	-0.7	0.5	2.2			2.1	1.7	1.8	1.4	1.3	1.1	
Public sector debt-to-revenue ratio 1/	57.6	62.6	67.5	56.9	44.7			40.7	42.0	43.2	41.2	41.3	40.7	
Gross financing need 6/	1.3	1.4	2.9	1.8	-0.2			-0.9	-1.0	-0.6	-0.1	-0.2	-0.6	
in billions of U.S. dollars	1.0	1.0	2.0	1.3	-0.1			-0.9	-1.1	-0.7	-0.1	-0.3	-0.8	
Key Macroeconomic and Fiscal Assumptions						10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	4.5	3.4	2.2	3.7	6.1	4.7	2.5	5.7	5.5	4.2	4.5	4.5	4.5	4.8
Average nominal interest rate on public debt (in percent) 7/	3.4	3.6	3.4	3.7	3.8	3.5	0.3	4.4	4.4	4.3	3.8	3.8	3.8	4.1
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-1.1	-0.2	-0.8	-1.8	-2.8	-1.2	2.2	0.8	4.7	4.6	2.5	1.2	0.6	2.4
Nominal appreciation (increase in US dollar value of local currency, in percent)	-7.9	-12.7	-7.9	18.8	7.1	-2.8	9.4	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	4.6	3.8	4.2	5.5	6.6	4.6	2.5	3.6	-0.3	-0.3	1.2	2.6	3.2	1.7
Growth of real primary spending (deflated by GDP deflator, in percent)	3.9	3.0	2.7	-1.1	0.3	5.3	4.8	3.7	3.3	2.5	7.4	1.1	-0.5	2.9
Primary deficit	0.3	0.0	0.7	-0.1	-2.6	-1.0	1.8	-2.7	-1.9	-1.8	-1.6	-1.3	-1.3	-1.8
								II. Stress Tests for Public Debt Ratio						**Debt-stabilizing primary balance 12/**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2005-10 8/								**9.8**	**9.9**	**10.2**	**10.0**	**9.8**	**9.3**	**-0.5**
A2. No policy change (constant primary balance) in 2005-10								**9.8**	**8.7**	**7.8**	**6.4**	**4.7**	**2.9**	**-0.1**
B. Bound Tests														
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006								**9.8**	**9.4**	**9.4**	**9.1**	**8.7**	**8.2**	**-0.3**
B2. Real GDP growth is at historical average minus one standard deviations in 2005 and 2006 10/								**9.8**	**11.4**	**14.4**	**16.3**	**18.0**	**19.3**	**-0.7**
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006								**9.8**	**14.1**	**18.6**	**18.1**	**17.5**	**16.7**	**-0.6**
B4. Combination of B1-B3 using one standard deviation shocks								**9.8**	**12.2**	**14.9**	**14.5**	**14.1**	**13.4**	**-0.5**
B5. One time 30 percent real depreciation in 2005 11/								**9.8**	**13.3**	**13.4**	**13.0**	**12.6**	**11.9**	**-0.4**
B6. 10 percent of GDP increase in other debt-creating flows in 2005								**9.8**	**19.5**	**19.7**	**19.2**	**18.5**	**17.6**	**-0.7**

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

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ 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 numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

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

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

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

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

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

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

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

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

Table 2. External Debt Sustainability Framework, 2000-2010
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2000	2001	2002	2003	2004			2005	2006	2007	2008	2009	2010	
								I. Baseline Projections						Debt-stabilizing non-interest current account 7/
External debt	49.4	56.2	60.2	58.7	46.4			**46.2**	**45.2**	**45.3**	**44.5**	**43.2**	**41.6**	**-4.6**
Change in external debt	1.8	6.8	4.0	-1.5	-12.3			-0.2	-1.0	0.1	-0.9	-1.2	-1.6	
Identified external debt-creating flows (4+8+9)	-3.4	1.7	1.3	-6.0	-16.5			-4.8	-3.4	-2.7	-3.1	-3.3	-3.3	
Current account deficit, excluding interest payments	-1.3	-0.9	-1.3	-0.2	-2.8			-1.8	-0.2	0.2	0.3	0.2	0.0	
Deficit in balance of goods and services	-1.9	-1.5	-2.5	-4.0	-9.0			-7.8	-5.5	-4.4	-3.8	-3.7	-3.5	
Exports	31.0	32.7	33.5	36.1	40.4			42.4	39.5	38.8	37.7	36.9	35.6	
Imports	29.1	31.2	31.0	32.1	31.4			34.7	34.0	34.4	34.0	33.2	32.1	
Net non-debt creating capital inflows (negative)	-3.2	-4.7	-0.6	-2.5	-2.1			-2.0	-2.1	-2.2	-2.2	-2.3	-2.1	
Automatic debt dynamics 1/	1.1	7.3	3.2	-3.3	-11.6			-1.0	-1.1	-0.8	-1.2	-1.3	-1.2	
Contribution from nominal interest rate	2.5	2.5	2.1	1.7	1.4			1.4	1.2	1.1	0.8	0.6	0.6	
Contribution from real GDP growth	-2.1	-1.8	-1.3	-2.1	-2.8			-2.5	-2.4	-1.8	-1.9	-1.9	-1.8	
Contribution from price and exchange rate changes 2/	0.7	6.6	2.3	-3.0	-10.2			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	5.2	5.1	2.7	4.5	4.2			4.6	2.5	2.8	2.2	2.1	1.7	
External debt-to-exports ratio (in percent)	159.6	172.0	179.5	162.7	114.9			108.8	114.6	116.9	117.8	117.1	116.7	
Gross external financing need (in billions of US dollars) 4/	8.5	9.8	11.5	13.6	12.8			13.0	10.7	9.5	8.7	7.7	4.9	
in percent of GDP	11.3	14.3	17.0	18.5	13.6			12.8	10.0	8.5	7.4	6.1	3.6	
Key Macroeconomic Assumptions						8-Year Historical Average	8-Year Standard Deviation							Projected Average
Nominal GDP (US dollars)	75.2	68.6	67.3	73.4	94.1			101.7	107.4	111.5	118.0	126.6	136.5	
Real GDP growth (in percent)	4.5	3.4	2.2	3.7	6.1	3.6	2.3	5.7	5.5	4.2	4.5	4.5	4.5	4.8
Exchange rate appreciation (US dollar value of local currency, change in percent)	-5.7	-15.0	-7.8	-0.4	13.4	-4.5	8.6	-1.4	0.4	0.0	0.0	0.0	0.0	-0.2
GDP deflator (change in domestic currency)	4.6	3.8	4.2	5.5	6.6	4.2	1.5	3.6	-0.3	-0.3	1.2	2.6	3.2	1.7
GDP deflator in US dollars (change in percent)	-1.4	-11.8	-4.0	5.2	20.9	-0.4	10.2	2.2	0.2	-0.3	1.2	2.7	3.2	1.5
Nominal external interest rate (in percent)	5.4	4.6	3.7	3.1	3.0	4.2	0.8	3.3	2.9	2.5	1.8	1.4	1.4	2.2
Growth of exports (US dollar terms, in percent)	10.8	-3.8	0.7	17.3	43.5	9.1	15.9	13.6	-1.8	2.1	2.9	4.9	4.2	4.3
Growth of imports (US dollar terms, in percent)	13.2	-2.2	-2.5	12.9	25.3	-22.5	76.6	19.3	3.6	5.2	4.3	5.0	4.3	7.0
Current account balance, excluding interest payments	1.3	0.9	1.3	0.2	2.8	0.3	2.3	1.8	0.2	-0.2	-0.3	-0.2	0.0	0.2
Net non-debt creating capital inflows	3.2	4.7	0.6	2.5	2.1	4.9	3.9	2.0	2.1	2.2	2.2	2.3	2.1	2.2
								II. Stress Tests for External Debt Ratio						Debt-stabilizing non-interest current account 7/
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2005-09 5/								**46.2**	**44.0**	**42.0**	**40.1**	**38.9**	**37.6**	**-4.5**
A2. Country-specific shock in 2005, with reduction in GDP growth (relative to baseline) of one standard deviation 6/								**46.2**	**45.2**	**45.3**	**44.5**	**43.2**	**41.6**	**-4.6**
A3. Selected variables are consistent with market forecast in 2005-09								**46.2**	**45.2**	**45.3**	**44.5**	**43.2**	**41.6**	**-4.6**
B. Bound Tests														
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006								**46.2**	**46.6**	**48.2**	**47.2**	**45.8**	**44.0**	**-4.8**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**46.2**	**48.2**	**50.8**	**49.8**	**48.4**	**46.6**	**-5.2**
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006								**46.2**	**57.3**	**72.1**	**70.5**	**68.4**	**65.9**	**-7.3**
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006								**46.2**	**49.7**	**53.7**	**52.5**	**50.9**	**48.8**	**-5.0**
B5. Combination of B1-B4 using one standard deviation shocks								**46.2**	**56.1**	**67.6**	**66.2**	**64.2**	**61.6**	**-6.5**
B6. One time 30 percent nominal depreciation in 2005								**46.2**	**65.0**	**65.0**	**63.6**	**61.8**	**59.4**	**-6.6**

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, ε = nominal appreciation (increase in dollar value of domestic currency), and α = 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/ For projection, line includes the impact of price and exchange rate changes.

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

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

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

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

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

IMF Executive Board Concludes 2005 Article IV Consultation with Chile

On July 29, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Chile.[1]

Background

Over the past two decades, Chile has adhered to a sound and consistent policy framework. Its policy mix has been based on fiscal prudence, a successful monetary policy based on an inflation targeting framework with a floating exchange rate, free trade, and an open capital account, within a sound financial regulatory and supervisory framework.

Since 2000, the current administration has been adhering closely to the structural surplus rule, a key fiscal innovation. The fiscal rule, which requires a cyclically adjusted central government overall surplus of 1 percent of GDP, has proven to be an effective counter-cyclical tool. During 2000–03, when output growth was below its long-run trend, the actual overall balance of the central government registered deficits of just below 1 percent of GDP a year on average, and in 2004 the balance shifted to a surplus of 2.2 percent of GDP, consistent with the strong economic recovery and high copper prices. The transition to a full-fledged inflation targeting framework has been completed in 2000. The framework has been successful at keeping inflation very close to the mid-point of the target band of 2–4 percent—2.8 percent a year on average during 2000–04, while allowing the peso to float freely.
A strong external environment and an expansionary monetary policy has helped spur Chile's economic growth in 2004 and in early 2005. Robust growth in the global economy, including Asia—which absorbs one-third of Chile's total exports—has helped boost mineral export prices, particularly copper, Chile's main export commodity. Chile has also benefited from low world

[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.

interest rates. Reflecting these developments, real GDP grew by 6.1 percent in 2004, the strongest rate of growth in 7 years. Despite steady employment growth, the unemployment rate is still relatively high, at about 8 percent, as strong economic growth has encouraged more workers to return to the labor market.

In the context of a still weak economic recovery and downward pressure on domestic prices, the monetary authorities eased their policy stance in late 2003 and in early 2004. Later in the year, when it was clear the economic recovery was well under way, and the forecast inflation has returned above the center of the target range, the central bank initiated a tightening cycle toward a neutral stance. It has raised its policy rate on seven occasions since September 2004, by a total of 175 basis points to 3.5 percent in mid-July 2005.

External conditions faced by the Chilean economy remain broadly favorable but increases in petroleum prices could lead to a slowdown in global demand and in Chilean exports. The authorities have taken steps to protect the economy from sudden cuts in natural gas imports and to encourage a switch in electricity generation from relatively cheap natural gas to alternative sources.

In the period ahead, the economy is expected to continue its robust growth, and GDP is projected to grow by 5.5–6 percent in 2005. Reflecting a supportive external environment, and a still expansionary monetary policy, strong investment growth is expected to continue in 2005. Domestic consumption would also pick up, boosted by higher incomes, an increase in employment, and strong consumer lending. Consistent with strong growth and high copper prices, the fiscal balance is projected to register a surplus of 2.3 percent of GDP in 2005. The current account surplus is projected to narrow to 0.5 percent of GDP in 2005, reflecting a higher import bill, including on oil and capital good imports.

Executive Board Assessment

Executive Directors commended the Chilean authorities for their consistent and skillful implementation of sound macroeconomic policies, which have helped entrench low inflation and sustain economic growth while contributing to a significant reduction in poverty. Directors observed that Chile’s macroeconomic policies, centered on well-established rules and institutions, have been reinforced in recent years by strict adherence to the structural fiscal surplus rule and a highly regarded inflation targeting framework. Supported by increasing trade and financial integration and a robust financial system, these policies have paid considerable dividends, providing counter-cyclical support to the economy, strengthening its resilience to external shocks, and leading to favorable market ratings and sustained economic growth. Chile remains a model reformer and Directors looked forward to its continued leadership role in building a strong political consensus in favor of a robust macroeconomic policy framework in the period ahead.

Directors noted that Chile’s short-term outlook appears bright. A favorable global environment, continued strength of mineral prices, the ongoing rebound in private investment, and the pick up in domestic consumption are expected to contribute to strong economic growth in 2005 and 2006. Existing risks to the outlook appear manageable, and Directors commended the authorities for their prompt action to mitigate the impact of disruptions in the supply of gas from the region.

Directors welcomed the authorities' strict adherence to the structural fiscal surplus rule, which calls for a surplus of 1 percent of GDP in the overall balance of the central government. While further entrenching Chile's commitment to a prudent fiscal policy, this rule has also been effective in providing counter-cyclical support to the economy since its adoption in 2000. Directors commended the authorities for restraining spending, despite higher revenues from the surge in copper prices. Going forward, Directors advised continued commitment to fiscal discipline. They welcomed plans to require future budgets to accumulate resources to cover potential future contingent liabilities and to include a measure of the structural fiscal position. Directors called for progress on the introduction of an appropriate and transparent mechanism by the government to cover the annual deficits of the central bank, with a view to working toward its recapitalization while preserving its institutional independence.

Directors supported the thrust of the government's debt management strategy, including the authorities' decision to selectively prepay debt and replenish the Copper Stabilization Fund. They also welcomed the rapid growth of exchange rate hedges, and supported efforts to deepen the domestic financial market, including the development of a market for long-term peso-denominated bonds.

Directors recognized that Chile's inflation targeting framework has gained a high degree of credibility and successfully helped anchor inflation expectations. They considered that the monetary stance in 2004 had been appropriate, with inflation gradually returning to the mid-point of the 2–4 percent target band. Directors also supported the gradual tightening of monetary policy under way, which is consistent with the inflation objective and the closing of the output gap.

Directors observed that the floating exchange rate regime has benefited the economy and allowed it to adjust smoothly to external shocks. They commended the central bank's transparent policy framework, with no intervention in the foreign exchange market. Together with fiscal prudence, this framework has helped support competitiveness, as evidenced by the strong growth in nontraditional exports.

While the Chilean banking sector is robust, Directors saw room for further progress on improving the financial system's efficiency and oversight consistent with the recommendations of the 2004 Financial System Stability Assessment. Early approval of the Capital Markets II draft law would be an important step in this regard. Directors welcomed the strengthening of market risk regulations in the banking sector. They looked forward to further improvements in the supervision of the insurance sector and steps to foster competition among private pension funds. While private pension funds are generally well run, Directors felt that a judicious liberalization of restrictions on the investment of these funds would encourage a risk-based approach in the management of their investments. Directors welcomed the authorities' plan to revise Chile's Anti-Money Laundering and Combatting the Financing of Terrorism (AML/CFT) legislation to enhance the ability of the Financial Intelligence Unit (FIU) to obtain information.

Directors encouraged the authorities to continue to accord a high priority to reforms aimed at promoting sustained growth and further reducing income inequality and high unemployment over the medium term. To sustain the ongoing diversification of exports, they supported efforts to boost research and development and improve further the business environment. They also welcomed reforms to improve pre-school coverage for low income groups, provide education subsidies to low-income households, and enhance funding for tertiary education. Directors stressed that further improvements in labor market flexibility would also be important to expand employment opportunities.

Directors underscored Chile's leadership role in opening markets through comprehensive and sustained trade and financial market liberalization. They welcomed the implementation of recent bilateral trade agreements and encouraged the authorities to continue their efforts in supporting multilateral trade liberalization.

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

Chile: Selected Economic Indicators

	1999	2000	2001	2002	2003	2004
	(Annual percentage change, unless otherwise specified)					
Production, prices and trade						
Real GDP	-0.8	4.5	3.4	2.2	3.7	6.1
Total domestic demand	-5.7	6.0	2.4	2.4	4.8	7.9
Consumption	-0.4	3.6	2.9	2.5	3.9	5.2
Investment	-20.1	14.0	0.8	2.2	7.8	16.1
Fixed	-18.2	8.9	4.3	1.6	5.7	12.8
Inventories 1/	-0.7	1.2	-0.8	0.2	0.5	1.0
Net exports 1/	5.2	-1.3	1.0	-0.2	-1.0	-1.8
Consumer prices						
End of period	2.3	4.6	2.7	2.9	1.1	2.4
Average	3.3	3.8	3.6	2.5	2.8	1.1
Real wages	2.4	0.7	2.6	1.2	2.3	0.2
Unemployment rate	9.7	9.2	9.2	9.0	8.5	8.8
Employment growth (end of period)	-0.6	-0.5	1.8	1.0	2.6	3.3
Exports (U.S. dollars)	3.8	10.8	-3.8	0.7	17.2	43.6
Imports (U.S. dollars)	-15.0	13.2	-2.2	-2.5	12.9	25.3
Terms of trade	5.6	5.1	-7.3	3.9	4.7	21.6
Real effective exchange rate (EOP) 2/	-6.2	2.5	-9.5	-6.3	2.1	-1.3
Money, credit, and interest rates						
Broad money 3/	4.0	5.3	4.9	3.3	2.3	11.7
Credit to the private sector	7.2	12.1	8.1	9.6	11.4	14.8
Three-month interest rate 4/	11.0	10.8	7.2	3.9	2.8	1.8
	(In percent of GDP)					
External Debt and Balance of Payments						
Gross external debt	47.6	49.4	56.2	60.5	59.1	46.5
Public	8.2	8.0	8.9	10.7	12.7	10.5
Private	39.4	41.4	47.3	49.8	46.4	36.0
Current account balance	0.1	-1.2	-1.6	-0.9	-1.5	1.5
Exports of goods and services	28.8	31.0	32.7	33.5	36.0	40.4
Imports of goods and services	-26.5	-29.1	-31.2	-31.0	-32.1	-31.4
Net income and transfers	-2.2	-3.1	-3.1	-3.4	-5.5	-7.5
Financial Account 5/	-1.1	1.6	0.7	1.0	1.0	-1.7
Foreign direct investment, net	8.5	1.2	3.8	3.3	3.4	7.1
Portfolio investment, net	-4.4	0.8	0.2	-3.4	-2.9	-3.6
Other investments, net (inc. reserve assets)	-4.2	-0.8	-2.4	1.0	1.0	-4.9
Saving and investment						
Gross domestic investment	20.9	21.9	22.1	21.7	22.0	21.7
Public	3.2	2.7	2.6	2.6	2.3	2.1
Private	17.7	19.1	19.5	19.1	19.7	19.6
National saving	21.0	20.6	20.6	20.7	20.6	23.2
Public 6/	1.7	2.7	2.8	2.0	2.8	5.0
Private	19.3	18.0	17.8	18.7	17.8	18.2
External saving	-0.1	1.2	1.5	1.0	1.4	-1.5
Public sector finance						
Public sector gross debt	40.1	41.7	42.9	43.4	40.2	35.5
Central government	13.8	13.7	15.0	15.7	13.1	10.9
Central government balance	-2.1	-0.6	-0.5	-1.2	-0.4	2.2

Sources: Central Bank of Chile, Ministry of Finance, Haver Analytics, and IMF Staff estimates.

1/ Contribution to growth.

2/ A decrease is a depreciation.

3/ Excluding time deposits of private pension funds.

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

5/ Includes errors and omissions, but excludes reserves.

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

Statement by Javier Silva-Ruete, Alternate Executive Director for Chile and Eduardo López-Escobedo, Senior Advisor to Executive Director
July 29, 2005

Key Points

- *Improved overall global conditions for the Chilean economy and a supportive policy stance have contributed to the cyclical upturn since early 2004. The risks to short-term growth, either from an unbalanced pattern of expansion or energy scarcity have been mitigated, while capital formation is still growing strongly. Underlying inflationary pressures and unit labor costs remain subdued, while some propagation of current oil price hikes is to be expected. The Central Bank of Chile (CBCh) has been gradually withdrawing monetary policy stimulus, while fiscal policy remains within the structural surplus rule. Overall, macroeconomic policies remain supportive of the current upturn in growth.*

- *Chile's economic policy framework is geared to sustaining strong economic growth and to strengthening the economy's resilience to external and internal shocks. It is characterized by a strong commitment to macroeconomic and financial stability, surveillance and regulatory framework pursuing microeconomic efficiency, and policies promoting social equity.*

- *The challenges ahead consist of balancing the continuity of policies and institutions supporting the current strengths of the economy, further increasing productivity growth, and improving income distribution.*

INTRODUCTION

1. On behalf of our authorities we thank the staff for their insightful report and set of papers. They reflect well the open and frank discussion held in this Article IV Consultation. They are also the result of the broad scope of the mission's enquiry, which included meetings with government officials, private sector representatives, think tanks, and the economic teams of the presidential candidates.

2. **The gradual development of sound monetary and fiscal policies over the years has resulted in a very robust macroeconomic policy framework since 2000.** The fiscal policy framework is based on a solid commitment to a structural fiscal budget surplus of 1 percent of GDP. The monetary and financial policy framework is characterized by inflation targeting, floating exchange rate, open capital account, sound financial regulation and supervision, and the maintenance of prudent levels of international reserves. The adoption of this framework has allowed macroeconomic policy to be more efficient in smoothing the effects of internal and external shocks on output, and in controlling inflation. At the same time, significant progress has been made in microeconomic policy, institution building, and structural reforms.

3. While these developments have contributed to build up significantly the resilience of the economy, a casual or uninformed reading of the Staff Report could suggest that GDP evolution is mainly driven by fluctuations in the price of copper, and the domestic inflation rate by movements in the foreign exchange rate. In sharp contrast with such an interpretation, the fact is that **the performance of the Chilean economy since the adoption of its current policy framework in 2000 has been very successful at administrating and smoothing out, in a sustainable way, fluctuations of the global economic conditions, changes in commodity prices, external and internal negative energy shocks, regional economic and financial turbulence, and the political cycle**. During this period, the amplitude of the business cycle has been substantially lower than under similar conditions in the past, and annual inflation has been maintained around the target range set by the CBCh between 2 and 4 percent. The CBCh utilizes an inflation targeting framework and in this framework the evolution of the exchange rate is one among many determinants of the inflation dynamics. Furthermore, the pass-through from exchange rate depreciation to CPI inflation has been reduced significantly in recent years.

DEVELOPMENTS AND NEAR-TERM ECONOMIC PROSPECTS

4. **During the nineties, Chile was one of the fastest-growing economies in the world, to a large extent due to gains in efficiency**. In the past 15 years, the per capita income gap in Chile has diminished compared to high-income countries by around 25 percent. High growth and focalization of social expenditure have resulted in major advances in social indicators and poverty alleviation.

5. **After the slowdown in 1998-2003, favorable global and domestic economic conditions have contributed to higher economic growth.** Fifteen years of continued high expansion averaging around 6½ percent growth per year was slowed down by the onset of the Asian crisis and by global and regional turbulence in 1998-2003. Appropriate and timely monetary and fiscal policies were able to smooth the fluctuations, ending up with an average GDP growth of 2¾ percent a year. Robust world economic growth, high commodity prices, and a stronger expansion of the most important trade partners such as the Asian economies and the U.S., have been at the background of a 6 percent GDP growth during 2004 and 2005. This higher growth rate also has been decisively supported by an expansionary monetary policy.

6. **The pick-up in economic activity has gradually become more broad-based across sectors and aggregate demand components.** Both tradable and non-tradable sectors have contributed to the over 6 percent GDP growth rate in 2004 and the first five months of 2005. The value added in the energy sector has recovered, thanks to the improvement in hydrological conditions and the reduction in natural gas cuts. Fixed capital formation remains brisk, whereas exports have decelerated somewhat their year-on-year expansion. Consumption has gradually gained strength, while the pace of inventory accumulation has not accelerated further. Even though the main negative risks to the short-term outlook have tended to dissipate, the positive risk linked to a persistently favorable evolution of capital formation has become more apparent.

7. **These very favorable growth developments have not yet translated into higher underlying inflationary pressures.** Most, if not all news in the short-term inflationary outlook have been linked to the direct effect of higher oil prices and the related incidence in the regulated services tariffs. Although some propagation of these shocks to core inflation is expected in the next quarters, its magnitude remains very uncertain. Meanwhile, unit labor costs do not yet exhibit year-on-year positive increases, in spite of higher nominal wage growth and the reduction in the legal workweek, thanks to the sharp pace of labor productivity growth.

8. **Macroeconomic policies have remained supportive of the current cyclical upturn**. Monetary policy conditions remain clearly expansionary in spite of the 175 basis point increase, from 1.75 percent to 3.5 percent, in the monetary policy rate since September 2004. Credit and monetary aggregates still show high growth rates, and domestic interest rates remain low, while the real exchange rate has not shown an additional appreciation in the face of improving fundamentals. Fiscal expenditures in 2004 and 2005 have been in line with the structural budget surplus rule, resulting in a large increase in the current surplus thanks to surprisingly high tax receipts and copper returns. Fiscal policy will likely provide a bit more aggregate demand push in 2006 after the upward revision in the assumptions for the long-term price of copper and trend GDP growth.

9. **There are some external and domestic risks to the near-term economic prospects.** The main external risk factor appears to be the persistence of high oil prices. Also important are the widening regional imbalances between public and private savings and investment within and between the main economic zones, and the effect that sudden adjustments in interest rate and currencies might have on financial markets uncertainty and global activity. Particularly relevant is the U.S. monetary normalization and its effect on the sovereign spread conditions. On the domestic side, the risks are related to the evolution of private consumption, against the backdrop of a weakening in several negatively contributing factors such as energy shortages related to the supply of gas and hydrological conditions, and the accumulation of inventories. Also, there is still uncertainty on how will the reduction in the legal working-week weigh on the economy.

KEY GOALS OF THE ECONOMIC POLICY FRAMEWORK: MACROECONOMIC AND FINANCIAL STABILITY, EFFICIENCY AND SOCIAL EQUITY

10. The effectiveness and credibility of Chile's economic policy framework rely on three key aspects:

- A strong **commitment to macroeconomic and financial stability** reflected in well-specified targets for fiscal and monetary policies operating under a floating exchange rate regime, a fully open capital account, and sound financial regulation and supervision.

- A continuous promotion of **microeconomic efficiency** by fostering competition and setting appropriate incentives, and implementing a market-friendly supervision and regulatory framework.

- A systematic commitment to **social equity,** embedded in policies targeting poverty reduction and improved opportunities for low-income groups.

11. The first two aspects are essential in achieving sustained long-term growth and strengthening the economy's resilience to external shocks, while allowing the provision of a stable flow of resources to implement far-reaching social policies. Putting in place this policy framework has required considerable efforts in building and strengthening Chile's institutions.

COMMITMENT WITH MACROECONOMIC AND FINANCIAL STABILITY

12. The **fiscal** rule operation, explicitly based on a target for the central government structural surplus of 1 percent of GDP, has contributed to strengthen Chile's credibility in the international financial markets, reducing the spread at which residents can borrow abroad, and allowing monetary policy to be more effective as a result of automatic stabilizers along the cycle. The commitment of the authorities to the fiscal discipline is not only demonstrated by their strong adherence to the policy framework, but also by their **strengthening of fiscal transparency and accountability**. With that purpose, the government has sent to Congress a draft law committing future administrations to provide information on the medium-term projections of public finances, reflecting all macroeconomic and financial implications. Thus the computation of the structural budget would be incorporated in the draft budget presented to Congress each year. Furthermore, our authorities' **attention to the long-term fiscal consolidation** is revealed by the proposed creation of a special fund to finance in part future obligations originated from the government's guarantees to pay minimum and assistance pensions. As clearly shown in the Selected Issues Paper, possible future pension liabilities are limited in scope and are unlikely to give rise to fiscal stress.

13. An independent central bank with an explicit mandate of achieving price stability sets its **monetary policy** on an inflation target framework. This is **a symmetric 2-to-4 percent range centered on 3 percent**. The CBCh's operational aim is to maintain the overnight nominal interest rate on inter-bank loans equal to the monetary policy interest rate (MPR), which is met with open-market operations. In turn, the MPR level is determined in such a way that the 12-24 month inflation forecast is close to 3 percent. **Transparency and accountability** of the monetary policy have been continuously strengthened by a timely flow of information to market participants. In this direction, and following the models of Australia, Canada, U.K. and Sweden, the CBCh has recently announced that the disclosure schedule of the minutes of Monetary Policy Meeting will be shortened and that they will highlight the opinions and arguments of its Board members. Institutionalization of both monetary and fiscal policy rules has simplified **policy coordination** between the government and the CBCh, while preserving the bank's autonomy.

14. The monetary policy setting has been complemented with a **floating exchange rate regime** to facilitate the adjustment of the real exchange rate in the presence of external shocks. This regime, together with Chile's improved creditworthiness, has reduced the benefits of holding a high level of international reserves, which is expected to be reduced by redeeming part of the CBCh's dollar-linked debt with foreign reserves. However, the Central Bank still considers that maintaining a significant amount is justifiable because it serves as a

buffer stock against international liquidity shocks, and permits the authorities to credibly intervene in the foreign exchange market under exceptional circumstances.

15. The CBCh and the Ministry of Finance have also been working on ways to strengthen the bank's balance sheet, which shows a structural return differential between its assets and liabilities. This is mainly the consequence of actions taken by the CBCh during the crisis of 1982 in order to prevent the collapse of the domestic financial sector.

16. The **capital account liberalization** was completed in 2001 with the abolition of all remaining capital controls and, therefore, nowadays Chile has a fully open capital account.

17. On the issue of financial integration with the rest of the world, our authorities welcome the Selected Issues Paper which analyzes Chilean external debt. The paper makes the important point that, while Chile's private external debt is relatively high when using as benchmark other countries with similar credit risk ratings, its **external debt is in fact consistent with its per capita income, trade openness and size of the economy**. The paper also documents in a systematic way several aspects of the Chilean external debt that make it less vulnerable to market fluctuations than a first look might suggest.

18. On the **financial sector front**, Chile's sound and resilient financial system, along with its effective regulation and supervision, is the result of a continuous process of reforms and updating, both essential to reduce the impact of external shocks in Chile's increasingly integrated economy. Currently, Chile's financial sector is characterized by a sound and profitable banking industry, an active corporate and CBCh bond market, a significant availability of security-related instruments ─mortgage-backed securities, mortgage bonds, short-term commercial papers and structured products─, and a growing foreign exchange derivatives market. The CBCh has recently taken new actions, which include the modernization of the payment and settlement systems; the issuance of the Financial Stability Report, intended to monitor the strengths and vulnerabilities of the internal and external payments systems; and the review of liquidity and market risk regulation, in coordination with the Superintendency of Banks.

19. Despite these developments, Chile's financial system still faces important challenges, which the second reform to the Capital Markets Law should address. As the staff rightly points out, passing this law has been difficult since it includes second-generation financial reforms, such as funding risky projects through tax exemptions and collateralizations, which are not easily approved in a pre-electoral environment. Regarding the Selected Issues Paper on banking competition, despite the staff's comprehensive and deep analysis, the fundamental question of whether the authorities should be concerned by a banking industry operating in a monopolistically competitive environment remain unanswered. A related issue is which are the regulatory policy implications of this finding.

SUPERVISION AND REGULATION ORIENTED AT MICROECONOMIC EFFICIENCY

20. In regards to **labor market issues**, one of the main concerns of Chile's administration has been the slow reduction in unemployment rate, which always lags behind the recovery of the activity. The slow decline of the unemployment rate is within the range of experience in

previous economic recoveries and is explained by the increase in the labor force as the result of improved expectations on finding a job. Moreover, the increase in the labor force has resulted from the increased participation of women, which in Chile have a relatively low participation rate. On a more structural ground, there has been progress in ensuring worker's protection by further consolidation of the unemployment insurance scheme, and the expected approval by Congress of oral labor trials with more expeditious procedures is a step forward in that direction.

21. One of the trademarks of the current administration has been the importance given to the development of **public infrastructure**. Our authorities agree that there are more areas that could be strengthened while going forward, and actions are being taken in this direction. On conflict resolution procedures, the Ministry of Public Works recently established a board of independent professionals to act as arbitration panels. On the issue of project evaluation, public sector benchmarks are being developed for some public projects (e.g. prisons, judiciary buildings in Santiago, and a potential hospital concession). Regarding design and engineering specifications, changes proposed by contractors are being increasingly accepted, like the completed Costanera Norte, an urban highway redesigned by a contractor.

22. In terms of the **regulatory framework for utility services**, it is worth mentioning the electricity law recently approved by Congress, which will eliminate long-term price uncertainty and promote investment in the sector, thus allowing the diversification of energy sources. Investment in the energy sector is expected to exceed US$ 2 billion in the next decade.

SOCIAL EQUITY

23. Chile has registered significant distributive and poverty changes in the last fifteen years. Thanks to a slight improvement during the first half of the nineties, income distribution is better than in the eighties, but notably more regressive than during the sixties. Historical, social, cultural, territorial, racial and gender factors explain the relative rigidity of income distribution. However, **the main achievement in the last 15 years has been the reduction of poverty in Chile**. In fact, poverty incidence has decreased substantially from 45 percent in 1987 to 19 percent in 2003.

24. **The impact of Chile's well-focalized social policies is evidenced by the fact that, after considering government transfers, income inequality between the richest and the poorest quintiles of the population is halved.** This sizable impact could be enhanced in the future thanks to the government's initiatives in health care, education, and housing. The government is implementing a **health care reform**, which reinforces primary health and prevention, reorganizes the medical public sector, and improves public hospital management. The government has also launched the AUGE plan, which aims to improve coverage for critical and expensive illnesses. In **education**, Congress recently approved the access to publicly-guaranteed credits to students enrolled in private universities. In **housing** policy, the government is carrying out the renegotiation and forgiveness of mortgage debt for the lowest income groups on publicly-funded dwellings, favoring more than 260 thousand families.

LONG-TERM CHALLENGES

25. Despite Chile's progress, our authorities are aware that efforts must be redoubled to face the remaining challenges, and thereby further narrow the still large income gap with developed countries. However, in the pursuit of these objectives, special care must be given to policies and institutions that support growth and macroeconomic stability.

26. First, it is necessary to take a **new leap in productivity** that will support a steady increase in the economy's growth rate. On technological innovation, policies and institutions must be modernized in order to (i) improve technological education and increase the degree of technological adoption and innovation in the overall economy; (ii) expand the access to new technologies by micro, small and medium-size enterprises; and (iii) to promote greater interaction between universities, technological centers and enterprises. The recently approved mining royalty law will generate revenues from the extraction of non-renewable mineral resources to be used for financing technological innovations, which is a crucial ingredient to sustaining the country's growth rate over the medium- and long-term.

27. Second, to **improve income distribution**, efforts should be focused on (i) improving pre-school and high school coverage; (ii) enhancing quality of education at every level, with emphasis on preschool, elementary, and high school for the two lower-income quintiles; and (iii) enhancing coverage and delivery mostly by improving management and efficiency in both the public and private health care sectors.