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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/76

10:00 a.m., May 14, 1984

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Alfidja	
	G. Ercel, Temporary
	X. Blandin
A. Donoso	M. Teijeiro
R. D. Erb	M. K. Bush
	T. Alhaimus
T. Hirao	T. Yamashita
J. E. Ismael	
	L. Leonard
A. Kafka	
G. Laske	G. Grosche
G. Lovato	N. Coumbis
R. N. Malhotra	
Y. A. Nimatallah	
	T. de Vries
	R. Bernardo, Temporary
	O. Kabbaj
	M. Camara, Temporary
M. A. Senior	
	I. Fridriksson, Temporary
N. Wicks	T. A. Clark
Zhang Z.	Wang E.

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present

Central Banking Department: L. M. Koenig, Deputy Director. Exchange and Trade Relations Department: D. K. Palmer, Associate Director; M. Guitian, P. A. Molajoni, A. Pera. Legal Department: P. L. Francotte, Ph. Lachman. Middle Eastern Department: J. G. Borpujari. Research Department: E. C. Meldau-Womack. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; P. D. Brenner, L. E. Escobar, M. R. Figuerola, J. Jaramillo-Vallejo, J. E. Leimone, J. F. van Houten. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: S. R. Abiad, C. J. Batliwalla, S. E. Conrado, J. Delgadillo, S. El-Khouri, S. M. Hassan, G. E. L. Nguyen, Y. Okubo, D. C. Templeman. Assistants to Executive Directors: Chen J., G. Gomel, V. Govindarajan, D. Hammann, N. U. Haque, H. Kobayashi, A. Koné, D. S. Lousada, G. W. K. Pickering, T. Ramtoolah, M. Rasyid, D. J. Robinson, C. A. Salinas, A. A. Scholten, Shao Z., S. Sornyanyontr, Wang C. Y., M. A. Weitz, J. C. Williams.

1. REPORT BY MANAGING DIRECTOR

The Managing Director, reporting briefly on his participation in a May 11 gathering of a number of trade ministers from industrial and developing countries, recalled that the morning discussions had been devoted to the issue of trade negotiations in the GATT on safeguards. Ministers had pointed to the difficulty of reaching agreement on a code on safeguards and had indicated that the work in Geneva toward that end had been progressing very slowly. Some safeguards were related to conjunctural balance of payments problems, while others were linked to the need for structural adjustment in hard-hit industries and obsolete sectors; and those were the most difficult to tackle in a coordinated, multilateral way.

In the afternoon, he had been invited by United States Trade Representative Brock--the organizer of the meeting--to say a few words on the linkages between finance, debt, and trade, the Managing Director continued. He had focused first on how, from the Fund's point of view, the debt problem could best be resolved. He had referred to the cooperative arrangements that had been put together in 1982-83 and had indicated that, at present, the Fund was taking a more forward-looking approach to rescheduling difficulties and was insisting on linking debt solutions to strong adjustment programs. Of course, success in dealing with the debt problem would be heavily dependent on the durability and quality of economic recovery in the industrial countries and in the world at large. In that respect, he had indicated to the ministers a number of the conditions that the Fund saw as necessary to improve the durability of the recovery, and he had mentioned the importance of reducing protectionism as an aid to the recovery and to the resolution of debt problems. More generally, he had suggested that it was important for ministers of finance to work hand in hand with ministers of trade to ensure that the recovery gained strength.

The time seemed ripe for liberalizing trade, the Managing Director said. The recession had been overcome in the industrial countries and, while some unemployment problems persisted--especially in Europe--good progress had been made toward improving the overall economic setting. In such a context, it was important for the developing countries to export more so that they could service their debt. At the same time, a great many of them were nearly ready to resume import growth, even though they had been severely traumatized by the depth of the debt problem. If the developing countries were to become an engine of world trade growth, the protective measures imposed against their exports had to be lifted. In the course of the meeting, he had made a strong plea to the trade ministers of the industrial countries to take the sort of action that would clearly indicate their understanding of the developing countries' problems and their willingness to respond to them. Multilateral trade negotiations were perhaps the best way to develop a comprehensive approach to the problems he had mentioned; however, such negotiations would take time and, in the meanwhile, some immediate action was required on the trade front to facilitate matters for the developing countries in particular.

The Executive Directors took note of the report by the Managing Director.

2. CHILE - 1983 ARTICLE IV CONSULTATION, AND CONSULTATION UNDER STAND-BY ARRANGEMENT

Executive Directors considered the staff report for the 1983 Article IV consultation with Chile and the consultation under the stand-by arrangement (EBS/84/50, 3/9/84; Cor. 1, 3/27/84; Cor. 2, 3/30/84; Sup. 1, 3/30/84; and Sup. 2, 5/10/84). They also had before them a report on recent economic developments in Chile (SM/84/66, 3/20/84; and Cor. 1, 3/30/84).

The staff representative from the Western Hemisphere Department, referring to a recent cable from the Chairman of the Bank Advisory Committee for Chile, noted that, as of close of business on May 11, 1984, commitments had been received totaling approximately US$735 million, which represented about 94 percent of the amount requested and was sufficient to ensure that the Fund program would have a reasonable chance of success. It was expected that commitments for the balance would be received by early June and that agreements could be signed by the middle of June.

Mr. Donoso made the following statement:

> Chile is now in the second year of a stand-by arrangement, which expires at the end of 1984. At the present meeting, the Executive Board is requested to approve the understanding reached between the Chilean authorities and the Fund's management regarding the policies and measures that Chile will pursue during the second year of the arrangement.
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> It should be pointed out that the Board meeting was originally scheduled to take place on April 2, 1984; however, because the current Minister of Economy and the Finance Minister were taking office in Santiago on that day, it was thought advisable to postpone a Board decision on the second year of the arrangement until the new economic authorities had time to discuss with the staff the agreement reached with their predecessors. From the conversations that followed in Washington from April 11 through 13, it was decided to go ahead with the program as originally designed. Furthermore, an understanding was reached to advance to the current quarter the meetings with the staff representatives originally scheduled for July in order to review the policies affecting demand management and relative prices during the second half of 1984.
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> As a result of the conversations in Washington, renewed momentum was given to the effort of securing the US$780 million loan in new money from the international banking community. This

financing, which is essential to Chile's 1984 economic recovery, has already been almost fully committed by the banks, reflecting the excellent working relationship that has been established with them.

The international economic and financial crisis has been particularly hard on Chile. Real GDP fell in the past two consecutive years, dropping some 15 percent in the period. The challenge being faced now by the country is illustrated by the fact that the Chilean economy would have to grow at a 17.6 percent rate to return to the level of activity observed in 1981. The road to economic normalcy thus remains a long and difficult one, despite the enormous effort already made by the country and the international financial community. Still, as a result of that effort, Chile has made substantial progress toward achieving a satisfactory balance in its external accounts, which is reflected in the decline in the deficit of the current account of the balance of payments from the equivalent of 14.3 percent of GDP in 1981 to only 5.4 percent of GDP in 1983. Furthermore, the Chilean Government is planning to avoid any sharp drop in the level of its international reserves this year.

Since the second half of 1983, production has been on an upward trend; despite this incipient recovery, however, the country continues to face a series of problems remaining from the recession of the past two years. Social and political considerations require that they be confronted decisively. Of these problems, the very high level of unemployment must be given priority; and efforts are being made at various levels of the Government, in coordination with the private business sector, to implement an effective plan of action to reduce unemployment.

The excessive burden imposed on the heavily indebted private sector by current debt service schedules is also a problem that has to be dealt with at the earliest possible date. It is absolutely essential to reinforce confidence in the private sector to permit a positive response to the reactivation effort and to government economic policy in general. To achieve this objective, high-level commissions have been formed to study specific issues and propose solutions to the main problems faced by the private sector. Commissions tackling the internal debt problem and the issues raised by the status of various domestic banks and major conglomerates that are today watched over by regulatory agencies have already made substantial progress. Only a vigorous recovery of private business can strengthen its weak equity position and lighten the burden of its excessive indebtedness at home and abroad. Without a robust private sector there is little chance of solving the country's perennial shortage of capital investment. It is the intention of the Government of Chile to restore the confidence of the private sector so that it can once again take a leading role in the economic development of the country.

The Chilean authorities themselves are, by their actions, reaffirming their faith in the country's private business and banking community to overcome the country's present difficulties.

Chile's authorities strongly believe that the only real and lasting solution to the unemployment problem, the badly needed strengthening of the private sector, and the burden imposed by the large external debt, is to accelerate the pace of economic recovery. Growth at a reasonable rate cannot be postponed much longer. With the available resources, a higher level of economic activity and employment could be achieved without relinquishing the agreed-upon targets for inflation and international reserves. The emphasis will be on export-led, labor-intensive, economic growth. It should be kept in mind that plenty of labor, land, technical and entrepreneurial skills, and industrial capacity remains unutilized; and these are real resources that the country could and should put to work. Still, the authorities are very much aware of the importance of ensuring that faster growth is compatible with a maintenance of equilibrium in the external accounts as well as with a moderate level of inflation. Hence, the economic recovery should take place within the framework of the agreed-upon stand-by program.

Balance of payments equilibrium is essential. Without it the economic recovery soon will lose momentum, paving the way for new and difficult foreign exchange problems. The external accounts issue should thus be tackled decisively from the beginning. However, there should be no feeling that it is impossible to achieve higher growth and employment while also working toward equilibrium in the external accounts. Much depends on how the country achieves its higher growth rate and on the nature of the balance of payments policies and other actions that are undertaken. It should be made clear at the outset that the Chilean authorities do not consider it desirable to implement balance of payments measures--such as exchange and import controls--that interfere with the fair play of market forces.

The authorities think that the right approach to faster growth is through well-designed demand management policies. More to the point, advantages are seen in cautiously expansive credit and monetary policies, with fiscal measures becoming more flexible and responsive to social needs, all of course within the well-defined quantitative parameters of the stand-by program. It is the intention of the authorities to subordinate fiscal and monetary policies to the goal of maintaining inflation at the programmed level. There is no intention to pursue policies, such as price control schemes, that will obstruct the free functioning of the market. It is felt that current conditions are such that an increase in aggregate demand should not end up being inflationary, because a parallel increment in supply would follow; the abundance of unutilized domestic resources should be of great help in this respect. The midyear review will give an opportunity for the authorities to exchange views with the staff on this point. It is felt that the built-in flexibility already in the program could make possible demand management policies geared toward achieving the main objectives of creating more jobs and stimulating economic activity.

It should be kept in mind that Chile has not benefited so far from the economic recovery under way in the industrial world. On the contrary, Chile's terms of trade have remained extremely unfavorable and have continued to deteriorate. Of particular significance have been the low copper prices in the world market; price quotations for copper, Chile's main export item, remain below the 1984 average of 75 cents per pound assumed in the balance of payments projections of the stand-by program. On the other hand, interest rates in the dollar market have shown an upward trend in the past few months, placing an extra burden on Chile's already heavy external debt service requirements. Nevertheless, Chile has kept its balance of payments within the parameters negotiated with the Fund and intends to continue to do so.

The Chilean Government has always been serious about meeting its international commitments, often paying a high price to comply. It is the intention of the authorities to continue in this tradition; at the same time, however, it is strongly felt that there is a need for consultations with the Fund staff to explore the scope for a reasonable degree of flexibility to deal with temporarily adverse international developments over which the Chilean authorities have no control. The authorities believe that it is not appropriate to sacrifice reasonable growth simply to accommodate temporary negative developments in the international economic and financial environment; flexibility on the part of Chile's international partners means that ways should be found to share the burden of unexpected adverse developments. At the same time, it must be pointed out that the Chilean authorities have been realistic in accepting painful but necessary measures whenever confronted with deteriorating conditions of a permanent nature.

The problems faced by Chile are not unique; they are experienced by practically all of Latin America and by developing countries in general. The widespread problems associated with external debt will be in evidence for a long time, and it is everybody's responsibility to find adequate solutions to them. Negotiations are essential, but all parties must be willing to compromise, so that a better arrangement can be found.

The period of adjustment of the Chilean economy will extend beyond the end of 1984 when the current stand-by arrangement expires. The fact that Chile will have to continue to work very closely with the Fund in the years ahead calls for a reaffirmation of the open and straightforward relationship that Chile has maintained with the Fund in the past. In this spirit, the Chilean authorities would like to request the support of the Executive Directors for the proposed decisions and to thank the Managing Director and the staff for their efforts to help the Chilean economy to recover from its difficulties.

Mr. Kafka, remarking that he was impressed by recent developments in the Chilean economy, observed that most economic indicators--including GDP, industrial production, exports and imports--had been positive in the final two quarters of 1983. Moreover, the current account of the balance of payments had been significantly better than programmed, and the rate of inflation during the four months ended April 1984--12 percent on an annual basis--had been nearly halved from the rate registered in the same period in 1983.

As noted during the July 1983 review of the Chilean program, most of Chile's recent problems had been caused by a sharp deterioration in the loan portfolio of the banking system--following previous overlending and low quality lending--as well as by the world recession, Mr. Kafka said. The recapitalization scheme, under which there had been a voluntary sale of part of the nonperforming portfolio of the banking system to the Central Bank, had been helpful, although its impact had been modest. In addition, the progress toward global recovery had helped some of the nonperforming loans to return, at least in part, to a performing status. As a result, the financial system was expected to show a small operational profit in 1984. He welcomed the banking supervisory authorities' new regulations to limit banks' exposures to single borrowers and to bank subsidiaries. Also welcome was the development of the deposit insurance scheme, which would insure only up to a certain limit. He hoped that that limit would be observed in practice where appropriate.

The balance of payments deficit on current account had been significantly reduced in 1983, partly because of the flexibility of the new exchange rate policy that had gone into effect after September 1982, Mr. Kafka commented. Of course, the authorities also recognized that appropriate domestic conditions were essential to the stimulation of export-led growth.

The staff seemed concerned about the authorities' intention to ease the fiscal stance in 1984, Mr. Kafka noted; even the maximum increase projected for the overall deficit was relatively small, however, and there was no reason to believe that Chile would not remain at the lower end of the range. Also, tight monetary policy would protect the balance of payments and help to avoid any surge in inflation. Finally, he agreed with the proposed decision and with the program for the second year of the stand-by arrangement. He could also strongly support Mr. Donoso's general remarks on the debt problem.

Ms. Bush said that she was pleased that the Chilean authorities had reconfirmed their adherence to the commitments outlined in their economic policy memorandum of March 12, 1984 and that, despite the regrettable delay, performance under the stand-by program had remained basically on track. However, notwithstanding recent compliance with most performance criteria, the behavior of the Chilean economy with regard to growth, inflation, and external balance still called for improvement. Growth had been negative in both 1982 and 1983; inflation remained at the double-digit level; and continued weak investment and domestic savings performance raised questions about the medium-term outlook.

The desire of the Chilean authorities to encourage economic recovery following two years of negative growth was understandable, Ms. Bush continued. There was at present good evidence that recovery was under way; however, caution must be exercised to avoid a premature resurgence of domestic demand, given the continued unacceptable rate of inflation, the large current account deficit, and the very large foreign debt problem. While welcoming the continued reliance of the authorities on market forces as the appropriate mechanism of adjustment, she noted their need to resort to a number of interventionist measures, mainly because of the crisis in Chile's financial institutions early in 1983. It was important for the authorities to be flexible in adapting economic policies to any unexpected developments, such as unforeseen changes in world interest rates or the price of copper. And it was to be expected that they would be prompt in implementing new measures if the anticipated degree of progress in shifting resources toward investment and export growth--especially nontraditional exports--did not materialize. The staff had correctly stressed the importance of sending the right pricing signals throughout the economy with regard to the exchange rate, interest rates, wage rates, and prices of publicly produced goods and services. While current rates and prices for those items appeared to be broadly on track, there were still some reasons for concern. For example, the authorities and the staff seemed convinced that, based on the return of the real effective exchange rate to about the 1978 level, Chilean goods and services were currently price-competitive in world markets. However, there had been some appreciation of the peso during part of 1983 and, based on wholesale prices rather than consumer prices, the index had actually been 16 percentage points higher than at the end of 1978. Moreover, it was not clear what had been happening during early 1984. More important, perhaps, the performance of total noncopper exports and of exports of industrial goods alone did not look promising over the period 1979-83.

The level of interest rates, too, raised some questions, Ms. Bush commented. Lending rates had generally been at least slightly positive in recent years; however, by the end of 1983, real lending rates had been only about 2 percent and deposit rates only a little over 1 percent on a monthly basis, which compared with real monthly rates of about 4.5 percent and 3.5 percent, respectively, at the end of 1982 and even higher rates in world markets. Supplement 1 to the staff report suggested that real rates had increased in the first two months of 1984, but it was unclear to what level they had risen. In that connection, she welcomed the assurances of the authorities that they would assign an appropriate weight to the level of world market interest rates in setting 30-day deposit rates during 1984. Attractive real interest rates and other incentives to private savings were particularly important, given the low gross national savings rate in Chile and the authorities' objective of stimulating savings and investment. The probability of achieving those objectives should also be enhanced by the measures taken to reduce the tax burden on productive enterprises and on personal income; she welcomed those steps, which should have a positive effect on recovery of the Chilean private sector and thus on the authorities' commitment to a free market economy.

Wage restraint was another key variable in the adjustment effort, Ms. Bush considered. Following high real wage increases in 1979-81, the termination of automatic indexing in June 1982 seemed to have interrupted the previous pattern. Real wages in peso terms in 1982, and in both peso and dollar terms in the first 11 months of 1983, had declined; and the nominal increase earlier in 1984 in government salaries had been quite modest. Those developments, together with the recent cut in salaries of top managers of the principal public enterprises, should set a good example for the negotiation of moderate wage increases in the private sector. That was particularly important at present, since an adequate rate of profitability in the business sector was crucial to a recovery of investment and of export expansion. She noted that the ratio of private investment to GDP had fallen sharply from an average of 14.6 percent in 1979-81 to only 5.3 percent in 1982-83, with a forecast ratio of only 5.7 percent for 1984. Any evidence of the state of business profitability, beyond that shown in the staff papers, would be welcome.

She was pleased to see that the authorities were maintaining at market levels the prices of tradable goods sold by public enterprises and that, in all other cases, prices were being set to cover operating costs and to provide a margin for financing investment, Ms. Bush remarked. The authorities' approach was important, not only to avoid the problem of government subsidization of public enterprises, which was evident in all too many cases, but also to ensure that resources were being allocated efficiently. She urged that prices of nontradable goods should be reviewed regularly and brought up to market levels when feasible.

In contrast to the situation in many countries examined by the Board, the public sector budget in Chile had been in surplus as recently as 1980 (5.5 percent of GDP) and 1981 (0.8 percent of GDP), and the shift into deficit, which was still quite small, had been very recent indeed; nevertheless, the fiscal deficit needed to be monitored with care. In particular, the potential effects of the proposed contingency investment plan, which might be brought into play if there was an unexpected excess of private savings, must be weighed very carefully by the authorities and examined by the staff at the time of the midterm review. Similarly, the rates of increase in the money supply (M-2), which had averaged 28 percent in 1981-83 and were forecast to be nearly 25 percent in 1984, did not seem consistent with a deceleration of inflation. In fact, it was disappointing to note that inflation, which had fallen below the double-digit level in the 12 months from December 1980 to December 1981 and (as an average rate) in 1982, had reaccelerated in 1983 to the 20-25 percent range. On the other hand, the sharp fall in the past few months was an encouraging sign.

Commenting on Chile's foreign debt situation, Ms. Bush remarked that, at the end of 1983, total outstanding debt had represented more than 88 percent of GDP, which compared with a ratio of less than 37 percent for all non-oil LDCs and less than 55 percent for all countries in the Western Hemisphere, where the largest debtors resided. Similarly, the debt service ratio of 54 percent of earnings from exports and services expected in 1984 was far in excess of the average for developing countries. Before the recent debt rescheduling, the figure had been as high as 74 percent. The efforts to improve the debt maturity profile, including a limitation of $125 million on new external debt in the one- to five-year maturity range, were welcome. Together with the authorities' medium-term debt strategy described on page 21 of the staff report, those efforts were good steps toward the sort of forward planning needed by many countries to avoid or reduce large debt service requirements. Such planning should include room for contingencies in case not all assumptions proved correct. Finally, she could reluctantly agree to approve the multiple currency practices through end-1984 and to accept the waivers of performance criteria contained in the draft decision.

Mr. Clark remarked that, like others, he could endorse the staff appraisal and proposed decisions. The Chilean authorities were to be commended for their determined and successful effort to put the program back on track during a difficult period. Progress had been made both in restoring the level of output and in bringing inflation down; however, despite the emerging recovery, the outlook remained uncertain, with the debt service ratio, for example, projected to remain over 70 percent throughout the 1980s. With domestic savings at a relatively low level, fiscal policy would need to be cautious and external borrowing held firmly in check.

Given the depth of the 1982/83 recession, the authorities' desire to relax fiscal policy somewhat in 1983/84 was understandable, although he shared the staff's concern about the risks involved, Mr. Clark continued. He was happy to note that public sector savings were projected to increase and that the expected rise in the deficit would be largely due to expenditure on capital projects, which should benefit the trade balance in the long run. Given the fiscal relaxation, however, the Chilean authorities should be cautious about adopting further expansionary measures that would necessitate mobilization of the contingency reserve. It was crucial for them to be absolutely certain that the level of domestic savings was sufficient to finance such expenditure without crowding out the private sector and that there would be no increased pressure for external borrowing. Clearly the conclusions of the midyear review would be important in that respect.

The authorities should be commended for their restraint in setting wages in recent years, Mr. Clark considered. However, since real wages had fallen by nearly one half in the 18 months to November 1983, and were currently at their lowest level for many years, the scope for further reductions seemed limited. It might therefore prove difficult to hold nominal wages at their present level in 1984, especially since prices were projected to rise by 20 percent. If wage increases did prove necessary, it was to be hoped that offsetting measures to cut expenditures or raise additional revenues could be implemented.

Commenting on revenues, Mr. Clark noted that the ratio of revenue to GDP had declined almost continuously since 1979 and was projected to fall by a further one half percentage point in 1984. Given the need to increase domestic savings, that trend could hardly be seen as desirable. In part, of course, the fall had been due to the privatization of the social security system, and the loss of public savings should be offset by an increase in private savings, which would be stimulated in part by certain tax reforms. Unfortunately, those reforms would be the cause of part of the projected fall in revenue in 1984; he would be interested in hearing whether the staff saw any scope for raising revenue, perhaps through a broadening of the tax base.

On the external side, with particular focus on debt management, Mr. Clark observed that an unusually high proportion of outstanding debt was due to the private sector, which added an extra element of risk. The debt service profiles showed two "humps" emerging: one for the private sector between 1985 and 1987, and the other for official debt between 1988 and 1989. In the circumstances, it seemed likely that there would be little respite from the debt problem before the end of the decade. As the staff and Mr. Donoso had noted, much would depend on the level of interest rates and on developments in copper prices, and prospects for copper prices at present were uncertain. For the medium term, the developments in communications and electronics could have a profound and depressive effect on demand; the assumptions the staff had made on the copper price might therefore be rather optimistic. In that regard, he would have welcomed a sensitivity analysis on copper prices. On balance, in view of the uncertainties and the substantial accumulation of external debt, he wondered whether the current account objectives for the program period and beyond were sufficiently ambitious.

The existence of exchange restrictions in Chile was regrettable, Mr. Clark commented. In particular, the spread between the official and parallel market exchange rates, although recently reduced, had had the effect of encouraging unofficial exports and thereby reducing the foreign exchange available to the authorities. While he could agree, with some reluctance, to the retention of restrictions until the end of 1984, he hoped it would not prove necessary to extend them beyond that point. He also hoped that the midyear review would include a firm timetable for phasing out the restrictions. Finally, he would welcome an explanation by the staff of the relationship between performance criteria and drawings, with particular emphasis on whether or not anything depended upon compliance with the December 1984 performance criteria. Also, as he understood it, the modification of the decision applied to the breaching of the end-March performance criterion; he was unclear what was being done in relation to a similar breaching of the end-December 1983 criteria.

Mr. Grosche stated that, like others, he was in broad agreement with the staff appraisal and could support the proposed decisions. He had noted with satisfaction that the authorities would continue cooperating with the Fund and that the commercial banks had committed themselves to the necessary lending.

In adhering to strict monetary and fiscal discipline, the authorities had managed to overcome the financial crisis of early 1983 and to bring the stand-by arrangement back into full operation. The measures undertaken by the authorities revealed a substantial degree of commitment to the program, which contrasted favorably with earlier experience. The new stance of monetary policy, in particular, was an improvement over the previous approach. Although the Central Bank had had to inject a large amount of liquidity into the system in order to bail out financial institutions, and although the peso had had to be devalued, the new policy had helped to reduce inflation considerably. Under the previous policy, internal liquidity had been created only when, and insofar as, the Central Bank had accumulated foreign reserves. Since the current account of the balance of payments had shown deficits, the accumulation of foreign reserves could only occur through foreign lending to the private sector. The system had collapsed after Chile had lost its creditworthiness due to the financial crisis of several institutions.

In their economic policy memorandum, the authorities had taken note of some difficulties that had caused major strains on the financial system, Mr. Grosche continued. While their point was rightly taken, the authorities had not mentioned one important fact, namely, the relatively high real interest rates prevailing in 1981 and 1982. The new policy of guiding short-term interest rates had helped to bring those rates down. While welcoming the lower rates, he cautioned against too expansionary a stance for monetary policy; real interest rates should remain competitive, and the authorities should keep a close eye on the net domestic assets of the Central Bank. The program envisaged a steep increase in those assets--from Ch$24 billion at end-1983 to Ch$217 billion at end-1984. In that respect, there appeared to be a need for firm surveillance, in particular on the private banks' lending policies, in order to keep the program on track.

With regard to fiscal policy, Mr. Grosche observed that the public sector budget deficit would grow in 1984 but would remain low by comparison with deficits in other Latin American countries. The higher projected deficit was accounted for by a considerable increase in projected capital expenditure and additional public investment outlays in the energy field. Since half the overall deficit would be financed from external sources, he foresaw no great difficulty. It should be remembered that investment in relation to GNP remained low in Chile and would have to be increased over time if the high rate of unemployment was to be reduced. On the other hand, it was to be hoped that the authorities would continue to work toward reducing the share of current expenditure in GDP, an action that should be accomplished mainly through a reduction in transfers and subsidy payments and a lower wage bill.

The substantial improvement in the current account during 1983 was welcome, Mr. Grosche said. However, as other speakers had observed, the future did not look bright. As for the trade balance and the importance of copper exports in that balance, he would have appreciated a sensitivity analysis by the staff with respect to copper prices.

In view of the very high debt service ratio, the staff and other speakers had appropriately suggested that developments in the current account should be closely monitored, Mr. Grosche remarked. Some relief might be provided if nondebt-creating foreign direct investment could be restored to the level of earlier years. In that regard, he commended the authorities for their exemplary medium-term strategy as described on page 21 of the staff paper. Finally, he encouraged the Chilean authorities to discontinue the remaining exchange restriction and multiple currency practice at the earliest possible date.

Mr. Nimatallah said that, like others, he was in general agreement with the staff's analysis and conclusions and could support the proposed decisions. The Chilean authorities had made commendable progress in stabilizing the economy since mid-1983. As the staff had noted, the bleak position at the end of 1982 had been made even worse by the financial crisis of January 1983. However, the authorities had acted courageously and firmly to restore fiscal and monetary discipline, strengthen competitiveness, and get the 1983 program back on track. As a result, inflation had been reduced and the trade balance had improved considerably. Equally encouraging had been the recent signs of a moderate recovery in output.

Nonetheless, serious problems remained, Mr. Nimatallah continued. Much still needed to be done to restore domestic and external confidence and to reduce the sizable external debt burden. The program for 1984 provided an appropriate framework for meeting those objectives. In particular, he welcomed the continuing emphasis on wage restraint, the cautious monetary stance, and the move to reform the financial system. On the external side, he supported the commitment to a flexible exchange rate policy designed to maintain competitiveness and promote exports. The comprehensive medium-term strategy for dealing with the debt problem was farsighted and appropriate, and he hoped that the authorities would take full advantage of the emerging recovery in the industrial countries to strengthen their efforts to adjust and to repay their debts.

Commenting on fiscal policy, Mr. Nimatallah noted that the ratio of the public sector deficit to GDP was projected to rise from 3 percent in 1983 to about 4.5 percent in 1984. The increase in public sector activity was justifiable for several reasons. First, the increase in public expenditures was expected to lead to a higher proportional increase in investment spending, which was important to enhance capital formation and increase the productive capacity of the economy for growth. Second, the increase in the public sector deficit would be financed by noninflationary means. Third, the increase in public sector activity was intended to compensate for the slowdown in private sector activity. For those reasons, the stance of fiscal policy appeared justified at present. However, if private demand recovered strongly and led to an overheating in the economy, there would be a need to shift toward fiscal restraint. Hence, it was prudent to expect a thorough review of fiscal policy during the medium-term review of the program. Finally, he was pleased to hear that the commercial banks had agreed on an adequate financing package for Chile.

Mr. Lovato considered that, under the emergency plan introduced by Chile following the financial crisis in early 1983, the economy had performed satisfactorily and, by September, had returned to the path originally foreseen under the stand-by program. Policies for the second year of the arrangement had been designed in recognition of the unsettling events of 1983 and with a view to stabilizing the financial system in a more durable way than had been possible with the necessary short-term emergency measures of the previous year. The authorities wanted to provide public sector stimulus to a severely dislocated and stagnating productive system. He agreed with them that financial prudence alone would not be sufficient to relieve the country of its current economic distress; on the other hand, from a medium-term perspective, the authorities had little room for maneuver in the setting of policy because of the large external debt and debt servicing requirements, which were expected to continue well into the decade.

It was apparent from the staff projections that domestic resources would need to be transferred abroad in sizable amounts for a protracted period if the debt falling due was to be serviced as planned, Mr. Lovato continued. The amount of adjustment that remained to be accomplished was substantial, and it was doubtful whether adequate external financing could be counted upon to lengthen or soften the needed adjustment process. The country had succeeded in rescheduling the debt due in 1984, but even higher debt repayments would have to be faced in 1985-87.

Commenting on the program for 1984, Mr. Lovato said that, as he understood it, the authorities intended to provide a stimulus to private sector activity with some fiscal easing. Their intention was based on the idea that, first, the level of idle capacity was quite high; second, according to the program, the stimulus would arise from new capital formation and not from current outlays; and, third, the resulting budget deficit would not be monetized, since it could be financed partly through external sources and partly through nonmonetary means domestically. However, he tended to agree with the staff that the fiscal easing would entail a risk in both the short and medium term; and he joined the staff in recommending that the authorities should carefully monitor developments in the economy and should be willing to act according to evolving conditions.

Another important question in the domestic area was the behavior of private sector savings, Mr. Lovato considered. Throughout the 1970s, savings had responded slowly to the then prevailing high interest rates. In 1983, however, they had increased considerably as a proportion of GDP, which was an encouraging development if viewed in the context of the authorities' need to reduce Chile's dependence on foreign financial resources. He wondered whether the staff had lately detected any new patterns in the interest rate elasticity of savings or whether other factors, such as a redistribution of income to social groups with a higher propensity to save, seemed to be playing a larger role in the process.

On the external side, Mr. Lovato observed that the crawling peg system, designed to maintain a stable level for the peso in real terms, had improved the near-term outlook for Chile's accounts. In particular, it was expected to maintain the country's external competitiveness and give some impetus to tradable output and exports. Given the uncertainties prevailing in the domestic arena, the external front became all the more important for promoting adjustment in Chile. The country's competitive position therefore needed to be carefully monitored to ensure that it did not fall into the misguided policy path of the past.

Remarking on external debt management, Mr. Lovato said that he could subscribe to the strategy outlined in Section III of the staff report. The central element of that strategy was the recognition that total net borrowing must be reduced in 1984 and in future years in a way that was consistent with a shrinking use of external financing vis-à-vis domestic resource mobilization. Debt management of that sort could offer the authorities an opportunity to create the conditions for an economy that was less dependent on others and was thus more stable. He had been happy to note that rescheduling agreements had been concluded that fully covered principal payments due to commercial banks in 1983/84, and that satisfactory arrangements had been reached with foreign commercial banks for new loan disbursements that would cover the financing gap for 1984. However, he wondered whether the estimates of Chile's gross financing requirements for 1984 were perhaps optimistic, especially given that the main item of payments was interest, that interest rates were increasing, and that imports could turn out to be larger than projected, especially if they followed the trend set in the first quarter of 1984. In conclusion, he could support the proposed decisions with the recommendation that Chile's remaining exchange restriction be removed as soon as possible.

Mr. Senior, expressing support for the proposed decisions, said that he was pleased that assurances had been given by the commercial banks regarding the commitment of a new loan necessary to help support the economic program for the second year of the stand-by arrangement. The timely disbursement of those resources would help the authorities to implement the measures contemplated in the program for 1984 and would improve the prospects for a satisfactory adjustment effort.

The emergency financial measures and strict monetary and credit policies adopted during 1983 had returned the program to its original path, and he was happy to see that the favorable signs of economic performance observed in the second half of 1983 had continued through the first few months of 1984, Mr. Senior remarked. On the domestic front, the inflation rate had sharply decelerated, in line with the programmed target for 1984. The economic recovery initiated in the later part of 1983 had also continued, and the rate of financial savings had accelerated in real terms. The pickup of economic activity was particularly welcome, since it was the result not only of the stimulus provided by public spending on housing and infrastructure but also of the pressure of realistic pricing policies, which had contributed to output increases in the industrial sector. There had been a 12.6 percent growth in industrial production in the year ended March 1984.

On the external side, the position of the Chilean economy had also improved satisfactorily, as evidenced by the trade surplus in the first quarter of 1984, Mr. Senior continued. Smaller than originally anticipated, the trade surplus was partly the result of a better than expected export performance and the cessation of the loss of net international reserves. Those positive signs seemed even more impressive when account was taken of the unfavorable external environment facing the economy, particularly the relative reluctance of foreign commercial banks to provide new resources and the depressed state of economic activity in neighboring countries.

All performance criteria as of end-March 1984 had been met, with the exception of the subceiling on domestic indebtedness of the nonfinancial public sector, Mr. Senior commented. Since the noncompliance with respect to the subceiling on domestic financing had been due to factors that were beyond the control of the authorities and were temporary in nature, the thrust of the program had not been affected. He welcomed the flexible approach followed by the Fund in dealing with such situations.

He would appreciate some further elaboration by the staff on the factors behind the shortfall in disbursements from the multilateral financing institutions, which, in the case of Chile, seemed to be partly related to delays in reimbursements to those same agencies, Mr. Senior said. The amount of that shortfall represented a relatively small proportion of total net external disbursements expected to be received by Chile in the coming months and would thus have only a relatively minor effect on the behavior of domestic financing. However, given the trend to rely more on multilateral borrowing as an important source of external financing, such disbursement difficulties could further complicate the pattern of financing and, hence, of adjustment in which economic programs were framed.

Commenting on the program for 1984, Mr. Senior welcomed the continued implementation of realistic pricing policies with regard to exchange rates, interest rates, and wages. In conjunction with a cautious monetary and fiscal stance, those policies seemed to be consistent with the planned reduction of the internal and external imbalances in the economy. The assumptions of a 4 percent real growth in GDP, a decline in inflation to 20 percent, and an increase of 15.3 percent in gross domestic savings also seemed realistic.

On the fiscal side, Mr. Senior agreed with the authorities that the projected expansion in the overall public sector deficit was consistent with the contemplated progress toward financial stability and was appropriate, given the depressed state of private economic activity. On the expenditure side, he noted that the fiscal program included a substantial increase in public investment which, as indicated by Mr. Donoso, contemplated the development of key projects that would contribute to increased exports and import substitution. Those increases, in combination with further restraint in current spending, were to be welcomed. However, if private investment did not recuperate in the course of 1984, it would be appropriate to consider further fiscal action to stimulate economic activity. The flexibility incorporated in the fiscal program by the introduction of a contingency investment plan, which would be activated only if domestic financial savings were available, was particularly welcome. He agreed with the staff that developments in the economy should be monitored closely to avoid any crowding out of the private sector or any other development that could lead to significant deviations from the projected path of the program or that could endanger the achievement of its objectives. The authorities had already demonstrated their determination to adopt any measures necessary to bring the program back on track, and he was convinced that they would continue to do so.

Mr. Leonard expressed the hope that, following the Board's discussion, the Chilean stand-by arrangement would once again be in full operation. It would be unfortunate if the degree of continuity in policy application implicit in a two-year stand-by arrangement were to be interrupted by a delay in reaching understandings on the second year of the program. He broadly supported the policies to be pursued in 1984; the continued commitment by the authorities to rely on market forces and price incentives to guide resource allocation was most welcome, although he hoped that further progress could be made toward unifying the exchange rate and removing exchange restrictions. Also helpful would be a continued effort to ensure positive real interest rates and less control over the domestic prices of goods sold by the public enterprises; and he would welcome a rapid phasing out of Central Bank intervention in the financial system and the elimination of the existing multiple currency practices and exchange restrictions.

Commenting on fiscal policy, Mr. Leonard agreed with the staff that the increase in the fiscal deficit as a percentage of GDP in 1984 entailed significant risks in both the short and medium term. The economic outlook was in fact beginning to improve and, as recent GDP figures seemed to suggest, any increase in the deficit could threaten the re-establishment of financial stability; indeed, it could well limit the increase in the real credit available to the private sector within the program's credit targets and thus endanger new investment. He noted, in passing, that real bank credit to the private sector had declined by about 9.6 percent in 1983 and was projected to increase by only 2 percent in 1984.

It was worrying that the authorities might implement contingency plans for public sector investment if private demand were to lag in the second half of 1984, Mr. Leonard continued. In his view, any further fiscal expansion should be undertaken only with extreme caution. And he would expect the case for any such expansion, if it were to occur, to be very well argued by the staff in the midyear review. Indeed, in view of the riskiness of the program, the authorities should be encouraged to develop another contingency plan to reduce the extent of the fiscal imbalance in case domestic or external circumstances turned out to be less positive than were currently expected.

With regard to the efforts underway to improve the structure of the Chilean economy, Mr. Leonard welcomed the authorities' intention to continue to rely on market forces and price incentives to guide resource allocation. Such an approach encouraged increased integration of Chilean producers with global markets and also helped to limit protectionist measures elsewhere against Chilean exports. Less control over the domestic prices of goods sold by the public enterprises would be in line with the authorities' stated intention. In that connection, he wondered why domestic prices were not being increased to help offset the projected decline in the petroleum company's operating surpluses, in view of the increased cost to the economy of importing oil.

The authorities correctly viewed progress in re-establishing a sound financial system as a crucial element in strengthening the structure of the Chilean economy, Mr. Leonard considered. He welcomed their efforts to introduce deposit insurance, the recapitalization of domestic banks, and the reform of financial legislation. As noted by the staff, a large proportion of the losses incurred by the financial system had been shouldered by the Government and had resulted in a doubling of the ratio of the external public debt to GDP between 1982 and 1983. The ability of the authorities to repeat such measures was questionable; consequently, it was essential to ensure that the financial system was developed so as to minimize any further emergency assistance. Also, he urged the authorities to move as quickly as possible to eliminate Central Bank intervention in the financial system.

The staff had observed that the real effective exchange rate had returned to the average level prevailing in 1977-78, a period of relative balance of payments equilibrium, Mr. Leonard continued. However, the underlying situation since that time seemed to have changed with the marked deterioration in Chile's terms of trade since 1979 and the sharp increase in scheduled debt repayments. That view was reinforced by the existence of the gap between the official and parallel rates. Also, it appeared that the two indicators of real effective exchange rates gave a somewhat different picture. The indicator based on the wholesale price index, for example, suggested that competitiveness in the second half of

1983 had been at a level not unlike that in mid-1977, although considerably above the 1977-78 average. However, even the indicator based on the consumer price index, which presented a more favorable picture of competitiveness, showed that the rate had appreciated on average by about 6.6 percent in 1983. In light of those factors, he wondered whether the decision in December 1983 to change the rate of depreciation with respect to the U.S. dollar from the Chilean rate of inflation to that rate minus the world rate of inflation had been entirely appropriate. In his view, "getting the exchange rate right" was an important factor in encouraging increases in noncopper exports, which would make the external sector less vulnerable to developments in the international market for copper.

Like other Directors, he regarded the medium-term prospects for the balance of payments as precarious, Mr. Leonard commented. Some of the assumptions used to draw up Tables 5 and 12 of the staff report appeared to be optimistic, particularly the assumption that interest rates on foreign debt would remain unchanged and that the spread and fees charged by banks would be lower than in 1983. Thus far, there were few indications that those assumptions would be borne out.

A critical factor in the balance of payments projections was the level of new capital inflows, Mr. Leonard said. It remained to be seen whether, over the medium term, official creditors would provide the level of resources foreseen, especially since their doing so might require a reduction in lending to other LDCs. More important, perhaps, Chile's debt service ratio would remain in excess of 70 percent for the next five years, and it was unclear for how many more years the banks would be willing to reschedule principal amounts due while concurrently extending new credits to cover interest payments. Those concerns pointed to the importance of continuing to analyze the exchange rate and other policies bearing on Chile's balance of payments so that, in the event of adverse developments, the authorities would have maximum room for maneuver through the current external account. Finally, like others, he could support the proposed decisions.

Mr. Alfidja stated that he, too,could support the proposed decisions and had no difficulty granting the requested waiver of the performance criteria relating to the unification of the exchange rate system and to the elimination of some temporary exchange restrictions. He was in general agreement with the staff appraisal and could endorse the authorities' proposed policy stance for the 1984 program. The authorities should be commended for their successful implementation of the emergency plan that had been introduced in March 1983 in order to bring the 1983 economic program back on track. As indicated by the staff, the current two-year program was aimed at restoring confidence in the economy by laying the foundation for economic recovery while improving the balance of payments performance and reducing the rate of inflation. Based on the principal macroeconomic developments that had occurred in late 1983 and during the first quarter of 1984, it appeared that the economy was moving in the right direction. The recovery that had begun toward the middle of 1983 was gaining momentum, thanks to an expansion in agricultural output and a sustained growth of industrial production; moreover, the rate of increase in consumer prices had declined markedly at end-March 1984, compared with the level a year previously. And the current account deficit in 1983 of 5.4 percent of GDP was well below the program projection of 8.1 percent of GDP. Similarly, the overall balance of payments surplus had exceeded the program target, albeit only slightly.

On the fiscal front, thanks to the establishment of a permanent deposit insurance scheme and to the modification of the legislation governing financial institutions, confidence in the financial system had been restored, Mr. Alfidja noted. Some improvement had also been registered in external competitiveness; indeed, the authorities had been able to restore the competitiveness of the country's exports to the level attained in 1977-78, owing to an active exchange rate policy. The economic program for 1984 was designed to consolidate the progress achieved thus far by further strengthening the financial system and by fostering economic recovery. He welcomed the authorities' commitment to taking appropriate measures aimed at improving the efficiency of resource allocation.

The economic and financial policies that the authorities intended to pursue throughout 1984 seemed appropriate to achieve the program objectives, Mr. Alfidja remarked. He was certain that the authorities were aware of the existence of major imbalances in the economy: inflation and unemployment were not yet under control, the overall financial position of the public sector needed improvement, and the external debt situation was particularly deserving of sustained attention, as interest payments alone had exceeded one third of exports of goods and services during the past several years. He urged the Chilean authorities to persevere in their adjustment effort by continuing to exercise fiscal and monetary discipline. The attainment of their economic and financial objectives would be made possible in part by the support provided by Chile's foreign creditors. In that regard, he welcomed the indication by the staff of the commercial banks' commitments for an amount of financial support that was very much in line with what had been assumed under the program.

Mr. de Vries joined others in commending the Chilean authorities for the way in which they had coped with the serious economic and financial crisis that had beset the economy in 1982 and early 1983. Because of their efforts, GNP had increased by 5 percent in the fourth quarter of 1983, and inflation had fallen to an annual rate of 12 percent in the first four months of 1984. At the same time, noteworthy reductions had taken place in the spread between the official and parallel exchange rates, although that had occurred mainly because the exchange rate on the parallel market had appreciated quite sharply. He would be interested in hearing from the staff whether that tendency had continued.

While he could understand the desire of the authorities to increase the stimulation to the economy somewhat, he could also accept the staff's advice to exercise caution and to maintain financial stability to the extent possible, Mr. de Vries continued. He had no difficulty with the creation of a contingency plan that would be examined during the mid-term review to determine whether its implementation was advisable.

Commenting on specific areas of the Chilean economy and policy, Mr. de Vries remarked that the recent drop in the inflation rate fit the Chilean experience of sudden rises and falls in that rate. In a recent seminar, it had been argued that such movements might be explained by the striking stability in nominal interest rates and by the fact that the exchange rate of the Chilean peso was pegged to the U.S. dollar. Given the openness of the Chilean economy, volatility in the dollar exchange rate produced the remarkable phenomenon of sharp rises and falls in the inflation rate, which probably affected the performance of the economy under the program. He would be interested in staff comment on that matter.

Since mid-1982, the Chilean Central Bank had introduced an array of measures to deal with the domestic financial situation, Mr. de Vries observed. While those measures had been necessary in the particular circumstances of the Chilean economy, they entailed certain costs, some of which would become evident only over time. For example, certain of the arrangements had built-in indexation clauses; and he hoped that the authorities would resist the temptation of dealing with the cost of those clauses by allowing inflation to increase. Other costs, of course--such as the interest rate subsidies--were a real claim on the Government and would have to be met either by higher taxes or by cuts in expenditure.

The medium-term scenario envisaged by the authorities suggested the elimination of any further increases in external debt in real terms, which implied, given the present exchange rate policy, additional nominal borrowing abroad at roughly the rate of inflation in the industrialized countries, Mr. de Vries noted. As a percentage of GDP, the external debt would therefore remain roughly the same for the immediate future. Although that policy might seem acceptable, it posed some problems in the short run. First, debt servicing was already very high, which meant that there would have to be continued reliance on rescheduling. Second, if there were no inflation in the world, Chile would be able to get by without contracting any fresh credit. However, inflation did exist, which was why the Chilean authorities were attempting to limit the cost of borrowing to roughly the rate of inflation. Still, if Chile was to succeed over time, it would be necessary to look toward a successively reduced need for fresh credit, which pointed to a more rapid correction of the current account than was currently planned.

As other speakers had noted, the savings ratio in Chile was low in relation to those in other countries and was below the original program target of more than 20 percent of GDP, Mr. de Vries commented. The projected savings ratio for 1984 was only slightly above 15 percent; he wondered whether an improved domestic savings ratio might not help to improve investment potential as well as prospects for the economy as a whole.

Mr. Ismael recalled that economic disturbances resulting from a financial crisis in early 1983 had moved the Chilean program off course in its first year. However, the authorities had made a determined effort to put the program back on track, and it was encouraging to note that progress had been made in the areas of growth and unemployment and in the external sector. The latest developments in growth and inflation as reported by Mr. Donoso were proof of the authorities' commitment to adjustment. However, he remained concerned about the high debt service ratio, which was projected to rise from 75 percent in 1984 to more than 80 percent in 1988. It was difficult to imagine how Chile would be able to maintain a reasonable rate of growth and an open trading system with such a high debt service burden. Also, external debt service projections were based on the assumption that the interest rate of 9 percent would continue and that real copper prices would be maintained at 1984 levels. Those assumptions could prove to be optimistic, so that the outlook for the external sector might not be as positive as that projected by the staff.

A principal weak feature in the Chilean economy was the prevailing large financing gap, Mr. Ismael remarked. Gross national savings in 1983 were estimated at 4.9 percent of GDP, while net external borrowing had amounted to about 10 percent of GDP; the public sector had not recorded any savings at all. It was important to improve incentives for promoting both public and private savings in Chile. Without such an effort, Chile would have to rely heavily on external capital, which might be difficult to obtain in future, given the large debt servicing obligations. Finally, on the exchange system, he had noted the existence of multiple currency practices in Chile, which had arisen from the dual exchange rate and the subsidy paid on certain foreign interest payments and principal repayments by the private sector. There were also exchange restrictions in the economy, based on the limitations on the sale of foreign exchange for tourism and the 120-day deferment period on import payments. He was happy to hear that those practices and restrictions were temporary in nature and that the authorities intended to reduce them during 1984.

Mr. Malhotra commended the Chilean authorities for bringing the 1983 program back on track, thus justifying the flexible approach that had been adopted by the Fund in departing from previously set criteria in the face of the unfortunate developments that had taken place in early 1983. Inflation had moderated considerably in the first few months of 1984, and the authorities were continuing with their policy of wage moderation. In that regard, any further reductions in real wages, below the levels already reached, might not be wise. It should also be noted that the authorities had been following prudent pricing policies and that interest rates had, by and large, been positive.

The program for 1984 seemed well designed, Mr. Malhotra considered. His colleagues had already commented extensively on the proposed fiscal deficit, which appeared to be appropriate under the circumstances. Also justified was the possibility of further public sector spending if the private sector did not take up the slack in the economy. Of course, the authorities should heed the note of caution sounded by the staff and should monitor economic developments closely.

Reviewing the medium-term prospects, he found it difficult to be optimistic about the Chilean economy, because the level of external debt and the debt servicing burden would remain high through 1990, Mr. Malhotra continued. Given the level of unemployment, there was a need to increase investment, especially in labor-intensive activities, which required additional resources; on the other hand, the prospect of large fresh inflows of foreign savings appeared to be limited. Hence, the area of domestic savings was crucial. The current level of savings appeared to be low, and anything the authorities could do to raise additional savings and direct them to increasing investment in order to reduce unemployment deserved the highest priority.

Efforts to relieve the debt situation by keeping the exchange rate flexible and by improving exports would be welcome, Mr. Malhotra said. However, the financial community would need to play a role as well. In that regard, he had been interested in the Chairman's recent references to a more "forward-looking approach" to debt restructuring. In conclusion, he could support the staff report and the proposed decisions.

Mr. Bernardo said that he, too, could support the proposed decisions. Notwithstanding the serious problems which remained, he was satisfied with the performance of the economy under the program during the second half of 1983 and the first half of 1984, and he commended the authorities for putting the program back on track. The policies and performance criteria agreed upon for 1984 seemed appropriate. Monetary policy would be sufficiently tight and, although the public sector atypically contemplated an increase in the overall deficit by 1.5 percent of GDP, that increase was clearly due to the "lumpy" phasing of a hydroelectric project. In that respect, he welcomed the built-in flexibility under the program that allowed for greater fiscal stimulus if private sector demand slackened and trade balances improved beyond expectations. Still, like the staff and others, he advised the authorities to exercise caution in providing such a stimulus.

With regard to the exchange rate, Mr. Bernardo welcomed the reversal of the real effective appreciation of the peso and the recent narrowing of the spread between the official and parallel rates to less than 10 percent. Also, the proposal for the temporary approval of Chile's multiple currency practices and exchange restrictions was acceptable, although he wondered to what extent the emergence of a tolerated parallel market rate with a material spread over the official rate should be considered as a multiple currency practice.

As others had observed, the area of main concern over the medium term continued to be the evolution of Chile's debt servicing capacity, Mr. Bernardo remarked. Table 6 of the staff paper showed a debt-servicing burden ranging from 72-83 percent of earnings from exports and services from 1984 to 1989; and, even with rescheduling, the figure was projected to be 53.9 percent in 1984. The average GDP growth rate during the period was assumed to be 8.5 percent a year, while the average growth of earnings from exports and services was calculated at 9.5 percent. Those figures seemed optimistic, and he wondered on what assumptions they had been based. Forecasting issues apart, it could be asked whether such large debt service ratios and transfers of resources to the rest of the world were consistent with good growth performance. Clearly, medium- and long-term solutions to the problems of debt would need to be found.

The terms for refinancing were another cause for concern, Mr. Bernardo considered. During the Board discussion of July 1983, his chair had requested elaboration regarding reported pressure from banks for the Government to guarantee private financial sector debt before a new financing package would be provided. Such guarantees had been given and, in conjunction with a consolidation of short-term financial debt, the share of private nonguaranteed debt had dropped from 70 percent at end-1982 to 50 percent at end-1983. The resulting heavier debt servicing burden on the Government was reflected in the more than doubling of the annual debt service of medium- and long-term external debt by the public sector from \$1.3 billion in 1984 to \$3 billion in 1988. That projection--shown in Table 28 of the paper on recent economic developments--was based on the stock of outstanding debt alone and did not reflect the effects of future debt restructuring. Given the developments he had mentioned, a number of questions arose. First, was the situation in Chile consistent with the Fund's own views on the matter of government guarantees for private debt? Second, was it consistent with the program's basic economic strategy of relying on market forces to guide resource allocation in the economy? Third, what would be the impact on the evolution of Chile's fiscal position over the medium term? Fourth, in that context, should not the Fund be concerned with the magnitude of the financial package as well as with its terms? And, fifth, to what extent were requests from the financial community for government guarantees prevalent in other negotiated packages?

There was a further aspect of the issue that was of immediate relevance to the program's criteria for 1984, Mr. Bernardo said. Ceilings on contracting and guaranteeing of external debt of \$3.85 million excluded external debt contracted or guaranteed by the private financial system "because the authorities would like to avoid any suggestion that new external debt by commercial banks requires approval by the Central Bank and thus carries an implicit official guarantee." He could understand that the Government might wish to take that stance to strengthen its position in resisting future pressures for the Government to guarantee private debt; on the other hand, he wondered whether it would not be desirable for the Government to have a mechanism for limiting private debt, particularly in view of the possibly irresistible pressures being brought to bear on the Government later on.

Mr. Zhang stated that, while he could agree with many points in the staff appraisal, he did not feel that it gave an adequate assessment of the anticipated changes in the real sector of the Chilean economy that would have a bearing on the implementation of the 1984 program. Prior to the approval of the stand-by arrangement by the Board in January 1983, the authorities had already adopted an economic policy that had led to a sharp fall in imports and a balance in the trade account following four previous years of deficit. Under the stand-by arrangement, imports had been further sharply curtailed and, in spite of stagnant exports, the trade account had moved into surplus of more than US$1 billion in 1983, which was a remarkable achievement. The authorities had also been successful in resolving the financial crisis in early 1983 and, for the year as a whole, they had been able to maintain control over public expenditure and to pursue tight monetary policies. Nonetheless, like many other developing countries in similar situations, particularly those in Latin America, the sharp movement in the Chilean external balance and in internal financial conditions had been achieved at the cost of an equally sharp deterioration in the real sector of the domestic economy. In fact, during 1982-83, Chile had been the country in Latin America that had suffered the most severe recession, as reflected in the fall in GDP by 14.3 percent in 1982 and by another 0.8 percent in 1983. At the same time, visible unemployment had exceeded 20 percent.

The most important factor responsible for the developments he had mentioned had been the change in gross domestic investment, which had declined from 21 percent of GDP in 1981 to 10 percent of GDP in 1982 and 1983, Mr. Zhang continued. That decline in gross investment had, in turn, resulted in a sharp curtailment in imports during those years. The volume of imports, more than 70 percent of which consisted of intermediate and capital goods essential for domestic investment and production, had been cut by 44 percent in 1982 and by an additional 22 percent in 1983. More than any other factor, the decline in gross investment would have an adverse impact upon Chile's recovery and growth over the next few years, and the program for 1984 would have to be evaluated in that context.

According to the staff, one of the basic objectives of the program was to establish policies that would restore confidence and lay the basis for economic recovery in the context of an improved balance of payments performance and a reduction in the rate of inflation, Mr. Zhang noted. He wondered whether the staff really felt that the present overall policy stance would promote a self-sustained economic recovery and growth in the medium term. The projection of a 4 percent increase in GDP for 1984 seemed rather optimistic and ambitious, and there was no evidence in the report that exports and direct foreign investment would be the major stimulating factors. Hence, the projected increase in GDP could not be realized unless there was an appropriate increase in gross investment which, in turn, would depend on an adequate increase in imports. It was not clear from the staff report whether the proposed policies for 1984 had a growth objective and made the necessary provision for the realization of that growth in the projected increases in investment and imports. It was also disappointing in that regard that no projections for medium-term growth targets had been attempted.

It would be interesting to know whether the stabilization measures contemplated under the 1984 program would provide adequate strengthening of the overall financial conditions and profit prospects in the private sector and would encourage an increase in investment in 1984, Mr. Zhang commented. In the past, Chile had relied upon large inflows of foreign capital to finance its interest investment; however, under the 1984 program, that source of financing would be considerably constrained, and he wondered how the savings-investment gap would be closed.

Remarking on specific policies, Mr. Zhang observed that, in the fiscal field, the program did not appear to anticipate continued weak private demand; hence, the budget deficit for 1984 was programmed to increase to 4.5 percent of GDP from the level of 3 percent registered in 1983. However, no similar expansion was expected in the monetary field, which would remain restrictive. He wondered whether such a policy mix was appropriate.

Observing that the current account of the balance of payments was expected to deteriorate in 1984, Mr. Zhang considered that the Chilean authorities would need to decide during the year whether to reduce their need for external financial resources by cutting down domestic economic targets or by further increasing their external debt. Also, real per capita GDP and consumption, which had fallen sharply during 1982 and 1983, were not expected to recover in 1984. Hence, the continued implementation of austerity measures would require the continued consensus among the various economic and social groups not to ask for excessively expansionary policies. In conclusion, judging from the experience of the past two years, the task of realizing the adjustment objectives under the program, although difficult, did seem to be within the reach of the authorities. All things considered, one of the most worrisome problems facing the Chilean economy remained the external debt and its management.

The staff representative from the Western Hemisphere Department, explaining the decline in revenue in relation to GDP over the past few years, observed, first, that a change had been effected in the social security system. The Government no longer received social security contributions; rather, they went to a number of private sector funds. It had been estimated that the shift in contributions accounted for approximately 2 percentage points of GDP. Another factor contributing to the decline in revenues was the level of imports, which had fallen by 50 percent in nominal terms from the 1980/81 level. In that regard, it had been asked whether the authorities had any plans to increase the tax base or in some other way raise additional revenue. As he understood it, the authorities felt that there was room to lower the very high tax rates applying to profits of businesses and corporations in order to give incentive to investment. Some modifications in the tax structure had also been suggested as a way of stimulating private sector savings.

A question had been raised on the relationship between purchases from the Fund and program performance during 1983, the staff representative recalled. For technical reasons, Chile had not made a purchase at the time of the scheduled drawing in February. One reason was that the December 31 ceiling on indebtedness of the public sector had not been met. In addition, there had been a clause in the program indicating that Chile would not be able to purchase after December 31, 1983 if it had not reached an agreement with the Fund on a program for 1984. The latter point was being dealt with at the present meeting. The schedule of purchases for the second year of the program was in the documents before Directors, and it should be noted that there was no explicit link being made between the December 31, 1983 performance and the May 15, 1984 purchase; however, a link had been made between the March 31, 1984 performance and the May purchase.

With regard to the medium-term effect on the Chilean economy of changes in copper prices, the staff representative observed that some Directors had questioned the staff's assumptions for copper prices during the program period. The staff had originally assumed an average copper price of 75 cents per pound; however, in a recent revision, it had recommended that the authorities lower the average projection for 1984 to 71 cents per pound. At the same time, projections for production and exports had been revised. The staff had been told by the authorities that increases in production and shipments of copper had taken place in the first quarter of 1984 and that the higher level of production and exports could be continued throughout the year. In the circumstances, the shortfall of 4 cents in the copper price would be offset by the higher level of production, so that the value of copper exports for the year as a whole would remain largely unchanged. As for the medium-term projections, there was no denying that copper prices were typically volatile and that assumptions for the medium term might not be realized. However, the staff had assumed that the real price of copper would be maintained in future at about the 1984 level, and there was at present no reason to change that assumption. Chile, by comparison with its competitors, was a low-cost producer of copper. The break-even point for other producers was in the range of US$0.80-$1.00 or higher, which was well above the break-even point for Chile.

Commenting on savings performance, the staff representative remarked that, historically, savings in Chile had been low, although they had been on an upward trend since 1981. Thus far in 1984, savings performance had been quite good, calculated at an annual rate of over 20 percent. He was not of course implying that such performance could be continued throughout the year; indeed, the numbers had fallen sharply in April because of the changes in several Government officials of ministerial rank and because questions had been raised internally about the direction of economic policy in Chile. In that regard, he understood that those questions had been answered by the new authorities during the past month with an indication of support for the Fund program.

A number of questions had been asked about the measures being adopted to increase the savings rate in Chile, the staff representative recalled. In the private sector, tax reform was aimed at improving private sector savings performance. Interest rate increases were also planned in response to recent world market developments.

With regard to questions on the shortfall in loan disbursements from multilateral agencies, the staff representative said that, as he understood it, the shortfalls were related to a delay in reimbursements on investment projects. The delays were apparently administrative in nature, and the authorities and the institutions were working to clarify the issues involved and to bring the reimbursements back on schedule.

In response to Mr. Leonard's question about why domestic prices of petroleum products had not been increasing in line with international price increases, the staff representative said that, as he understood it, Chile had a very straightforward pass-through system in which all transportation and storage costs were added to a Caribbean posted price and passed on in full to all domestic consumers. He was not aware that the staff had made any issue of the lack of adequacy of domestic petroleum prices; certainly, the accounts of the State Petroleum Company indicated that growing surpluses--from 1 percent of GDP in 1979 to almost 4 percent of GDP in 1983--had been passed on to the Central Government, and that the trend was expected to continue in 1984.

As noted in the staff report, the spread between the parallel and official market rates had shrunk from the very high numbers registered in March 1983 to about 8-10 percent at present, the staff representative observed. While there had been a small increase in the spread in the month of April--which the staff believed was related to changes in government officials at the time--an adjustment of interest rate policies domestically should go a long way toward continuing the trend of shrinking the spread. The staff continued to feel that the official exchange rate was a viable one, although the latest developments in interest rates and in copper prices would need to be monitored. During the midyear review, the staff would have a better idea of the trends of copper prices and the impact of the interest rate rise.

Responding to those who had wondered whether it would not be better to use the wholesale price index to deflate the exchange rate series in order to get a real effective exchange rate, the staff representative considered that it would be more appropriate to use the consumer price index. The weighting within the consumer price index was more closely indicative of cost changes; the wholesale price index was heavily weighted, in his view, with imported consumer and industrial goods.

Commenting on the inflation experience in Chile, the staff representative said that he could not accept the view that inflation in Chile was especially volatile. In his view, the pattern of inflation was explainable in terms of the policies that had been implemented. A graph of inflation trends over the past ten years showed that the rate had declined from 600 percent in the early 1970s, to a level of 35 percent a year in late 1979 through 1981 through appropriate demand policies. In the first half of 1982, during the recession, the rate of inflation had declined to zero but had risen strongly in the second half of the year following the midyear devaluation. Since then, inflation had tended to decline again, reflecting cautious demand management. During the first four months of 1984, inflation had been at an annual rate of 12 percent.

With regard to questions about the role of government guarantees in private sector debt, the staff representative remarked that a distinction should be made between the guaranteeing of external debt of the financial system and the guaranteeing of debt of the corporate private sector. Chile had not guaranteed the external debt of the corporate private sector but only the refinanced elements of the external debt of the financial system.

Several questions had been raised about whether or not the staff's assumptions for growth in 1984 were reasonable, the staff representative from the Western Hemisphere Department recalled. Directors seemed to be asking where the program stood in terms of establishing the basic underpinnings necessary for sustainable growth in future and, in that context, whether the projected 4 percent rate of growth in 1984 was possible. Indicators through the first quarter of 1984 suggested that the trend was quite positive; indeed, the authorities believed that the projection of a 4 percent rate of growth might be too low and that even faster growth was possible during the year. Aware of some of the uncertainties facing Chile at present, the staff had not wanted to appear optimistic in its projections; however, it continued to believe that a 4 percent rate of growth--and perhaps even as much as a 5 percent rate--was possible.

The Deputy Director of the Exchange and Trade Relations Department, elaborating on the relationship between performance criteria and drawings, remarked that no drawing had been directly linked to end-1983 performance. Paragraph 4(b) in Attachment III of EBS/84/50, Supplement 2 made clear that drawings after December 31, 1983 were dependent on understandings on the exchange system, on the establishment of performance criteria for the second year of the program, and on observance of those criteria. Therefore, the end-December 1983 performance criteria had been only indicative and could not prevent drawings in 1984. The data for December 31, 1984 were also intended to be indicative. The period of the arrangement extended through January 9, 1985, and the last purchase had to take place during the period in which the arrangement was in effect. By January 9, 1985, however, data to measure performance at end-December 1984 would not yet be available and, consequently, the year-end outcome could not affect drawings.

Mr. Clark observed that, with the sort of procedure described by the Deputy Director of the Exchange and Trade Relations Department, there was a danger of a jump or "bulge" at the very end of each year of the program that was not taken into account as the program began the new year. He understood from Mr. Donoso's earlier statement that Chile intended at least to explore the idea of a further program with the Fund, which sharpened his concern about how the performance criteria at end-1984 would be treated.

The Deputy Director of the Exchange and Trade Relations Department remarked that the recent policy trend had been toward linking annual programs precisely to prevent the problem to which Mr. Clark had referred. Experience suggested that cases in which end-year performance diverged widely had been rather infrequent. In the Chilean case, it was clear that the departure at end-1983 had been relatively small; indeed, had the annual programs been linked, it was likely that the staff would have proposed to the Executive Board the extension of a waiver for the departure that had taken place. Of course, departures in some other cases had been more significant and they had prompted the move toward a policy of linking annual programs.

A number of questions had been raised on the matter of the extension of government guarantees to private foreign debt when a debt rescheduling scheme was being discussed between a country and its creditors, the Deputy Director recalled. Generally speaking, the Fund discouraged the extension of such guarantees on several grounds. First, the guarantees burdened the country's fiscal position. Second, they had implications for what might be called the "discipline of the market" which could thereby be undermined. Of course, government guarantees were an important element in the negotiation between debtors and creditors, and there might be situations in which the extension of guarantees could be considered appropriate; however, as a general matter, the staff was not in favor of granting government guarantees to private debt. The staff representative from the Western Hemisphere Department had explained the scope of the extension of government guarantees in the Chilean case; he had not addressed the issue of their effect on the medium-term outlook for the economy. His own sense of the situation was that the extension of guarantees by one country involved in a rescheduling exercise would put pressure on other countries in similar situations to extend them. In that context, the contracting of private debt should perhaps be subject to limitations if guarantees were to become a feature of rescheduling exercises. That was an issue that raised serious questions about the appropriate definition of public sector debt and the desirability of close monitoring of private sector borrowing abroad.

The Deputy Managing Director recalled that, in February 1984, he and others on the staff had discussed with the Advisory Committee of Banks on Chile the effort--particularly on the part of one bank--to extend further the guarantees and subsidies discussed on page 23 of the staff paper. The staff had demonstrated graphically that any such effort would in effect require a further tightening of monetary and fiscal policy. He had concluded his presentation to the Advisory Committee by alerting the banks that the Chilean program would have to be renegotiated if the guarantees or subsidies were further extended. Hence, in at least one instance, the staff was on record as vigorously opposing efforts by the banks to extend guarantees and subsidies. The staff had pointed out that, almost certainly, such efforts would require crowding out of private sector credit so that, in effect, the foreign commercial banks would in one sense be acting against their own interests.

Mr. Leonard remarked that his earlier question about petroleum prices in Chile had not been in reference to the performance of the petroleum company in 1983; rather, he had been referring to the projected performance in 1984. It had been mentioned on page 17 of the staff report that "the operational surplus of public enterprises is projected to decline by 1.3 percent of GDP in 1984 compared with 1983." That projected decline had then been explained as the result of (a) the drop in the peso value of copper exports and (b) the higher imports of petroleum products by the state petroleum company. The latter point had suggested that there must be some form of loss entailed in the imports; yet it had been explained that all costs were covered. In the circumstances, he wondered why there should be a projected decline in the surplus as a result of higher imports.

The staff representative from the Western Hemisphere Department commented that the state petroleum company functioned as an importer as well as a domestic producer. On its domestic production, the company had to pay a production tax to the Government. Within the accounts of the state enterprises, the operational surplus excluded the transfer to the Government; hence, as the state petroleum company shifted toward more imports and less domestic production, its operational position would tend to deteriorate because the additional imports would be costed at market prices, which were considerably higher than the costs for local production.

Mr. Donoso remarked that, in his view, a number of positive developments had occurred in the economy since the second half of 1983, including an increase in production. At the same time, positive developments on the monetary side were seen as a clear consolidation of the financial system. However, while his authorities saw those developments as important, they were not satisfied, in part because the production increases had occurred from a very low base. Hence, they looked toward further improvements in the rate of unemployment and in the strengthening of the financial situation of the private sector.

With regard to unemployment, the authorities had indicated to management and staff the possibility of introducing new taxes and distributing resources in a way that encouraged employment. Also, commissions had been established to study the debt situation, with a view to consolidating private sector debt. The notion that a number of difficulties in the economy remained to be overcome had led the authorities to be somewhat conservative, although not necessarily so in establishing demand management policy. They felt that it was important not to lose the momentum already begun, and they were therefore prepared to apply some fiscal stimulus if it appeared that demand in the private sector was weak.

Noting that some Directors had welcomed the contingency plan while others had expressed some concern about its use, Mr. Donoso considered that some clarification of the current situation might be helpful. In 1983, the fiscal deficit of the overall public sector had been equivalent to 3 percent of GDP, and the staff was now projecting an increase to 4.5 percent of GDP for 1984. That increase could not be interpreted as an equivalent additional stimulus on the fiscal side. Of the 1.5 percentage points, 0.5 percentage points corresponded to the adjustment to inflation of the internal public debt. Another half point corresponded to a reduction in what was called capital income of the public sector, and that was a lower planned level of sales of financial assets of the public sector as compared with 1983. In his view, the expansive element of policy was more related to the difference between the additional public investment--which was the equivalent of 1.9 percent of GDP--and the additional public savings--which was the equivalent of 1.3 percent of GDP--which left only 0.6 percent of GDP as additional stimulus.

The Chilean authorities were looking forward to a mid-year review of fiscal policies in hopes of getting a definition of the appropriate level of stimulus to be applied, depending on the behavior of the private sector, Mr. Donoso said. The idea was that, if private sector demand was weak--which would be perceived in the trade surplus--and if there was financing available, the time would be ripe to add some fiscal stimulus. The authorities welcomed such built-in flexibility in the program and looked forward to holding comprehensive discussions on the matter on the occasion of the midyear review. At present, however, they felt that the basic change in the fiscal situation was not so expansionary as to cause any worry.

The Chilean authorities also attached importance to ways of introducing flexibility to cope with adverse temporary external developments, Mr. Donoso remarked. Since the economy was especially dependent upon copper prices and interest rates, they were worried about having to tighten or loosen policy depending upon changes in copper prices or interest rates that might be transitory.

On increases in the parallel exchange rate during the previous week, Mr. Donoso observed that any change tended to produce some uncertainty. However, it was important to note that the change in the parallel exchange rate had occurred during a time when it was becoming clear that interest rates were rising and that the price of copper was falling, and when it was not yet known whether there would be financing available to deal with the deterioration in the current account. It was to be hoped that, once the projections for private capital flows were firmer, the situation would return to normal in the sense that the gap between the parallel exchange rate and the official exchange rate would be fairly narrow.

With regard to Mr. de Vries's comments on the "volatility" of inflation in Chile, Mr. Donoso agreed that, within the range of rates of 20-30 percent, erratic movements could occur because of external developments. An interesting discussion had taken place in the country toward the end of 1980 and the beginning of 1981, when people had been attempting to predict the rate of inflation. No one had been able to make a good projection and, as mentioned by the staff, the rates of inflation in early 1982 had become negative, mainly because the dollar had been appreciating at the time, which had had a direct influence on the price of exports. All relevant prices, from the point of view of the Chilean economy, had been falling in nominal terms, which had placed great deflationary pressure on the economy and had led to negative rates of inflation one year later. No one had been able to predict such a development because no one had given much weight to those external factors.

The authorities were concerned about short-term prospects for the economy and recognized the need for caution in the administration of the program, Mr. Donoso commented. Relatively speaking, they were more optimistic about the medium term, although some notes of caution had been sounded by members of the Executive Board. Without making much use of external resources, Chile had been growing at the rate of about 8 percent a year in real terms in the years 1976-79, when net absorption of external resources in the economy had been about 2-3 percent of GDP as measured by the trade deficit. Problems had not appeared until 1980-82. In developing a medium-term scenario for the economy, one had to consider the very important variables such as rates of interest, the level of the U.S. dollar, and the savings ratio in the economy. As noted by the staff, the authorities had already begun to change the tax structure in order to reduce capitalization of profits. So long as the level of production was depressed, as at present, it was only natural to expect a lower than normal savings ratio. People were attempting to maintain consumption as far as possible; hence, savings ratios reflected drastically what was happening with respect to GDP. Because of the special policies being implemented by the authorities and the expectation of a recovery of economic activity, it was only reasonable to expect a relatively fast recovery in the savings ratio in future. That, together with an improvement in interest rates and a better external environment should help to create more positive prospects for the medium term.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the thrust of the staff appraisal contained in the report on the 1983 Article IV consultation with Chile. They welcomed the renewed commitment of the Chilean authorities to the objectives of the stand-by arrangement and approved Chile's program for the second year under the arrangement.

Directors noted that economic policy in Chile in 1983 had been conducted in a particularly difficult environment. Economic recovery from the severe 1982 recession was hampered by continued weak foreign demand for Chile's exports, depressed world commodity prices, protectionist tendencies abroad, and a heavy private debt service burden. The situation was aggravated by the financial crisis that occurred in early 1983. In such conditions, the Chilean authorities' success in bringing the economy back on the adjustment path of the program in the second half of the year was highly commendable.

Directors observed with satisfaction the indications of economic recovery since mid-1983 and the lower than expected rate of inflation and external current account deficit for 1983 as a whole. They also took note of the priority that the authorities attached to reducing unemployment and of their desire to foster export-led, labor-intensive growth and to restore confidence in the private sector. In that context, Directors shared the staff's concern that, if private sector confidence were to rebound strongly, the fiscal stance envisaged in the program might imperil the progress toward financial stability achieved so far. For that reason, Directors urged the authorities to be particularly prudent in their implementation of fiscal policies in 1984. Several Directors also wondered whether monetary policy was tight enough to achieve a further reduction in inflation and to protect the balance of payments. Developments in the economy, especially with respect to the trade balance and real money holdings, should be monitored closely; and the authorities should not delay in shifting toward greater restraint in the event that private sector demand recovered strongly.

A number of Directors cautioned the authorities with regard to the implementation of the fiscal contingency program involving additional public expenditures. If the recent increases in international interest rates should be maintained or even extended, and copper prices continued to be relatively weak, the authorities should be prepared to tighten their policies in order to keep the program on track. Indeed, as suggested by one Director, given the uncertainties of the economic situation confronting the authorities, they would be well advised to develop without delay a contingency plan that would deal with a possible weakening of the country's external position.

Directors supported the authorities' reliance on market-oriented price policies in guiding resource allocation. They underscored the importance of keeping prices in the public sector at realistic levels and maintaining a competitive exchange rate, and they referred with some concern to indicators that suggested a real effective appreciation of the exchange rate in late 1983. As to interest rate policy, Directors welcomed the greater weight given to foreign interest rates in establishing the level of domestic rates but hoped that interest rate guidance by the Central Bank could be withdrawn as the financial system regained strength. Continued application of tight wage policy in the public sector and of free wage determination in the private sector were considered appropriate.

In view of Chile's heavy external indebtedness and the continued vulnerability of the balance of payments, Directors stressed the need for decreasing reliance on external savings and for greater recourse to concessional loans. In that context, a number of Directors commented on the need to raise the fairly low level of domestic savings; interest rates would have to be particularly responsive to international conditions if capital outflows and a decrease in savings were to be avoided. Directors welcomed the cooperation shown by foreign commercial banks in committing themselves to providing the necessary "critical mass" of foreign private financing of the balance of payments in 1984. The sharp increase in scheduled amortization payments after 1984 pointed to the desirability of supporting Chile's adjustment effort with reasonable understandings regarding the orderly settlement of debt obligations.

Directors welcomed the reduction of the spread between the official and parallel exchange rates, although they noted that the spread had varied from time to time with shifts in confidence and had risen substantially since the end of March 1984. Directors also welcomed the reduction of the subsidies paid on certain external debt service payments. At the same time, they urged Chile to make more rapid progress in reducing reliance on exchange restrictions, multiple currency practices, and import surcharges.

In sum, Directors supported the authorities' approach. However, the risks inherent in the proposed strategy for 1984 led most Directors to place particular emphasis on the need to maintain close contact between the Chilean authorities and the Fund through 1984, and they stressed the importance which they attached to the midyear review of the program.

The Article IV consultations with Chile will continue to be held on a 12-month cycle.

The Executive Board then adopted the following decisions:

Exchange Measures Subject to Article VIII

1. The Fund takes this decision relating to Chile's exchange measures subject to Article VIII, Sections 2 and 3, in the light of the 1983 Article IV consultation with Chile conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Chile maintains a multiple currency practice arising from a subsidy on certain foreign interest payments and principal repayments 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 gives rise to 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. In view of the temporary nature of these multiple currency practices and exchange restrictions, the Fund grants approval for their retention through December 31, 1984.

Decision No. 7698-(84/76), adopted
May 14, 1984

Consultation Under Stand-By Arrangement

1. Chile has consulted with the Fund in accordance with paragraph 6 of the letter of December 13, 1982 attached to the stand-by arrangement for Chile (EBS/82/227, Supplement 2) as modified by the letter dated July 8, 1983 (EBS/83/134), and paragraph 4 of the stand-by arrangement, in order to reach understandings with the Fund regarding the policies and measures that Chile will pursue during the second year of the arrangement.

2. The letter dated March 12, 1984 from the Minister of Finance and the President of the Central Bank, together with the annexed Memorandum on Economic Policy of Chile for the second year of the stand-by arrangement shall be attached to the stand-by arrangement for Chile (EBS/83/227, Supplement 2) and the letter dated December 13, 1982, together with the annexed Memorandum on the Economic Policies of Chile, as modified by the letter dated July 8, 1983 (EBS/83/134), shall be read as supplemented and modified by the letter dated March 12, 1984, together with the annexed Memorandum on Economic Policy.

3. Accordingly, Chile will not make purchases under this stand-by arrangement:

a. during any period in which

(i) the data at the end of the preceding period, other than the period ended March 31, 1984, indicate that the limit on the total indebtedness of the nonfinancial public sector or the sublimit on domestic indebtedness of the nonfinancial public sector described in Table 1 of the memorandum annexed to the attached letter has not been observed, or

(ii) the limit on the net domestic assets of the Central Bank described in Table 2 of the memorandum annexed to the attached letter is not observed, or

(iii) the data at the end of the preceding period indicate that the net international reserve target described in Table 3 of the memorandum annexed to the attached letter has not been observed, or

(iv) the limit or sublimit on the contracting and guaranteeing of external debt by the public sector described in Table 4 of the memorandum annexed to the attached letter is not observed; or

b. after June 30, 1984, until the review contemplated in paragraph 6 of the attached letter has been completed.

4. The Fund finds that, in light of the letter dated March 12, 1984, Chile may make purchases under the stand-by arrangement, notwithstanding that the exchange system has not been unified and notwithstanding the retention of the existing restrictions on payments for travel and other invisible transactions, as described in paragraph 4(b) of the stand-by arrangement.

5. Paragraph 4(c) of the stand-by arrangement for Chile in EBS/82/227, Supplement 2, January 11, 1983, shall be amended to read as follows:

"(c) during the entire period of this stand-by arrangement while Chile has any overdue financial obligation to the Fund, or if Chile...."

Decision No. 7699-(84/76), adopted
May 14, 1984

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/75 (5/9/84) and EBM/84/76 (5/14/84).

3. INDONESIA - RELEASE OF INFORMATION

The Executive Board approves the proposal to release the staff report on recent economic developments in Indonesia to the Inter-Governmental Group on Indonesia, as set forth in SM/84/104 (5/7/84).

Adopted May 10, 1984

4. SWAZILAND - RELEASE OF INFORMATION

The Executive Board approves the proposal to release the staff report on recent economic developments in Swaziland to the United Nations, as set forth in EBD/84/134 (5/7/84).

Adopted May 10, 1984

5. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to an Executive Director as set forth in EBAP/84/96 (5/8/84).

Adopted May 10, 1984

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/97 (5/8/84) and EBAP/84/100 (5/10/84) and by Advisors to Executive Directors as set forth in EBAP/84/98 (5/9/84) and EBAP/84/100 (5/10/84) is approved.

APPROVED: November 14, 1984

LEO VAN HOUTVEN
Secretary