

August 9, 2000

### Statement by the Chilean Authorities

1. The Chilean economy exhibited a strong performance over most of the 1990's, with real GDP growth averaging 7.8 percent between 1990 and 1997, and inflation declining gradually from 27 percent to 6 percent. These positive results notwithstanding, Chile was not spared the contagion effects of the Asian and Russian crisis, which resulted in a sharp deterioration of the terms of trade and a decline in net flows of capital in 1998. This, coupled with a sharp surge of domestic demand, led to a further widening of the current account deficit causing recurrent pressures on the peso during the year. In response to these pressures, monetary policy was tightened significantly in 1998, while public expenditure was reduced to below budgeted levels, and the exchange rate was allowed to depreciate in real effective terms. As a result, real GDP growth slowed to 3.4 percent in 1998 with domestic demand growth decelerating from over 9 percent to below 2 percent, while inflation continued to decline. By year-end, domestic demand was contracting and unemployment had risen to close to 9 percent. This situation prompted the central bank to ease the stance of monetary policy starting in the fourth quarter of 1998, and the government to implement countercyclical fiscal measures in mid-1999. Fiscal impulse doubled to 1.5 percent of GDP in 1999, with the central government position moving from a surplus of 2 percent of GDP in 1997 to a deficit of 1.5 percent. Domestic demand contracted by 10 percent while GDP fell by 1 percent in 1999, reflecting also the effects of a severe drought and electricity rationing.
2. Output and demand growth turned positive in the second half of 1999, and preliminary figures point to output growth of over 6 percent in the period January-May 2000. The recovery in employment, however, has been somewhat slower than anticipated, because growth has been led by exports which are less labor intensive than other sectors linked to domestic demand, such as construction and commerce. The government has moved to accelerate the implementation of labor intensive projects, as they believe that it is just a matter of time for employment to recover as expected from the evolution of the cycle.
3. The Chilean government agrees with the thrust of the report prepared by the staff of the IMF. Therefore, we would like to complement the report by discussing in more detail the underpinnings of the economic policy that the new administration is putting in place. The economic policy is based on three pillars: The **first pillar**, is a conservative macroeconomic policy which is rules-based in the fiscal and monetary areas. The **fiscal rule** seeks to attain a 1 percent of GDP structural surplus for the central government from 2001 onwards, based on a measure of structural position defined by correcting for the state of the cycle and incorporating long-term copper prices. Defining the fiscal stance in this manner provides fiscal policy with a key countercyclical dimension. Although the level of public debt is low at 9 percent of GDP, the government has decided to achieve fiscal consolidation over a two-

year period to recover fiscal soundness, which has been one of Chile's main distinctive landmarks over the past decade and which, together with a sound financial system, has sheltered the economy from contagion in the past. This is particularly important as the turmoil in the international markets for emerging economies still continues as evidenced by the effects on spreads following the decline in the NASDAQ Index earlier in the year. The **monetary rule** seeks to maintain inflation in a 2-4 percent range, and the central bank will react whenever the inflation rate forecast, under the assumption of no change in the stance of monetary policy, within a 12 to 24 month horizon threatens to deviate from the middle of the band. This is a symmetric rule which is being implemented against the backdrop of a freely floating exchange rate, with no intervention by the central bank, in sharp contrast with monetary policy which is active. In the context of inflation targeting and a freely flexible exchange rate, the central bank has more degrees of freedom to pursue a countercyclical monetary policy even if external shocks push the economy into the opposite side of the cycle being faced by the world economy.

4. The **second pillar** of the economic policy is given by sound supervisory and regulatory frameworks, including that concerning the financial system. These frameworks are based on market-friendly regulations intended to foster competition in a number of areas, by setting the right incentives, including continuing to reduce import tariffs. The financial system is the showcase sector in this area, as discussed below.

5. The **third pillar** consists of bold social policies. Pillars one and two are instruments that will make possible the achievement of sustainable high rates of growth which will provide resources for the implementation of far-reaching social policies. Chile has attained a reduction in poverty levels that can be considered a world record, with the poverty rate being halved to 22 percent in just 11 years. According to a World Bank study, 80 percent of the reduction in poverty can be ascribed to growth. Growth results in an increase in employment and income and provides the fiscal sector with resources to level the playing field for the poor through public expenditure in health, education, training and technological enhancements.

6. In the fiscal front, as noted above, the government is engaged in a substantive effort to strengthen the public finances to attain a structural surplus of 1 percent of GDP for the central government from 2001 onwards, with no increase in taxes. This requires a tight control of public expenditure, which will increase about 4 percent in real terms over 2000-2001, therefore below the rate of growth of GDP. In other words, the consolidation of the public finances will come not only from riding the upside of the cycle but also, and more importantly, from structural improvements. These improvements are needed because the weakening of the public finances that occurred over the past few years was not just cyclical. Given that central government expenditure increased significantly faster than GDP in 1998-99, the budgetary gap will not close automatically with the resumption of growth in the short run. A further effort will be required in order to generate a structural adjustment in the government finances.

7. The strong fiscal adjustment, which has encountered resistance and has implied investing a significant amount of political capital by the new administration, is viewed by the administration as key to return to a sound macroeconomic position that creates the conditions for sustained growth. The question is why go to a surplus and not a small deficit that maintains the debt to GDP ratio constant, when government revenues are expected to increase as the cycle reverses? First, it is to be noted that this objective will be pursued against the backdrop of central bank losses, which are projected to amount to about 0.4 percent of GDP. Second, the proposed fiscal policy stance aims at increasing central government savings from 2 percent of GDP to 4-5 percent. It is to be noted that the substitution between public and private savings (as a ratio to GDP) is estimated at 0.50 compared with 0.73 assumed in the IMF report. Therefore public savings constitute a powerful device to increase domestic savings. This, in turn, is the key mechanism to reduce external vulnerability by maintaining the current account deficit under control. Furthermore, it is difficult to put in place incentives to increase private savings by the required amounts, because in a fast growing economy people tend to anticipate consumption, which is facilitated through increased financial intermediation. Consequently, it is essential to increase public savings to attain the savings necessary to finance the investment rate required to grow at 6 to 7 percent, which, in turn, is key to continue to reduce poverty as noted above.

8. It is worth noting that the fiscal effort implies an intergenerational distribution effect, as the present generation will finance public investment outlays that will impact favorably on future generations. This is an appropriate path to follow because the resolution of poverty cannot wait, and there is a need to contain external indebtedness to reduce vulnerability to external shocks. It has been argued that growth alone is not the answer to poverty resolution. Again let us reiterate that we do not favor the concept of trickle down at all. Growth provides the resources to finance bold social policies in the areas of education, training, health and judiciary reform, areas where the government has already embarked in important initiatives. These include among others, the extension of the school day, doubling the number of computers in schools, and providing health services in a more timely manner. These are key measures to improve income distribution over the medium-term.

9. It should also be noted that the government is strongly fostering fiscal transparency. We are starting to implement measures that should result in fiscal data that meets the highest IMF standards in three years time.

10. On labor issues, the administration considers that the unemployment insurance bill (already in congress) and the labor market reform (under discussion) will not impact adversely on labor market flexibility and consequently on private investment. These reforms have been discussed extensively with business associations and unions, and changes have been incorporated in the government proposals to reflect their concerns. In fact, because unemployment insurance is partially based on individual saving accounts and operates in the event of either voluntary or involuntary job separation, it will ease distortions arising from the severance payment scheme which depends on workers' tenure (e.g., biases turnover against low tenure workers and creates moral hazard to promote layoffs rather than voluntary

separation). Furthermore, the government has stated clearly that the primary objective of the reforms is to facilitate collective bargaining at the firm level rather than at the industry level.

11. Public enterprises in Chile are managed in a holding company by a decentralized agency and have a market orientation. Most of these enterprises are highly profitable and some will be traded in the stock exchange. Investment decisions are determined by profitability criteria as in the private sector. Consequently, in defining the stance of fiscal policy, it is appropriate to focus on the central government. Moreover, although the central bank losses are being taken into consideration to determine the size of the structural surplus of the central government that is required, they will not be included in the structural balance because they are highly unstable along the business cycle, and because the central bank does not provide financing to the central government. Focusing fiscal policy on the central government structural balance aims at having a measure of the fiscal stance that is transparent and clear. Fiscal policy is implemented and will continue to be implemented through the budget.

12. Regarding the establishment of supervisory and regulatory frameworks, the government's approach is to foster competition through market-friendly regulations. One key area is the capital account. In this regard, it is very important to note that although the administration has modified the approach taken on capital controls, it has not forsworn the past, meaning that the philosophy regarding the use of capital controls has not changed. We are now moving from second best policies to first best ones following a continuum of policies made possible by external and domestic developments, and based on empirical evidence which has shown that portfolio-equity flows are not as volatile as once believed. The Chilean experience has been that net portfolio-equity flows decline but do not reverse in the event of a crisis. Investors face large losses if they liquidate their positions as a result of a large depreciation of the exchange rate and high interest rates, so they weather the crisis staying in the country. This is not the case with short-term loans, which are very volatile. Measures implemented include the elimination of the one-year permanence requirement, while the unremunerated reserve requirement on capital inflows has been maintained at zero, remaining as a contingency instrument.

13. During the 1990's, capital controls were used to prevent overindebtedness and overspending and to change the composition of foreign financing towards less volatile flows, like investment and longer-term liabilities so as to reduce vulnerability. In a freely floating exchange rate system relative to the crawling band system implemented prior to September 1999, investors are more aware of the exchange risk, and there is some dampening of capital inflows as a result. This consideration of exchange risk notwithstanding, the bulk of Chile's foreign debt is dollar denominated, so the use of synthetic financial products, as has been promoted in Chile, serves the purpose of a better distribution of risk among the residents of the country, but the aggregate exchange risk of the country is not hedged. Conscious of this fact, we are putting in place incentives for the development of a market for local currency denominated instruments in the international capital markets. In this connection, tax treatment has been equated on interest paid for debt in dollars and in pesos (indexed or not), and the World Bank has issued indexed debt in pesos (UFs) which will help for

benchmarking. Moreover, there is a segmentation of the market as there are corporations that tap the external market directly with ADRs, due to the fact that the domestic stock exchange is not integrated enough with international markets. To promote further integration of markets, we intend to eliminate the tax on capital gains to non-residents, and further legislation to protect the rights of minority shareholders. It is important to deepen the domestic stock exchange while making it more liquid, so that small and medium-sized enterprises (PYMEs) can have access to financing through this market.

14. In sum, the administration is moving towards better targeted instruments in the area of capital account and prudential regulations, promoting the use of hedging to reduce the exchange risk. A devaluation would affect favorably the trade balance, but depending on the size of foreign currency liabilities there is also a negative effect on the balance sheets of banks and corporations. Consequently, there is a tension in the system. At the time of the Asian and Russian crisis, the central bank was forced to intervene to sustain the exchange rate, as there were mismatches in currencies, with the system being better prepared to deal with high interest rates than with a large devaluation. Although banks did not have a large open exposure in foreign currency, their clients did. In this connection, from May 11, 2000 banks and third parties have been authorized to trade forwards with foreign counterparts whenever Chilean currency is involved (pesos or UFs), and banks have been allowed to hedge credit risk associated with their fixed-income portfolio and commercial loans with residents, by making use of financial derivatives for both domestic and foreign currency.

15. External loans are very procyclical and there is a need to maintain a strict control of the open position of the banks, which cannot exceed 20 percent of capital and reserves. The Superintendency of Financial Institutions is working in establishing a system to ensure that the currency mismatch of corporations does not constitute a source of vulnerability for the banking system. The objective is to improve the transparency and the timeliness of information that corporations provide to banks, and to the financial market in general. Banks will now have to take into account currency mismatching of the clients in their pricing of risk. If the Superintendency detects that banks are pricing risk derived from currency mismatching incorrectly, it will move to impose additional provisioning. The administration intends to replicate the philosophy underlying the unremunerated reserve requirement in this manner, but not in an indiscriminate manner as before, but on the basis of actual risk.

16. While agreeing with the overall thrust of the report as noted above, we strongly believe that the advice given by the Fund staff in the report regarding the future level of the monetary policy rate (referred in the report as benchmark interest rate) is debatable and thus should be carefully qualified. Moreover, the expectations regarding developments in domestic demand on which the advice was based, failed to materialize and consequently, it became outdated. The central bank conducts monetary policy in a forward looking manner based on inflation prospects. Thus, the bank monitors economic conditions to assess their effects on inflationary pressures on the basis of a comprehensive forecasting model for inflation, and relays its findings to the market through the Monetary Policy Report and monthly statements. This is done on a continuous basis because conditions do change and, more importantly, conclusions on policy actions have to be modified as a result. In the more than three months that have

elapsed since the Fund staff was in Chile, domestic demand has clearly recovered at a slower pace than expected at that time, unemployment rates are higher than projected, and long-term interest rates have fallen by more than 40 basis points, signaling that the market is not expecting an increase in the monetary policy rate. Up to date core inflation remains in the lower part of the central bank's inflation target range (2.7 percent in May-June when using the IPCX measure which excludes perishables and fuel products; 1.6 percent using IPCX1 which excludes transportation costs), there are no signs of acceleration in core inflation measures or wages despite the increase in oil-related prices. There is no indication of a propagation effect of the increase in petroleum prices and the first round increase in transportation costs, which have been affecting headline inflation.

17. In the area of trade policy, the report is somewhat unbalanced because although it recognizes the openness of the Chilean economy, it does it in a perfunctory manner and focuses instead on the use of price-bands and safeguards, implemented in the face of a sharp decline in commodity prices in the last two years. These are mentioned several times throughout the report notwithstanding the fact that they relate to five agricultural products, have been imposed on a temporary basis, for a time period which is significantly less (maximum of two years compared with eight years) than allowed by the WTO.

18. Chile is an open economy, with an index value of 1 under the Fund's trade restrictiveness index, one of only 18 countries in the world in this category, and ranked second (behind Singapore) in the recently published Emerging Market Access Index for 2000 in *The Economist* (06/10/00, page 114). Chile's open trade regime and the efforts made through the unilateral tariff reduction program, despite the turmoil prevailing in world markets in the last two years, received little attention in the report, thus painting an overall negative picture. For example, it could have been noted in the report that given the bilateral agreements negotiated by Chile, the actual average tariff is even lower than 9 percent (on a trade-weighted basis). Also, the fact that by 2003 Chile's uniform tariff will be 6 percent is not even mentioned in some parts of the report, or not enough emphasis given to the fact that Chile's tariff will fall by 45 percent (from 11 to 6 percent).

19. Moreover, the price-band scheme is not a new policy. It has been in place for more than 15 years. Its purpose is to reduce the adverse impact of instability in world prices of sugar, wheat and vegetable oils. The current levels of the tariffs reflects a sharp decline in these prices over the past two and a half years, and are not permanent. As international prices for these commodities rise, the tariff levels for these products will fall. To the extent that lower international prices continue to prevail, the tariff levels will also decline.

20. Also, two assertions made in regards to the price-bands and safeguards are contestable. First, that the high tariffs resulting from the price-band scheme caused a misallocation of resources. How would temporarily high tariffs lead to a misallocation of resources? Shouldn't producers respond to permanent changes in tariffs? Second, that such tariffs have caused undesirable income distribution effects. A significant number of the producers protected by the price-band scheme are small and medium producers with no access to other mechanisms to protect them from sudden and sharp price declines. So although important

food items are covered by the price band, the income distribution effects are in principle ambiguous. However, we recognize that without proper research no definite conclusions can be provided. Incidentally, in spite of the actual tariff levels, the domestic price of sugar in Chile is one of the lowest domestic prices of the world. This suggests that, if anything, protection in Chile is lower than in most countries

21. On the issue of the discrepancy regarding official data on short-term debt with creditor data prepared by the BIS, the central bank is making efforts to reconcile the existing differences. The discrepancies have already been reduced significantly by identifying that the BIS numbers include credit in foreign currency that branches of foreign banks extend to their clients in Chile, which is not foreign debt. Further narrowing of the differences requires quantification of Chilean securities held by foreign commercial banks so as to avoid double counting, and to estimate trade-related credits. We question also if the definition used to estimate these liabilities does in practice correspond to international standards. In particular, this question arises from the fact that under Fund-supported programs it is customary to exclude trade related credits from the definition of short-term debt for the purpose of establishing performance criteria. These liabilities arise in the conduct of trade operations, and are not viewed as increasing the vulnerability of a country, but just the opposite if they reflect an opening of the economy to international trade.

22. Two other issues merit attention. One is the methodology used to calculate the vulnerability indicators on external debt. As mentioned in the discussion of debt and reserve indicators of external vulnerability, by failing to take into account the net liability position of the private sector, i.e. foreign assets as well as liabilities, the report concludes in Box 3 that Chile's least favorable indicator might be the level of external debt and point to the fact that it has been rising rapidly relative to GDP over the past few years. Although the report notes that the external debt ratios should be considered against Chile's foreign assets, it does so in the context of concluding that the more important issue may not be the solvency of the economy as a whole, but the monitoring of the foreign exchange exposure of individual agents in the private sector. In our view, the conclusion should be that in a globalized world where financial markets have become more integrated, the normal path followed is that the private sector acquires both assets and liabilities abroad. Consequently, efforts should be made to gather information on assets to obtain a correct assessment of the vulnerability stemming from the debt indicators. Proceeding in this manner also is the only way for constructing indicators that allow comparability among countries.

23. The second issue refers to the pension system. The Chilean pension system has been used as an example by many countries. Despite this recognition, the system requires some adjustments in order to improve efficiency. In particular, investment policy regulation needs to be updated to allow for greater flexibility in portfolio management and limit herd-behavior, maintaining appropriate risk regulations. Regulations should also foster enhanced competition in the system in order to decrease administration costs. Finally, reforms are needed to improve the functioning of the annuity market and increase the coverage of the system.

24. In concluding, we want to convey our appreciation to the Fund staff for a very good set of papers and interesting and useful discussions, including on the topics reviewed in the Selected Issues paper.