

EBS/84/238

CONFIDENTIAL

November 26, 1984

To: Members of the Executive Board  
From: The Secretary  
Subject: Chile - Review Under the Stand-By Arrangement

Attached for consideration by the Executive Directors is a paper on a review under the stand-by arrangement for Chile. A draft decision appears on page 14.

It is proposed to bring this subject to the agenda for discussion on Friday, December 7, 1984, subject to Executive Board agreement to a request by the Executive Director for Chile for a waiver of the circulation period.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. van Houten (ext. (5)8624).

Att: (1)

INTERNATIONAL MONETARY FUND

CHILE

Review Under the Stand-By Arrangement

Prepared by the Western Hemisphere and the Exchange  
and Trade Relations Departments

(In consultation with the Fiscal Affairs, Legal, and Treasurer's  
Departments)

Approved by E. Wiesner and Manuel Guitian

November 26, 1984

I. Introduction

On September 10, 1984 the Executive Board completed a review under the stand-by arrangement approved on January 10, 1983.<sup>1/</sup> Under the decision completing that review the remaining purchase by Chile under the stand-by arrangement, equivalent to SDR 54 million, is contingent upon the successful completion of a review of economic policies that would seek to ensure the continued implementation of the economic program. The discussions which form the basis of this review were held in Santiago in the period October 22-November 14, 1984.<sup>2/</sup>

As of October 31, 1984 the Fund's holdings of Chilean pesos amounted to 268 percent of Chile's quota of SDR 440.5 million, including 25 percent corresponding to use of the reserve tranche, and 67 percent to purchases under the compensatory financing facility. Full use of the remaining resources (SDR 54 million) under the stand-by arrangement would raise the Fund's holdings of pesos to 280.5 percent of quota by the end of the stand-by period. Further information on Chile's relations with the Fund is presented in Appendix I.

II. Background and Performance Under the 1984 Economic Program

The economic program for 1984 envisaged the implementation of policies to foster economic recovery and consolidate the progress made in 1983 in re-establishing financial stability and strengthening the financial system. Demand management policies were designed to be consistent with a growth rate of about 4 percent, overall balance of

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<sup>1/</sup> EBS/84/179 (8/20/84) and Supplement 1 (9/7/84).

<sup>2/</sup> Staff representatives in the discussions were J. van Houten (Head), P. Brenner (both WHD), P. Molajoni (ETR), C. Muniz (WHD), and A. Cooke (secretary-WHD). The mission was assisted by J. Leimone, resident representative in Santiago.

payments equilibrium, and a reduction of inflation to less than 20 percent from 23 percent in 1983. All the performance criteria of the program for September 30, 1984 were observed (Table 1).

Following a strong expansion of real GDP during the first semester of 1984, economic activity is estimated to have declined in the third quarter as a result of the dampening effects of a decline in the terms of trade (principally reflecting lower copper prices) and increased interest rates abroad. Uncertainties about the direction of economic policy in response to the harsher external environment also contributed to the decline in economic activity. It is expected that activity will weaken further in the final quarter of the year. Even so, for 1984 as a whole real GDP is projected to increase by over 5 percent in relation to 1983.

During the first semester, GDP growth was accompanied by an increase in employment and a decline in inflation to an annual rate of 13 percent. The rate of inflation through July and August remained low, but employment ceased to grow.

The deficit of the nonfinancial public sector in the first nine months of 1984 was 1.4 percent of GDP less than programmed, principally because of a combination of higher than expected operational surpluses and lower capital outlays by public enterprises. Capital formation by the general government was somewhat larger than programmed, but this was more than offset by lower transfer payments to the private sector and lower domestic interest payments due to the slowdown of inflation. General government current revenue developed as projected (Table 2).

The operational surpluses of the enterprises exceeded the amounts envisaged in the program for the first nine months by the equivalent of 0.5 percent of GDP. The improvement reflected a better than projected performance of the state copper company (CODELCO), the state petroleum company (ENAP), and the state steel company (CAP). Current spending by CODELCO was below projection and revenue was boosted by an unexpected rise in the mineral content of the ore at CODELCO's main open-pit mine, which resulted in output exceeding the program level by 7 percent. Up to midyear, the increase in production more than offset the effect on the value of exports of lower than projected copper prices. The operations of ENAP showed an improvement as domestic sales were maintained while imports of petroleum were below the original estimate and local production exceeded projections. Domestic sales of steel by CAP were moderately higher than had been projected.

Capital outlays by the public enterprises were 0.7 percent of GDP less than programmed. The construction of the Colbun-Machicura hydroelectric plant proceeded at a slower pace than had been envisaged, and the capital spending plans of CODELCO were implemented at a lower than programmed cost. The financing of the deficit of the nonfinancial public sector in the January-September 1984 period was split evenly between external and domestic sources, as had been envisaged in the program.

Table 1. Chile: Performance Under the Stand-By Program, 1984 <sup>1/</sup>

	1984		
	Mar. 31	June 30	Sept. 30
(In billions of Chilean pesos)			
<u>Net domestic assets of the</u>			
<u>Central Bank</u>			
Limit	140	160	180
Actual	136	149	177
Margin	4	11	3
<u>Outstanding indebtedness of</u>			
<u>the nonfinancial public</u>			
<u>sector</u>			
Limit <sup>2/</sup>	590 <sup>3/</sup>	632	664
Actual	582	603	640
Margin	8	29	24
<u>Outstanding domestic indebt-</u>			
<u>edness of the nonfinancial</u>			
<u>public sector</u>			
Limit <sup>2/</sup>	138 <sup>3/</sup>	149	161
Actual	142	133	138
Margin	-4	16	23
(In millions of U.S. dollars)			
<u>Net international reserves</u>			
<u>of the Central Bank</u>			
Target	1,000	1,115	1,205
Actual	1,099	1,356	1,315
Deviation	99	241	110
<u>Contracting and guaranteeing</u>			
<u>of external debt by the</u>			
<u>nonfinancial public sector</u>			
<u>Limit on debt with maturity</u>			
<u>of 1 to 10 years</u>			
	3,850	3,850	3,850
Actual	1,467	2,603	2,797
Margin	2,383	1,247	1,053
<u>Limit on debt with maturity</u>			
<u>of 1 to 5 years</u>			
	125	125	125
Actual	75	75	125
Margin	50	50	--

Source: Central Bank of Chile.

<sup>1/</sup> Foreign currency is converted at Ch\$89 per U.S. dollar for the period January-March, Ch\$91 per U.S. dollar for the period April-June, and Ch\$94 per U.S. dollar for the period July-September.

<sup>2/</sup> The limit and sublimit have been adjusted to reflect revisions in the base data for December 31, 1983 in accordance with the provision of Table 1 of the Memorandum on the Economic Policies of Chile.

<sup>3/</sup> Indicative limit, not a performance criterion for this date.

Table 2. Chile: Operations of the Consolidated Nonfinancial Public Sector

(In percent of GDP)

	1981	1982	Est. 1983	1984			
				January-September		Year	
				Prog.1/	Est. 1/	Prog.	Proj.
<u>General government current revenue</u>	31.7	30.2	27.9	19.8	19.8	27.3	27.3
Taxes on income and property	5.7	5.8	5.0	3.0	2.9	4.1	4.2
Taxes on goods and services	13.0	13.6	13.6	9.9	10.1	13.9	14.0
Taxes on international trade	2.2	1.5	2.4	2.1	2.2	2.9	3.0
Social security tax	4.7	3.3	2.8	2.1	2.1	2.8	2.8
Other tax (net of IVA rebate)	-0.7	-1.2	-1.2	-0.8	-0.9	-1.2	-1.2
Nontax revenue	6.8	7.2	5.3	3.5	3.4	4.8	4.4
<u>Operating surplus of the public enterprises</u>	5.6	8.3	11.6	7.2	7.7	10.2	10.9
Of which: CODELCO	1.9	2.5	4.3	2.0	2.2	3.3	3.3
<u>Net transfers to general government</u>	-5.5	-7.1	-8.8	-5.4	-5.5	-7.5	-7.9
<u>General government current expenditure</u>	26.3	32.2	30.7	21.6	21.0	29.3	29.7
Wages and salaries	7.7	7.9	6.7	4.6	4.7	6.2	6.3
Goods and services	2.9	3.4	3.3	2.1	2.2	3.0	3.2
Social security payments to private recipients	8.1	10.9	9.7	7.4	7.1	10.0	9.8
Transfer and subsidy payments to private sector	6.8	9.1	8.9	5.8	5.7	7.7	8.0
Interest on public debt	0.4	0.6	1.8	1.4	1.2	2.1	2.1
Other	0.4	0.4	0.3	0.2	0.2	0.2	0.2
<u>Current account surplus of the nonfinancial public sector</u>	5.5	-0.8	--	--	1.0	0.8	0.5
<u>Net capital revenues</u>	0.4	2.1	1.9	1.2	1.0	1.5	1.3
Revenue	3.2	7.9	3.9	2.4	2.1	3.2	2.9
Financial investment	-2.7	-5.7	-2.0	-1.2	-1.1	-1.7	-1.6
<u>Capital formation</u>	5.1	4.7	4.9	5.0	4.3	6.8	6.6
General government	2.5	2.1	2.1	1.8	1.9	2.7	2.8
Public enterprises	2.6	2.6	2.8	3.2	2.5	4.1	3.8
<u>Overall surplus or deficit (-)</u>	0.8	-3.4	-3.0	-3.8	-2.4	-4.5	-4.7 2/
<u>Financing</u>	-0.8	3.4	3.0	3.8	2.4	4.5	4.7
External	2.7	1.1	-1.0	1.9	1.2	2.2	3.6
Internal	-3.5	2.3	4.0	1.9	1.2	2.3	1.1
<u>Memorandum item</u>							
Nominal GDP (in billions of Chilean pesos)	1,289	1,229	1,546	...	...	1,941	1,934

Sources: Ministry of Finance; and Fund staff estimates.

1/ Ratios are taken in relation to full year GDP estimate.

2/ Figure is compatible with the net borrowing requirements established in the program. The ratio to GDP differs from the program ratio as a result of changes in nominal GDP and average exchange rate from those projected in the program.

Notwithstanding the better than programmed fiscal performance, the deficit in the current account of the balance of payments in the first nine months of 1984 was US\$580 million (2.9 percent of GDP) larger than expected (Table 3). This outcome reflected to an important extent strong import demand by the private sector, initially in response to the faster than expected rate of growth of GDP and later because of fears of a devaluation or an increase in import duties. In the January-September period the value of imports (in U.S. dollar terms) was about 12 percent higher than envisaged in the program.

The value of exports, which in the first semester of 1984 had been in line with the program, fell considerably short of projection in the third quarter of the year. The shortfall was related principally to lower than projected prices of exports. In particular, the copper price averaged 60 U.S. cents a pound in the third quarter compared with a programmed price of 80 U.S. cents. Net nonfactor service payments exceeded projections, reflecting the higher import level and a larger deficit on travel services than originally envisaged. Net factor service payments were close to the program level as the effect of higher foreign interest rates was offset by lower than forecast interest payments by the private corporate sector.

Capital inflows in the first nine months of 1984 exceeded projections by a substantial amount, financing the higher current account deficit and permitting a larger than planned net international reserve position. Somewhat larger medium- and long-term net capital inflows compensated for lower than projected direct investment. Other net capital inflows exceeded expectations by a wide margin on account of a sizable drawdown of foreign assets by the financial system and the corporate private sector, and of a larger than envisaged use of foreign credit lines by the state copper company (CODELCO). The net drawdown of foreign assets by the private sector was related to efforts by the corporate sector in Chile to improve its domestic balance sheet through a reduction in the ratio of debt to equity. The use of credit lines by CODELCO was associated with the financing of copper exports and thus should not present repayment or refinancing problems upon maturity.

Domestic financial assets held by the private sector expanded by 6.2 percent in real terms in the first nine months of 1984 (Table 4). The expansion was uneven; an unseasonably rapid growth in the initial months of the year was followed by a decline in the second quarter when foreign interest rates moved up and world copper prices weakened. In the third quarter, the rate of growth of financial assets turned positive again in real terms as domestic interest rates increased. Domestic bank credit to the private sector expanded in real terms throughout the first three quarters of 1984, whereas credit to the public sector contracted sharply in real terms in the April-June period in reflection of lower than projected total financing needs and larger than programmed external financing.

Table 3. Chile: Balance of Payments

(In millions of U.S. dollars)

	1981	1982	1983	1984			
				Jan.-Sept.		Year	
				Prog.	Prel.	Prog.	Prel.
<u>Current account</u>	-4,733	-2,304	-1,073	-873	-1,454	-1,250	-1,821
Trade balance	-2,677	63	1,009	795	298	995	399
Exports	(3,836)	(3,706)	(3,827)	(3,070)	(2,841)	(4,100)	(3,668)
Copper	[1,738]	[1,685]	[1,871]	/1,319/	/1,220/	[1,867]	/1,633/
Other	[2,098]	[2,011]	[1,956]	/1,751/	/1,621/	[2,233]	/2,035/
Imports	(-6,513)	(-3,643)	(-2,818)	(-2,275)	(-2,542)	(-3,105)	(-3,270)
Nonfinancial services	-701	-555	-471	-392	-465	-498	-514
Financial services	-1,463	-1,921	-1,703	-1,363	-1,371	-1,848	-1,805
Transfers	108	109	92	86	84	100	99
<u>Capital account</u>	4,698	1,015	388	885	1,464	1,250	1,787
Direct investment	362	384	148	100	51	160	70
Scheduled amortization	-1,106	-1,206	-1,814	-1,102	-1,130	-1,551	-1,525
Special amortization	-686 <sup>1/</sup>	-42 <sup>1/</sup>	-236 <sup>2/</sup>	...	...	...	...
Medium- and long-term gross disbursements	5,095	2,619	3,096	1,904	1,968	2,673	2,659
From agreement with foreign banks	(--)	(--)	(2,450)	(1,288)	(1,393)	(1,803)	(1,836)
Refinancing	[--]	[--]	[1,150]	/738/	/772/	[1,019]	/1,019/
New loans	[--]	[--]	[1,300]	/550/	/622/	[784]	/817/
Other disbursements	(5,095)	(2,619)	(646)	(616)	(574)	(870)	(823)
Nonfinancial public sector	[790]	[1,025]	[293]	/466/	/420/	[613]	/610/
Private sector <sup>3/</sup>	[4,305]	[1,594]	[353]	/150/	/155/	[257]	/213/
Change in medium- and long-term assets of private sector	-37	9	17	--	4	--	4
Commercial credits	-31	-894	-103	-19	-59	-84	-19
Other net inflows	1,102	144	-719	-28	631	52	598
Nonfinancial public sector	(716)	(-19)	(-231)	(-3)	(169)	(39)	(269)
Private sector <sup>3/</sup>	(386)	(163)	(-488)	(-25)	(462)	(13)	(329)
<u>Errors and omissions</u>	105	-76	45	--	62	--	62
<u>SDR allocations</u>	28	--	--	--	--	--	--
<u>Overall balance of payments</u>	98	-1,365	-641	12	73	--	28
<u>Valuation adjustment of official reserves</u>	-93	-28	53	--	33	--	33
<u>Changes in official reserves (increase -)</u>	-5	1,393	588	-12	-106	--	-61

Sources: Data provided by the Central Bank of Chile; and staff estimates.

<sup>1/</sup> Prepayments of debt.

<sup>2/</sup> Corresponds to transfer of assets of Banco Andino de Panama to Chilean banks against their deposits in that institution.

<sup>3/</sup> Consists principally of a reduction in the foreign assets of the Banco del Estado and the private corporate sector.

Table 4. Chile: Monetary Indicators <sup>1/</sup>

	1983					1984				
	Mar.-	June-	Sept.-	Dec.-	Dec. 1983	Mar.-	June-	Sept.-	Proj.	Dec. 1984-
	Dec. 1982	Mar.	June	Sept.	Dec. 1982	Dec. 1983	Mar.	June	Dec.-	Dec. 1983
<b>A. Central Bank</b>										
(Change in millions of U.S. dollars)										
International reserves <sup>2/</sup>	-1,029	-161	749	-147	-588	-106	256	-42	-45	63
Medium- and long-term foreign liabilities <sup>3/</sup>	-7	-11	1,076	225	1,283	-5	392	239	187	813
(Percentage change) <sup>4/</sup>										
Net domestic assets	156.3	14.2	58.1	80.4	313.0	23.5	22.2	40.5	92.4	187.6
Liabilities to the private sector <sup>3/</sup>	6.5	-6.3	4.3	14.9	19.5	7.7	-1.1	-1.4	16.9	22.7
<b>B. Financial System</b>										
(Change in millions of U.S. dollars)										
International reserves <sup>2/</sup>	-698	-287	830	-25	-180	-213	317	628 <sup>5/</sup>	54	786 <sup>5/</sup>
Medium- and long-term foreign liabilities <sup>6/</sup>	1	-85	1,128	413	1,457	122	507	1,044 <sup>5/</sup>	154	1,827 <sup>5/</sup>
(Percentage change) <sup>7/</sup>										
Net domestic assets	7.2	7.6	8.0	9.9	36.9	6.5	4.7	6.3	14.5	38.0
Credit to the public sector (net) <sup>8/</sup>	85.9	76.7	17.4	147.9 <sup>9/</sup>	855.4 <sup>9/</sup>	13.7	-1.4	4.5	19.1	41.0
Credit to the private sector	-0.2	4.5	7.2	7.6	20.3	3.8	5.2	4.6	12.4	29.2
Liabilities to the private sector <sup>8/</sup>	2.4	6.0	5.0	6.5	21.4	7.3	3.0	6.7	14.3	34.6
<b>Memorandum items</b>										
Inflation rate (CPI)	3.8	6.0	7.1	4.4	23.1	2.4	4.0	4.2	14.8	27.4
Exchange rate (pesos per U.S. dollar)	--	5.8	6.3	6.3	19.2	0.8	3.7	25.7	12.5	47.8

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

<sup>1/</sup> Changes based on end-of-period data; foreign currency components are valued at end-of-period exchange rates, except for the third quarter of 1984, when the changes in the foreign currency components were valued at the average exchange rate of that period.

<sup>2/</sup> Minus sign indicates a decline.

<sup>3/</sup> Program definition. Excludes central bank promissory notes in the hands of the private sector and foreign liabilities on account of the refinancing of private and public sector debt.

<sup>4/</sup> As percent of liabilities to the private sector at the beginning of the period.

<sup>5/</sup> Flows include the conversion of short-term foreign liabilities to medium-term foreign liabilities.

<sup>6/</sup> Includes refinancing operations.

<sup>7/</sup> Changes with respect to the stock outstanding at the end of the previous period.

<sup>8/</sup> Includes holdings of treasury notes by the nonfinancial private sector.

<sup>9/</sup> Includes credit operations on account of the 1983 capitalization of the Central Bank.



### III. Review of Economic Policies and Short-Term Prospects

The staff noted that prospects for the second half of 1984 and subsequent years were affected adversely by unfavorable external factors that were expected to place pressure on the balance of payments. Also, the trade balance had been weakened because of a much higher than projected import level related to the faster than envisaged rate of growth of demand, and to expectations of changes in the exchange rate and import duties.

These developments indicated that major policy adjustments would be required for the economic program for 1984 to be implemented successfully. At the time of the September review under the stand-by arrangement, the authorities reiterated their commitment to the economic program for 1984 and communicated to the Fund their intentions with regard to fiscal, monetary, and interest rate policies. At the same time they indicated that they would implement measures that would seek to reconcile the balance of payments and growth objectives over the medium term as they expected to begin discussions with the Fund in the near future on an economic program covering the 1985-87 period.

Subsequently, on September 18, 1984, the authorities devalued the peso by 19 percent in relation to the U.S. dollar, raised import duties from an average of about 21 percent to a uniform rate of 35 percent, and announced that a drawback system for exporters would be established to mitigate the adverse effects of higher duties on exports. Since then they have announced that effective in January 1985 public sector wages at the lower salary levels will be fully adjusted for the increase in the cost of living in 1984, and that wages at higher levels will be adjusted only in part. As an advance on these adjustments, small monthly bonuses for public employees, pensioners, and beneficiaries of employment and welfare programs have been granted. The authorities estimated that, on a weighted basis, the wage increases would amount to about 70 percent of the cost of living increase in 1984.

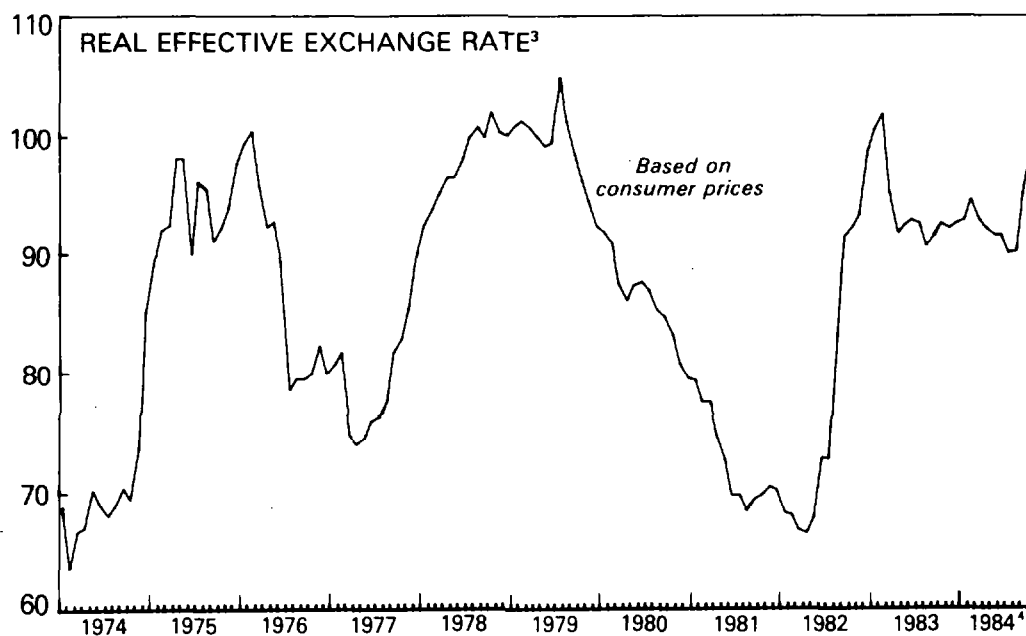
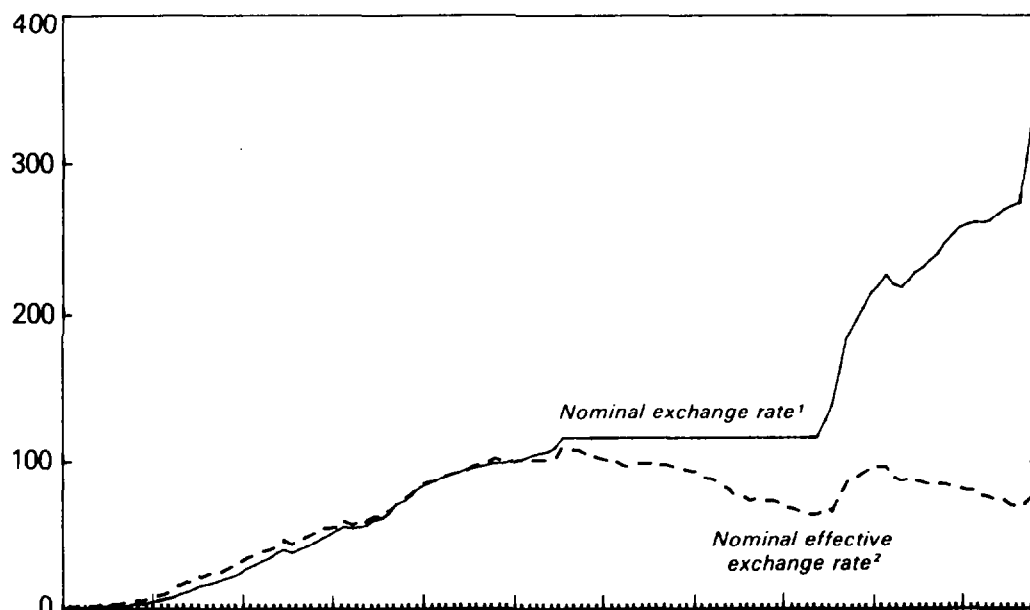
The following sections contain a report of the discussions with the authorities on the recent policy actions in the context of the objectives of the 1984 economic program.

#### 1. External sector policies

The authorities explained that the decision to devalue was taken following an assessment of the prospects for a number of external variables, including foreign interest rates and copper prices. This assessment indicated that a major change in relative prices was needed if Chile's balance of payments and growth objectives were to be reconciled over the medium term. It was expected that the devaluation would help also to restrain import demand in the remaining months of 1984, following a speculative upsurge in imports in the second and third quarters of 1984. Chart 1 indicates the development of the average monthly real effective exchange rate of the peso through September 1984.

# CHART 1 CHILE EXCHANGE RATE INDICES

(Dec. 1978 = 100)



Sources: Central Bank of Chile, *International Financial Statistics*, and Fund staff estimates.

<sup>1</sup>Pesos per U.S. dollar at end of period.

<sup>2</sup>Nominal exchange rate index adjusted by a weighted index of exchange rate movements of major trading partners.

<sup>3</sup>Real exchange rate index adjusted by weighted indices of prices and exchange rate movements of major trading partners.

<sup>4</sup>Partly estimated.



The devaluation was accompanied by an announcement that the newly established real effective exchange rate of the peso would be maintained by continuing the previous crawling peg system whereby the peso was depreciated on a daily basis during any one month at a rate equivalent to the change in the consumer price index in the previous month less an estimate of external inflation.

The combination of the devaluation and the increase in import duties had a sharp impact on domestic prices. The consumer price index rose by 2.9 percent in September and 8.2 percent in October, compared with an 11 percent increase in the first eight months of 1984. The authorities were concerned about the sharp acceleration of inflation and in an attempt to moderate expectations of further price increases, announced that the peso would be depreciated in November by about one half the rate of inflation registered in October. They explained to the staff that this deviation from the established policy was temporary, and that the established exchange rate policy would apply after November. The staff expressed its concern about the probable effect of the deviation in November on Chile's competitiveness, and it urged the authorities to refrain from using the exchange rate as a short-term policy instrument.

In reply to queries by the staff as regards the maintenance of the restriction on the sale of exchange for tourism and of the minimum import payment period, the authorities commented that balance of payments pressures continued to be very strong. They said that implementation of further liberalization of the exchange system would have to wait until the effects of the devaluation took hold. With respect to the continued existence of the officially recognized parallel exchange market, the authorities said that the spread with respect to the official market had narrowed to about 8 percent since the devaluation, compared with a 20-25 percent spread before the exchange rate action. They were confident that with the pursuit of prudent demand management and a credible exchange rate policy the spread would continue to decline.

The devaluation had not been applied to the reference exchange rate which governs the subsidy on certain debt service payments by the private sector, and as a result the subsidy had increased from Ch\$14 per U.S. dollar to Ch\$37 per U.S. dollar. At the same time, however, the total value of outstanding debt which could benefit from the subsidy in the future was reduced substantially as a result of a number of dedollarization provisions which were in effect until October 15, 1984; these provisions had allowed debtors to shift from dollar-denominated loans to domestic currency debt indexed to the rate of inflation.

As was noted above, the September devaluation was accompanied by an increase of import duties to a uniform level of 35 percent. The authorities defended the increase in import duties as a fiscal revenue measure. However, it would start to yield additional revenues only in early 1985, since all outstanding import registrations could be exercised using the tariff rate existing at the time the registration was effected.

The authorities agreed with the staff that the tariff action was likely to reduce the benefits of the devaluation for export growth over the medium term. For this reason, a drawback scheme was being worked out by a technical commission. The new drawback scheme would complement two existing schemes to promote exports but these are administratively complex and have only limited application. One of these establishes a drawback for goods imported directly by the exporter for his own use, and the second scheme applies to goods imported into free zones and intended for re-export following a process of transformation. Exporters would be able to choose between the available schemes.

## 2. Fiscal and monetay policies

The authorities agreed with the staff that the exchange rate action described above needs to be supported by appropriate fiscal and monetary management for the objectives of the economic program to be met.

The authorities indicated that the operations of the nonfinancial public sector through September 1984 had been substantially better than programmed, notwithstanding the shortfall of copper prices in relation to the program. In the fourth quarter, the continued shortfall of copper prices was expected to affect adversely the operational surplus of CODELCO. However, the operational surplus of other public enterprises was projected to more than offset the shortfall. In particular, the operational surplus of the state petroleum company (ENAP), was expected to improve sharply as a result of the 23 percent increase in the domestic price of petroleum derivatives implemented after the September devaluation.<sup>1/</sup>

With respect to the fiscal measures which had been under discussion during the September 1984 review, the authorities stated that the reduction in public works expenditures and in transfers to the National Regional Development Fund had been implemented. However, projected sales of assets by the state holding company (CORFO) were no longer expected to materialize. Also a number of other revenue measures, including a stamp tax on renegotiated debt and increases in weekend road tolls for automobiles, had not yet been implemented. These measures were included in a bill scheduled to be discussed by the Government in the near future in the context of the 1985 budget. The staff agreed with the authorities' observation that the positive impact of the devaluation on the public finances more than offset any revenue shortfall associated with the delayed implementation of these revenue measures.

Capital spending by public enterprises and the general government was expected to increase in the fourth quarter relative to previous periods notwithstanding the cuts mentioned above, but would still remain below the program level for the year as a whole. General government current spending in the fourth quarter also was expected to rise

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<sup>1/</sup> Approximately one half of the sales of ENAP derive from domestic petroleum production.

in relation to the previous three quarters principally on account of the special Ch\$400 monthly bonus given to general government employees, (and their dependents) and to pensioners in the September-December period 1/ to compensate in part for the price increases following the devaluation and tariff increase.

The staff observed that although it would appear on the basis of the authorities' fiscal plan for the fourth quarter that the nonfinancial public sector deficit for the year as a whole would remain within the program, a smaller deficit in the fourth quarter would have been more appropriate to avoid placing undue strain on the domestic financial system at a time when monetary policy was being tightened substantially. The authorities replied that they did not consider the planned fourth quarter deficit to be a problem requiring urgent action, as they expected that the demand for credit by the private sector would be weak in this period. They also noted that the level of spending projected for the fourth quarter might not be reached, as had occurred in the first three quarters of the year. Nevertheless, they were reluctant to change the projection at this stage, as this might give rise to new spending pressures.

The September 1984 devaluation placed a heavy burden on central bank operations. The authorities had anticipated that the devaluation would be costly to the Central Bank as the debt dedollarization provisions and the maturing swap operations were completed at the predevaluation exchange rate. Thus, in October the net central bank credit expansion had been large and the net international reserve loss substantial. The authorities agreed with the staff's observation that a substantial tightening of credit policy was required in the remaining period of 1984 if the program objectives were to be achieved. They presented the staff with a monetary plan consistent with this objective and as of the last week of October stepped up sharply open market sales.

Until September 1984, this year's rise in foreign interest rates had not fully been reflected in increased domestic interest rates, principally because the Central Bank was suggesting an upper limit on interest rates for 30-day deposits without adequately taking into account movements in foreign interest rates, while continuing at the same time to pay subsidy on dollar-peso swap operations. Following the devaluation the Central Bank permitted market forces a larger role in determining interest rates. The subsidy on swaps was reduced by 1 percentage point to 4.6 percent per year, and the policy of suggesting the 30-day rate was abandoned. However, the resulting sharp increase in 30-day deposit rates to over 8 percent a month, in reflection of a temporary price surge following the devaluation and import tariff increase, gave rise to a strong public reaction. Consequently, within a short period, the policy of suggesting interest rates was reintroduced,

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1/ The Ch\$400 bonus corresponding to January 1985 is to be paid before December 25, 1984.

with the level set at 4.5 percent a month. Interest rates on operations of over 30 days have continued to be determined by the market, however, and in real terms such rates are above corresponding foreign interest rates.

#### IV. Staff Appraisal

Economic prospects for the final quarter of 1984 and subsequent years are not encouraging for Chile as unfavorable external factors are expected to place pressure on the balance of payments. Foreign interest rates continue to be substantially higher than had been expected and copper prices continue to be much weaker than had been projected.

Notwithstanding these difficulties, at the time of the September 1984 review under the stand-by arrangement, the authorities reiterated that they would continue to adhere to the economic program agreed with the Fund. The staff noted at that time that continued adherence to the economic program through the end of 1984 would involve a number of policy adjustments in the short term.

On September 17, 1984, shortly after the review was completed by the Executive Board, the Chilean authorities devalued the peso by 19 percent in terms of the U.S.dollar, and announced that the improved competitiveness of the economy would be protected through a policy of daily small depreciations at a rate equivalent to the difference between domestic and foreign inflation. The staff supports this measure as a key element in protecting the balance of payments while strengthening economic growth over the medium term.

However, in November the authorities temporarily slowed the rate of depreciation of the peso following the sharp rise in consumer prices in October. It is the view of the staff that this shift of policy needs to be corrected to avoid adverse effects on Chile's competitiveness and the possible undermining of the credibility of exchange rate management. Hence the staff welcomes the authorities intention to return to the basic exchange rate adjustment policy in early December 1984, and urges the authorities to refrain from using the exchange rate as a short-term policy instrument.

The authorities have presented to the staff a fiscal and monetary plan for the fourth quarter of 1984 that was in accordance with the economic program. The fiscal plan for the fourth quarter contemplates using the outstanding margin available under the economic program at the end of the third quarter. Although this plan is in conformity with the public sector indebtedness established in the economic program, the staff would urge the authorities to examine their strategy with a view to reducing spending in the final months of the year so as to reduce pressure on domestic financial markets.

The monetary plan involves a substantial tightening of central bank net credit policy in November and December following a sizable credit expansion in the immediate post devaluation period. In conformity with this plan, as of late October the Central Bank has expanded open market sales substantially and has permitted domestic interest rates to rise markedly. The staff notes that the authorities will need to persevere in their tight policy stance if the credit program is to be fully implemented and the balance of payments target is to be achieved. Consistent with this policy, the Central Bank reduced somewhat the subsidy paid on peso-dollar swap operations and eliminated the suggested interest rate ceiling on 30-day deposits. However, the suggested ceiling was reimposed shortly thereafter, reportedly to correct unstable domestic market conditions. This was a step in the wrong direction and the staff would encourage the authorities to keep domestic interest rates competitive with foreign rates and to ease interest rate controls further as domestic market conditions stabilize.

The September 1984 increase in import duties to a uniform level of 35 percent has been defended by the authorities as a fiscal measure which would begin to have effect only in 1985. To moderate the effects on exporters of the increase in duties, a drawback scheme was to be implemented promptly. Difficulties in finding an adequate technical solution have delayed the implementation of such a scheme. The export sector, consequently, continues to be penalized by the tariff increase. The staff notes that the tariff action raises questions about the medium term growth strategy of the Chilean authorities, and expects to raise this issue in the context of the discussions of a medium-term economic program covering the 1985-87 period.

In summary, the Chilean authorities have taken strong policy actions to adhere to the economic program for 1984 and set the stage for balance of payments adjustment over the medium term. Nevertheless, the staff would caution the authorities to take care not to undo the positive effects of their actions through short-term manipulation of basic policies as this might create uncertainties about the course of economic management and thus undermine the achievement of the 1984 objectives as well as the medium-term strategy.



V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board.

1. Chile has consulted with the Fund in accordance with paragraph 2 of the Executive Board Decision No. 7800-84/139 of September 10, 1984 (EBS/84/179, 8/20/84; and Supplement 1, 9/7/84) which completed a review under the stand-by arrangement for Chile (EBS/82/227, Supplement 2, 1/11/83).
2. The Fund finds that no further understandings are necessary, and that Chile may proceed to make purchases under the stand-by arrangement.

Chile - Fund Relations  
(As of October 31, 1984)

I. Membership Status

- (a) Date of membership: December 31, 1945
- (b) Status: Article VIII

II. General Department

- (a) Quota: SDR 440.5 million.
- (b) Total Fund holding  
of Chilean pesos: SDR 1,181.5 million or 268.2 percent  
of quota as of October 31, 1984.

	Millions of SDRs	Percent of Quota
Of which:		
Under CFF	295.0	67.0
SBA: general resources	236.0	53.6
EAR	210.0	47.7

- (c) Fund credit to Chile amounts to SDR 741 million or 168.2 percent of quota.

III. Current Stand-by or Extended Arrangement and Special Facilities

- (a) Current stand-by:
  - (i) Duration: From January 10, 1983 to January 9, 1985
  - (ii) Amount: SDRs 500 million
  - (iii) Utilization: SDRs 446 million
  - (iv) Undrawn balance: SDRs 54 million

- (b) Previous stand-by arrangements since 1974.

<u>Date of Approval</u>	<u>Duration</u>	<u>Amount</u>	<u>Amount Actually Drawn</u>
January 1974	1 year	SDR 70 million	SDR 70 million
March 1975	1 year	SDR 79 million	SDR 20 million

- (c) Compensatory financing facility:

<u>Date of approval</u>	<u>Amount</u>
January 10, 1983	SDR 295 million

IV. SDR Department

SDR position:	As of October 31, 1984	Millions	Percent of
		of SDRs	Net Cumulative Allocation
	Net cumulative allocation	121.9	100.0
	Holdings	(12.3)	(10.1)

B. Nonfinancial Relations

- V. Exchange Rate Arrangement: The Chilean peso is pegged to the U.S. dollar. On September 17, 1984 the peso was devalued from Ch\$93 per U.S. dollar to Ch\$115 per U.S. dollar. The official rate is adjusted daily on the basis of the Chilean rate of inflation during the previous month less the world rate of inflation, assumed for this purpose to be no more than 0.4 percent per month. The official rate on October 31, 1984 was Ch\$117.10 per U.S. dollar. This policy was temporarily interrupted during November when the rate of depreciation for the month was set at approximately one half the rate of inflation of October.

Chile maintains a multiple currency practice arising from a subsidy of approximately 40 percent on certain foreign debt service payments by the private sector on foreign debt contracted before August 6, 1982. The size of the spread between the exchange rates in the official market and the parallel market in which a number of current invisible transactions take place also constitutes a multiple currency practice. Chile maintains exchange restrictions arising from the limitations placed on the sale of foreign exchange for tourism and from a 120-day deferment period on import payments. These measures have been approved by the Fund through the end of 1984.

- VI. Last Consultation: The 1983 Article IV consultation discussion was completed, and performance criteria for the second year of the stand-by arrangement were approved by the Executive Board on May 14, 1984 (EBS/84/50). The consultation is under the standard 12-month cycle. The required midyear review under the stand-by arrangement was completed and a further review, to be completed prior to the final purchase under the stand-by arrangement, was established by the Executive Board on September 10, 1984 (EBS/84/179 and Supplement 1).
- VII. Technical Assistance: The Central Banking Department provided a consultant on bank supervision, concerning the system for classification of doubtful and problem loans. The consultant visited Santiago from July 1 to August 23, 1982. Another Central Banking Department consultant visited Santiago during March 1984 to review legislation on a national deposit insurance scheme.

The Bureau of Statistics provided a technical assistance mission to Chile on January 16-28, 1983. The mission assisted the Central Bank in converting its monetary data system to the new Fund data system. During the first week of August 1983, a representative of the Bureau of Statistics presented a seminar on improving the methodology for producing government finance statistics. A representative of the Bureau of Statistics arrived in Santiago on November 19, 1984 to assist in revising the presentation of the monetary accounts.

- VIII. Resident Representative: A resident representative has been stationed in Chile since November 1982. Mr. John Leimone was assigned to Chile for an initial appointment of one year beginning July 1984.

## Chile: Economic Indicators

	1981	1982	1983		1984	
			Prog.	Est.	Prog.	Proj.
<u>Real economy (rates of growth)</u>						
Real GDP	5.7	-14.3	4.0	-0.8	4.0	5.5
Nominal GDP	19.9	-4.7	41.6	25.8	25.2	25.1
Consumer prices						
Average	19.7	9.9	28.3	27.3	21.5	20.5
End of year	9.5	20.7	25.0	23.1	20.0	27.3
<u>Nonfinancial public sector</u> <u>(ratios to GDP)</u>						
Overall surplus or deficit (-)	0.8	-3.4	-1.7	-3.0	-4.5	-4.7
External financing (net)	2.0	2.7	1.7	-1.0	2.2	3.6
Internal financing (net)	-2.8	0.7	--	4.0	2.3	1.1
<u>Money (percentage changes)</u>						
Money	-4.6	6.3	...	27.7	...	30.0
Money and quasi-money	35.6	9.1	30.0	21.4	24.8	34.6
Real money and quasi-money <sup>1/</sup>	23.8	-9.6	4.0	-1.4	4.0	5.7
<u>Balance of payments</u>						
<u>(a) Ratios to GDP</u>						
Current account	-14.3	-9.6	-7.2	-5.4	-6.0	-9.2
Trade balance, f.o.b.	-8.1	0.3	4.5	5.1	4.8	2.0
Exports, f.o.b.	11.6	15.5	20.0	19.5	19.6	18.6
Imports, f.o.b.	-19.7	-15.1	-15.5	-14.4	-14.9	-16.6
Net factor payments	-4.4	-8.0	-9.2	-8.6	-8.8	-9.1
Other (net)	-1.8	-1.9	-2.5	-1.9	-1.9	-2.1
<u>(b) Millions of U.S. dollars</u>						
Current account	-4,733	-2,304	-1,602	-1,073	-1,250	-1,821
Trade balance, f.o.b.	-2,677	63	1,000	1,009	995	399
Exports, f.o.b.	3,836	3,706	4,450	3,827	4,100	3,849
Imports, f.o.b.	-6,513	-3,643	-3,450	-2,818	-3,105	-3,270
Nonfinancial services	-701	-555	-648	-471	-498	-513
Financial services	-1,463	-1,921	-2,054	-1,703	-1,848	-1,805
Transfers	108	109	100	92	100	99
Capital account	4,698	1,015	1,117	388	1,250	1,787
Direct investment	362	384	450	148	160	70
Medium- and long-term capital	3,132	1,371	591	1,063	980	1,138 <sup>2/</sup>
Short-term	1,205	-740	76	-822	110	579
Other	42	-104	--	100	--	95
<u>Change in net international reserves (increase -)</u>						
	-7	1,393	485	588	--	-61
<u>Renegotiation of external debt</u>						
	--	--	...	1,100	1,000	1,019
<u>External debt (millions U.S. dollars)<sup>3/</sup></u>						
Total public and publicly guaranteed	12,553	13,815	...	14,832	...	17,152 <sup>4/</sup>
Total private	4,415	5,157	...	7,447	...	10,802 <sup>4/</sup>
	8,138	8,658	...	7,385	...	6,350
External debt (percent of GDP)	38.1	57.3	...	75.4	...	87.3
<u>Debt service (percent of exports of goods and services)</u>						
	58.0	72.0	72.1	51.6 <sup>5/</sup>	53.9 <sup>5/</sup>	57.1 <sup>5/</sup>
<u>Exchange rate (total currency per U.S. dollar)</u>						
<u>Official rate</u>						
End of period	39.0	72.4	...	87.2	100.0	129.4
Average	39.0	50.9	...	78.5	93.0	98.4
Parallel rate (end of period)	...	...	...	95.0	...	...

<sup>1/</sup> Deflated by the consumer price index.

<sup>2/</sup> Does not include the consolidation of US\$1.2 billion of short-term debt.

<sup>3/</sup> Medium- and long-term debt.

<sup>4/</sup> Includes US\$1.2 billion of short-term debt which was consolidated to a medium-term loan in early 1984.

<sup>5/</sup> Includes relief from rescheduling operations.

## Chile: Macroeconomic Flows

(As percent of GDP)

	1981	1982	1983	1984	
				Prog.	Est.
I. <u>Balance of Payments 1/</u>					
<u>Current account surplus or deficit (-)</u>	-14.3	-9.6	-5.4	-6.0	-9.2
Trade balance	-8.1	0.3	5.1	4.7	2.0
Exports	(11.6)	(15.5)	(19.5)	(19.6)	(18.6)
Imports	(-19.7)	(-15.2)	(-14.4)	(-14.9)	(-16.6)
Net factor payments	-4.4	-8.0	-8.6	-8.8	-9.1
Other services and transfers	-1.8	-1.9	-1.9	-1.9	-2.1
<u>Capital account</u>	14.3	3.8	2.4	6.0	9.3
Private capital and other	13.3	-1.0	-3.0	0.2	0.5
Financial public sector	-1.0	2.0	6.2	3.6	5.2
Nonfinancial public sector	2.0	2.7	-0.8	2.2	3.6
<u>Net official reserves (increase -)</u>	--	5.8	3.0	--	-0.1
II. <u>Aggregate Expenditure, Savings, and Investment</u>					
<u>Aggregate domestic expenditure</u>	109.9	101.6	96.8	98.4	100.1
Consumption	89.2	91.7	86.5	85.9	86.6
Gross domestic investment	20.7	9.9	10.3	12.5	13.5
Nonfinancial public sector	(5.1)	(4.7)	(4.9)	(6.8)	(6.6)
Private sector	(15.6)	(5.2)	(5.4)	(5.7)	(6.9)
External savings	14.3	9.6	5.4	6.0	9.2
National savings	6.4	0.3	4.9	6.5	4.3
Nonfinancial public sector	(5.5)	(-0.8)	(--)	(0.8)	(0.6)
Private sector	(0.9)	(1.1)	(4.9)	(5.7)	(3.7)
<u>Memorandum item</u>					
Domestic savings	10.8	8.3	13.5	14.1	13.4
III. <u>Nonfinancial Public Sector</u>					
<u>Savings</u>	5.5	-0.8	--	0.8	0.6
<u>Net capital revenue</u>	0.4	2.1	1.9	1.5	1.3
<u>Capital expenditure</u>	5.1	4.7	4.9	6.8	6.6
<u>Overall surplus or deficit (-)</u>	0.8	-3.4	-3.0	-4.5	-4.7
<u>Memorandum items</u>					
Overall borrowing requirements (defined as overall deficit plus net capital revenues)	-0.4	5.5	4.9	6.0	6.0
(As percent of private national savings plus external savings)	(-2.6)	(51.4)	(47.6)	(51.3)	(46.5)
IV. <u>Underlying Basic Data</u>					
Annual growth rate of real GDP (in percent)	5.7	-14.3	-0.8	4.0	5.5
GDP in billions of Chilean pesos	1,289	1,229	1,550	1,941	1,934
GDP in billions of U.S. dollars (market exchange rate)	33.0	24.1	19.7	20.9	19.7
GDP in billions of U.S. dollars (at 1985 real effective exchange rate)	21.4	17.1	16.6	17.2	17.4
Average exchange rate (pesos per U.S. dollar)	39.0	50.9	78.5	93.0	98.4

1/ As percent of GDP in U.S. dollars at average market exchange rate.

