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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/8

10:00 a.m., January 10, 1983

W. B. Dale, Acting Chairman

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
	C. Taylor
	H. G. Schneider
	P. D. Péroz, Temporary
A. Donoso	M. Teijeiro
R. D. Erb	C. Dallara
	T. Alhaimus
	I. R. Panday, Temporary
	T. Yamashita
R. K. Joyce	
A. Kafka	C. Robalino
G. Laske	G. Grosche
G. Lovato	G. Gomel, Temporary
R. N. Malhotra	
	S. El-Khouri, Temporary
J. J. Polak	T. de Vries
	K. G. Morrell
	O. Kabbaj
	E. I. M. Mtei
	J. L. Feito
	I. Fridriksson, Temporary
Zhang Z.	Wang E.

L. Van Houtven, Secretary
J. C. Corr, Assistant

Also Present
African Department: C. E. Hunter. Exchange and Trade Relations Department: M. Guitian, A. Pera. External Relations Department: H. O. Hartmann, H. P. Puentes. Fiscal Affairs Department: P. R. Rado. IMF Institute: A. Bello. Legal Department: H. Elizalde. Research Department: G. I. Brown, Brown, K.-Y. Chu, D. Folkerts-Landau, N. M. Kaibni, P. J. Monteil, T. K. Morrison, A. Salehizadeh. Western Hemisphere Department: S. T. Beza, Associate Director; C. E. Sansón, Deputy Director; J. O. Bonvicini, P. D. Brenner, M. Caiola, D. S. Hoelscher, J. S. Lizondo, C. L. Ramirez-Rojas, F. Rubli-Kaiser, J. F. Van Houten, E. V. Zayas. Advisor to the Managing Director: E. W. Robichek. Advisors to Executive Directors: J. R. N. Almeida, J. Delgadillo, A. B. Diao, M. A. Janjua, P. Kohnert, H.-S. Lee, P.-C. Maganga-Moussavou. Assistants to Executive Directors: H. Arias, L. E. J. Coene, T. A. Connors, G. Ercel, A. Halevi, M. Hull, J. M. Jones, J. A. K. Munthali, V. K. S. Nair, Y. Okubo, G. W. K. Pickering, C. A. Salinas, J. Schuijer, A. Yasseri.

1. CHILE - 1982 ARTICLE IV CONSULTATION; STAND-BY ARRANGEMENT; AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors considered the staff report for the 1982 Article IV consultation with Chile, together with a request for a two-year stand-by arrangement equivalent to SDR 500 million (EBS/82/227, 12/13/82; Cor. 1, 1/5/83; and Sup. 1, 1/7/83), and a request by Chile for a purchase under the compensatory financing facility equivalent to SDR 295 million (EBS/82/228, 12/13/82; and Sup. 1, 1/7/83). They also had before them a report on recent economic developments in Chile (SM/82/160, 8/15/82; and Sup. 1, 12/13/82).

The staff representative from the Western Hemisphere Department made the following statement:

> The staff has just received the following information on recent developments.
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> A summary of the Central Bank accounts for January 6, 1983 is given in Table 1 (Annex I). It indicates that the net domestic assets of the Central Bank are well below the ceiling applicable for the January 1-March 31, 1983 period and that the sum of the net international reserves and the deposits related to balance of payments loan disbursements exceeds the target programed for March 31, 1983 by US$202 million.
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> The net official international reserve loss during 1982 was US$1,392 million and the balance of payments support loan disbursements totaled US$138 million. This compares with a projected reserve loss of US$1,100 million and balance of payments support loan disbursements of US$550 million. As the program allows for a larger net international reserve loss when balance of payments loan disbursements fall short of the expected level, the outcome for 1982 was within the expected limits.
>
> The rate of inflation measured by the changes in the consumer price index was 20.8 per cent during 1982, compared with an estimate of 19.6 per cent. Table 2 (Annex II) provides the profile of the monthly rate of inflation during 1980-82. The decline in the rate of inflation in November and December appears consistent with the rate of inflation in 1983 of 25 per cent projected in the program.
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> The unemployment rate in the Greater Santiago Area, which had reached as high a level as 24.6 per cent in the September-November 1982 period, declined to 21.9 per cent in the October-December 1982 period.
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> Nominal interest rates on short-term deposits and lending operations in the last quarter of 1982 have increased. In December 1982, the monthly nominal short-term lending rate was

5.5 per cent, compared with 4.3 per cent in September. At the same time the average short-term deposit rate rose to 4.6 per cent from 3.6 per cent in September. The rise in real terms has been more pronounced, as deposit rates in December 1982 were 4.2 per cent and 3.3 per cent, respectively, compared with zero and -0.7 per cent in September 1982.

Mr. Erb asked whether the staff had figures for the growth of the economy, and of imports, on a fourth-quarter-to-fourth-quarter basis.

The staff representative from the Western Hemisphere Department replied that real economic growth from the fourth quarter of 1982 to the fourth quarter of 1983 would probably be well above the projected growth of 4 per cent for the year as a whole. There would probably be a small decline in imports on the same basis.

Mr. Donoso made the following statement:

I wish to thank the staff for the excellent set of papers on the 1982 Article IV consultation with Chile and on Chile's request for resources under the stand-by arrangement and the compensatory financing facility.

After decades of slow growth and sporadic financial difficulties, the Chilean economy faced a major crisis in the first half of the 1970s. Enormous fiscal deficits financed with central bank credit, coupled with unrealistic exchange rates and generalized price controls, led to a drop in output, hyperinflation, and the exhaustion of official net international reserves.

The oil crisis of the year 1974 and the resulting deterioration in Chilean terms of trade worsened the situation. The authorities faced the situation by embarking on a stabilization effort in the context of a complete program of structural reforms.

The aim of that program was to accelerate the rate of growth through opening the economy to international trade and competition; transferring productive activities from the public sector to the private sector; strengthening and enlarging the scope of private property; and generally freeing prices and eliminating economic distortions so as to improve resource allocation. Controlled prices and the rate of interest were freed. The average tariff on imports, which was 105 per cent in 1974, was reduced to 44 per cent in 1975, 33 per cent in 1976, 20 per cent in 1977, 14 per cent in 1978, 10.9 per cent in 1979, and 10.1 per cent in 1980. 1/ All nontariff restrictions were eliminated.

1/ The only imports to which a tariff above 10 per cent is applied are automobiles above 850 cc. Lately, there have been increases in tariffs applied to specific imports where dumping has been ascertained. These tariffs are temporary.

Fiscal expenditure decreased 27 per cent in real terms between 1973 and 1980. The fiscal deficit, which amounted to 55 per cent of the total fiscal expenditures in 1973, was reduced and then transformed into a surplus in 1976-80. Approximately 400 enterprises under state control were transferred to the private sector. The remaining state enterprises eliminated their losses and generated an operational surplus of around US$500 million in 1980.

Fiscal expenditure in social areas and programs increased their share from 30 per cent of total fiscal expenditure in 1973 to more than 50 per cent in 1980. This implied an absolute increase in fiscal expenditure for social purposes. Numerous other reforms were also implemented during this period. Among them we could mention tax reforms (elimination of special treatments and tax exemptions, and the introduction of a value-added tax), and the social security reforms (introduction of a system of compulsory savings out of wages that are capitalized in individual accounts managed by specialized private entities). There have also been reforms in the public health system, in the educational system, as well as in most productive sectors, always aiming at increasing the participation of the private sector and improving resource allocation.

The performance of the Chilean economy improved strongly under the program. The rate of inflation declined from more than 500 per cent in 1973 to 31 per cent in 1980. After a reduction in 1975, GDP grew at the rate of 4.1 per cent in 1976 and from then on at an average annual rate of 8 per cent until 1980. The annual rate of growth of employment during 1976-80 was about 3.4 per cent, which compares favorably with the annual rate of 1.9 per cent during the decade of the 1960s.

At the same time, there were positive results from policies implemented to reduce poverty. The rate of infant mortality was reduced from 79 per 1,000 children born alive in 1973 to 39 per 1,000 children born alive in 1980. Impressive advances were also achieved in education and nutrition.

As a result of the reduction in import tariffs, accompanied by a real depreciation of the peso, nontraditional exports increased from less than US$200 million per year during 1970-74 to $1,240 million in 1980. Exports of copper, which amounted to 75 per cent of total exports in 1970-74, declined in relative terms to 50 per cent of exports in 1979-80. The important remaining problem in 1980 was the rate of unemployment, still at a level of 11.8 per cent, though steadily falling.

After 1976, the deficit in the current account of the balance of payments grew from 4 per cent of GDP in 1977 to 7.1 per cent of GDP in 1980, reflecting the insufficiency of domestic savings to finance growing investment. There were no problems in obtaining the foreign resources, and, given the monetary policy being applied, the financing of the deficits occurred at the same time as a systematic increase in international reserves. The increase in external debt was almost all private debt.

In mid-1979, when all potential pressures for credit expansion arising from the public sector deficits had been eliminated, a rate of exchange of Ch$39=US$1 was established.

The U.S. dollar began to apreciate vis-à-vis other major currencies in the last quarter of 1980. In addition, there was a reduction of the nominal prices of an important number of Chilean exports. The average reduction in nominal prices in U.S. dollars of goods amounting to 50 per cent of Chilean exports was 15 per cent during 1981. Prices of imports did not change during the period, so that the economy faced a deterioration in its terms of trade. To the loss of income resulting from the deterioration in terms of trade was added the increase in international rates of interest to be applied to the service of the external debt.

Because the peso is fixed to the U.S. dollar, the appreciation of the dollar involved an appreciation of the peso with respect to the currencies of Chile's major trading partners or a reduction in the price of tradeables as measured in Chilean pesos. To this deflationary pressure was added the decrease in the nominal prices of exportables already mentioned. During 1981, the reduction in the price of tradeables led to a reduction in the wholesale price index of -3.9 per cent.

A widespread system of wage indexation existed. The minimum increase in wages that a firm engaged in collective bargaining could offer was one that would bring real wages to the same level agreed upon at the past bargaining session. Government employees and nonunionized workers received wage increases equivalent to inflation since the last adjustment, whenever the increase in prices accumulated to a certain pre-established figure.

This system prevented the reduction in the prices of nontradable goods from occurring with the required rapidity. The increase in consumer prices during 1981 was still at the rate of 9.1 per cent. Wages increased in real terms, and the relative price of tradeables deteriorated during the year.

Because of the increase in the international rate of interest, and probably because of a perceived risk of devaluation, the domestic rate of interest rose in the last months of 1980 and during 1981 to about 25-30 per cent a year in real terms, having been about 5 per cent a year in real terms in 1979 and 1980.

During 1979-80, an appreciable spread between interest rates paid on foreign borrowing and interest rates paid to national depositors in the financial system existed. This spread did not show up in the form of high real domestic interest rates because the internal rate of inflation had been higher than the international one. However, when the appreciation of the dollar brought down the internal rate of inflation, the maintenance of the spread implied high real domestic interest rates.

The deterioration in the terms of trade and the increase in the external rate of interest depressed national income. The decrease in the price of tradeables, the increase in real wages and, the increase in the real internal rate of interest slowed down the increase in production. By the end of 1981, production had stopped growing and started falling during 1982.

Aggregate demand still remained high and was financed with external resources in 1981, but fell in 1982. Thus, after an increase in the current account deficit to 14 per cent of GDP in 1981, the reduction in demand during 1982 almost halved the level of imports, while GDP decreased about 13 per cent. The rate of unemployment rose above 20 per cent. The reduction in income and imports decreased government revenues, bringing about a fiscal deficit in 1982 for the first time in years.

Measures were taken to facilitate the economic recovery during the period May-July 1982. All future wage indexation was abolished in relation to both private and public employment. The wage floor in collective bargaining was reduced to the level existing in July 1979. These measures were expected to facilitate any necessary real wages adjustment and to change conditions so as to make it possible to have a devaluation without offsetting price increases. Restrictions on capital flows were virtually eliminated. Limits on the terms of export prefinancing and import credits were relaxed. A uniform 5 per cent reserve requirement on foreign borrowing was established in place of reserve requirements that varied according to the maturity of the loan.

Banks were allowed to relend their foreign borrowings in pesos. These measures were expected to facilitate arbitrage by the financial institutions and reduce the rate of interest.

The peso was devalued on June 15 to restore competitiveness to the Chilean economy. On September 29 the peso was fixed at the rate of Ch$66 = US$1 adjustable daily on the basis of inflation in the previous month minus 1 per cent a month. To deal with the emerging fiscal deficit, a number of measures were taken in the first half of 1982. In June 1982, the salaries of higher paid employees of the public sector were cut by 10 per cent in addition to the elimination of the automatic adjustment.

Taxes on tobacco products were raised. The programed decline in tariffs on imports of highly priced automobiles was halted. Incentives to settle overdue tax liabilities were introduced.

These measures eliminated the rigidities making adjustment in the economy difficult. All of them were consistent with the basic economic strategy of the Chilean Government, i.e., to promote adjustment and growth by relying on market forces and price incentives to guide resource allocation.

As can be seen in EBS/82/227, page 31, Table 8, the Chilean economy has gone through a tremendous adjustment during 1982. The deficit on the goods and nonfactor services account was reduced from 9.9 per cent of GDP in 1981 to 1.4 per cent of GDP in 1982. At the same time, GDP fell 12.8 per cent in real terms during 1982. Combining these figures, we can estimate the reduction in real domestic expenditures during 1982 to have been around 20 per cent in real terms. Thus, no additional reductions in real domestic expenditure are needed to get to a surplus in the goods and nonfactor services account of 2.8 per cent of GDP in 1983, as contemplated in the program, if GDP grows 4 per cent in real terms.

The new exchange rate system should lead to an average real exchange rate during 1983 at least 30 per cent higher than the average real exchange rate during 1982. The reduction in real wages and the higher real exchange rate should make possible the targeted increase in GDP for 1983 and the improvement in the trade account.

To keep demand under control, the program contemplates a limit on the net indebtedness of the nonfinancial public sector. This limit is consistent with the planned overall deficit of the public sector of 1.7 per cent of GDP for 1983.

The overall deficit of the public sector during 1982 amounted to 4 per cent of GDP. To reduce this deficit to the targeted level of 1.7 per cent of GDP in 1983, and given an expected reduction in general government revenues in 1983, the authorities plan to make reductions in current expenditures of the general Government amounting to 7.1 per cent of GDP and to bring about an increase in the surplus of public enterprises through adjustments in tariffs on goods and services provided by those enterprises.

The monetary program for 1983 assumes a rate of inflation of 25 per cent, an increase of 4 per cent in real money and quasi-money holdings, and US$485 million of losses in international reserves for the year. The programed increase of 40 per cent in the net domestic assets of the financial system consistent with those assumptions, will be totally channeled as credit to the private sector, as no domestic credit to the public sector is planned.

A current account deficit will remain during 1983 and 1984, amounting to 7.2 per cent of GDP and 4.7 per cent of GDP, respectively. The authorities are confident that foreign financing will be available in the required amounts. Should the expected availability of foreign financing or any of the assumptions underlying the program not be realized, the authorities stand ready to apply the necessary corrective measures, including the tightening of credit conditions.

The reduction of import duties to a uniform 10 per cent level is a clear indicator of my authorities' strong commitment to an open economy. They have maintained this feature of their policies during 1981 and 1982 in spite of the obvious pressures to raise the level of protection. They see the progress of the Chilean economy as strongly related to the maintenance of duties at this low level, to the freedom to mobilize capital, and to the absence of restrictions on payments and transfers for current international transactions.

For important reasons, the authorities have established limitations on the sale of foreign exchange for invisibles, and a preferential exchange rate applying to the servicing of external debts contracted before August 6, 1982 on a temporary basis. They plan to eliminate these measures before the end of 1983, as contemplated in the program.

Mr. Kafka commented that he strongly supported both the request for a stand-by arrangement and the use of the compensatory financing facility. After the crisis that had culminated in the events of 1973, Chile had succeeded in returning to a strong balance of payments position, and the rate of inflation had been reduced from about 500 per cent in 1973 to 30 per cent in 1980. Real GDP had grown at an average rate of 7 per cent a year in 1976-80, exports had grown rapidly, and Chile's creditworthiness had been unquestioned. After equilibrium had been attained in the external and fiscal sectors, the emphasis of economic policy had focused on reducing domestic inflation, and the exchange rate had been fixed to help to achieve that goal. That policy had been entirely justified in the context of prevailing credit, fiscal, and monetary policies, but it was less clear whether it had been justified in light of the wage policy being pursued at that time and since modified. However, the policy had been undermined by the drastic change in the terms of trade, a clear example that purchasing power parity should not be the only criterion of exchange rate policy. There had been an abrupt deterioration of the external sector and of internal economic activity. The authorities' abandonment of the fixed exchange rate in the context of appropriate internal measures was welcome. The action should greatly help in the recovery of Chile's international competitiveness and in the recovery of output.

He endorsed the fiscal measures taken by the Chilean authorities to increase revenue, Mr. Kafka continued, including the creation of new income and property taxes, increases in public sector tariffs, and sales of public sector assets. He also endorsed the measures aimed at decreasing expenditures by eliminating wage indexation. It was important to mention the authorities' continued efforts to reduce, within the expenditure restraints, the level of unemployment. The authorities should be encouraged to strengthen fiscal policy by austerity measures in general government expenditures to help reduce the deficit, estimated at 10.3 per cent of GDP at the end of 1982, and projected to decline to 7.2 per cent of GDP in 1983, with a further reduction to 4.7 per cent of GDP in 1984.

Commenting on monetary policy, Mr. Kafka considered that the abandonment of a fixed exchange rate in June 1982 should help to reduce capital outflows and permit an increase in the availability of domestic savings. He welcomed the easing of restrictions on payments and transfers for current international transactions, a policy consistent with the authorities' desire to restore financial confidence among domestic and foreign banks.

Particularly helpful among the measures adopted in the previous two weeks was the modification of the subsidy to foreign currency debtors, Mr. Kafka suggested. However, perhaps even the new kind of subsidy, paid in the form of bonds, was unnecessary, at least to the extent being granted. The whole matter could be better handled through the income tax system, possibly through amplified loss-carry-forward provisions. In any event, the courageous program adopted by the Chilean authorities augured well for the resumption of adequate growth rates and for the absorption of unemployment to the extent that the world economy would permit.

Mr. Feito observed that the first question to be answered was why had external shocks had a considerably more serious impact on the real economy in Chile than in other similar countries? What were the major causes of the 18 per cent decline in GDP growth, from a positive 5.3 per cent in 1981 to a negative 12.8 per cent in 1982? Part of the answer could be found in the weak state of the world economy, the accompanying deterioration in Chile's terms of trade, the real effective appreciation of the peso, and the increase in international interest rates. However, other similar economies had been affected by those external shocks without experiencing such an outstanding decline in real GDP. Thus, there had to be other factors, specific to the Chilean economy, behind the drop in output.

The pricing of labor services and the working of the financial system appeared to be the major causes of the relatively poorer performance of the Chilean real economy, Mr. Feito continued. According to many observers, the behavior of real wages and the process of financial intermediation were responsible for the tendency of the Chilean economy to suffer from high unemployment, despite considerable growth in output, and for real interest rates to be significantly higher than international rates. The combination of growing imperfections in those factor markets with increased liberalization in the goods market and the weakening of world economic conditions had imposed a severe squeeze on the traded goods sector; it had also impaired the performance of other branches of the economy.

The price mechanism had not been allowed to function freely in the labor market, as it had in the goods market, Mr. Feito observed. Until recently, legislation governing the determination of wages and salaries had resulted in downward rigidity in the purchasing power of wages. Adjusted for changes in the consumer price index, wages and salaries had increased by an average of about 10.5 per cent in 1981, according to Table 10 of SM/82/160, and similar increases had taken place in each of the preceding three years. It was doubtful whether productivity growth had increased at a similar rate, especially in the most recent two years. It was even more serious, particularly for the sectors exposed to international competition, that such an increase in real wages had taken place in the face of sharp declines in the terms of trade and significant reductions in the prices of tradeables.

The behavior of real wages in Chile pointed to the need for consistency between liberalization in the goods market and liberalization in factor markets, Mr. Feito considered. If an economy was opened up to international competition without the necessary flexibility in the market for labor services, the growth of the tradeable sector would soon come to a halt, and the sector would eventually be reduced to its original size. Therefore, he agreed with the staff that the abandonment of the wage indexation system and the lowering of the wage floor for collective bargaining should be instrumental in restoring growth to the tradeable sector and in helping the recovery of the whole economy.

The functioning of the financial system had been another cause of the current recession in Chile, Mr. Feito went on. Two questions had to be explained: first, the reasons why real rates of interest had been higher than international rates in recent years, and second, the reasons for the financial crisis that had taken place in 1981 and 1982. On the latter question, the staff gave the impression in SM/82/160 that the origin of the financial crisis was in the financial system itself and that it resulted from, inter alia, overlending and low-quality lending by some banks and other financial institutions. However, in EBS/82/227, the view was expressed that the origin of the financial crisis lay in the weakening of the real economy. Both phenomena had to have played a part; he invited the staff to set out in straightforward terms the major developments leading to the financial crisis.

The persistence of high real interest rates could indicate high productivity of investment, Mr. Feito remarked, or a low rate of domestic savings coupled with controls preventing capital inflows from eliminating the excess demand for credit, or a combination of both factors. In 1982, the growing fiscal deficit, the expectations of devaluation, and the likelihood of higher lending risks might have contributed to the explosive rise in the already high interest rates. In any event, the low rate of domestic savings in the economy and, in particular, the relatively weak response of financial savings to increases in real interest rates should be noted. The situation was all the more puzzling if account was taken of the fact that public sector savings had usually accounted for the greater share of national and domestic savings until 1982. In Table 8, EBS/82/227, the savings rate of the private sector was shown as 2.7 per cent in 1980 and 2.3 per cent in 1981. He invited the staff or Mr. Donoso to comment on the reasons for the low savings performance of the private sector in Chile. Were corporate savings or household savings the major factor behind the low rate? In the same table, private savings were projected to be about 7.1 per cent of GDP by the end of the program period in 1984. Obviously, the balance of payments situation achieved under the program would be viable only if that rate of savings were achieved and if it were maintained thereafter. It should be noted, however, that a rate of national private savings of 7.1 per cent implied more than doubling the average savings performance of the three years to 1982. He invited the staff to comment on the means by which such a structural change in the private propensity to save would be accomplished.

The Chilean authorities were to be commended for the impressive transformation of the economy that they had achieved in a short time, Mr. Feito suggested. The current difficulties and the financial program under the stand-by arrangement could offer an opportunity to correct some structural deficiencies and to improve the long-run stability of the economy. He strongly supported both requests by Chile and endorsed the proposed decisions.

Mr. Erb commented that, with regard to the compensatory financing facility request, he agreed that the export shortfall had been largely beyond the control of Chile. Nevertheless, it was a matter of concern that, in the report for the Article IV consultation and request for stand-by arrangement (EBS/82/227), the staff appeared to give more emphasis to the role of the exchange rate in the export shortfall than it did in the paper on the compensatory financing facility (EBS/82/228). On page 5 of EBS/82/227, the staff stated: "A weakening in world market conditions and the real effective appreciation of the peso affected most other, i.e., noncopper, exports as well." In EBS/82/228, in the section "Causes of the Shortfall and Export Prospects," there was little discussion of the role of the exchange rate in contributing to the export shortfall. He emphasized the need for documents dealing with the compensatory financing facility, which often stood alone when a request for compensatory financing was not accompanied by an Article IV consultation report or by a request for a stand-by arrangement or extended arrangement, to be comprehensive in treating the issue, a specific criterion relating to the use of the compensatory financing facility. He invited the staff to comment on the apparent inconsistency in the present case.

The adjustment program that the authorities had planned with the support of the Fund was basically sound, Mr. Erb considered. He agreed with the authorities' decision to alter their earlier plans to restore

Chile's international competitiveness through demand restraint and a reduction in nominal wages. That policy had been costly in lost output and high unemployment. The move to a more flexible exchange rate policy, together with demand restraint based on the continuation of the effort to contain the deficit of the nonfinancial public sector, and real wage restraint, should help to put Chile on an adjustment path that would minimize the short-run costs.

The authorities should be commended for their efforts to implement the current adjustment program while preserving the central framework of their open trade and payments system that had, along with their commitment to market-determined pricing, served them well in recent years, Mr. Erb observed. He hoped that recent slippages from that basic approach would be corrected as soon as possible. The authorities should also be commended for containing the public sector deficit in 1982, and for the planned reductions in 1983 and 1984. They had contained expenditure on employment programs to reasonable levels. The more flexible determination of real wages would play a major role in achieving both balance of payments adjustment and the expansion of real economic activity. The authorities were aware that the temporary containment of real wage growth was necessary in order for the flexible exchange rate policy to be effective.

The staff correctly stated that the authorities' most pressing immediate problem was the massive net reduction of foreign debt by the Chilean private sector, Mr. Erb continued. He understood that the authorities had pursued a policy of rapid credit creation by the Central Bank in the latter part of 1981 and most of 1982 to re-establish confidence in the domestic financial system. Net credit expansion of the Central Bank had been projected to slow significantly in the fourth quarter of 1982. He welcomed the most recent information from the staff that net domestic assets of the Central Bank were well within the ceiling applicable for the January-March period. It was a matter of concern, however, that net international reserve losses in 1982 had exceeded earlier projections as balance of payments support loans had fallen short of expectations. The increase in the growth of net domestic assets of the Central Bank was expected to slow from an annual rate of 123 per cent in 1982 to 32.7 per cent in 1983, while net domestic assets of the financial system were expected to increase by approximately 40 per cent, compared with 30 per cent in 1982.

The authorities were facing a dilemma, Mr. Erb remarked, since credit had to be available to take care of the liquidity problems of parts of the private sector, but, at the same time, they had to constrain overall credit expansion if economic and financial stabilization was to be achieved and if further capital flight was to be avoided. The authorities had developed special tools that would help them to pursue both objectives, but he was concerned that the expansion of central bank credit in excess of the programed rate--possibly even at the programed rate--could induce further net capital outflows. Such expansion might not, thereby, lead to an equivalent net increase in the actual availability of credit to the private sector, but rather to larger than anticipated reductions in international reserves. The authorities clearly could not afford such developments. He invited the staff or Mr. Donoso to comment further on those questions. What, if any, further measures might be available to ensure that the objectives of adequate domestic credit creation and reserve protection were achieved?

Changes in the rediscount rate had been put into effect on January 1, 1983, Mr. Erb noted, accompanied by changes in the subsidy scheme for debt service payments. Those changes were in the right direction, but complete elimination of the subsidy applied to principal repayments might be helpful in the effort to stem the net reduction in foreign debt held by the private sector. The question of the level of international reserves and the related prospective developments in the net foreign debt position of the Chilean private sector emphasized the importance to the success of the program of developments affecting the capital account. Other programs that the Board had recently approved or that had been negotiated by the staff and approved by management had placed special emphasis on the projected capital developments. He was not suggesting that current account developments or the policy framework necessary to support developments in both the current and capital accounts were any less important, but that such policy efforts required the support of adequate financing. In that context, more information relating to projected capital account developments in 1983 would have been useful. For example, what did the $450 million in new private investment depend upon? What assumptions underlay the projected increase in other private sector inflows of $204 million, and how did that increase relate to the net increase in private sector exposure, about $18 million?

The matter of international reserves was relevant to exchange rate policy, Mr. Erb observed. Although the current exchange rate management system was an improvement over the fixed-rate policy maintained from 1979 to June 1982, there was a danger that the revised system would remain insufficiently flexible to help to re-establish a more sustainable balance of payments position while meeting the authorities' foreign reserve targets. Therefore, he urged the authorities to keep the exchange rate system under constant review, especially during a period such as the present, when the economy was undergoing transition. He endorsed the staff's view that there were fiscal alternatives to the preferential exchange rate system implemented by the authorities to aid those parts of the private sector holding large external debts. He hoped that the multiple currency practice would be eliminated early in the program. Because of both the domestic and international financial uncertainties in Chile, he strongly endorsed the provision in the stand-by arrangement for prompt consultations between the authorities and the Fund. While the usual quantitative performance criteria were important in the present case, as in others, the consultation and review process took on special significance when the economic and financial outlook was subject to more than the normal degree of uncertainty.

Mr. Laske noted that Chile had experienced a severe economic and financial crisis, brought about primarily by the prolonged deterioration in the world economy. Exports earnings for Chile's traditional export commodities had fallen precipitously, mainly because of falling prices for its mining products. There had also been a significant decline in exports of nontraditional goods, an event for which a misguided exchange rate policy and a pervasive system of wage indexation had to be held responsible, at least to a large extent. It was, therefore, gratifying that the authorities had already taken determined steps to correct the situation. In the exchange rate area, after some uncertainty that appeared to have held up earlier consideration of the present request by the Executive Board, the authorities had finally settled on a crawling peg system initially linked to the U.S. dollar. Equally important was the replacement of full wage indexation by a system of free collective bargaining based on the real level of wages prevailing in mid-1979.

The crawling peg system introduced in September 1982 had replaced a free floating of the peso that had been in effect for a little more than a month, Mr. Laske continued. The floating rate had been preceded by a peg to a currency basket, identical in its composition, but not in its weighting, to the SDR basket. Chile's foreign trade was heavily directed toward the United States, the major industrial countries of Europe, and Japan. Together, those countries accounted for about two thirds of Chile's exports and imports. He did not question the present appropriateness of the new system adopted in September 1982, but he wondered whether the advantages of the adjustable dollar peg were greater than those of a peg to a currency basket.

The second feature of the crawling peg system, Mr. Laske observed, was its daily adjustment to an inflation differential. It was an interesting feature, but its operational application was unclear. The Chilean consumer price index was compared to world inflation, a variable that, because of its comprehensiveness and complexity, had to be estimated. For the first six to seven months of the operation of the crawling peg, the guiding inflation differential had been set at 1 per cent. That rather crude measurement could well lead to either overshooting or undershooting of the official exchange rate. Therefore, close monitoring of worldwide inflation developments and occasional adjustment of the inflation differential used in the determination of the crawling peg might be necessary in order to avoid unwarranted appreciation or depreciation of the peso.

His authorities had seen press reports to the effect that the Chilean authorities had announced, on December 18, 1982, the elimination of the preferential exchange rate for the servicing of old private sector debt, Mr. Laske stated. He invited the staff or Mr. Donoso to comment on the validity of the reports, and also on the suggestion by Mr. Kafka that private sector debtors could be compensated for the loss experienced after the exchange rate depreciation through appropriate provisions in the tax code rather than through a direct subsidy. He joined Mr. Erb in hoping that the authorities would find it possible to eliminate the preferential exchange rate at an early stage in the stand-by program.

The other important action taken by the authorities was the elimination of the wage indexation scheme, Mr. Laske considered. Because the scheme had been linked to past inflation, it had prevented wages in Chile from being adjusted promptly to a decline in inflation and to diminishing inflationary expectations. There could be little doubt, as the authorities recognized, that a fall in real wages was indispensable at present following the rise in real wages that had continued despite the precipitous decline in economic activity and the concomitant rise in unemployment. The depreciation of the peso since the abandonment of the old exchange rate system in June 1982 had caused a sharp increase in the consumer price index, and further sizable price increases were forecast for 1983. Therefore, the new liberalized system of wage determination would be exposed to a severe test. Pressures to compensate as much as possible for recent price increases by raising nominal wages could become strong. If those pressures could not be resisted, the authorities would have to stand ready to take commensurate adjustment actions in exchange rate and financial policies.

A severe crisis in Chile's financial system had been brought about by the domestic impact of the decline in foreign demand for Chile's exports, Mr. Laske observed. In 1982, the Central Bank had extended liquidity assistance on a large scale to certain banks and financial institutions in order to save them from failure as a result of loan losses and withdrawals of deposits. He welcomed the measures taken by the authorities to strengthen their prudential supervision of the operations of the financial institutions, in particular, the new regulations under which a bank's exposure to a single borrower and to the bank's own subsidiaries would be narrowly circumscribed. The special assistance extended to financial institutions in 1982 appeared to have created a large cushion of liquidity. According to Table 5 in EBS/82/227, the net domestic assets of the Central Bank had more than doubled in 1982, and they were projected to increase by about one third in 1983. It would be interesting to know whether the special assistance operations of the Central Bank had ceased in the third quarter of 1982, or whether further extensions of emergency aid had become, or might become, necessary. The purchase of the "bad loan" portfolios by the Central Bank ought to have relieved the pressures on the threatened institutions.

The current account of the Chilean balance of payments had recorded a huge deficit in 1981, Mr. Laske noted. It had been reduced significantly in 1982, mainly through a marked reduction of imports. For 1983, a further decline in the deficit was projected, primarily through increased exports, the expectation of a recovery in the world economy, and a strengthening of Chile's competitiveness. The calculation for the two postshortfall years assumed a relatively large increase in the world market price for copper, an important factor in Chile's export performance. However, recovery in the United States and other industrial countries did not appear to be imminent. If Chile's exports grew at a slower rate than assumed for the program, the authorities would find it necessary to tighten demand management further so as to prevent a sharper than projected decline in international reserves.

Commenting on the services account, Mr. Laske remarked that the projections for the program were based on a U.S. prime rate of 13 per cent. Recently, the prime rate had fallen below that level, a development that should ease the constraints on Chile's current account. He asked whether the staff had calculated the effect of that favorable change in assumptions on the balance of payments projections for Chile.

The Chilean private sector had engaged in substantial foreign borrowing in recent years, Mr. Laske continued, and the present problems stemmed, in part, from foreign creditors' perception that their exposure to Chile had become too large. Consequently, Chile had been unable to continue borrowing abroad in 1982, other than through balance of payments assistance by official lenders, and there had even been a significant withdrawal of funds. The medium-term and long-term external debt of Chile was presented in Table 6 of EBS/82/227; he understood that substantial amounts had also been borrowed on short maturities. For example, in SM/82/160, the staff stated that the state copper company had covered its 1981 financial deficit--which had amounted to as much as 0.7 per cent of GDP--through short-term borrowing abroad. Information on short-term debt, in particular debt to the international banks, would have helped to provide a full picture of Chile's debt situation and the debt maturity structure. The balance of payments projections for 1983 provided for capital inflows, other than direct private investment, of more than $600 million. Did those projections also provide for the renewal of short-term debt in 1983?

The policy program for the requested stand-by arrangement indicated that the Chilean authorities had committed themselves to strong and courageous adjustment measures, Mr. Laske considered. The implementation of those measures would serve to restore confidence at home and abroad in the ability of the Chilean authorities to deal with the problems facing them. Considerable importance should be attached to the constant monitoring of the situation by the authorities and the staff. He assumed that additional measures were being discussed and that action would be taken if developments required it. A close watch on events as they unfolded was certainly essential to the success of the adjustment effort since the outlook for Chile was surrounded by more than the usual degree of uncertainty. He supported Mr. Erb's comments regarding the treatment of the exchange rate issue in EBS/82/228 and EBS/82/227. Furthermore, in one paper the balance of payments figures and balance of payments projections were shown in U.S. dollars, while in the other they were shown in SDRs. It would be easier for the reader if both papers used the same presentation.

Mr. Lovato commented that the Chilean economy was in a state of disarray. The staff had provided a number of disturbing figures concerning the real economy--a projected decline in real GDP in 1982 of almost 13 per cent, an estimated decline in industrial production of 20 per cent, and unemployment soaring to staggering levels, 24 per cent in the third quarter of 1982, although, according to supplementary information provided by the staff, it had declined in the fourth quarter. Despite those facts, the staff's assessment was confined to the external outlook and to the conventional appraisal of fiscal and monetary policies without offering a deeper explanation of the severe recession afflicting the country.

The recession was largely attributed to the external shocks suffered by the Chilean economy in 1981, Mr. Lovato continued, including the deterioration in the terms of trade, stagnant world demand, and a decline in capital inflows. Mr. Donoso had mentioned in his statement two other causes of the country's economic problems: high real wages and high real interest rates. To some extent, the high real wages were accounted for by the operation of an indexation system based on past inflation levels. The astonishingly high real interest rates--25-30 per cent--could not be seen simply as a response to rising foreign interest rates; they reflected an increasing domestic risk premium and expected exchange rate movements. However, a tentative case could be made that the high level of rates, occurring when the public sector operations had recorded a budget surplus and inflation had decelerated, was an outgrowth, inter alia, of excessive monetary restraint. The staff stated that credit demand by the private sector in 1981 had been brisk, yet the data in Table 5 of EBS/82/227 indicated that the Central Bank had pursued a deliberate policy of monetary contraction, reflected in highly negative rates of change for net domestic assets and base money creation. Did the staff share his view that domestic policies had played an important part in engineering the 1982 recession?

The course of envisaged economic policies was puzzling in light of the reasonable inferences that could be drawn from previous events, Mr. Lovato considered. Deflation continued to be seen as a primary policy target, real wages had been cut drastically, and monetary and fiscal restraints were being maintained as critical ingredients of the stabilization program.

Commenting on monetary policy, Mr. Lovato noted that the large increase in Central Bank net domestic assets recorded in the first half of 1982 had been intended solely to stabilize the financial intermediaries that had been experiencing problems. The increase was supposed to have been temporary, in order not to undermine the agreed reserve target. However, real economic activity appeared to be lingering at depressed levels, and it was difficult to see what would bring about revival in the growth of output at present. Would the projected increase in exports be able to generate sufficient stimulus to output and employment? Otherwise, what did the staff and the Chilean authorities think would happen to domestic demand behavior? The only variable implicitly assigned a role in bolstering domestic demand was a drastic redistribution of income from wage to profit earners, on the assumption that a major decline in real wages would increase corporate profits, both current and expected, and that business investment would thereby be stimulated. However, Directors were being told that business confidence in Chile was at a low point; he found it hard to believe that capital spending could, therefore, be induced to increase. The underlying financial structure, beset by bank bankruptcies, did not appear to be conducive to such a recovery. Furthermore, consumer expenditures were bound to be severely hurt by the decline in households' spending power caused by the combination of falling incomes and soaring unemployment.

Domestic demand could not be totally ignored, Mr. Lovato went on, if the authorities were concerned with generating real income growth, especially since a crucial target of the medium-term adjustment program was to improve the domestic savings capacity of the economy in order to make it less dependent on foreign financial resources. Since there was historical evidence that gross savings had responded very slowly throughout the 1970s to the prevailing high interest rates, the only avenue that the authorities might be tempted to take in order to bring about high savings was a massive redistribution of incomes to classes and groups with a higher propensity to save. He invited the staff to comment on that point.

Given the domestic uncertainties, Mr. Lovato observed, external policy became all the more important for promoting adjustment in the Chilean economy. Confidence abroad was to be restored, reliance on external borrowing was to be reduced, and the country's competitive position was to be improved. Those were the essential ingredients of the Fund-supported program, and its success or failure would crucially depend on the degree of response of the economy to the measures and adjustments implemented on the external front. The real appreciation of the peso--in excess of 30 per cent on an effective basis between June 1979 and April 1982--had presumably been intended by the authorities to help in the attainment of their anti-inflation target. However, it had been a serious mistake and had had a damaging effect on the country's export potential. On the demand side, it had switched foreign demand for price-sensitive Chilean exports to competing sources. More importantly, on the supply side, it had had a depressing effect on the prices of tradable goods relative to nontradable goods, thus discouraging output in the tradable sector and thereby decreasing the supply of exportables. Exchange rate policy had, therefore, compounded and aggravated the adverse effects on Chile's export earnings arising from the deteriorating terms of trade.

The changes in the exchange regime carried out in a succession of steps in 1982 had improved the near-term outlook for the country's external accounts, Mr. Lovato remarked. Those measures were, therefore, welcome; they were crucial to the success of the program. The assumptions and forecasts made by the staff for exports and GDP growth depended on the conduct of a proper exchange rate policy combined with a possible reversal of the adverse terms of trade trends.

He appreciated the authorities' resolve in attempting to redress a very precarious situation, Mr. Lovato stated, but he had serious doubts about the viability of an adjustment program that, in present circumstances, was bound to aggravate the harsh social and economic costs already being borne by the Chilean population. An equally severe, but more gradualist, approach would have better served the purpose of removing the country's present economic distress. With those reservations, he could support the request for the stand-by arrangement and for a drawing under the compensatory financing facility.

Mr. Taylor said that he was in broad agreement with the staff's analysis of Chile's economic difficulties, and with the policy responses developed in cooperation with the Chilean authorities. Given the size of the problems and the urgent need to restore external confidence, a two-year stand-by arrangement was the appropriate vehicle for Fund support. Restoration of external competitiveness seemed to be the appropriate principal objective for the slightly longer term, requiring both a more flexible exchange rate policy and firmer wage restraint than had previously been the case.

The courageous fiscal measures taken in March and June 1982 to limit the size of the emerging public sector deficit should be commended, Mr. Taylor continued. The intention to reduce the deficit to 1.7 per cent of GDP in 1983 and to eliminate it entirely in 1984 implied a policy of severe fiscal restraint. Fiscal management in the Chilean economy had been prudent and competent over a number of years; the strong degree of restraint being asked for was likely to be achieved. With unemployment around 25 per cent, it was understandable that the authorities should make strong efforts, within the fiscal constraints that they had set themselves, to encourage new productive efforts in their economy. However, a more sustained reduction of unemployment would depend on achieving a marked improvement in external competitiveness that would, in turn, depend very much on firm action to bring about a reduction in real wage levels. Wage pressures were likely to be strong in 1984 in the face of the sharp acceleration in consumer prices that had occurred, and those pressures would need to be firmly resisted if the advantages of a more competitive exchange rate were to be retained by the productive sector. He invited the staff or Mr. Donoso to comment on the prospects for wage restraint in 1983.

A more flexible exchange rate policy would also be important, Mr. Taylor noted. Some aspects of exchange rate management in 1982 had been questionable. For example, it was arguable that the devaluation had occurred too late, given the substantial real appreciation that had taken place through 1981. Since devaluation in June 1982, the authorities seemed to have lacked a consistent strategy for dealing with the rate. The volume of transactions benefiting from the preferential rate was circumscribed; nevertheless, uncertainties remained in that area. He joined other speakers in urging the authorities to proceed as rapidly as they could to unify the rate, if possible by the end of 1983. It would be an important move in the direction of further restoring confidence. He welcomed the announcement in December 1982 that the application of the preferential rate would be limited, as well as the authorities' commitment to eliminate the various emergency exchange rate restrictions before the end of 1983.

The most immediate problem was to deal with net capital outflows and to protect the reserves, Mr. Taylor considered, the decline of which was due, in part, to the sizable extension of credit in 1982 by the Central Bank to financial institutions in difficulty. A key factor would be the establishment of firm control over total domestic credit expansion; he welcomed the steps already taken in that direction, including the announcement of a sharp reduction in the issue of new bank notes in the first quarter of 1983. The measures under the program to contain net credit expansion by the Central Bank within acceptable limits and to increase the scope of open market operations were, therefore, an essential and appropriate part of the program.

In 1982, the fall in reserves, coupled with the restrictions existing at that time on capital inflows, played a large part in bringing about a sharp contraction in the money supply in the first half of the year, Mr. Taylor continued, a development that must have contributed to the emergence of high real interest rates. More recently, the removal of capital inflow restrictions and the reduction of uncertainties about the exchange rate appeared to have helped to bring interest rates down, at least temporarily. He noted the staff's statement at the beginning of the meeting that interest rates had increased again toward the end of 1982, a disturbing development that merited further comment. In any event, the experience of erratic interest rate movements was undesirable, and he welcomed the authorities' recent moves to strengthen the Central Bank's influence over market rates. It would be necessary to manage interest rates with flexibility and care, if more consistently realistic savings and investment incentives were to be established in the economy.

Commenting on the external debt situation, Mr. Taylor noted that external indebtedness remained high. The authorities should encourage higher nondebt creating inflows, and they should take a prudent approach to external borrowing. In that respect, the program ceiling on new external debt of one to ten years' maturity was appropriately restrictive. While Chile's short-term debt was relatively moderate, his authorities remained concerned in general about the absence of a quantitative short-term limit to complement the medium-term limits in cases such as Chile's. They recognized, however, that in Chile the ceiling on total parastatal debt from all sources would probably capture much of the short-term inflows.

He could support the request under the compensatory financing facility, Mr. Taylor stated. The relevant criteria had been satisfied, and although there was scope for differing views about world copper prices, he believed that the staff's projections of copper export earnings were reasonable. Like other speakers, he would have preferred a more explicit treatment in EBS/82/228 of the degree to which the shortfall had been outside the authorities' control. His authorities believed that determined policy steps were being taken to rectify the Chilean economy's economic problems on the basis of the Fund's advice. They also believed that those problems had to a great extent been the result of recession in Chile's major external markets, and they noted that demand management policies had been prudent over the years. In light of those factors, Fund assistance was certainly merited, and his authorities firmly supported the requests by Chile.

Mr. Joyce remarked that the Chilean economy had been subject to considerable stresses over the previous decade. The severe financial crisis experienced in the early 1970s had had a major impact on the economy; it had required a far-reaching stabilization effort that had met with a considerable measure of success. However, since mid-1981, economic developments in Chile had been worrisome. As the staff pointed out, those recent difficulties could in large measure be attributed to, first, the worldwide economic slowdown; second, the decline in prices for key Chilean exports such as copper, wood, and wood products; and, third, the decline in capital inflows that had maintained the peso at an overvalued rate, contributing to the decline in Chile's international competitiveness. However, developments also reflected economic policies pursued by the authorities that had delayed, and in some cases impeded, the required adjustment. The attempt to restore international competitiveness through demand and wage restraint policies alone had not been entirely successful; it had created its own problems, especially in the private sector. Decisive policy improvements were clearly required, and some important steps had been taken by the authorities in the latter half of 1982, particularly the exchange rate measures.

The most immediate problem facing the authorities was the massive net reduction of foreign debt by the private sector, Mr. Joyce continued. In view of the uncertainty in international capital markets, the new caution shown by international bankers, and the large number of business failures in Chile in 1982, it was essential that the Chilean authorities took the measures necessary to restore international confidence. In that regard, the normal provisions for consultation took on an added significance; he hoped that the Chilean authorities would not hesitate to keep the Fund informed and to consult quickly if it appeared that the events were not going as well as expected and that additional measures might be called for. He particularly welcomed Mr. Donoso's assurance that the authorities stood ready to apply corrective measures if the assumptions underlying the program were not fulfilled. The program itself provided a consistent set of policies that could underpin the required economic recovery. He agreed broadly with the thrust of the staff's analysis, and he supported each of the proposed decisions.

Commenting on fiscal policy, Mr. Joyce welcomed the Government's determination to reduce the public sector deficit to less than 2 per cent of GDP in 1983. Traditionally, the Chilean authorities had practiced fiscal prudence, and it was encouraging that the deficit was expected to be eliminated by 1984, for which firmer control would be required on current and capital expenditures, in particular on the public wage bill. He noted that it was planned to hold public sector wage increases below the level of inflation in 1983. However, the staff did not indicate how far the authorities expected that they could go toward offsetting the rather large increase in real wages that had occurred in 1982. Furthermore, the authorities planned not only to continue existing employment programs but also to initiate new ones. Given the high level of unemployment in Chile, he could appreciate why they felt obliged to take measures to limit the hardships of the current recession, but he hoped that those expenditures could be undertaken within the target levels, since the staff was correct in identifying reductions in the public sector deficit as a major element in the program's demand management efforts. He agreed with the decision to monitor and control the size of the public deficit through setting performance criteria on total national indebtedness and establishing a subceiling on the external debt of the nonfinancial public sector.

In SM/82/160, Mr. Joyce noted, the staff indicated that real wages had increased at an average of more than 10 per cent a year between 1978 and 1981, presumably a rate far in excess of productivity growth. It was clear that a major correction in real wages was required; he welcomed, therefore, the decision of the authorities in June 1982 to abolish wage indexation, in particular to abolish the system of making an initial wage offer in collective bargaining at levels large enough to compensate automatically for past inflation. However, the staff appeared to imply in a footnote on page 15 of EBS/82/227 that the authorities were considering the establishment of a nominal wage floor that would be linked to the real wages of the previous collective bargaining period. He invited the staff to comment further on how the system might work in practice, since it appeared that such a policy could limit the maneuverability of the authorities in adjusting real wages. The staff had not provided much data on recent trends in wage settlements, and further information would be welcome. For example, what was the implication of the statement on page 15 of EBS/82/227 that the wage floor for collective bargaining contracts was to be lowered to the real level of July 1979? Did that mean that there had been, or that there would be, a significant weakening in wage demands?

The authorities appeared to be taking the appropriate measures to contain the expansion of central bank net credit, Mr. Joyce considered. He noted that the Central Bank did not intend to provide net credit to the public sector in 1983 and that the monetary program for 1983 was regarded as consistent with the halving of the rate of inflation, although it was envisaged that there would be a further decline in net international reserves. However, the situation in the commercial banking sector was worrisome. The overextension of the commercial banking system in recent years had resulted in severe financial difficulties for some banks in 1982. Measures introduced by the Superintendency of Banks in late 1981 to strengthen the system of prudential controls on the loan portfolios of the banks were welcome, but it was not clear whether those new measures were consistent, or whether the staff considered them sufficient. The policy introduced by the Central Bank in July 1982 to purchase the "bad loan" portfolios of financial institutions and to allow them to write off the uncollected portions of the loans over ten years appeared to have received only conditional support from the staff. He agreed with the staff's view that the policy had to be "temporary and strictly circumscribed," but it was not clear whether the measures were seen by the authorities as purely temporary or whether the financial institutions themselves were expecting that they would be able to write off "bad loans" in the future. He invited the staff or Mr. Donoso to comment on that point.

The decision of the authorities in June 1982 to move toward a more flexible exchange rate was welcome, Mr. Joyce went on. As a result, there had already been a substantial depreciation of the peso. The present policy of maintaining the real external value of the peso would, if properly adhered to, provide a sound basis for the required balance of payments adjustment. However, he was concerned about the establishment of the preferential exchange rate for external debt service payments. Given the current environment of high debt service burdens for the private sector and the large number of business failures resulting from the recession in 1982, it was understandable that the authorities felt that they had to introduce such measures to alleviate the impact of the exchange rate depreciation. Nevertheless, such a multiple currency practice could pose an important drain on government reserves. He welcomed the inclusion in the performance criteria of the requirement that the practice be eliminated by December 31, 1983. However, there was little information in EBS/82/227 regarding how elimination was to be brought about; he wondered whether the authorities were considering measures to converge the two rates.

The projected improvement in the current account of the balance of payments appeared optimistic, Mr. Joyce stated. The increase of 17 per cent in the value of exports was relatively high, given the current weak world economic outlook. Moreover, it was questionable whether the 5 per cent decline in imports in addition to the already large decline in 1982 was consistent with a 4 per cent increase in real GDP projected for 1983. More important, the balance of payments projections assumed a capital inflow of more than $1 billion, of which $654 million was expected to enter through the private sector. Such a projection appeared optimistic, given the high level of existing private sector debt, over $10 billion in 1981, and the present high debt service ratio, estimated at 63 per cent in 1982. Furthermore, the projected increase in private sector indebtedness assumed that international banks would increase their exposure in Chile. Was there any evidence that the banks were prepared to do so?

The compensatory financing facility request was straightforward, Mr. Joyce observed. The temporary shortfalls in copper, molybdenum, and pinewood appeared to have been beyond the control of the authorities, but more information on that area would have been welcome. His authorities supported the proposed decisions. They commended the Chilean authorities for the steps already taken and for their determination to do more. They were concerned about the importance of restoring confidence in international markets and, therefore, they were concerned about the capital inflow projections and about the realism of the trade targets.

Mr. El-Khouri commented that, during the second half of the 1970s, the Chilean authorities had followed economic policies that had resulted in a significant strengthening of their economy. During that period, inflation rates had declined substantially, economic growth had risen to a sustained high level, employment had increased rapidly, and the balance of payments had moved into surplus. In 1982, however, the economy's performance had deteriorated rapidly, partly as a result of external developments.

The deterioration in Chile's terms of trade, as well as the exceedingly high international interest rates, had had a significantly adverse effect on the economy. Those factors, together with certain domestic maladjustments, had led to a deepening recession, to an intensification of inflationary pressures, and to a substantial loss in reserves.

The authorities had taken a number of measures in 1982 to cope with the rising external and domestic imbalances, Mr. El-Khouri continued. While some of those measures were steps in the right direction, the adjustment effort continued to require consolidation and strengthening. The authorities' program in support of the stand-by arrangement was a testimony to their determination to adjust in a comprehensive fashion. He agreed with the staff's appraisal that the authorities' proposals, as set out in the letter of intent, if implemented with resolve and with due regard to changing circumstances, were adequate to achieve the objectives of the stabilization program. Therefore, he supported the request for the stand-by arrangement.

Table 4 of Attachment 3 of EBS/82/227 set out the ceilings on the net domestic assets of the Central Bank, Mr. El-Khouri noted. The ceilings were specified over the duration of the quarters. What was the difference between that specification and one in which the ceilings were applicable to the end of the quarters? Specifically, what were the implications for purchases in subsequent quarters? Those general questions were relevant to other programs, but they appeared to be particularly relevant in Chile's case because of the promptness with which monetary data were being reported to the Fund.

The request under the compensatory financing facility met all the requirements of the relevant decisions, Mr. El-Khouri considered. In light of the questions that some Directors had raised regarding the export projections, he invited the staff to comment on the frequency of the revisions made in the projections for commodity prices and demand. Were the revisions made in the context of the World Economic Outlook exercise or simply on an ad hoc basis? It appeared possible that different projections could be made for different countries, depending on the timing of requests for purchases under the compensatory financing facility.

Mr. Polak stated that the opening sentences of the section on economic prospects and policies in EBS/82/227 set the tone for much of the Board's consideration of Chile's request. All Directors would agree that the first sentence was the starting point of the discussion: "The deep recession and the financial crisis in Chile have adversely affected confidence at home, as well as abroad, in the authorities' ability to manage the economy." The second sentence correctly stated that: "The immediate aim of the financial program is to set out a consistent set of policies designed to regain confidence and set the basis for economic recovery...." The program was clearly addressed to that goal, and, therefore, the Fund should support it. However, the third sentence was less encouraging: "The financial program built upon the basic economic strategy of the Chilean Government: i.e., to promote adjustment and economic growth by relying on market forces and price incentives to guide resource allocation in the economy." Chile's strategy did not appear to have consisted of the pursuit of a balanced set of economic objectives, but of the alternative pursuit of one objective without regard to other objectives of economic policy. As a consequence, there were many features of Chile's basic economic strategy that did not inspire confidence, even allowing for the fact that the Chilean economy had been unfavorably affected by the adverse developments in the world economy.

One example was the extreme reliance on monetary policy, which, in conjunction with the exchange rate policy, had consistently produced high real interest rates in Chile, Mr. Polak continued. The staff indicated that rates had been in excess of 25 per cent a year throughout 1981 and most of 1982. Those high real interest rates created the need for controls on capital inflows, contrary to the stated liberalist approach of the Chilean authorities. That type of conflict and distortion had been discussed by the Executive Board when it had considered the staff paper "Interest Rate Policies in Developing Countries" (SM/82/213, 11/12/82). In light of the analysis in that paper, which had been particularly applicable to Chile, he could not accept fully what the staff stated on page 22 of EBS/82/227, to the effect that it "fully supports the authorities' determination to continue to allow free interest rates to allocate efficiently credit flows and promote growth in domestic savings."

Other Directors had already commented on the relatively modest impact on domestic savings, Mr. Polak noted. But neither had there been an efficient allocation of credit flows. The high interest rates, together with the exchange rate, had resulted in a reduction in real domestic expenditure of 20 per cent, according to Mr. Donoso's statement. It had also produced sharp increases in the already high unemployment level in Chile.

Directors were being told that the guiding policy of the Chilean authorities was adherence to free market forces, Mr. Polak observed, but there were a number of significant exceptions to that policy, such as, capital inflows, and also the wage indexation system, which had caused a sharp increase in real wages. The abandonment of that system was welcome, but Chile should not go to the other extreme implied by the staff statement that "...wage policies..."--specifically endorsed by the staff later in the paper--"...have been adopted with a view to ensuring that the gains in terms of the economy's competitiveness will be maximized." That statement suggested that real wages would be minimized.

Contrary to the principle of market forces, Mr. Polak went on, Chile had practiced a fixed exchange rate policy for almost three years despite the fact that it had become increasingly obvious that the rate was highly unrealistic, having produced an effective appreciation of as much as 30 per cent. The new policy objectives were unclear, and the staff made conflicting statements about them. In the section on wages, the staff stated that: "These actions in the wage field are intended to sustain the real depreciation of the peso." In the next paragraph, dealing with external sector policies, the exchange rate management policy of the authorities was described as "to maintain the real value of the peso over time." First, the staff used the term "the real value of the peso" incorrectly: it was a measure of the purchasing power of the peso. The staff presumably meant to refer to the real effective exchange rate. Even so, there remained a conflict between the objective of real depreciation and the maintenance of the real effective rate.

In light of the above observations, the most important and the most interesting conclusion of the staff appraisal was contained in the last paragraph on page 21, Mr. Polak considered. Commenting on future relations between the Fund and Chile, the staff stated that: "The authorities should give particular attention to the provisions for consultations under the stand-by arrangement...." It was not the usual kind of statement found in the staff reports, but it was called for in the present circumstances. The staff had correctly emphasized the need for close consultations to ensure that policy changes, or the confirmation of existing policies, remained in line with the objectives of the stand-by arrangement. He urged the staff, in the course of consultations, to take full account of the many reservations expressed by Executive Directors on previous and proposed policies in Chile. He supported the request under the compensatory financing facility.

Mr. Zhang stated that he supported each of the proposed decisions.

Mr. Malhotra said that he also supported the proposed decisions. The stand-by program was comprehensive, the Government of Chile intended to reduce its budget deficits, and it planned to take strong action on the wages front.

The staff representative from the Western Hemisphere Department observed that the preferential exchange rate for foreign debt service payments constituted a multiple currency practice as well as a burden on monetary policy. The impact of the measure on the monetary program for 1983 had been substantially reduced, a development that a number of Directors had considered positive. Some Directors had also favored elimination of the system as soon as possible, a view with which the staff agreed. There was a tendency for the official rate and the preferential rate to converge since the official exchange rate moved in accordance with past inflation, less an allowance--1 per cent per month--for world inflation, while the preferential exchange rate moved in accordance with past inflation, or, faster than the official rate. Under the present system, however, the two rates would not converge until about the end of 1984. Nevertheless, the authorities had committed themselves to eliminating the system by the end of 1983. Therefore, at some point in 1983, there would have to be either an acceleration of the rate of depreciation of the preferential exchange rate or the elimination of the system, with the subsidy paid by another method, if the authorities wished to retain the subsidy feature. They had been considering the use of the tax system, as several Directors had suggested.

One especially strong factor in Chile's recession, the staff representative noted, had been the combination of a fixed exchange rate with high domestic inflation for almost three years. With a fixed exchange rate and the wage system indexed to past inflation, the Chilean economy had rapidly become uncompetitive. Over a two-year period, wages had risen almost 100 per cent in dollar terms. In addition, the Chilean economy was an open one, and both the export sector and the import-competing sector had declined sharply.

The explanation for the high real interest rates in Chile, the staff representative remarked, lay partly in the lag in inflationary expectations. For two years, inflation had been about 30 per cent a year; it had begun to decline in 1981, but interest rates had remained high that year and into 1982. In addition, because of capital outflows in 1982, there had been a lack of liquidity in the economy, despite the credit expansion by the Central Bank to meet the financial difficulties of the banking institutions. Month-to-month changes in real interest rates had been erratic; however, real interest rates were an ex post phenomenon, and the private sector could not be expected to anticipate month-to-month sharp changes in the rate of inflation.

The increase in real interest rates in the last months of 1982 had been a necessary consequence of the need to tighten credit, the staff representative suggested. Credit expansion in 1982 had been excessive; the program for 1983 would take time to become effective, and the reserve target would be attained only if credit were tightened significantly. The authorities were genuinely concerned about the impact of high interest rates on the possibility of an economic upturn and on their goal of reducing the rate of unemployment further, but they understood, correctly, that the immediate constraint on the economy was the balance of payments. To improve the balance of payments position, a tight domestic credit policy would be necessary to stem capital outflows. Inevitably, domestic interest rates would have to rise. Because of their concern, however, they had begun to use the rediscount rate as an indicator to help avoid "overshooting" of interest rates.

The crisis experienced by Chilean financial institutions was the result not only of the recession, the staff representative observed, but also of the high foreign indebtedness of the private sector, among other things. A significant part of that debt had been taken on by private sector entities at a time of fixed exchange rates, on the expectation that the system would remain stable. With the devaluation of the peso, companies with no foreign earnings had been faced with an increase in debt service payments in pesos without any corresponding increases in their income. Thus, the combination of the recession with the heavy exposure in dollars explained to a large extent why many financial institutions had been faced with nonperforming assets. Directors had generally agreed with the measures taken by the authorities to deal with the situation, including the write-off, over a ten-year period, of the "bad loan" portfolios. The authorities intended to limit that particular measure in both time and coverage.

The question whether the measures were sufficient to restore the health of the financial system, or whether further measures would be needed, was not an easy one to answer, the staff representative commented. At the moment, the program assumed that no additional large-scale financing would be necessary by the Central Bank during the program period. That assumption entailed a considerable element of risk. The authorities were prepared to meet the short-term liquidity problems of banks in difficulties within the constraints imposed by the program. The staff agreed that if the problems remained limited, they could be handled. If a financial institution ran into difficulties in 1983, the Central Bank could provide liquidity, and offset it, perhaps with a lag, through the sale of a Central Bank instrument to the market; alternatively, it could identify those financial institutions receiving a greater part of the reflow, and it could make appropriate arrangements with those institutions. A number of alternatives were under consideration by the Chilean authorities.

The savings rate in Chile had undoubtedly been low for a number of years, the staff representative noted. In the early 1970s, private sector savings had been negative. In recent years, they had turned positive--amounting to about 3 per cent of GDP in 1980. Nevertheless, the rate of private savings could be considered disappointingly low, given that free interest rates had offered the saver a high rate of return. The subject had been discussed in Chile for a number of years and the explanation had been couched in terms of a permanent income hypothesis. In the late 1970s, the Chilean economy had experienced a boom period, and it had been expected that income would increase in the future: the permanent income rise had been high, and economic participants had aimed their consumption pattern at that high level. As a result, savings had been less than would otherwise have been expected to occur. The argument went on to suggest that the present circumstances of the Chilean economy would cause a sharp change in expectations. The belief was that it would be some time before high rates of growth would return, that income would grow more slowly, and that there would, therefore, be a tendency to consume at a lower rate and, correspondingly, to save at a higher rate. In addition, the policy measures that had been taken would tend to shift income from wage earners to profits, or to those sectors of the economy that typically had a higher propensity to save.

Some had asked what advantages the present exchange rate system, a crawling peg linked to the difference between domestic and world inflation, had over a crawling peg linked to a basket of currencies, the staff representative observed. A case could be made for linking the exchange rate to the U.S. dollar, since most of Chile's trade was denominated in dollars, or to a basket of currencies. The practical differences between the present system and a link to a currency basket were not great. The important point stressed by Dir ors, with which the staff agreed, was that the authorities should maintain flexibility. The present system was a short-term solution, not necessarily the best, and the staff had strongly urged the authorities not to lengthen the announcement of the guarantees underlying the system beyond the present six-month period.

Commenting on the balance of payments, the staff representative noted that imports were expected to decline further in 1983, but by a moderate amount compared to the sharp contraction that had occurred in 1982. One Director had asked if such a decline would be consistent with an upturn in real activity. Part of the explanation lay in the change in the exchange rate; the rate had moved in favor of domestic production and against imports. If the expectations of increased savings proved correct, there would be a tendency to reduce spending, part of which would be in the form of less expenditure on imports.

The staff also expected a moderate upturn in exports in 1983, the staff representative went on. Copper, accounting for approximately 50 per cent of export earnings, was expected to increase only marginally in volume, while its price had been projected to average 75 cents per pound on the London Metal Exchange (LME) in 1983. Different views had been expressed concerning whether the projection was too high or too low; in an article in that day's Wall Street Journal the average price of copper in the first half of 1983 was projected to be 83 cents per pound LME. Thus, the staff projection of 75 cents per pound could be considered conservative.

Another factor affecting exports was the strong movement of the exchange rate in Chile's favor, the staff representative remarked. A number of nontraditional export products had been significantly affected by the decline in Chile's competitiveness over the previous two or three years: food, vegetables, fishing, and lumber. There were already indications that those sectors were recovering, particularly fishing. In the lumber industry, the Chilean authorities believed that the industry could recover the share of the market that had been lost as a result of noncompetitiveness. The industry was well established, and it used modern and efficient machinery. On the service side of the current account, the staff had based its calculations of the interest rate burden on a U.S. prime rate of 13 per cent. Already that appeared to be high; if the prime rate averaged 11 per cent in 1983, Chile's current account would improve by about $140-150 million as a result of lower interest payments.

Capital flows could be considered in three categories, the staff representative suggested, namely, direct investment, financial flows to the private sector, and financial flows to the public sector. Direct investment was expected to be a little lower in 1983 than in 1982, about $450 million compared with $480 million. It should be noted that both amounts were large compared with the two or three preceding years. Part of the flows arose from a number of large projects in the mining sector that had been started in 1982 and were expected to continue at about the same level in 1983. Another part was expected to be in the form of capital contributions by foreign banks that had an interest in financial institutions in Chile. The total of net financial flows, both public and private, was expected to be about $660 million, of which $200 million was expected to go to the private sector. However, about $150 million of that amount was to be borrowed by a commercial bank that was publicly owned, and that inflow could be considered public sector borrowing. The other $50 million was expected to arise from a return to a more normal pattern of trade financing. Thus, the staff expected only a modest new inflow into the Chilean private sector in 1983.

The $460 million inflow to the nonfinancial public sector was equal to the deficit of that sector assumed in the program, the staff representative noted. However, it was not necessary that those two amounts coincide. If the private sector was able to borrow more than the expected amount, then the public sector could borrow less and the program requirements would still be satisfied. The breakdown of the total $660 million of capital inflows was based on the staff's best judgment of what was likely to happen in 1983. As for the reasonableness of the assumptions, it was worth noting that, in December 1982, when world market conditions had been difficult for any Latin American country, Chile had been able to obtain a $300 million loan for one of its public companies. In fact, the loan had been oversubscribed, amounting eventually to $315 million; it had been contracted on relatively favorable terms, indicating that Chile had a sufficiently good credit rating that it might expect to obtain the amount of financing needed in 1983.

It had been suggested that there would be severe pressure on wages in 1983, the staff representative continued. The staff noted that, because of the high rate of unemployment, wage demands in recent months had been limited. The most recent information indicated that emphasis was being placed on employment stability rather than on large nominal wage increases. In the public sector, it was expected that employees of the Central Government would receive an increase of about 10-12 per cent in the middle of 1983, although a final figure had not yet been decided.

The consistency of the Chilean authorities' strategy had been questioned by Mr. Polak, the staff representative from the Western Hemisphere Department noted. The staff did not believe that the market orientation of the authorities' strategy had caused the recession or the financial problems that Chile was experiencing. Indeed, it could be argued that inadequate implementation of the strategy had resulted in a certain inconsistency in policies, as in the indexation of wages and the fixing of the exchange rate. Both those fundamental policy areas had been adjusted appropriately; thus, it was worth emphasizing that it was not the strategy per se that had been incorrect but the manner in which it had been, at times, implemented.

The staff representative from the Exchange and Trade Relations Department noted that one Director had referred, in passing, to the issue of short-term borrowing. The staff was preparing a report on the general issue of short-term indebtedness in which short-term debt questions would be discussed. Another Director had asked about the implications of the ceilings on net domestic assets. The normal practice was to formulate those ceilings either in terms of stocks outstanding at the end of the stated period, or in terms of cumulative changes in the stock over the period. For Chile, the ceilings had been defined in terms of stocks at the end of the period. The implication was that, when a country requested a drawing, the ceiling had to be observed on the basis of the latest available data. If the ceiling had not been observed at the most recent date, the drawing could not be made. However, if at a later stage within the quarter, net domestic asset expansion fell back under the ceiling, and if all the other criteria were being observed, the country could make the drawing at that point.

A number of Directors had expressed support for the inclusion of the consultation clause in the staff appraisal, the staff representative continued. The particular attention drawn to the consultation clause was appropriate in Chile's case, but that approach could be applied more generally. Like review clauses, consultation clauses were a necessary supplement to the quantitative performance criteria. The performance criteria served to indicate to the Executive Board whether the economy was performing as expected. If the economy was not performing as expected and the criteria were not met, the country could not draw. That inability to draw should logically lead to consultation to determine the reason for the lack of performance as measured by the quantitative criteria. It might be thought that the consultation clause had become a standard feature of the Fund's arrangements with members, to which no particular operational significance was attached. However, if the clause acquired the role and scope that the staff sought for it in the present case, much would be done to avoid the impression that the Fund's programs had become too rigid and precise.

The staff representative from the Research Department, commenting on the compensatory financing facility request, said that some Directors had suggested that the staff could have dealt more explicitly with the effect of the exchange rate on the calculation of the export shortfall. The appreciation of the exchange rate had had a particularly adverse impact on two sectors: wood and the group of commodities referred to as "other exports." On page 11 of EBS/82/228, the staff had stated that the sharp slowdown of other exports in 1979 and 1980 had been caused by the recession and by the real effective appreciation of the peso. There had also been an indirect reference to the effects of the overvaluation of the exchange rate in the section dealing with wood, in which the staff had pointed out that Chile had lost market shares in the shortfall year. However, the staff had not referred to the role of the exchange rate explicitly in the staff appraisal, and it had confined its comments in that section to the fact that the shortfall was overwhelmingly related to price developments clearly outside the control of Chile. In Table 4 of EBS/82/228, the staff had indicated that the volume of exports of major commodities, accounting for more than 70 per cent of exports, had increased by 12 per cent in the shortfall year, whereas prices for that group of commodities had fallen by 8 per cent. The group referred to as "other exports" was not included in Table 4, but, as noted, the staff had mentioned the adverse effects of the appreciation of the exchange rate as a factor in the shortfall for those exports.

One Director had asked about the frequency with which price projections were made by the staff, the staff representative continued. Projections were made for each paper on a request for compensatory financing. The staff took into account the most recent information on market developments, as well as projections made in connection with the World Economic Outlook and projections made by economists in other institutions, particularly in the World Bank. The market prices were then related to the export unit values of the particular country under consideration; there could be substantial variations between changes in market prices and changes in unit values, depending on the particular circumstances.

The projections for Chile had been made in November 1982 when the London Metal Exchange price of copper--to take the most important export commodity--had been 65.5 cents per pound, the staff representative observed. The staff's projections for the 12 months to September 1983 suggested a price about the same as that which the staff representative from the Western Hemisphere Department had mentioned with reference to calendar year 1983: about 75 cents per pound. Since the time that the projections had been made, the price had moved up from 65 cents per pound to 71 cents per pound in daily trading. It would be incorrect to use one day's trading as a justification, but it indicated that market prices were moving in the direction of the projection made in November 1982 for the 12 months to September 1983. Recent projections of copper prices made outside the Fund were more optimistic than those made by the staff, primarily because the staff had learned from experience to exercise caution in judging the prospects for an upturn in the world economy.

A Director had wondered why the balance of payments data in EBS/82/227--the paper on the Article IV consultation and stand-by request--were presented in terms of U.S. dollars, the staff representative from the Research Department observed, whereas in EBS/82/228--the paper on the compensatory financing facility request--the balance of payments data were expressed in terms of SDRs. In EBS/82/228, all calculations were expressed in SDRs; it was standard practice to do so for papers on compensatory financing. The balance of payments data used in EBS/82/228 were consistent with, and in fact were based upon the data used in the stand-by paper.

The staff representative from the Exchange and Trade Relations Department commented that there was a good deal to be said for always using the same unit of account in reports to the Executive Board. On the other hand, there was also considerable merit in using the same set of data used by the authorities. That had been the practice in stand-by papers in which discussion centered on policy measures and their impact on the prospective development of the economy. In papers discussing possible purchases under the compensatory financing facility, SDRs were used as a unit of account to provide uniformity for calculations made in connection with the requests for compensatory financing by many different members. In practice, however, as long as the two sets of data were consistent, they ought not to present more of a problem than that which sometimes arose in connection with the units of time used in stand-by and compensatory financing reports.

Mr. Zhang asked whether the staff might comment further on the reasons for the severity of the recession in Chile compared with other countries. The staff representative had mentioned Chile's large export sector, but that sector accounted for about only 18 per cent of GNP, not an unusually large proportion. The volume of exports in 1981 and 1982 had been about the same as in 1979 in dollar terms. Second, had there been significant changes in the distribution of income in Chile in recent years? If so, what had been the impact on savings? Historically, the propensity to consume among upper income groups in Chile had been high. Thus, it was an open question whether a shift from wages to profits would have a beneficial impact on the future rate of savings.

The staff representative from the Western Hemisphere Department replied that the openness of the economy depended on both exports and imports. In the period of the fixed exchange rate, when Chile had been able to obtain a great deal of foreign financing, imports had increased dramatically, and, as a result, the domestic industry had been slowly priced out of the market. Thus, the recession had affected import-competing industries, not only export industries. Investment had, in fact, declined sharply in 1982, as indicated in Table 8 of EBS/82/227. Gross domestic investment had fallen from 22 per cent of GDP in 1981 to 15.4 per cent in 1982, the decline being particularly strong in the private sector.

Commenting on the distribution of income, the staff representative from the Western Hemisphere Department noted that there were no national accounting data available on income by economic sector in Chile. However, the evidence from the growth of nominal wages during the period of the fixed exchange rate indicated that there had been a significant shift of income toward the wage-earning sector at that time. That shift had been instrumental in making the economy noncompetitive; it had caused a large rise in imports and, correspondingly, a low level of profits in the domestic import-competing industries. The increases in wages in 1980 and 1981 had amounted to about 100 per cent in nominal terms, expressed in pesos. However, because the exchange rate had been fixed, there had been a corresponding increase in dollar terms also, resulting in a deterioration of the economy's competitiveness. The beneficial impact on prices that might have been expected from the impact of the fixed exchange rate on import prices had not finally occurred until the end of 1981. The Chilean authorities had been anxiously awaiting such a beneficial effect for two years, but it had not occurred until the recession had become pronounced.

Mr. Dallara thanked the staff for the additional information that it had provided concerning the basis for the 1982 capital account projections. It would be helpful, in general, if such information could be included in the documents provided to Executive Directors, if necessary in supplements, accompanied, as appropriate, by the caveat required when dealing with detailed capital account projections. The information provided concerning the recent borrowing efforts by an official government entity was encouraging, but the private sector's debt situation in 1983 remained unclear.

First, was the expected reduction in the outstanding levels of net private sector debt in 1983 attributable to a more favorable international lending environment for Chile, or to the reduction in the rate of growth of net central bank credit? Second, did the modified system of subsidies continue to provide incentives for repayment of principal and, therefore, could its elimination help to deal with the potential problem of a further net reduction in outstanding foreign debt to the private sector?

The staff representative from the Western Hemisphere Department commented that, in order for outstanding private sector debt to stabilize, central bank credit policy would have to become tighter and real domestic interest rates would have to rise, a process already under way, with the prospect of relatively high interest rates continuing in 1983. In 1982, particularly in the second half of the year, there had been a reduction in overall private sector debt, so that in 1983 there would be that much less of an overhang to be reduced. Until December 20, 1982, the subsidy had encouraged the repayment of debt. Ideally, the subsidy should be eliminated, but its impact at present was less than it had been. He agreed that the international lending environment would have an important role to play in the debt picture. But the willingness of domestic entities to take on further debt was also important, since they had learned the lessons of overexposure in the previous two years. The program assumed that most of the expected reserve loss would occur in the first half-of the year; the authorities had reiterated their intention to tighten domestic credit further if that was what was required to create the conditions for the private sector to meet its credit needs through foreign financing.

Mr. El-Khouri commented that it was unclear whether the program contained a specific provision for a mid-term review. There was simply a reference to a consultation in the middle of 1983.

The staff representative from the Exchange and Trade Relations Department said that there was to be a review, but the review was not itself a performance clause because the quantitative ceilings had been set on a quarterly basis throughout the year, and there was no need to have both quantitative criteria and a review as performance clauses. It was correct to say that the reference to the consultation clause in the staff appraisal was not standard, but, as he had indicated earlier, it would be useful if countries were to pay closer attention to the consultation provisions, particularly when the international environment was uncertain, or when a program was not working out as had been expected.

Mr. Gomel recalled that Mr. Lovato had raised the question of the outlook for domestic demand in 1983. The authorities were relying on a drastic reduction in income in order to increase profits and, thereby, to stimulate investment. However, the environment for a needed increase in investment was unfavorable because business confidence was low, interest rates were expected to remain high, and the financial structure was weak. He invited the staff to comment further on that environment.

The staff representative from the Western Hemisphere Department said that both the staff and the authorities expected that the upturn in the economy would be slow. Within the authorities' strategy, the export sector was intended to be the engine of growth, but performance in that area would obviously depend a great deal on developments in the world economy. At the same time, the authorities had put together an economic program that they believed was consistent and that would give the private sector a measure of confidence that the economy would improve in the future. However, it was worth reiterating that domestic consumers were not expected to provide the demand but, rather, the export sector.

The Acting Chairman noted that Mr. El-Khouri had asked about the meaning of the net domestic asset ceilings in the stand-by arrangement. It was important to eliminate any ambiguity regarding those ceilings. On page 35 of EBS/82/227, the staff had referred to "the limit" (singular) on the net domestic assets of the Central Bank of Chile described in Table 4 of Attachment III. However, in Table 4, there were four individual ceilings, one for each quarter. The staff representative from the Exchange and Trade Relations Department had indicated that, if the actual data came within the ceiling values by the end of the period, the member could draw under that performance criterion even though the ceiling was intended to apply to the whole period. The second drawing under the present arrangement could take place on May 15, 1983; it would be judged in light of the performance criterion on net domestic assets as of March 31, 1983. Hypothetically, if Chile had observed the net domestic asset test throughout the entire first quarter, but the ceiling on net domestic assets in the second quarter had been exceeded by the time of the second drawing, for example on April 30, 1983, what were the implications?

The staff representative from the Exchange and Trade Relations Department replied that, in those circumstances, the country could not draw. The ceilings were normally expressed on a quarterly basis, and, as long as the country observed them for the quarter in question, all other things being equal, it would be entitled to draw. The net domestic asset ceiling, however, had to have been observed on the basis of the most recent data available at the time of the request for the country to be able to draw. In the Acting Chairman's example, the most recent data available indicated that the second quarter ceiling had been exceeded on April 30, 1983; therefore the country could not make the drawing. However, if later information became available that net domestic assets had returned within the ceiling, and all the other performance criteria had continued to be observed, the country became entitled to draw again.

Mr. Joyce wondered what would happen if, on May 15, 1983, at the time of the request for a drawing, the only figures available were for March 31, 1983, indicating that the country had met the performance criteria for the first quarter; but, a day or two later, data became available to show that the ceilings for the second quarter had been exceeded. Could the drawing, once authorized, be interrupted?

The Acting Chairman said that it was his understanding that drawings were not interrupted once instructions had been issued.

The staff representative from the Exchange and Trade Relations Department added that the important point was that the ceiling had to be observed at any given point in time whan a drawing was being requested. For purposes of the ceiling on net domestic assets, the end-of-quarter data did not have any particular significance once the quarter had passed.

Mr. Donoso noted that a number of Directors had commented on the problem of unemployment. The authorities in Chile had taken many initiatives to mitigate the problem. For example, a program had been started to create jobs for 100,000 family heads; by October 1982, 70,000 persons had been employed under that program. Since March 1982, a subsidy had been made available to enterprises hiring workers above the number of employees under contract on March 1. A further subsidy was available if the persons hired had been working in other government-supported employment programs. Subsidies had also been granted to reopen, on a temporary basis, certain plants in the sugar producing industry to deal with localized unemployment, and a similar program operated in state-owned forestries. Another program, expected to provide 40,000 jobs in 1983, had been set up to build sanitary facilities in houses of low-income residents.

Those programs had contributed to the reduction in the rate of unemployment that had occurred in recent months, Mr. Donoso continued. In Santiago, it was estimated that unemployment had been reduced by 3.5 per cent, at least part of which was the result of direct government action. Thus, the authorities were making every effort to reduce unemployment within the context of the limitations on public expenditure that were required in order to reduce the current account deficit. As the staff had pointed out, the fundamental concern with the problem of unemployment, in conjunction with the scarcity of resources, had led the Chilean authorities to reallocate budget resources toward labor-intensive public investment projects.

Commenting on the financial system, Mr. Donoso noted that the monetary authorities had introduced a new measure in mid-1982, namely, the acquisition by the Central Bank of the portfolio of "bad loans" of the financial institutions. A special feature of the new system was that those financial institutions cooperating with the Central Bank exchanged their "bad loans" for bonds issued by the Central Bank. The bonds had to be repurchased over the coming ten years at the rate of 5 per cent per semester. The institutions remained in a solid position in terms of assets relative to liabilities, making it unnecessary for the depositors to become concerned about their deposits, and thereby avoiding liquidity problems for the institutions. At the same time, no real change in the net asset position of the financial institutions was involved since they were committed to repurchasing the "bad loans." The aim had been to allow those financial institutions facing problems to continue operating until economic recovery allowed them to generate resources.

It was also important that the authorities had sought to avoid the need for central bank credit to cope with liquidity problems arising from depositors' uncertainty, Mr. Donoso remarked. However, it would still be possible to close down a given institution, if necessary, but to do so without causing problems for the financial system as a whole. It was true that liquidity problems might occur because of withdrawal of deposits from an institution, and that such a development could lead to credit expansion above the ceilings envisaged in the program. However, such expansion should prove to be temporary, because deposits taken from one institution would return to the system.

The likelihood of attracting sufficient foreign resources in 1983 to cover the expected current account deficit and reserve losses had been raised in the discussion, Mr. Donoso observed. It was worth noting that the net capital outflow from the private sector in 1982 had occurred at a time of enormous uncertainty resulting from changes in the exchange rate and from the low rate of interest. For part of the second half of 1982, the real rate of interest for one-month operations had been negative. Thus, there had been a strong incentive for the private sector to replace its foreign debt with debt denominated in pesos. The subsequent increase in the rate of interest altered the incentives, so that international reserves had begun to recover by the end of 1982. If interest rates remained positive, through an appropriate credit policy, it should be possible to maintain the level of foreign debt of the private sector. It appeared feasible that the planned current account deficit could be financed through foreign investment and through the use of foreign resources by the public financial sector in the event that there were difficulties in obtaining financing for the private sector. He stressed that his authorities were confident that capital flows to the private sector would occur as expected in the program, given the expected effect of their credit policy.

The multiple currency practice had already been modified as explained in the supplementary information provided by the staff, Mr. Donoso remarked. The differential between the official exchange rate and the preferential rate was being paid in bonds rather than cash for debts above $20,000. The monetary authorities' control over the growth of net domestic assets would thereby be enhanced. The preferential rate allowed economic units to have access to foreign currency only to service debts contracted before August 1982. Therefore, its effects on future debt contracting should be minor. The use of the preferential rate entailed a subsidy, but the existence of the rate would not necessarily affect the <u>net</u> foreign indebtedness of the private sector. That indebtedness would depend more on the comparison of the costs of using external or internal resources. Those costs were influenced by credit policy, which could, temporarily and with a loss of reserves, maintain the rate of interest paid on peso loans below the rate paid on foreign loans. Such a credit policy had existed for some months in 1982, but it had since been tightened, with a resulting increase in the internal rate of interest. He believed that it would be possible to continue the new credit policy and thereby to reverse the net capital outflows despite the maintenance of the preferential exchange rate. He emphasized that the limits imposed on the acquisition of foreign currency for invisible transactions were temporary, and that all bona fide requests were being honored by the Central Bank.

The Acting Chairman made the following summing up:

In concluding the Article IV consultation with Chile, Executive Directors generally expressed their agreement with the thrust of the staff appraisal, and they approved Chile's request for the use of Fund resources.

Directors noted that economic conditions in Chile in 1982 had been extremely difficult. The economy had experienced a deep recession, the rate of unemployment had been high, the external sector had been in severe disequilibrium, and confidence in the Chilean economy had been shaken. Directors expressed support for the authorities' strategy of focusing particularly on tackling the constraint imposed on the economy by the balance of payments problem, and they welcomed the authorities' decision to deal with the constraint in close collaboration with the Fund.

The Chilean peso had been depreciated by 40 per cent, and a flexible exchange system had been instituted with the objective of ensuring that the real external value of the peso would be kept at a realistic level. Wage indexation had been abandoned, and the wage floor for collective bargaining had been lowered. Directors stressed that those policies, even though, regrettably but necessarily, they might involve a significant reduction in household incomes in the short run, were fundamental to restoring Chile's competitiveness and to the restoration of confidence, the resumption of economic growth, and a consequent reduction in unemployment in due course.

Directors observed that the economic downturn and the drop in the world market price of copper had resulted in a decline in fiscal revenues and had led to the emergence of an overall public sector deficit in 1982 for the first time in several years. Directors strongly commended the authorities for their actions to limit the deficit to a manageable size in 1982 and to reduce it in 1983 to 1.7 per cent of GDP, including major cuts in planned current and capital spending, the adoption of new tax measures, increases in public sector tariffs, and sales of public sector assets.

Directors drew attention to the measures that had been taken to re-establish confidence in the domestic financial system, and they emphasized the importance of prudent credit management if that objective was to be achieved. Directors referred with concern to the high rate of Central Bank credit expansion in recent months, and many observed that the effectiveness of monetary policy had been greatly hindered by the subsidy implicit in the existing preferential exchange rate for external debt service payments. They welcomed the tightening of credit expansion and the modifications of the preferential exchange rate in a way which facilitates monetary control. They encouraged the authorities to eliminate the system altogether in order to avoid reductions in the private sector's foreign debt and the consequent loss of foreign reserves. Directors supported the authorities' intention to continue allowing interest rates to be determined by market forces. The use of the rediscount rate to influence the trend of market rates should be pursued with caution to avoid the emergence of unrealistic interest rates. Chile's undertaking to strengthen the supervision of the operations of the financial intermediaries was warmly welcomed.

Directors strongly commended the authorities for their determination to maintain an open economy. The elimination of exchange restrictions and the reduction and maintenance of import duties to a uniform 10 per cent had been major factors in the attainment of high economic growth rates in the second half of the 1970s and, together with appropriate demand and exchange rate management, those policies should aid in the resumption of economic growth. They strongly encouraged the authorities to maintain and ensure the necessary flexibility in exchange rate policy during the period of stabilization and transition in the Chilean economy.

Given the climate of uncertainty in international financial markets and the relatively soft world economic outlook, Directors stressed that the Chilean authorities should stand ready to take appropriate additional action to achieve their external target and to restore confidence. In that context, some Directors questioned whether the projections for exports and for capital inflows in 1983 would be attainable. They, therefore, attached considerable importance to the provision for consultation under the stand-by arrangement in order to monitor developments closely.

The Executive Board then turned to the proposed decisions, which it approved:

The decisions were:

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 1982 Article IV consultation with Chile concluded under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Chile maintains a multiple currency practice arising from the maintenance of a preferential exchange rate for debt service payments for private sector debt contracted before August 6, 1982, and maintains an exchange restriction arising from the limitations placed on the sale of foreign exchange for foreign travel and a

number of other invisible transactions. In view of the temporary nature of these measures, the Fund grants approval for their retention until not later than December 31, 1983.

Decision No. 7297-(83/8), adopted
January 10, 1983

Stand-By Arrangement

1. The Government of Chile has requested a stand-by arrangement for a period of two years from January 10, 1983 in an amount equivalent to SDR 500 million.

2. The Fund approves the stand-by arrangement attached to EBS/82/227.

3. The Fund waives the limitation in Article V, Section 3(b)(iii) of the Articles of Agreement.

Decision No. 7298-(83/8), adopted
January 10, 1983

Purchase Transaction - Compensatory Financing Facility

1. The Fund has received a request from the Government of Chile for a purchase of SDR 295 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979).

2. The Fund approves the purchase in accordance with the request.

Decision No. 7299-(83/8), adopted
January 10, 1983

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/7 (1/7/83) and EBM/83/8 (1/10/83).

2. CABLE ROOM - SHIFT WORK

The Executive Board approves the proposal set forth in EBAP/82/447 (12/30/82).

Adopted January 7, 1983

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/83/6 (1/6/83), EBAP/83/7 (1/6/83), and EBAP/83/9 (1/7/83) is approved.

APPROVED: June 20, 1983

LEO VAN HOUTVEN
Secretary

Table 1. Chile: Summary Accounts of the Central Bank

(In billions of Chilean pesos) 1/

	1981	1982				1983	
	Dec.	June	Sept.	Sept. (US$1= Ch$69)	Dec. (US$1= Ch$74)	Jan. 6 (Prel.)	Mar. 31 (Prog.)
Net international reserves	219.9	198.1	146.1	121.4	130.2	121.9	137.4
(In millions of U.S. dollars)	(3,187)	(2,870)	(2,117)	(1,795)	(1,795)	(1,647)	(1,857)
Deposits related to balance of payments support loans	--	--	--	9.5	10.2	10.2	40.7
Net domestic assets	-132.8	-107.6	-61.3	-23.1	-28.0	-21.4	-6.0
Medium- and long-term foreign liabilities	35.2	44.3	43.5	42.9	46.0	45.8	45.6
Liabilities to the private sector	51.9	46.2	41.2	46.0	46.0	44.5	45.0
Of which: Currency issue	(43.6)	(37.4)	(34.7)	(39.1)	(39.1)	(36.9)	(...)
Memorandum items:							
Net international reserves less deposits related to balance of payments support loans	219.9	198.1	146.1	111.9	120.0	111.7	96.7
(In millions of U.S. dollars)	(3,187)	(2,871)	(2,117)	(1,622)	(1,622)	(1,509)	(1,307)

Source: Central Bank of Chile.

1/ At Ch$69 = US$1 for 1982.
At Ch$74 = US$1 for the first quarter of 1983.