FOR AGENDA

EBS/82/134

CONFIDENTIAL

July 26, 1982

To: Members of the Executive Board

From: The Acting Secretary

Subject: Chile - Staff Report for the 1982 Article IV Consultation and Request for Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1982 Article IV consultation with Chile and a request for a stand-by arrangement. A draft decision appears on page 20.

This subject has been tentatively scheduled for discussion on Monday, August 23, 1982.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

CHILE

Staff Report for the 1982 Article IV Consultation and Request for Stand-by Arrangement

Prepared by the Western Hemisphere and Exchange and Trade Relations Departments

(In consultation with the Legal and Treasurers' Departments)

Approved by E. Walter Robichek and Manuel Guitian

July 26, 1982

The 1982 Article IV consultation discussions with Chile were held in Santiago during April 13-30 and May 24-June 4, 1982, and in Washington during June 29-July 2, 1982. During the staff's second visit to Santiago the authorities presented a request for a two-year stand-by arrangement in the upper credit tranches. Negotiations were concluded during the authorities' visit to Washington. The Chilean representatives included the Minister and Vice-Minister of Finance, the Budget Director, the President of the Central Bank of Chile and his two principal advisors, as well as the Ministers of Economy, Mines, and Planning, the President of the Chilean Copper Corporation, the Superintendent of Banks, the General Secretary of the National Energy Commission, the head of the National Statistical Institute, and officials of the Ministry of Agriculture. The staff representatives for either or both of the visits were L. Koenig (Head-CBD), J. Bonvicini, D. Hoelscher, and C. Muniz (all WHD), A. Pera (ETR), F. van Beek (WHD), and E. Frolia and A. Snell (Secretaries-WHD). Mr. J-C. Iarezza, Executive Director for Chile, participated in some of the policy discussions.

The stand-by arrangement which the authorities are requesting would amount to SDR 450 million, equivalent to 138.2 per cent of Chile's quota of SDR 325.5 million. The arrangement, which would cover a two-year period, would consist of SDR 230.4 million of ordinary resources and SDR 219.6 million of borrowed resources. The Chilean authorities are also requesting a purchase under the compensatory financing facility in an amount of SDR 274.3 million, equivalent to 84.3 per cent of Chile's quota. A waiver of the limitation in Article V, Section 3 (b)(iii) of the Articles of Agreement is required.

The program in support of which the stand-by arrangement is requested is described in the memorandum annexed to the attached letter and analyzed below. The phasing under the requested arrangement would be as follows: purchases would not, without the consent of the Fund, exceed the equivalent of SDR 122 million (the first credit tranche plus half as much in enlarged access) until November 15, 1982, SDR 163 million until February 15, 1983, SDR 204 million until May 15, 1983, SDR 245 million until August 15, 1983, SDR 286 million until November 15, 1983, SDR 327 million until February 15, 1984, SDR 368 million until May 15, 1984, and SDR 409 million until August 1, 1984.

As of June 30, 1982 the Fund's holdings of Chilean pesos amounted to 84.8 per cent of Chile's quota, of which 6.5 per cent corresponded to the oil facilities. On the assumption that Chile purchases the remaining amount of the reserve tranche and that repurchases are made on schedule, full use of the requested stand-by arrangement, together with the requested purchase of an amount equivalent to 84.3 per cent of quota under the compensatory financing facility, would raise the Fund's holdings of pesos to 322.5 per cent of quota by the end of the stand-by period (Table 1). Further information on Chile's relations with the Fund is presented in Appendix I.

Chile accepted the obligations of Article VIII, Sections 2, 3, and 4 on July 27, 1977. Chile maintains no restrictions on the making of payments and transfers for current international transactions. The exchange value of the Chilean peso is announced daily on the basis of a basket of currencies; a depreciation of 0.8 per cent per month in relation to this basket has been announced for the period ending June 15, 1983. The representative exchange rate is the same as the official rate.

I. Background

1. Introduction

In 1973 Chile experienced a severe financial crisis, characterized by a severe drop in output, hyper-inflation, and the exhaustion of the net international reserves. The policies adopted at that time included a major improvement in demand management, large corrective price increases, and the pursuit of a flexible exchange rate policy. In addition, the authorities carried out numerous structural reforms which increased the role of market forces in the economy. Since that time, the progressive curtailment of the role of the state in the economy and the broadening of the scope for private initiative has been a major aim of Chile's economic policies.

Following the mid-1970s stabilization effort, Chile experienced a number of years of strong economic growth; real GDP growth averaged 7 per cent per annum over 1976-81, compared with 4-1/2 per cent during the decade of the 1960s. Gross domestic investment increased from 8 per cent to 22 per cent of GDP over this period but, notwithstanding the prevalence of free interest rates, private saving responded only very slowly. The current account deficit of the balance of payments rose sharply as private borrowing abroad increased substantially. Contributing to the widening of the saving-investment gap was the progressive

Table 1. Chile: Projection of IMF Position--July 31, 1982-August 31, 1984

	Outstanding July 31, 1982 1/	Operations During First Year of Program Aug.-Nov. 1982	Dec. 1982-Feb. 1983	Mar.-May 1983	June-Aug. 1983	Outstanding Aug. 31, 1983	Operations in Second Year of Program	Outstanding Aug. 31, 1984
	(In millions of SDRs)							
Purchases	18.5	437.1	41.0	41.0	41.0	560.1	164.2	724.3
Under tranche policies	--	162.8 2/	41.0	41.0	41.0	285.8	164.2	450.0
Ordinary		(99.9)	(18.6)	(18.7)	(18.6)	(155.8)	(74.6)	(230.4)
Enlarged access		(62.9)	(22.4)	(22.3)	(22.4)	(130.0)	(89.6)	(219.6)
Compensatory purchases	--	274.3				274.3	--	274.3
Oil facility	18.5	--	--	--	--	--	--	--
Repurchases		12.8	2.8	2.8	--		--	
Under tranche policies		--	--	--	--		--	
Ordinary		(--)	(--)	(--)	(--)		(--)	
Enlarged access		(--)	(--)	(--)	(--)		(--)	
Compensatory financing		--	--	--	--		--	
Oil facility		12.8	2.8	2.9	--		--	
Net purchases		424.3	38.2	38.1	41.0		164.2	
Memoranda items								
Total holdings (end of period)	344.0	768.3	806.5	844.6	885.6	885.6	1,049.8	1,049.8
Excluding compensatory and oil facilities	325.5	488.3	529.3	570.3	611.3	611.3	775.5	775.5
	(In per cent of quota)							
Total holdings (end of period)	105.7	236.0	247.8	259.5	272.1	272.1	322.5	322.5
Excluding compensatory and oil facilities	100.0	150.0	162.6	175.2	187.8	187.8	238.2	238.2

Source: International Monetary Fund.

1/ Including scheduled repurchase under the oil facility for the equivalent of SDR 2.8 million on July , 1982 and assuming reserve tranche drawing before July 31, 1982.
2/ Includes a purchase equivalent to SDR 122 million prior to November 15.

appreciation of the Chilean peso which on an effective exchange rate basis using wholesale prices amounted to 26 per cent between June 1979, when the peso was fixed, and December 31, 1981 (Chart 1).

2. Recent economic developments

The Chilean economy experienced a slowdown in 1981. Real GDP growth for the year as a whole is estimated at 5 per cent (Table 2), but in the fourth quarter the rate of increase is believed to have declined to zero. Indications are that output declined sharply in the first half of 1982 (with construction, manufacturing, and commerce being the sectors most seriously affected), and the drop in real GDP for 1982 as a whole is projected at 6-7 per cent. Unemployment, as measured by the index for Santiago, was steady at 8-1/2 per cent over the first three quarters of 1981 but increased to 11 per cent in the fourth quarter and to 17 per cent in the three months ended May 1982.

Table 2. Chile: Economic Indicators

(In per cent)

	1978	1979	1980	1981	Projected 1982	Projected 1983
Change in GDP at constant prices	8.2	8.3	7.5	5.3	-6.5	3.7
Change in industrial production	10.2	8.2	4.0	0.1	-7.5	5.0
Change in consumer price index during period	30.3	38.9	31.2	9.5	11.2	7.4

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

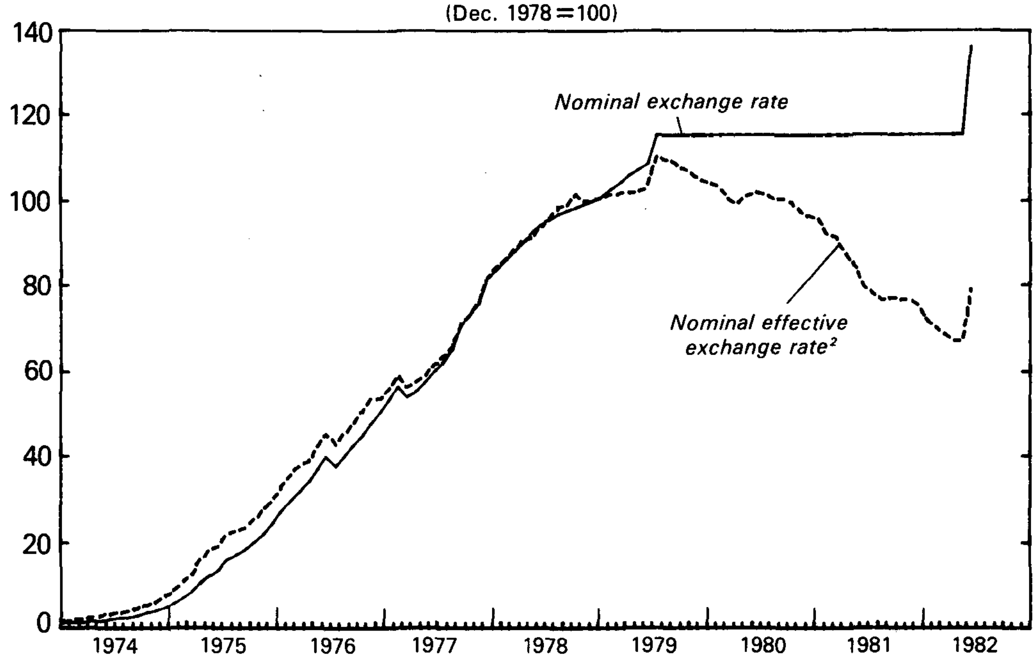
After five years of large overall surpluses, the balance of payments returned to equilibrium for 1981 as a whole; however, in the fourth quarter net international reserves declined by US$230 million and in the first half of 1982 there was a further decline of US$325 million. The rate of inflation has dropped sharply: consumer prices rose by 9-1/2 per cent during the 12 months ended December 1981, compared with 31 per cent in 1980; during the fourth quarter of 1981 the index rose by only 1 per cent and in the first five months of 1982 it declined by 0.3 per cent. The prevalence of indexation prevented wages from reflecting the rapid decline in inflation, leading to a sharp rise in real wages in 1981. However, indications are that nominal wages in the private sector declined marginally in the early part of 1982.

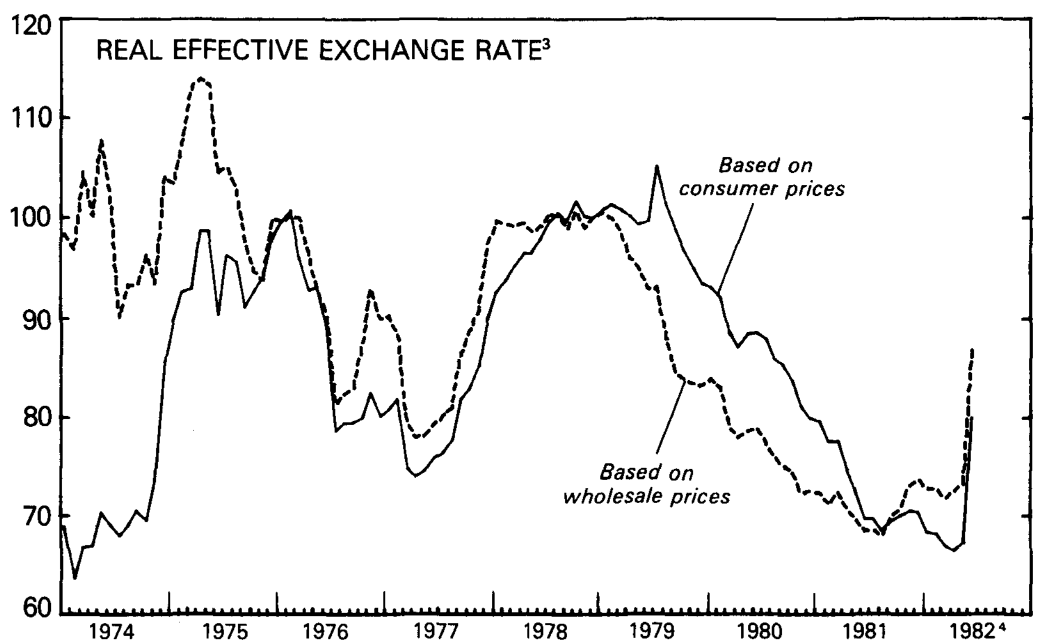
CHART 1

CHILE

EXCHANGE RATE INDICES

(Dec. 1978=100)





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

[1]Pesos per U.S. dollar at end of period.

[2]Nominal exchange rate index adjusted by a weighted index of exchange rate movements of major trading partners.

[3]Real exchange rate index adjusted by weighted indices of prices and exchange rate movements of major trading partners.

[4]Partly estimated.

A major factor behind the slowdown in activity in 1981 and the disappearance of the balance of payments surplus was the sharp reduction in export earnings brought about for the most part by the fall in the world price of copper, Chile's principal export commodity (Table 3). A weakening in world market conditions and the real effective appreciation of the peso affected most other exports as well. Particularly hard hit were exports of wood and wood products, industrial goods, and minerals. The fall in exports was accompanied late in the year by a slowdown in domestic demand and a pronounced decline in net private capital inflow, which reflected concern on the part of foreign lenders about the rapid increase in the debt of Chilean private enterprises over the preceding four years, and speculation against the peso. In the fourth quarter of 1981, as demand declined and output stopped growing, imports, which had increased strongly throughout most of the year, fell in absolute terms. During the period January-May 1982 imports declined further from the level registered in the last quarter of 1981, and thus the trade account was in virtual balance even though low world demand and prices kept exports at their depressed fourth quarter levels.

Despite the decline in earnings of the state-owned large copper companies and the substantial costs associated with the partial privatization of the social security system,1/ the operations of the public sector still registered a surplus of more than 2 per cent of GDP in 1981 (Table 4). The finances of the public sector moved into deficit over January-May 1982 as a wage increase for government employees, and increased expenditures related to the social security and educational reforms 2/ being carried out by the Government coincided with a sharp fall in revenue from import duties and income taxes.

1/ The reform of the social security system is described in Appendix I of the Recent Economic Developments paper.

2/ Including a large nonrecurrent expenditure related to severance pay to school teachers transferred to the local school systems.

Table 3. Chile: Summary Balance of Payments

(In millions of U.S. dollars)

	1978	1979	1980	1981	Projected 1982	Projected 1983
Current account	-1,088	-1,189	-1,971	-4,814	-2,680	-2,510
Trade balance	-426	-355	-764	-2,598	-70	210
Exports, f.o.b.	(2,460)	(3,835)	(4,705)	(3,960)	(3,801)	(4,620)
Of which: copper	/1,219/	/1,888/	/2,125/	/1,756/	/1,643/	/2,110/
Imports, f.o.b.	(-2,886)	(-4,190)	(-5,469)	(-6,558)	(-3,871)	(-4,410)
Services and transfers (net)	-662	-834	-1,207	-2,216	-2,610	-2,720
Capital account	1,946	2,251	3,165	4,791	2,419	2,610
Private sector (net)	1,388	1,909	3,080	4,497	1,561	2,550
Official sector (net)	558	342	85	294	858	60
Errors and omissions	-145	-4	50	93	--	--
SDR allocation	--	29	30	28	--	--
Overall balance	713	1,087	1,274	98	-261	100
Valuation adjustment	...	...	-30	-90	-63	--
Change in net official international reserves (increase -)	-713	-1,087	-1,244	-8	324	-100

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

Table 4. Chile: Public Sector Operations in Relation to GDP

(In per cent)

	1978	1979	1980	1981	Projected 1982	Projected 1983
Current account surplus or deficit (-)	8.7	9.2	10.8	5.9	-1.5	1.0
Capital revenues	2.1	2.1	2.0	4.0	4.0	3.3
Capital expenditure	8.7	6.5	7.0	7.6	6.2	5.4
Overall surplus or deficit (-)	2.1	4.8	5.8	2.3	-3.7	-1.0
Financing	-2.1	-4.8	-5.8	-2.3	3.7	1.0
Foreign (net)	1.4	0.3	-0.1	2.8	1.8	0.9
Domestic (net)	-3.5	-5.1	-5.7	-5.1	1.9	0.1
Banking system (net)	(-2.3)	(-2.6)	(-5.1)	(-4.8)	(1.9)	(0.1)
Other 1/	(-1.2)	(-2.5)	(-0.6)	(-0.3)	(--)	(--)

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

1/ Includes statistical discrepancy.

Over the first nine months of 1981, the repayment of government debt to the Central Bank of Chile brought about a contraction in the net domestic assets of that institution, which enabled it to reduce its net medium- and long-term foreign liabilities. However, Central Bank net domestic credit expanded substantially during the fourth quarter of the year, when the Bank found itself forced to extend emergency credits to a number of financial institutions which suffered a loss in deposits (Table 5). 1/ This credit expansion led to the net international reserve loss of US$230 million mentioned above, a loss which virtually offset the amount the Central Bank had gained over the first nine months of the year.

Over the first half of 1982 the net domestic assets of the Central Bank are estimated to have expanded by 26 per cent in relation to the starting stock of liabilities to the private sector, while these liabilities contracted by 15 per cent. Consequently, net official international reserves declined by US$324 million in spite of an increase of US$141 million in the Central Bank's medium- and long-term foreign liabilities. Net credit to financial intermediaries was responsible

1/ See Section III.1 of the Recent Economic Developments paper.

Table 5. Chile: Monetary Indicators

	1979	1980	Dec. 1980– Sept. 1981	Sept. 1981– Dec. 1981	1981	Est. Dec. 1981– June 30, 1982 1/	Proj. June 30 1982-83 1/
A. Central Bank							
(Change in millions of U.S. dollars)							
International reserves	894	1,226	240	-228	12	-324	--
Medium- and long-term foreign liabilities	370	-151	-508	90	-418	141	120
(Percentage change) 2/							
Net domestic credit	-57.2	-126.3	-67.5	49.1	-19.8	26.4	26.7
Liabilities to the private sector	36.3	35.9	-2.7	20.8	17.5	-14.9	14.3
B. Banking System							
(Change in millions of U.S. dollars)							
International reserves	846	468	-287	-77	-364	-489	-476
Medium- and long-term foreign liabilities	951	1,152	1,131	540	1,672	419	750
(Percentage change) 2/							
Net domestic credit	65.6	74.2	51.0	11.4	64.1	9.3	29.6
Credit to the public sector	-10.4	-24.2	-13.4	2.1	-10.7	2.8	5.5
Credit to the private sector	76.5	91.1	65.7	5.3	72.7	6.3	24.1
Liabilities to the private sector	63.0	60.2	32.6	4.1	38.0	--	16.2

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

1/ Foreign currency entries valued at the accounting rate of US$1.00=Ch$46.00.
2/ As per cent of liabilities to the private sector at the beginning of the period.

for the expansion in net domestic assets, while the decline in liabilities reflected seasonal factors, a drop in nominal GDP, and private capital outflows.

Despite the fact that the public sector was a net supplier of loanable funds in 1981 and that inflation was sharply lower, nominal interest rates on peso-denominated operations--which account for around 60 per cent of bank claims on the private sector--were extremely high during the year and even increased in the latter part of the year; at the end of 1981 they were the equivalent of 63 per cent per annum for loans and 48 per cent for deposits (Chart 2). The spread between lending and deposit rates also rose substantially as banks became more concerned about risk. These high interest rates reflected a number of factors including high foreign interest rates, heavy credit demand by the private sector, and the presence of large risk premia. Uncertainties about the exchange rate were exacerbated by the real appreciation of the peso and by the increase in the current account deficit of the balance of payments to a record 14.5 per cent of GDP. The public sector's domestic financing requirement--the first in seven years--and continued uncertainties regarding the soundness of the financial system combined to keep interest rates at high levels in early 1982, but rates began declining in February before rising again in May and June.

II. Economic Prospects and Policies for 1982-83

The strategy of the Chilean Government has been to promote adjustment and economic recovery by relying on market forces and price incentives to guide resource allocation in the economy. In line with this strategy, the authorities by keeping a tight rein on Central Bank credit did not interfere with the process that got under way in 1981 whereby spending adjusted to lower income, the one exception being the extension of support to a number of domestic financial institutions which fell into difficulties; the collapse of these institutions, it was felt, would have been internally disruptive and would have represented a threat to Chile's creditworthiness abroad.

Although import demand responded quickly and production costs apparently began to decline in early 1982, evidence accumulated that the market-induced process of domestic cost adjustment would be protracted and costly in terms of economic activity and employment, and therefore that domestic demand and incomes policies would need to be accompanied by a modification of the exchange rate. Accordingly, in mid-June 1982 the peso was depreciated from Ch$39 to Ch$46 per U.S. dollar and an exchange rate schedule covering the following 12 months was announced.1/ At the same time, action was taken to abolish all

1/ It was also announced that the rate for the peso henceforth would be set daily on the basis of a basket composed as follows: U.S. dollar, 60 per cent; Deutsche mark, 15 per cent; yen, 15 per cent; pound sterling, 5 per cent; and French franc, 5 per cent. For the next 12 months the peso will be depreciated by 0.8 per cent per month in relation to this basket of currencies.

wage indexation and to lower the wage floor for collective bargaining contracts. The exchange rate change is to be complemented and supported further by cautious monetary policies and fiscal policies aimed at keeping the fiscal deficit within manageable levels in 1982 and reducing it to the equivalent of 1 per cent of GDP in 1983. Achievement of the latter objective would lay the basis for a sustainable external position over the medium term.

The authorities are confident that the move to a more realistic exchange rate, and their supporting demand management and incomes policies, should restore economic growth while protecting the balance of payments. They are projecting that real GDP will increase by about 4 per cent in the first program year (July 1982-June 1983) and by a similar amount in 1983 as a whole. The rate of price increase is projected to climb to 15 per cent for the first program year, but to decline to 7-1/2 per cent for 1983 as a whole. The deficit in the current account of the balance of payments is projected to fall to 9 per cent of GDP in 1982 (from 14-1/2 per cent in 1981), and further to 8-1/2 per cent in 1983.

Chile's economic prospects for 1982-83 as well as the authorities' policies and the stand-by program are discussed below in greater detail.

1. Fiscal policy

The finances of the public sector were in overall surplus in each year from 1976 to 1981; over 1979-80 the surplus averaged 5.3 per cent of GDP. The year 1981 saw a decline in the surplus to 2.3 per cent of GDP as a consequence of two factors: the sharp fall in copper earnings and the cost of the social security reform, which included the creation of privately owned and operated social security funds.1/ For 1982 the public sector is projected to incur an overall deficit equivalent to 3.7 per cent of GDP, including a domestic financing need of about 2 per cent of GDP.

The potential 1982 fiscal deficit loomed much larger prior to the adoption of significant fiscal measures in January 1982. These included a sharp cut in planned current and capital spending, substantial income and property tax surcharges and higher excise taxes. Sales of major fixed assets by the public sector also are planned. Over the longer run the authorities intend to continue reducing the size of the public sector, selling to domestic or foreign investors all those fixed assets which do not need to be in the hands of the state for national security reasons.

Control over the public sector deficit with a view to a speedy return to fiscal equilibrium is assigned a central role in the authorities' strategy. To this effect, they intend to reduce the public

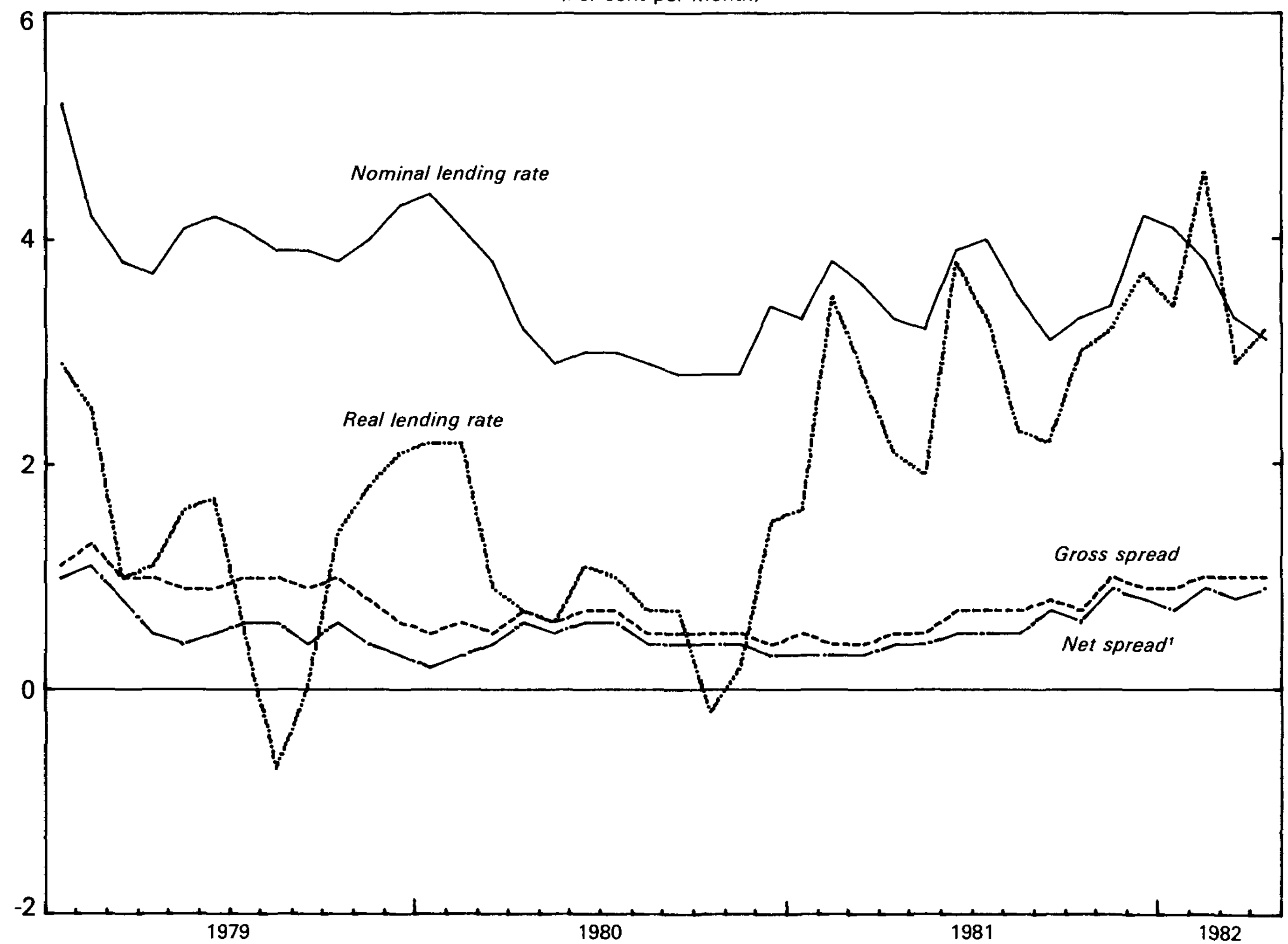
1/ The public social security system must continue paying out pensions while failing to take in new contributions.

CHART 2

CHILE

SHORT-TERM LENDING RATES AND SPREADS

(Per cent per month)



Source: Central Bank of Chile.

[1] Gross spread adjusted for net financial cost of fulfilling reserve requirements.

sector deficit to the equivalent of 3.4 per cent of GDP in the first program year, and to 1 per cent of GDP in 1983. Part of the decline--1 per cent--would reflect higher copper prices; the remainder would be achieved through substantial cuts in current spending by the general government and public enterprises and, to a lesser extent, cuts in investment expenditures.

To monitor and control the size of the public sector deficit, the authorities' financial program for 1982-83 includes limits on the total net indebtedness--domestic as well as foreign--of the nonfinancial public sector. Given the importance of copper tax receipts, these limits would be adjusted--either upward or downward, but subject to a maximum--by an amount which varies with one half of the difference between the average copper price assumed in the program's revenue estimates and the actual average copper price.1/ The maximum adjustment is the equivalent of 1 per cent of GDP in the first program year; the maximum adjustment would be reached if the average actual copper price differs from the projected price by 30 U.S. cents in either direction and would represent one half of the estimated impact on public sector revenues. In addition, with a view to controlling spending into the future, the financial program includes separate limits on the contracting of external debt by the nonfinancial public sector with maturities of between one and ten years.

2. Monetary policy

To ensure that domestic financial intermediaries are operating on a sound basis the authorities in late 1981 introduced a system of loan classification requiring banks to set aside special reserves against all loans that are not ranked in the highest two categories.2/ In addition, restrictions were put into effect on lending to a financial intermediary's own enterprises and on the amount of lending to a single enterprise.3/ Following the renewed extension of Central Bank support to financial intermediaries in the first half of 1982, the authorities in mid-July announced that the Central Bank would stand prepared to purchase the "bad-loan" portfolios of the banks (those not under intervention) in return for equivalent amounts of non-negotiable, non-interest bearing Central Bank paper (pagares). The banks would have to buy back 5 per cent of these portfolios every six months for a period of ten years, an arrangement which in effect permits them to write-off these loans over ten years. At the same time, the authorities established a uniform reserve requirement on foreign borrowing (with maturities of

1/ See Attachment III, Table 1.
2/ See Section III.3 of the Recent Economic Developments paper.
3/ The authorities recently requested the Central Banking Department to provide technical assistance to review the system and recommend any needed improvements.

less than six years) of 5 per cent in replacement of a system of multiple reserve requirements 1/ and permitted banks to relend their foreign borrowings in pesos.

The authorities expect that the above measures--together with the restoration of economic growth and confidence in the economy--will reduce the need for Central Bank direct support to financial intermediaries. Nevertheless, in view of the serious difficulties experienced by the Chilean economy in the last 12 months, such support may prove to be required, in which case partially offsetting open market operations will be undertaken. But the authorities still think it prudent and necessary to allow in their financial program for mid-1982 to mid-1983 for some contingent direct support to financial intermediaries. Hence, the net domestic asset limit incorporated in the authorities' financial program--which allows for an expansion equivalent to 27 per cent of the starting stock of liabilities to the private sector--takes into account a contingent expansion in net domestic assets. As in the case of the limit on public sector indebtedness, this limit would be adjusted to reflect--up to a maximum amount--one half of the difference between actual and projected copper prices.2/ The contingent expansion in the net domestic assets of the Central Bank would be financed by medium- and long-term foreign borrowing, as the authorities do not think it prudent to allow for a further decline in net official reserves. In this regard, it is worth noting that Chile's net official reserves have declined by US$550 million in the nine months ended June 30, 1982.

With respect to the consolidated banking system, projections of financial relationships are particularly difficult, given the uncertainties of the current Chilean situation. The policies contained in the authorities' monetary program suggest that over the period June 1982-June 1983 overall net domestic bank credit will expand by 30 per cent in relation to the banks' starting stock of liabilities to the private sector. The expansion will be supported in about equal measure by the growth in liabilities to the private sector and foreign borrowing by the commercial banks. Because of the public sector's limited use of domestic bank credit, credit to the private sector will represent the major part of this expansion.

With a view to reducing distortions in credit allocation and easing interest rate pressures over time the authorities have substantially eased restrictions on capital flows. Prior to December 1981 private capital inflows of less than two years average (or four years total) maturity were prohibited except to finance foreign trade operations. In December 1981 this window was opened and financial intermediaries and firms now are permitted to borrow abroad at short term subject to limits expressed in relation to their capital and surplus. In separate steps

1/ The 5 per cent requirement is equal to the average requirement on domestic private demand and time deposits. It also applies to import financing which was previously exempt.

2/ See Attachment II, Table 3.

in the period April-July 1982 the authorities relaxed and then abolished the limits on the terms of export prefinancing credits and import credits. As was mentioned, the reserve requirements on foreign borrowing were reduced to a uniform 5 per cent.

Since 1975 interest rates on loans and deposits have been free to move in response to supply and demand, and the authorities are committed to maintain the free interest rate policy.

3. Wage policy

The authorities view a reduction in real wage levels as indispensable to restoring the competitiveness of the economy and have acted to bring about such a reduction. A pervasive system of wage indexation in both the private and public sectors operating in a context of declining inflation was one of the reasons why, in the late 1970s, the inflation rate in Chile failed to decline to international levels as quickly as the authorities had hoped, contributing to the loss in competitiveness and to a widening deficit on current account of the balance of payments.

With the leveling off of economic activity and rise in unemployment in late 1981, instances of voluntary renegotiation of collective bargaining arrangements began to appear. The process of downward wage adjustment was slow, however, due to the existing wage indexation arrangements. Up until June 1982 Chile's labor legislation required that employers engaging in collective bargaining make a starting wage offer at least large enough to compensate workers for past inflation; in practice wage offers usually incorporated increases larger than the minimum amount. Government employees and nonunionized private workers also received a wage increase equivalent to past inflation and in 1981 the authorities began a four-year program of real wage increases for public employees. The authorities were aware that these wage provisions and policies led to an unsustainably large real wage increase and contributed to the slow reduction in unemployment. Consequently, as was noted above, all future wage indexation as regards both the public and private sectors was abolished following the exchange rate action of June 1982, and the wage floor for collective bargaining contracts was lowered to the real level of July 6, 1979. At the same time, the subsidy for the hiring of additional workers, which had been abolished in 1980, was reinstated. With respect to public sector wages, remunerations at the higher levels have been cut and no general wage increase is planned for 1983.

These actions in the wage field are expected to have beneficial effects on growth and employment and to sustain the real depreciation of the peso.

4. External sector policies

As a result of the exchange rate action taken in mid-June and the supporting demand management and incomes policies that have been developed, the authorities expect to limit the net official reserve loss during 1982 to the amount lost in the first half of 1982. For the first program year the authorities expect to achieve equilibrium in the overall balance of payments and for calendar 1983 an overall surplus of US$100 million.

Because of the sluggishness of world demand and the fact that the exchange rate adjustment took place only at midyear, the value of exports is projected to decline by 4 per cent in 1982. They are expected to rise by 21 per cent in 1983, in response to higher world commodity prices and demand as well as the improvement in Chile's competitiveness. The value of imports may fall by some 40 per cent in 1982 because of the weakness of economic activity, the depreciation of the peso, and overstocking. An increase of 14 per cent in imports is projected for 1983. As was noted above, the current account deficit is expected to decline to the equivalent of 9 per cent of GDP in 1982, and to 8.5 per cent of GDP in both the first program year and calendar 1983.

The opening of the economy via the elimination of all restrictions on payments and transfers for current international transactions and the progressive reduction of import duties to a uniform 10 per cent level have been a cornerstone of the authorities' economic policy and one which, despite the emergence of protectionist pressures, they are determined to maintain. A low level of protection is viewed as essential to the efficient allocation of resources in Chile and to the preservation of a competitive economy. Legislation introduced in 1981 which provides for countervailing duties in the case of dumping, is being applied with the utmost care. Each case is being subject to detailed scrutiny and to date no retaliatory actions have been approved.

As mentioned above, the authorities over time have reduced restrictions on inward and outward capital flows and in late 1981 financial intermediaries and private firms became eligible for access to the short-term capital markets abroad. By mid-1982 virtually all controls on inward capital flows had been abolished.

Public sector capital flows, which were very heavy in the late 1960s and 1970s, have been quite moderate in recent years and the burden of external public debt service has been falling over time. In December 1981 outstanding external public debt with a maturity of one year or more amounted to 14 per cent of GDP compared with 28 per cent in December 1978; service payments in 1981 accounted for 19 per cent of exports of goods and nonfactor services compared with 28 per cent three years earlier (Table 6).1/

1/ Debt service projections through 1986 are shown in Section IV.5 of the Recent Economic Developments paper.

Table 6. Chile: External Public Debt Operations, 1978-82 1/

	1978	1979	1980	1981	Projected 1982	Projected 1983
	(In millions of U.S. dollars)					
Net disbursements	677	399	-30	-90	1,527	160
Gross disbursements	1,459	1,311	842	1,030	2,059	905
Amortization 2/	-782	-912	-878	-1,120	-532	-745
Debt payments	888	959	1,140	941	1,020	1,192
Amortization 3/	604	605	663	451	532	745
Interest	284	354	477	490	488	447
Disbursed debt outstanding at end of year	4,336	4,810	4,720	4,504	6,031	6,191
	(In per cent)					
Gross disbursements/GDP	9	6	3	3	7	3
Net disbursements/GDP	4	2	--	--	5	1
Debt service/exports of goods and nonfactor services 2/	28	19	19	17	19	19
Interest/exports of goods and nonfactor services	9	7	8	9	9	7
Interest rate on new commitments	10.8	11.7	12.1	13.7	...	...
Debt/GDP	28	23	17	14	20	21

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

1/ Exclusive of Fund credit.
2/ Including prepayments.
3/ Excluding prepayments.

5. Performance criteria, mid-1982 to mid-1983

The authorities' financial program for the first year of the arrangement includes three quantitative performance criteria (Table 7). The first is a limit on the total stock of debt of the nonfinancial public sector, performance under which will be tested quarterly on September 30, 1982, December 31, 1982, March 31, 1983, and June 30, 1983. This performance criterion measures the total deficit of the nonfinancial public sector, regardless of whether it is financed domestically or from abroad.

Table 7. Chile: Quantitative Performance Criteria for Period Through August 15, 1983

	Stock on		Limits for 1/					
	Dec. 31, 1981	June 30, 1982 (Est.)	Sept. 30, 1982	Dec. 31, 1982	Mar. 31, 1983	June 30, 1983	Aug. 31, 1983	Sept. 30, 1983
	(In billions of Chilean pesos)							
Net domestic assets 2/3/	-70.2	-59.8	-49.5	-44.1	-44.1	-45.8	-48.3	-48.3
Outstanding indebtedness of the nonfinancial public sector	184.1	202.6	225.5	231.7	235.1	250.9	...	...
Domestic banking system	(-31.4)	(...)	(...)	(...)	(...)	(...)	(...)	(...)
Domestic nonbank private sector	(6.7)	(...)	(...)	(...)	(...)	(...)	(...)	(...)
External debt	(208.8)4/	(...)	(...)	(...)	(...)	(...)	(...)	(...)
Maximum adjustment to ceilings 5/	--	--	3.5	6.9	10.4	13.8	13.8	13.8
	(In billions of U.S. dollars)							
Contracting of external debt of one- to ten-year maturity 3/6/	--	--	1.4	1.4	2.4	2.4	2.4	...

Sources: Ministry of Finance; Central Bank of Chile; and Memorandum on the Economic Policies of Chile.

1/ For purposes of calculating these limits, all foreign exchange entries are converted at the accounting rate of Ch$46.00 per U.S. dollar.
2/ Defined as the sum of the Central Bank of Chile's liabilities to the private sector and medium- and long-term foreign liabilities minus its net international reserves.
3/ These limits are applied throughout the period.
4/ Equivalent to US$4,538.3 million, of which US$830.1 million corresponds to short-term debt and US$174.8 million to outstanding "bridge loans" as of the end of 1981.
5/ Both the net domestic assets limit and the outstanding indebtedness of the nonfinancial public sector limit will be adjusted to reflect--up to maximum amounts--the difference between actual and projected copper prices (ssee Attachment II, tables 1 and 3).
6/ Defined to include the contracting or guaranteeing, from May 21, 1982, of external debt by the nonfinancial public sector.

The second performance criterion is a set of ceilings on the nonfinancial public sector's contracting of foreign indebtedness with a maturity range of one to ten years. These ceilings constrain total external debt contracting of the nonfinancial public sector, including official guarantees of private sector debt, during the period May 21, 1982-August 31, 1983 and during the sub-period May 21-December 31, 1982.

A third performance criterion is the ceiling on the net domestic assets of the Central Bank of Chile, which are to be measured continuously throughout the period July 1, 1982-September 30, 1983. For purposes of this ceiling the net domestic assets of the Central Bank of Chile are defined as the sum of its liabilities to the private sector and its medium- and long-term foreign liabilities minus its net international reserves.

As noted above, both the ceiling on the net indebtedness of the nonfinancial public sector and the ceiling on the net domestic assets of the Central Bank would be adjusted--subject to a maximum--by an amount which varies with one half of the difference between actual and projected copper prices.

In addition to these quantitative performance criteria the program also contains as performance clauses (1) the customary injunction on the introduction of restrictions on payments and transfers for current international transactions, multiple currency practices, bilateral payments agreements inconsistent with Article VIII, and import restrictions for balance of payments reasons and (2) a review to reach understandings on the policies and performance criteria relating to the second year of the stand-by arrangement.

IV. Staff Appraisal

After four years of strong economic growth, the Chilean economy began to slow down in mid-1981 and by the end of the year was in a deep recession. The downturn in activity reflected both the recessionary conditions prevailing in the industrialized world, which led to a sharp fall in demand for Chile's main export commodities, and the decline in Chile's international competitiveness. In addition, in late 1981 Chile experienced a decline in net private capital inflow, reflecting not only world market conditions but also a series of business bankruptcies and bank difficulties in Chile which contributed to speculation against the peso. In the setting of sharply lower exports and net capital inflow, real GDP ceased growing, unemployment began to rise, and imports began to fall.

The authorities have determined that balance of payments adjustment, accompanied by a satisfatory rate of economic growth, could not be achieved on the basis of the existing exchange rate. Consequently, they have depreciated the peso by 15 per cent and in addition have provided for some additional exchange rate flexibility over the coming year. Supporting policies in the areas of fiscal, monetary, and wage policies have been developed with a view to ensuring that the gains in terms of the economy's competitiveness will be maximized. Policies in the fiscal area center around the progressive elimination of the deficit of the nonfinancial public sector and as such, are crucial to Chile's adjustment strategy. The deficit, which loomed very large for 1982, has been brought down to a manageable size by major cuts in planned current and capital spending, the adoption of new tax measures that include surcharges on income and property taxes, new excise taxes, and sales of public sector assets. Moreover, it should be recognized that the remaining deficit is largely the product of the social security reform and certain nonrecurrent outlays. The authorities' policies point to a reduced public sector deficit in 1983; however, if the price of copper does not recover as expected, the deficit could be somewhat larger and this has been allowed for in the program. The staff welcomes the authorities' commitment to reduce sharply the fiscal deficit in 1983, as a step towards a strengthening of national savings.

A principal source of international reserve loss in Chile in the second half of 1981 and the first half of 1982 was the extension of Central Bank credit to domestic financial intermediaries experiencing difficulties. In this regard, a system of strong prudential control over operations of financial intermediaries is very important. The recent action to allow the banks to, in effect, write off their "bad loans" over a ten-year period should reduce the likelihood of further Central Bank direct support. The staff recognizes the need for such action, but it would stress the importance of ensuring that the portfolio purchase offer is not only temporary but also strictly circumscribed. Given the difficulties experienced by the economy in the last 12 months and the fact that it may take time before full confidence is restored, the authorities' desire to include in their program some contingent support to financial intermediaries is reasonable. The authorities intend to offset, insofar as possible, any such support via open market operations. The staff welcomes these intentions and actions, but in view of the difficulties being experienced by the financial intermediaries, the situation will have to be monitored closely. In the present Chilean context, the staff would urge the authorities to give particular attention to the provisions for consultations under the stand-by arrangement so as to facilitate a prompt exchange of views and clear understandings on any additional measures that may be needed to ensure that the objectives of the program are achieved.

The staff supports the authorities' determination to continue to allow free interest rates to allocate credit flows and promote growth in domestic savings along with efficiency in their use.

The abandonment of wage indexation and lowering of the wage floor for collective bargaining to its July 6, 1979 level, together with the exchange rate change, should be instrumental in restoring economic growth and reducing unemployment. The staff agrees with the authorities that the opening up of the Chilean economy has been a major factor in the high economic growth of the past few years and believes that the authorities are to be commended for their determination to keep protection low.

In sum, the staff believes that Chile's financial program for the period mid-1982 to mid-1983, and the authorities' policies in general, are appropriate to achieve the objectives of balance of payments adjustment and a resumption of economic growth.

V. Proposed Decision

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

1. The Government of Chile has requested a stand-by arrangement for a period of two years from in an amount equivalent to SDR 450 million.

2. The Fund approves the stand-by arrangement attached to EBS/82/134.

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

Fund Relations with Chile

Date of membership:	December 31, 1945.		
Quota:	SDR 325.5 million.		
Fund holding of Chilean pesos:	As of June 30, 1982	Millions of SDRs	Per Cent of Quota
	Total holdings	276.3	84.8
	(Of which corresponding to oil facility)	(21.3)	(6.5)
SDR position:	As of June 30, 1982	Millions of SDRs	Per Cent of Net Cumulative Allocation
	Net cumulative allocation	121.9	100.0
	Holdings	(33.9)	(27.8)

Exchange rate: Chile's exchange rate is determined daily on the basis of a basket consisting of the U.S. dollar, the deutsche mark, the Japanese yen, the pound sterling, and the French franc. On July 13, 1982 the rate was Ch$46.68 per U.S. dollar.

Gold distribution (four distributions): 135,220.043 fine ounces.

Direct distribution of profits from gold sales: US$25.11 million.

Last consultation: The 1980 Article IV consultation was completed in October 1980 (EBM/80/160).

CHILE--Basic Data

Area and population	
Area	756,626 sq. kilometers
Population (1981)	11.4 million
Annual rate of population increase (1977-81)	1.7 per cent
Unemployment rate (May 1982--Greater Santiago)	17.3 per cent
GDP (1981)	SDR 27,871 million
GDP per capita (1981)	SDR 2,452
Origin of GDP (1981)	(per cent)
Agriculture, forestry, and fishing	8
Mining and quarrying	7
Manufacturing	21
Construction	6
Commerce	18
Other	40
Ratios to GDP (1981)	
Exports of goods and services	18.6
Imports of goods and services	33.5
Central government revenues	24.3
Central government expenditures	22.0
External public debt (end of year)	13.7
Saving	7.4
Investment	22.0
Money and quasi-money (end of year)	26.3

Annual changes in selected economic indicators	1978	1979	1980	1981
		(per cent)		
Real GDP per capita	6.6	6.7	5.7	3.5
Real GDP	8.2	8.3	7.5	5.3
GDP at current prices	69.4	58.4	38.7	19.7
Domestic expenditures (at current prices)	73.4	56.1	40.5	27.0
Investment	109.2	58.2	61.4	27.4
Consumption	67.5	55.7	36.1	26.9
GDP deflator	56.5	46.3	29.0	13.7
Wholesale prices (annual averages)	42.9	49.4	39.6	9.1
Cost of living (annual averages)	40.1	33.4	35.1	19.7
Central government revenues	61.1	64.0	34.5	24.9
Central government expenditures	49.3	49.4	32.0	36.1
Money and quasi-money	77.0	63.1	53.3	41.0
Money	67.0	58.2	56.4	-3.1
Quasi-money	82.5	65.2	51.9	62.9
Net domestic bank assets 1/	68.3	81.6	91.0	81.9
Credit to public sector (net)	-16.8	-18.1	-29.5	-13.6
Credit to private sector	94.5	88.1	111.0	92.5
Merchandise exports (f.o.b., in U.S. dollars)	11.9	55.9	22.7	-15.8
Merchandise imports (f.o.b., in U.S. dollars)	34.1	45.2	30.5	19.9

Central government finances	1978	1979	1980	Prel. 1981
	(millions of Chilean pesos)			
Revenues	113,200	185,696	249,824	311,944
Expenditures	105,089	157,006	207,208	281,930
Current account surplus or deficit (-)	16,041	42,206	58,106	46,189
Overall surplus or deficit (-)	8,111	28,690	42,616	30,014
External financing (net)	-2,565	-7,163	-6,467	-5,138
Internal financing (net)	-5,546	-21,527	-34,149	-24,876
Balance of payments	(millions of U.S. dollars)			
Merchandise exports (f.o.b.)	2,460	3,835	4,705	3,960
Merchandise imports (f.o.b.)	-2,886	-4,190	-5,469	-6,558
Investment income (net)	-488	-675	-930	-1,428
Other services and transfers (net)	-174	-159	-277	-788
Balance on current and transfers accounts	-1,088	-1,189	-1,971	-4,814
Official capital (net)	655	449	85	294
Private capital (net)	1,291	1,802	3,080	4,497
Errors and omissions	-145	-4	50	93
Allocation of SDRs	--	29	30	28
Change in official net reserves (increase -)	-713	-1,087	-1,274	-98

International reserve position 2/	Dec. 31 1980	Dec. 31 1981	Mar. 31 1982
Central Bank (gross)	3,220.1	3,189.5	3,047.9
Central Bank (net)	3,182.2	3,189.5	3,047.9
Rest of banking system (net)	-900.2	-1,151.9	-1,254.8

1/ In relation to the stock of money and quasi-money at the beginning of the period. Excludes contra-entry of SDR allocations.

2/ Gold valued at US$42.22 per ounce.

Chile: Summary of the Financial Program for the First Year of the Arrangement 1/

I. Major Assumptions

1. Real GDP is projected to decline by 6.5 per cent in 1982, reflecting a decline in manufactured output, commerce, and construction. An increase of output in these sectors is expected to lead to a 3.7 per cent recovery of real GDP in 1983. A similar rate of growth is estimated for the first program year, mid-1982 to mid-1983, with respect to the preceding 12-month period.

2. The terms of trade are projected to deteriorate by some 7 per cent in 1982. They are projected to recover by a similar magnitude in 1983.

3. The ratio of the domestic banking system's liabilities to the private sector to GDP, estimated at 34 per cent at the end of June 1982, is projected to remain unchanged from June 1982 to June 1983. The ratio of money to GDP is also projected to remain unchanged over this same period, at approximately 5.5 per cent.

II. Targets

1. Domestic inflation of 11.2 per cent and 7.4 per cent is projected for 1982 and 1983, respectively.

2. Overall balance of payments equilibrium is projected over the period July 1982-June 1983, compared with an overall deficit of US$261 million in 1982. The current account deficit, which exceeded 14 per cent of GDP in 1981, is projected to decline to 9 per cent of GDP in 1982 and to about 8.5 per cent of GDP in the program year. The overall balance of payments is measured in terms of changes in the net international reserves of the Central Bank, adjusted for valuation changes.

III. Principal Elements of the Program

1. Fiscal policy

a. The overall deficit of the nonfinancial public sector is to be limited to the equivalent of 3.7 per cent of GDP in 1982 and to be reduced to 1 per cent in 1983. Over the period July 1982-June 1983 it is to amount to the equivalent of 3.4 per cent of GDP. (These magnitudes are gross of transfers of social security funds from the public to the private system.)

1/ Actual and projected data on the macroeconomic flows and selected economic and financial indicators for the period 1980-83 are shown in Tables 8 and 9.

At the start of 1982, the authorities took measures aimed at substantially reducing the potential fiscal deficit; these included:

(a) Revenue measures for the equivalent of 1.6 per cent of GDP, comprising (i) increases in income tax rates, (ii) surcharges on license plate fees and on the tax on nonagricultural real estate, (iii) a tax on gambling, and (iv) sales of assets by decentralized agencies and state enterprises.

(b) Expenditure measures for the equivalent of 1.0 per cent of GDP including (i) a 15 per cent reduction in transfers from the Treasury to the rest of the general government, (ii) the lowering of retirement and severance benefit payments to teachers through postponing their transfer to the municipal school system, and (iii) the reduction of subsidies and tax rebates.

The expected improvement in the operations of the nonfinancial public sector for 1983, amounting to the equivalent of 2.7 per cent of GDP, reflects the following:

	Effect as Per Cent of GDP
(a) Higher copper revenue	1.2
(b) Lower capital revenue	-0.7
(c) Lower current revenue	-3.6
(d) Reduction in current expenditure of general government	3.9
(e) Reduction in current expenditure of the rest of the public sector	1.2
(f) Reduction in capital expenditure	0.8

The reduction in current revenue is due to the expiration of the temporary revenue measures introduced in 1982, the lagged effect of the decline in economic activity in 1982 on income tax collections in 1983, and a decline in nontax revenues.

b. Quarterly limits have been established on the stock of debt of the nonfinancial public sector over the first year of the program. These limits are performance criteria.

2. Monetary policy

a. During the 12 months ended June 30, 1983, the maximum permissible expansion of net domestic credit of the Central Bank would be the equivalent of 27 per cent of the stock of its liabilities to the private sector at the beginning of the period. Quarterly limits on the level of net domestic credit of the Central Bank have been established as performance criteria for the period through September 30, 1983.

b. Interest rate determination is to remain free from controls.

c. Supervision of operations of financial intermediaries will continue to be strengthened. Any necessary financial assistance to banks by the monetary authority is projected to be partially financed by placement of Central Bank notes within the domestic financial system.

3. Wage policy

a. A guaranteed real wage floor equivalent to the level prevailing on July 6, 1979 has been established for collective bargaining negotiations. All other indexation and wage floor arrangements for the public and private sectors have been abolished.

b. No public sector wage increase is projected during the first year of the program year.

4. External sector policies

a. Over the first year of the program, the exchange rate for the Chilean peso in terms of the U.S. dollar will be determined daily on the basis of a basket of the following currencies: the U.S. dollar (60 per cent), the deutsche mark (15 per cent), the Japanese yen (15 per cent), the pound sterling (5 per cent), and the French franc (5 per cent). The authorities have announced their intention to depreciate the Chilean peso against this basket on a daily basis at a rate of 0.8 per cent per month during the 12 months ending June 15, 1983.

b. Foreign borrowing commitments with maturities of one to ten years by the nonfinancial public sector are to be limited to US$1.4 billion over the period May 21-December 31, 1982, and to US$2.4 billion over the period May 21, 1982-August 31, 1983. These limits are performance criteria.

c. Import duties are expected to remain at the present 10 per cent level.

d. As a performance criterion, the authorities will not introduce restrictions on payments and transfers for current international transactions, will not introduce multiple currency practices, will not conclude bilateral payments agreements which are inconsistent with Article VIII of the Articles of Agreement, and will not impose import restrictions for balance of payments reasons.

Table 8. Chile: Macroeconomic Flows

(As per cent of GDP)

	1980	1981	1982	1983
I. Balance of Payments				
Current account surplus or deficit (-)	-7.2	-14.6	-9.1	-8.5
Trade balance	-2.7	-7.9	-0.2	0.7
Factor payments	-3.4	-4.3	-7.3	-7.5
Other services and transfers	-1.1	-2.4	-1.6	-1.7
Capital account	11.7	14.6	8.0	8.8
Private capital	11.8	11.8	6.2	7.9
Nonfinancial public sector	-0.1	2.8	1.8	0.9
Net official international reserves (increase -)	-4.5	--	1.1	-0.3
II. Public Sector				
Public sector savings	10.8	5.9	-1.5	1.0
General government current account 1/	1.4	0.7	-6.4	-5.3
Rest of public sector's operating surplus	9.4	5.2	4.9	6.3
Capital revenue	2.0	4.0	4.0	3.3
Capital expenditure	7.0	7.6	6.2	5.4
Overall surplus or deficit (-)	5.8	2.3	-3.7	-1.0
Net foreign financing	-0.1	2.8	1.8	0.9
Net domestic financing	-5.7	-5.1	1.9	0.1
III. Saving and Investment				
Gross domesticfinvestment	20.7	22.0	9.1	12.0
Public sector	5.1	5.3	5.0	4.5
Private sector	15.6	16.7	4.1	7.5
Investment = savings	20.7	22.0	9.1	12.0
External savings	7.2	14.6	9.1	8.5
Gross national savings	13.5	7.4	--	3.5
Public sector	(10.8)	(5.9)	(-1.5)	(1.0)
Private sector	(2.7)	(1.5)	(1.5)	(2.5)
Memorandum item				
Annual growth rate of real GDP	7.5	5.3	-6.5	3.7

1/ Net of transfers and taxes from the rest of the public sector.

Table 9. Chile: Selected Economic and Financial Indicators, 1980-82

	Actual 1980	Est. 1981	Program 1982	1983
(Annual per cent changes, unless otherwise specified)				
National income and prices				
GDP at constant prices	7.5	5.3	-6.5	3.7
GDP deflator	29.0	13.6	7.0	11.5
Consumer prices (average)	31.2	9.5	11.2	7.4
External sector (on the basis of U.S. dollars)				
Exports, f.o.b.	22.7	-15.8	-4.0	21.5
Imports, c.i.f.	30.5	19.9	-41.0	13.9
Non-oil imports, c.i.f.	39.2	25.8	...	...
Export volume	8.6	-4.3	1.0	8.0
Import volume	10.9	18.1	-42.0	8.5
Terms of trade (deterioration -)	-4.0	-13.5	-7.0	7.0
Nominal effective exchange rate (depreciation -)	8.7	27.7	...	...
Real effective exchange rate (depreciation -)	14.4	-1.5	...	...
General government budget				
Revenue	35.4	25.1	-5.8	5.1
Total expenditure	34.7	37.3	7.8	0.6
Money and credit				
Domestic credit 1/	74.2	64.1	24.2	25.2
Government 1/	-24.2	-10.7	5.7	0.4
Private sector 1/	91.1	72.7	21.5	26.1
Money and quasi-money	60.9	40.1	6.8	15.6
Velocity (GDP relative to M)	4.1	3.5	3.2	3.2
Interest rate 2/	37.4	40.9	...	...
(In per cent of GDP)				
Overall public sector surplus or deficit (-)	5.8	2.3	-3.7	-1.0
Domestic financing	-5.1	-4.8	1.9	0.1
Foreign financing	-0.1	2.8	1.8	0.9
General government savings 3/	1.4	0.7	-6.4	-5.3
General government budget surplus or deficit (-)3/	-2.0	-2.6	-7.5	-5.8
Gross domestic investment	20.7	22.0	9.1	12.0
Gross domestic savings	13.5	7.4	--	3.5
Current account deficit	7.2	14.6	9.1	8.5
External debt 4/	17.6	13.8	22.1	22.6
Debt service ratio (in per cent of exports of goods and non-factor services)4/	20.0	18.3	20.0	19.6
Interest payments (in per cent of exports of goods and non factor services)4/	8.1	9.0	9.3	7.6
(In millions of SDRs, unless otherwise specified)				
Overall balance of payments	970	83	-230	91
Gross official reserves (months of imports)	6.4	5.3	7.9	7.2
Gross official reserves (months of current payments)	4.7	3.5	4.0	3.8

1/ In per cent of liabilities to the private sector at the beginning of the period.
2/ Annual average on 30-day time deposit.
3/ Net of taxes and transfers from the rest of the public sector.
4/ Inclusive of use of Fund credit.

Chile--Stand-By Arrangement

Attached hereto is a letter, with annexed memorandum, dated -----, 1982 from the Minister of Finance and the President of the Central Bank of Chile requesting a stand-by arrangement and setting forth:

(a) the objectives and policies that the authorities of Chile intend to pursue for the period of this stand-by arrangement;

(b) the policies and measures that the authorities of Chile intend to pursue for the first year of this stand-by arrangement; and

(c) understandings of Chile with the Fund regarding reviews that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of Chile will pursue for the remaining period of this stand-by arrangement.

To support these objectives and policies the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For a period of two years from , 1982, Chile will have the right to make purchases from the Fund in an amount equivalent to SDR 450 million, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund.

2. (a) Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 122 million until November 15, 1982, the equivalent of SDR 163 million until February 15, 1983, the equivalent of SDR 204 million until May 15, 1983, the equivalent of SDR 245 million until August 15, 1983, the equivalent of SDR 286 million until November 15, 1983, the equivalent of SDR 327 million until February 15, 1984, the equivalent of SDR 368 million until May 15, 1984, and the equivalent of SDR 409 million until August 1, 1984.

(b) None of the limits in (a) above shall apply to a purchase under this stand-by arrangement that would not increase the Fund's holdings of Chile's currency in the credit tranches beyond 25 per cent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 per cent of quota.

3. Purchases under this stand-by arrangment shall be made from ordinary and borrowed resources in the ratio of 2 to 1 until purchases under the arrangement reach the equivalent of SDR 122,062,500, and then from ordinary and borrowed resources in the ratio of 1 to 1.2, provided that any modification by the Fund of the proportions of ordinary and borrowed resources shall apply to amounts that may be purchased after the date of modification.

4. Chile will not make purchases under this stand-by arrangement that would increase the Fund's holdings of Chile's currency in the credit tranches beyond 25 per cent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 per cent of quota:

(a) During any period before July 1, 1983 in which

(i) the data at the end of the preceding period indicate that the limit on the total indebtedness of the non-financial public sector described in Table 1 of the memorandum annexed to the attached letter is not observed, or

(ii) the limit on the contracting and guaranteeing of external debt by the public sector described in Table 2 of the memorandum annexed to the attached letter is not observed, or

(iii) the limit on the net domestic assets of the Central Bank of Chile described in Table 3 of the memorandum annexed to the attached letter is not observed, or

(b) After June 30, 1983, if suitable performance clauses for the second year of the arrangement have not been established in consultation with the Fund as contemplated by paragraph 6 of the attached letter, or if such performance clauses, having been established, are not observed, or

(c) during the entire period of this stand-by arrangement if Chile

(i) imposes restrictions on payments and transfers for current international transactions, or

(ii) introduces multiple currency practices, or

(iii) concludes bilateral payments agreements which are inconsistent with Article VIII, or

(iv) imposes import restrictions for balance of payments reasons.

When Chile is prevented from purchasing under this arrangement because of this paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and Chile and understandings have been reached regarding the circumstances in which such purchases can be resumed.

5. Chile's right to engage in the transactions covered by this stand-by arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Chile. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 5, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Chile and understandings have been reached regarding the circumstances in which such purchases can be resumed.

6. Purchases under this arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in SDRs if, on the request of Chile, the Fund agrees to provide them at the time of purchase.

7. The value date of a purchase under this stand-by arrangement involving borrowed resources will be normally either the 15th day or the last day of the month, or the next business day if the selected day is not a business day. Chile will consult the Fund on the timing of purchases involving borrowed resources.

8. Chile shall pay a charge for this arrangement in accordance with the decisions of the Fund.

9. (a) Chile shall repurchase the outstanding amount of its currency that results from a purchase under this stand-by arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchase as Chile's balance of payments and reserve position improves.

(b) Any reduction in Chile's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

(c) The value date of a repurchase in respect of a purchase financed with borrowed resources under this stand-by arrangement will normally be either the 6th day or the 22nd day of the month or the next business day if the selected day is not a business day, provided that repurchase will be completed not later than seven years from the date of purchase.

10. During the period of the arrangement Chile shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Chile or of representatives of Chile to the Fund. Chile shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Chile in achieving the objectives and policies set forth in the attached letter and annexed memorandum.

11. In accordance with paragraph 6 of the attached letter, Chile will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria in paragraph 4 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Chile has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Chile's balance of payments policies.

Santiago, Chile
July , 1982

Mr. J. de Larosière
Managing Director
International Monetary Fund
700 19th Street, N.W.
Washington, D.C. 20431
U.S.A.

Dear Mr. de Larosière:

1. For many decades the Chilean economy expanded at a slow rate and only sporadically attained its potential growth. A principal cause of this unsatisfactory growth performance was a high degree of government intervention in the economy, which resulted in a suboptimal allocation of resources and contributed periodically to financial instability. The traditional syndrome of slow growth and financial instability reached a critical point in 1973, a year in which Chile experienced an annual inflation rate that was variously estimated at 500, 1,000, and 2,000 per cent. During that year, severe commodity shortages appeared and the entire production process came into crisis. As a consequence, output declined sharply and the economy suffered a severe balance of payments crisis.

2. The 1973 crisis led to a turning point in Chile's economic policy. The Government not only moved to re-establish stability but also began to implement policies aimed at giving a freer rein to private initiative in economic decision making. These policies, which were supported by use of Fund resources under two successive stand-by arrangements and access to the oil facility, were not long in yielding positive results. Balance of payments equilibrium was restored by 1976, notwithstanding the 1974 oil crisis, and the sharp fall in world copper prices which followed. Thereafter, Chile entered a period of rapid economic growth and a strong balance of payments performance which made unnecessary any further recourse to Fund resources.

3. By 1979, in view of the satisfactory rate of economic growth and the achievement of a sound balance of payments, the reduction of inflation became the paramount objective of economic policy. The reduction of inflation to international levels was sought through a sound fiscal policy and a move to a fixed exchange rate. Domestic prices took time to respond, but from late 1980 on inflation declined rapidly, a development to which the appreciation of the U.S. dollar contributed. However, indexation prevented wages from reflecting the rapid decline in inflation, and the sharp rise in real wages distorted the cost-price relationship and weakened Chile's international competitiveness.

4. These difficulties were compounded by the impact of the world economic slowdown on the Chilean economy. Business bankruptcies caused by high labor costs and economic stagnation endangered a number of domestic financial institutions, which required Central Bank credit. Such Central Bank support was confined to only the most critical cases and, hence, the official international reserve loss which it involved was kept to a manageable scale. Late in the year, import demand adjusted sharply downward and there was evidence that production costs were beginning to fall. But there also were indications that the process of domestic cost adjustment would be protracted and, therefore, that domestic demand and incomes policies would need to be accompanied by a modification of the exchange rate. Accordingly, in mid-June 1982 the peso was depreciated from Ch$39 to Ch$46 per U.S. dollar and an exchange rate schedule covering the following 12 months was announced.

5. The change in exchange rate policy is consistent with the strategy of the Chilean Government of promoting adjustment and economic recovery by relying on market forces and price incentives to guide resource allocation in the economy. In support of this strategy and these policies, which are described in the attached Memorandum on the Economic Policies of Chile, the Government of Chile wishes to request a two-year stand-by arrangement from the International Monetary Fund in the amount of SDR 450 million.

6. During the period of the stand-by arrangement, the authorities of Chile will consult periodically with the Fund in accordance with its policies on such consultations about the progress being made in the implementation of the program described in the attached memorandum and about any policy adaptations judged to be appropriate for the achievement of its objectives. Also, on or before June 30, 1983, the authorities of Chile will consult with the Fund in order to reach understandings on the policies and performance criteria relating to the remaining period of the stand-by arrangement.

Yours truly,

Miguel Kast Rist
President
Central Bank of Chile

Sergio de la Cuadra Fabres
Minister of Finance

Attachment: Memorandum on the Economic Policies of Chile

Memorandum on the Economic Policies of Chile

1. In 1973 Chile experienced an economic crisis of a magnitude unprecedented in its history, a crisis characterized by hyper-inflation, an extremely weak balance of payments, and a severe drop in output. With the policies of stabilization and structural change adopted by the Government which took office late that year, the country entered a period of rapid economic growth, balance of payments surplus, and declining inflation.

2. As growth accelerated and the balance of payments performance strengthened, the reduction of the domestic inflation rate became the paramount objective of economic policy. A substantial reduction in inflation was achieved principally through a sound fiscal policy. In mid-1979 it became possible to establish a fixed relationship between the Chilean peso and the U.S. dollar. For some time subsequent to this, domestic inflation continued above international levels, but in late 1980 it began to decline markedly, a development to which the appreciation of the U.S. dollar contributed. However, with the decline in inflation, wage indexation resulted in a sharp increase in real wages. This gave rise to concern about employment and Chile's international competitiveness.

3. The international economic slowdown compounded the difficulties facing the Chilean economy. The contraction in foreign demand led to a sharp fall in the world price of copper, a commodity which accounts for 50 per cent of Chile's export earnings, and affected other exports as well. In addition, in late 1981 Chile experienced a sharp decline in net private capital inflow, a reflection of conditions in international financial markets as well as of a series of business bankruptcies and resulting bank difficulties in Chile. In this setting, real GDP ceased growing and import orders dropped sharply in the fourth quarter of 1981.

4. At this point, it became imperative to adjust Chile's cost-price relationship and thus to restore its international competitiveness. Initially this objective was pursued exclusively through domestic demand and incomes policies; in mid-June it was decided to supplement these policies with an exchange rate adjustment and the announcement of an exchange rate schedule covering the following twelve months.

5. The economic program for the period ahead entails continued caution in demand management. The Government already has taken strong fiscal actions, including the introduction of major income and property tax surcharges, excise tax increases, and sharp cuts in current spending, to reduce the fiscal deficit which--given the fall in copper revenue and import duty collections--loomed potentially large for 1982. The expectation is that for 1982 as a whole the overall net borrowing requirement of the nonfinancial public sector will at most be 3.7 per cent of GDP; this net borrowing requirement is projected to fall to

1 per cent of GDP in 1983. For the program period July 1, 1982-June 30, 1983 the overall public sector net borrowing requirement will be limited to 3.4 per cent of GDP. Accordingly, the stock of debt of the nonfinancial public sector to all lenders, whether domestic or foreign, will be held to the amounts shown in the annexed Table 1.

6. Over the longer run, it is the Government's intention to continue reducing the size of the public sector with a view to increasing further the scope for private initiative. In this context, to ensure that the nonfinancial public sector pursues prudent spending policies over the medium term, ceilings have been established on its contracting or guaranteeing of foreign indebtedness within a maturity range from over one to less than ten years, excluding private external debt guaranteed by CORFO. These ceilings are shown in the annexed Table 2.

7. The pursuit of a firm fiscal policy, entailing the re-establishment of fiscal equilibrium in the shortest possible time, is intended to maximize the amount of financial resources available to the private sector in an environment of financial stability. The Central Bank of Chile does not pursue an active monetary policy, and this has helped to speed balance of payments adjustment. Consistent with this policy, ceilings have been established on the net domestic assets of the Central Bank of Chile. These ceilings are shown in the annexed Table 3.

8. Free interest rates have been a fundamental factor in promoting private savings, controlling credit demand, and ensuring that credit is channeled to the most productive uses. This freedom will not be interfered with. Another important step in ensuring a stable flow of financial savings has been the creation of privately owned social security funds, which invest their resources free from government interference. The autonomy of these funds will be strictly respected. Finally, restrictions on capital flows have been sharply reduced over time in order to minimize distortions in credit allocation. Specifically, ceilings on medium-term private foreign borrowing have been raised substantially and both banks and private nonbank borrowers have been given access to the short-term capital market abroad.

9. To facilitate the process of adjustment and help safeguard the position of domestic financial institutions, in late 1981 the Government strengthened the powers of the Superintendency of Banks, instituting a strong system of prudential controls which includes a loan classification system and constraints on a financial intermediary's lending to a single enterprise and to its own subsidiaries. These controls appear to be working well, but will be kept under constant review and improved as necessary.

10. A critical element in improving the cost-price relationship and Chile's international competitiveness is the area of wage determination. The Government has announced that no further layoffs of workers will take place in the public sector this year, and it has requested that the private sector likewise refrain from layoffs. To make this policy

consistent with the aim of economic recovery, and in recognition of the fact that real wages in Chile were at an unsustainable level, all wage indexation has been abolished. Moreover, the wage floor for private sector collective bargaining contracts has been reduced to the June 1979 real level, public sector remunerations at the higher levels have been cut and no public sector wage increase is planned.

11. The Government reiterates its commitment to an open economy. The abolition of import and exchange restrictions and the reduction of import duties to a common ad valorem level of 10 per cent has been one of the most important factors in the increase in well-being of the Chilean people. This achievement will not be sacrificed to pressures of special interests. The adjustment attained thus far, and the strong and sustained growth awaiting Chile once the policies now in place yield their full effect and world economic conditions improve, will demonstrate conclusively that there is no reason or need for a return to protectionism.

Table 1. Chile: Limits on Total Indebtedness of the Nonfinancial Public Sector

(In billions of pesos at US$1 = Ch$46)

	Limits	Maximum Adjustment to Limits
September 30, 1982	225.5	3.5
December 31, 1982	231.7	6.9
March 31, 1983	235.1	10.4
June 30, 1983	250.9	13.8

NOTE: The above limits shall be adjusted, up to the maximum indicated for each date, by an amount which varies with the difference between the actual average copper price for the period June 30, 1982 and the test date in question, and the assumed average copper price for the same period as indicated in Table 4. For each U.S. dollar cent of price difference the adjustment is Ch$115 million for the period July 1-September 30, 1982; Ch$230 million for the period July 1-December 31, 1982; Ch$345 million for the period July 1, 1982-March 31, 1983; and Ch$460 million for the period July 1, 1982-June 30, 1983. The adjustment will have the effect of lowering (raising) the limit whenever the actual average price exceeds (is below) the assumed average price.

Table 2. Chile: Ceilings on the Contracting and Guaranteeing of Foreign Debt 1/ by the Nonfinancial Public Sector 2/

(In millions of U.S. dollars)

Period	Ceiling
May 21, 1982-December 31, 1982	1,400
May 21, 1982-August 31, 1983	2,400

1/ Foreign external debt with maturity above 12 months and below 120 months.

2/ Excludes foreign external debt of Banco Central, Banco del Estado, SIÑAP, and private external debt guaranteed by CORFO.

Table 3. Chile: Ceilings on the Net Domestic Assets of the Central Bank

(In billions of pesos at US$1 = Ch$46)

	Ceilings	Maximum Adjustment to Ceilings
July 1-September 30, 1982	-49.5	3.5
October 1-December 31, 1982	-44.1	6.9
January 1-March 31, 1983	-44.1	10.4
April 1-June 30, 1983	-45.8	13.8
July 1-September 30, 1983	-48.3	13.8

NOTE: The above ceilings shall be adjusted, up to the maximum indicated for each date, by an amount which varies with the difference between the actual average copper price for the period June 30, 1982 and the test date in question, and the assumed average copper price for the same period as indicated in Table 4. For each U.S. dollar cent of price difference the adjustment is Ch$115 million for the period July 1-September 30, 1982; Ch$230 million for the period July 1-December 31, 1982; Ch$345 million for the period July 1, 1982-March 31, 1983; and Ch$460 million for the period July 1, 1982-September 30, 1983. The adjustment will have the effect of lowering (raising) the limit whenever the actual average price exceeds (is below) the assumed average price.

Table 4. Chile: Assumed Copper Prices

(In U.S. dollar cents per pound)1/

	Average Price
July 1-September 30, 1982	72.0
July 1-December 31, 1982	75.0
July 1, 1982-March 31, 1983	77.5
July 1, 1982-June 30, 1983	80.0
July 1, 1982-September 30, 1983	82.4

1/ The reference price is that of the spot quotation of Copper Higher Grade on the London Metal Exchange.