

EBS/82/227

CONFIDENTIAL

December 13, 1982

To: Members of the Executive Board

From: The 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 by Chile for a stand-by arrangement. Draft decisions appear on page 23.

This subject has been tentatively scheduled for discussion on Monday, January 10, 1983.

Att: (1)

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

December 10, 1982

The 1982 Article IV consultation discussions with Chile were held in Santiago during April 13-30 and May 24-June 4, 1982, in Washington during June 29-July 2, 1982, and in Santiago during August 10-18 and September 27-October 11, 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 in late June. Subsequent changes in Chilean economic policies resulted in a reopening of the negotiations which were concluded in early October 1982. The present report supersedes and replaces the previous consultation report and request of stand-by arrangement (EBS/82/134, 7/26/82 and Correction 1 8/4/82). A statistical supplement (SM/82/160, Sup. 1, 12/13/82) to the report on recent economic developments (SM/82/160, 8/5/82) has also been circulated.

The Chilean representatives in the consultation discussions included the Minister of Finance and Economy, the Vice Ministers of Finance and Economy, the Budget Director, the President of the Central Bank of Chile and his principal advisors, as well as the Ministers of Labor, 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 first two Santiago visits were L. Koenig (Head), J. Bonvicini, D. Hoelscher, and C. Muniz (all WHD), A. Pera (ETR), F. van Beek (WHD), and E. Froila and A. Snell (Secretaries-WHD). The staff representatives for either or both of the last two Santiago visits were J. van Houten (Head), P. Brenner, C. Muniz (all WHD), A. Pera, L. Perez (both ETR), S. Palazzo (Secretary ETR) and T. Puri (Secretary-WHD).

The stand-by arrangement which the authorities are requesting amounts to SDR 500 million, equivalent to 153.6 per cent of Chile's quota of SDR 325.5 million. The arrangement, which would cover a two-year period, would consist of SDR 253.2 million of ordinary resources

and SDR 246.8 million of borrowed resources. The Chilean authorities are also requesting a purchase under the compensatory financing facility in an amount of SDR 295 million, equivalent to 90.6 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 May 15, 1983, SDR 176 million until August 15, 1983, SDR 230 million until November 15, 1983, SDR 284 million until February 15, 1984, SDR 338 million until May 15, 1984, SDR 392 million until August 15, 1984, and SDR 446 million until November 15, 1984.

As of November 30, 1982 the Fund's holdings of Chilean pesos amounted to 80.07 per cent of Chile's quota, of which 1.74 per cent corresponded to purchase under the oil facility. 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 90.6 per cent of quota under the compensatory financing facility, would raise the Fund's holdings of pesos to 344.2 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.

I. Background

1. Introduction

In 1973 Chile experienced a severe financial crisis, characterized by a large drop in output, hyper-inflation, and the exhaustion of the official net international reserves. A far-reaching stabilization effort was initiated at that time. The policies adopted included a major improvement in demand management, large corrective price increases, the pursuit of a flexible exchange rate policy, and 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 have provided the framework for Chile's economic policies.

A strong economic performance followed Chile's stabilization effort; 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,

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

	Outstand- ing Dec. 31, 1982	Operations During First Year of Program				Total Operations in First Program Year	Operations in Second Year of Program
		Jan.-Mar. 1983	Apr.-June 1983	July-Sept. 1983	Oct.-Dec. 1983		
(In millions of SDRs)							
<u>Purchases</u>		417.0	54.0	54.0	54.0	579.0	216.0
Under tranche policies		122.0	54.0	54.0	54.0	284.0	216.0
Ordinary		(81.4)	(24.5)	(24.5)	(24.5)	(154.9)	(98.0)
Enlarged access		(40.7)	(29.5)	(29.5)	(29.5)	(129.1)	(118.0)
Compensatory purchases		295.0	--	--	--	295.0	--
Oil facility		--	--	--	--	--	--
<u>Repurchases</u>		2.8	2.8	--	--	5.6	--
Under tranche policies		--	--	--	--	--	--
Ordinary		(--)	(--)	(--)	(--)	(--)	(--)
Enlarged access		(--)	(--)	(--)	(--)	(--)	(--)
Compensatory financing		--	--	--	--	--	--
Oil facility		2.8	2.8	--	--	--	--
<u>Net purchases</u>		<u>414.2</u>	<u>51.2</u>	<u>54.0</u>	<u>54.0</u>	<u>573.4</u>	<u>216.0</u>
<u>Memoranda items</u>							
Total holdings (end of period)	331.2 <u>1/</u>	745.3	796.5	850.5	904.5	904.5	1,120.5
Excluding compensatory and oil facilities	325.5	447.5	501.5	555.5	609.5	609.5	825.5
(In per cent of quota)							
Total holdings (end of period)	101.7 <u>1/</u>	229.0	244.7	261.3	277.9	277.9	344.2
Excluding compensatory and oil facilities	100.0	137.5	154.1	170.1	187.3	187.3	253.6

Source: International Monetary Fund.

1/ Assumes a reserve tranche purchase of SDR 70.5 million before December 31, 1982.

gross national 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 current account deficit was the progressive appreciation of the Chilean peso which on an effective exchange rate basis, using consumer prices, amounted to 48 per cent between June 1979, when the peso was fixed, and May 1982 (Chart 1), the month prior to the depreciation of the peso.

2. Recent economic developments

The Chilean economy experienced a slowdown in 1981. Real GDP growth for the year as a whole is estimated at about 5-1/4 per cent (Table 2), but in the fourth quarter the rate of increase is believed to have slowed to zero. Output declined sharply in the first half of 1982 (with construction, manufacturing, commerce and services, most seriously affected) and the drop in real GDP for 1982 as a whole is projected at about 12-3/4 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 of that year and to almost 24 per cent in the three months ended September 1982.

Table 2. Chile: Economic Indicators

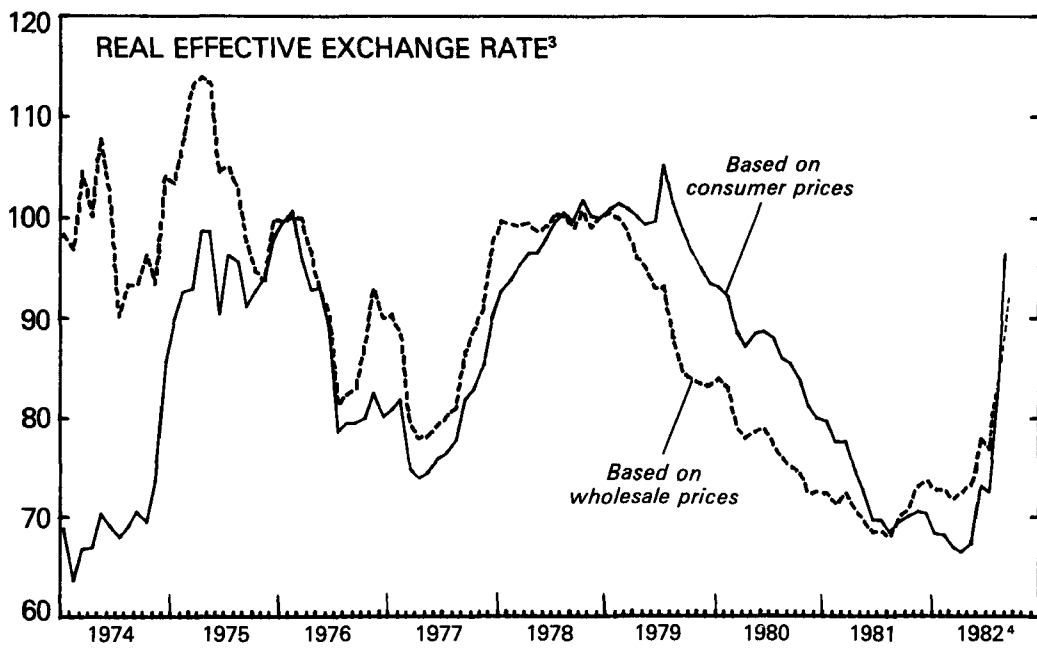
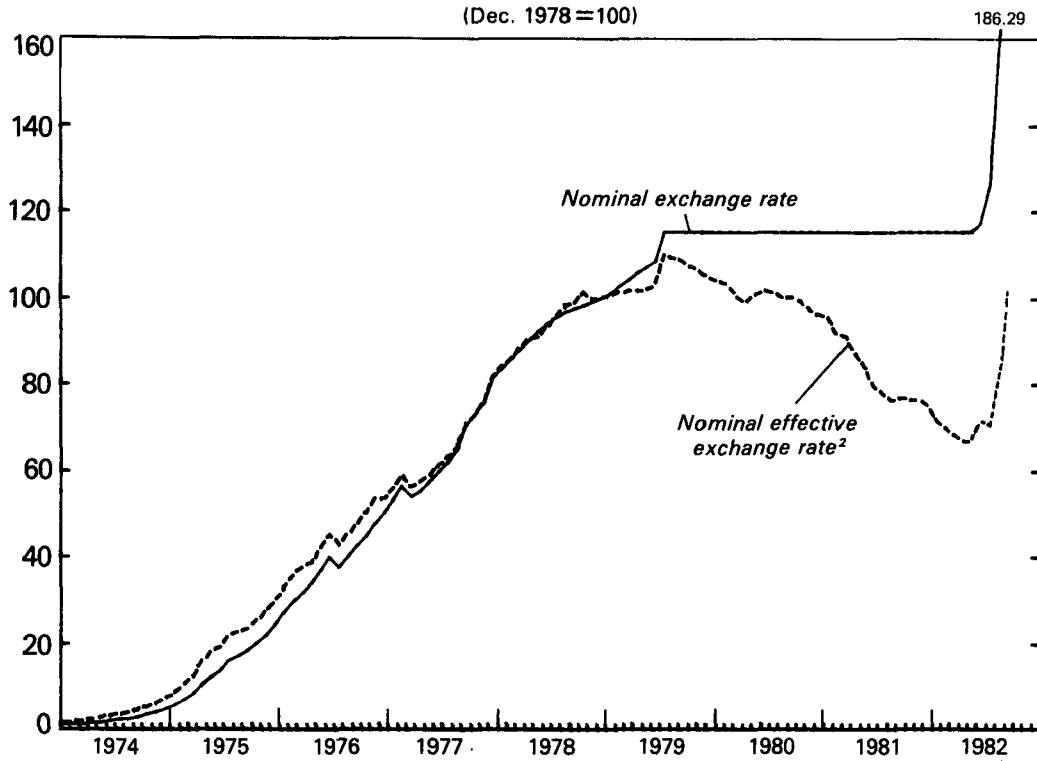
(In per cent)

	1978	1979	1980	1981	Projected	
					1982	1983
Change in GDP at constant prices	8.2	8.3	7.5	5.3	-12.8	4.0
Change in industrial production	10.2	8.2	4.0	0.1	-20.0	7.0
Change in consumer price index during period	30.3	38.9	31.2	9.5	19.6	25.0

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 of 1981 net official international reserves declined by US\$205 million and in the first half of 1982 there was a further decline of US\$316 million. The rate of inflation 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 about 1 per cent, and in the first six months of 1982 inflation was virtually zero. However, the decline in inflation was not

CHART 1
CHILE
EXCHANGE RATE INDICES



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

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

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

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

⁴Partly estimated.

accompanied by a corresponding deceleration in nominal wage increases, because the indexation of wages was automatically linked to past rates of inflation.

A number of factors contributed to the slowdown in GDP growth and the accompanying disappearance of the balance of payments surplus. Copper export earnings were reduced sharply 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. Fueled by large private capital inflows, domestic demand continued to be strong in the first half of 1981. However, in the latter half of 1981, the fall in exports was accompanied by a slowdown in domestic demand and a pronounced decline in net private capital inflow, a decline that 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. The deceleration in demand and lower capital inflow resulted in a contraction in the value of imports in the fourth quarter of 1981, followed by a precipitous drop in the period January-June 1982. As a result, the trade account is projected to be in surplus in 1982, compared with a US\$2.6 billion trade deficit in all of 1981.

The authorities had initially intended to restore Chile's international competitiveness through demand restraint and a reduction in nominal wages. However, as this strategy was taking an excessively large toll in terms of a contraction in GDP and rising unemployment, the fixed exchange rate for the peso was abandoned on June 15, 1982 and the automatic wage indexation mechanism was eliminated. The initial depreciation of the peso on June 15 was 15 per cent. For the period thereafter, the value of the peso was linked to a basket of currencies and an exchange rate schedule covering the following 12 months was established. However, uncertainty about economic conditions and an expansionary monetary policy contributed to continued heavy net official reserve losses, and led to the floating of the peso on August 5, accompanied by Central Bank intervention to dampen excessive exchange rate movements.

In the following weeks the peso depreciated sharply, and on September 3, 1982, the Central Bank announced that it would sell foreign exchange at a preferential exchange rate for foreign debt service payments. The preferential rate, which only applies to servicing of debt by the private sector contracted before August 6, 1982, was initially fixed at Ch\$49.6 per U.S. dollar and is adjusted daily on the basis of the rate of change in the consumer price index of the previous month. The floating exchange rate was abandoned altogether on September 29, when a rate of exchange of Ch\$66 per U.S. dollar was established.^{1/} It was announced that the exchange rate would be adjusted daily, with the

^{1/} The previously described preferential exchange rate for servicing foreign debt was maintained.

Table 3. Chile: Summary Balance of Payments
(In millions of U.S. dollars)

	1978	1979	1980	1981	Projected	
					1982	1983
Current account	-1,088	-1,189	-1,971	-4,652	-2,486	-1,602
Trade balance	-426	-355	-764	-2,598	150	1,000
Exports, f.o.b.	(2,460)	(3,835)	(4,705)	(3,960)	(3,800)	(4,450)
Of which: copper	/1,219/	/1,888/	/2,125/	/1,756/	/1,743/	/1,950/
Imports, f.o.b.	(-2,886)	(-4,190)	(-5,469)	(-6,558)	(-3,650)	(-3,450)
Services and transfers (net)	-662	-834	-1,207	-2,054	-2,636	-2,602
Capital account	1,946	2,251	3,165	4,669	1,386	1,117
Private investment	177	233	170	376	480	450
Other private sector (net)	1,211	1,676	2,910	4,021	-145	204
Official sector (net)	558	342	85	272	1,051	463
Errors and omissions	-145	-4	50	50	--	--
SDR allocation	--	29	30	28	--	--
Overall balance	713	1,087	1,274	95	1,100	-485
Valuation adjustment	--	--	-30	-90	--	--
Change in net official international reserves (increase -)	-713	-1,087	-1,244	-5	1,100	-485

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

rate of depreciation based on the difference between the previous month's rate of change of the consumer price index in Chile and the external rate of inflation, estimated at 1 per cent per month for an initial period of four months.^{1/} The Central Bank would intervene in the exchange market with the objective of maintaining the market rate of exchange within a band of 2 per cent either way of the daily reference exchange rate.

In the three month period ended September 30, 1982, the net international reserves declined by US\$750 million and the total net reserve loss over the January-September 1982 period was US\$1,068 million. Following the depreciation of the peso, the rate of price increase rose sharply from approximately zero in the first semester to an estimated 20 per cent in the latter half of the year.

The operations of the public sector still registered a surplus of more than 1 per cent of GDP in 1981 despite the decline in earnings of the large state-owned copper companies and the substantial costs associated with the partial privatization of the social security system ^{2/} (Table 4). The finances of the public sector moved into deficit in the first semester of 1982 as a wage increase for government employees, increased expenditures related to the social security and educational reforms ^{3/} being carried out by the Government coincided with a sharp fall in revenue from import duties and income taxes.

In March 1982 a number of fiscal measures were taken to limit the size of the emerging deficit. A gambling tax was created, income tax exemptions for companies constructing low income housing were eliminated, temporary surcharges were imposed on personal income and real estate, and the automobile road tax was raised by 60 per cent for one year. Finally, budgeted general government expenditures were cut by 4 per cent and sales of public sector property were accelerated. In June, the salaries of higher paid employees of the public sector were cut by 10 per cent and the automatic adjustment of general government wages and salaries was eliminated; taxes on tobacco products were raised; the programmed decline in duties on high priced automobiles was halted; and incentives to settle overdue tax liabilities were introduced.

^{1/} Extended to six months on October 18, 1982.

^{2/} The reform of the social security system is described in Appendix I of the Recent Economic Developments paper.

^{3/} Including a large nonrecurrent expenditure related to severance pay to school teachers transferred to the local school systems.

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

(In per cent)

	1978	1979	1980	1981	Projected	
					1982	1983
Current account surplus or deficit (-)	8.7	9.0	10.6	5.5	-0.2	2.2
Capital revenues	2.1	2.4	2.0	3.6	2.6	2.1
Capital expenditure	8.7	6.7	7.0	7.9	6.4	6.0
Overall surplus or deficit (-)	2.1	4.7	5.6	1.2	-4.0	-1.7
Financing	-2.1	-4.7	-5.6	-1.2	4.0	1.7
Foreign (net)	1.4	0.3	-0.1	2.6	2.0	1.7
Domestic (net) ^{1/}	-3.5	-5.0	-5.5	-1.4	2.0	--

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 and to increase its net official reserves. However, Central Bank net domestic credit expanded substantially during the fourth quarter of 1981, when the Bank extended emergency credits to a number of financial institutions which suffered a loss in deposits. This credit expansion led to a net international reserve loss of US\$205 million, a loss which virtually offset the amount the Central Bank had gained over the first nine months of the year (Table 5).

In the first half of 1982 the net domestic assets of the Central Bank are estimated to have expanded by over 30 per cent in relation to the starting stock of base money, while the latter rose by a little more than 6 per cent. Consequently, net official international reserves declined by US\$316 million notwithstanding an increase of US\$132 million in the Central Bank's medium- and long-term foreign liabilities. The net credit expansion was directed mainly to financial intermediaries in difficulties; the slow growth in base money reflected seasonal factors, a drop in nominal GDP, and private capital outflows.

Table 5. Chile: Monetary Indicators

		Dec. 1980-	Sept. 1981-		Estimated		Projected		
	1980	Sept. 1981	Dec. 1981	1981	Dec. 1981-	June-Sept.	Sept.-Dec.	1982	1983
					June 1982	1982	1982	1982	(US\$1=
						(US\$1=Ch\$69)			Ch\$77)
A. <u>Central Bank</u>									
(Change in millions of U.S. dollars)									
International reserves	1,243	210	-205	5	-316	-752	-32	-1,100	-485
Medium- and long-term foreign liabilities	-148	-477	59	-418	132	-11	536 <u>1/</u>	657 <u>1/</u>	--
(Percentage change) <u>2/</u>									
Net domestic assets	-9.9	-32.7	10.4	-23.5	31.7	53.1	28.9	123.1	32.7
Base money	58.9	-11.3	1.1	-10.3	6.3	13.6	2.2	23.5	8.9
B. <u>Financial System</u>									
(Change in millions of U.S. dollars)									
International reserves	775	-167	-80	-247	-441	-673	152	-962	-485
Medium- and long-term foreign liabilities	1,288	1,474	607	2,081	358	14	549 <u>3/</u>	921 <u>3/</u>	145
(Percentage change) <u>4/</u>									
Net domestic assets	81.2	58.3	8.4	69.9	17.1 <u>5/</u>	...	12.9 <u>6/</u>	29.8	40.2
Credit to the public sector (net)	-24.4	-13.1	1.3	-11.3	4.8 <u>5/</u>	...	0.5 <u>6/</u>	5.2	--
Credit to the private sector	109.2	84.0	8.1	95.3	-4.0 <u>5/</u>	...	19.3 <u>6/</u>	14.9	56.1
Liabilities to the private sector	70.6	38.6	2.4	41.9	-2.3 <u>5/</u>	...	4.2 <u>6/</u>	1.8	30.0

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

^{1/} Of which US\$550 million represent public sector foreign currency deposits (including US\$150 million from Banco del Estado) derived from the proceeds of balance of payments support loans obtained by public sector entities.

^{2/} As per cent of base money at the beginning of the period.

^{3/} Of which US\$400 million represent public sector foreign currency deposits derived from the proceeds of balance of payment support loans obtained by public sector entities.

^{4/} As per cent of liabilities to the private sector at the beginning of the period.

^{5/} December 1981 - August 1982.

^{6/} August 1982 - December 1982.

Faced with a deepening financial crisis, the Central Bank in the June-September 1982 period expanded net credit by over 50 per cent of the starting stock of base money. The net credit expansion contributed to a further US\$750 million decline in net international reserves. In the fourth quarter of 1982, Central Bank net credit expansion is projected to slow down significantly. This deceleration, together with balance of payments support loans obtained by public entities from foreign commercial banks, is expected to virtually stop the net international reserve drain in the final quarter of 1982.

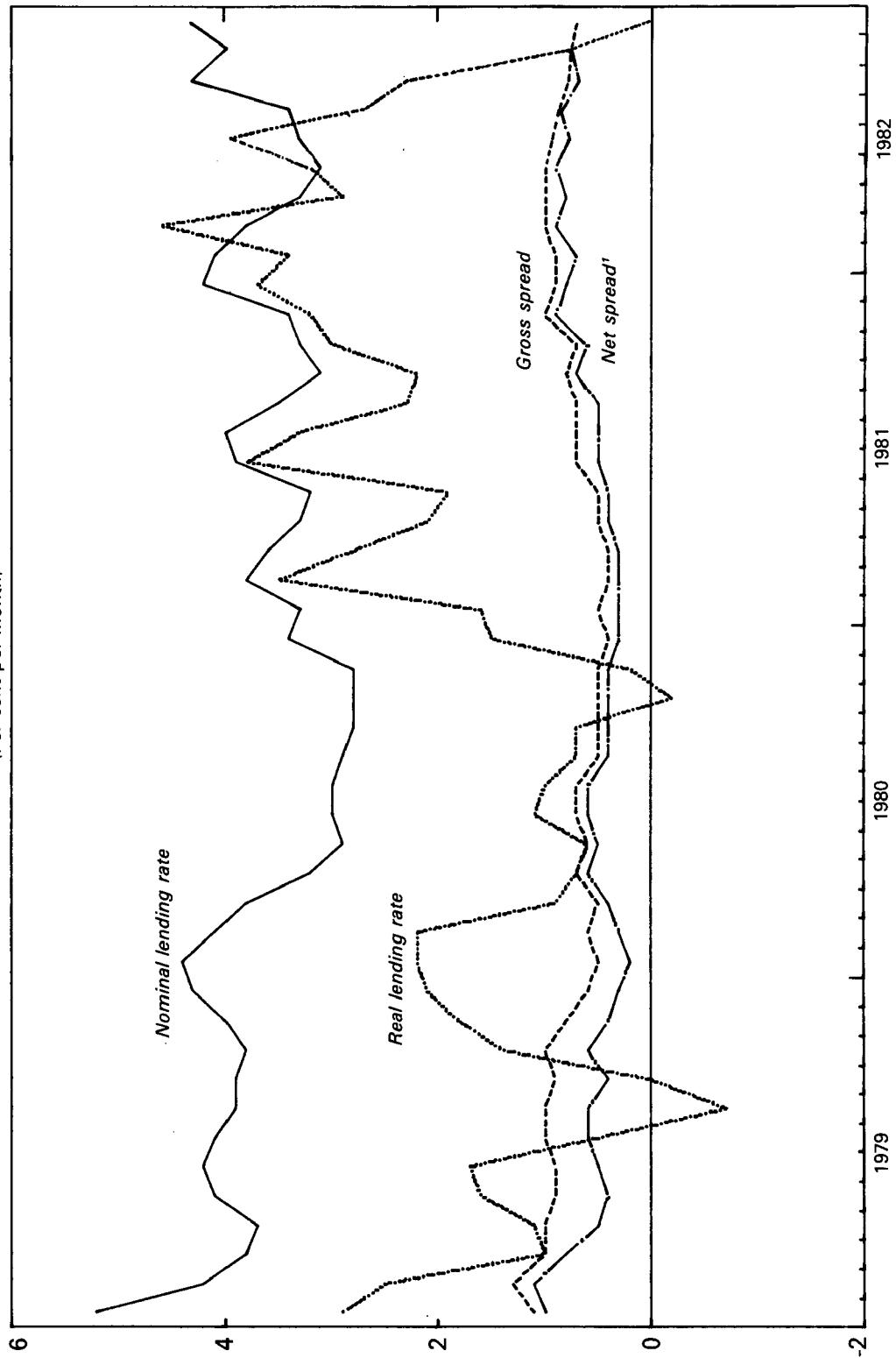
Despite the fact that the public sector was a net supplier of loanable funds in 1981 and that inflation was sharply lower, nominal interest rates on peso-denominated operations--which account for around 60 per cent of bank claims on the private sector--were extremely high during the year and even increased 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). 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 sizable increase in the current account deficit of the balance of payments. The spread between lending and deposit rates also rose substantially as banks became more concerned about risk. In the first nine months of 1982 the public sector's domestic financing requirement--the first in seven years--continued uncertainties regarding the soundness of the financial system and a massive shift by the private sector away from foreign currency denominated debt following the depreciation of the peso, combined to keep interest rates at high levels.

II. Economic Prospects and Policies for 1983-84

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 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 within a framework of a satisfactory balance of payments performance and a gradual reduction in the rate of inflation.

The financial program builds 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. The restoration of competitiveness through the depreciation of the peso and the change to a flexible exchange rate regime is consistent with this basic strategy. The exchange rate change has been complemented by the elimination of wage indexation and a lowering of the wage floor for collective bargaining and is to be supported by cautious monetary policies and fiscal restraint, continued interest rate flexibility, and maintenance of an open economy.

CHART 2
CHILE
SHORT-TERM LENDING RATES AND SPREADS
(Per cent per month)



Source: Central Bank of Chile.
1Gross spread adjusted for net financial cost of fulfilling reserve requirements.

The authorities anticipate that these policies should restore confidence and economic growth. They project that real GDP will increase by about 4 per cent in 1983 and by a somewhat larger amount in 1984. The rate of price increase, which is expected to rise to an annual rate of over 40 per cent in the second half of 1982, is projected to slow to about 25 per cent in 1983. For 1984 a further reduction in inflation is anticipated.

The size of Chile's external indebtedness and the changed conditions in the world capital market require that Chile will need to rely more heavily than in the past on its own savings capacity to finance economic recovery. Hence, the program contemplates a sizable reduction in Chile's net use of foreign resources to a level which is considered sustainable over the medium term. The current account balance of payments deficit which amounted to US\$4.6 billion (14.2 per cent of GDP) in 1981, is estimated to be reduced to US\$2.5 billion (10.3 per cent of GDP) in 1982, and is projected to decline to US\$1.6 billion (7.2 per cent of GDP) in 1983. For 1984 a further reduction to 4-5 per cent of GDP is projected to bring the balance of payments into equilibrium.

The authorities' most pressing immediate problem is the massive net reduction of foreign debt by the Chilean private sector. To slow the net capital outflow and protect the net international reserves of the Central Bank, the authorities have tightened domestic credit conditions, extended the duration of the exchange rate adjustment mechanism from four months to six months, and entered into foreign exchange swap arrangements with local commercial banks. However, there remains a risk that the restoration of domestic and foreign confidence may take longer than expected and that net capital flows may remain negative longer than anticipated. In this event, the authorities are prepared to tighten credit conditions beyond what is called for in the program to protect the net international reserves. The authorities are confident that their stabilization policies, which are described below, provide a sound basis for a resumption of positive private and public capital flows during 1983.

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 1.2 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 about 4 per cent of GDP. The potential 1982 fiscal deficit loomed much larger prior to the adoption in March and June of the fiscal measures which have been described in Section I.2 above.

^{1/} The public social security system must continue paying out existing pensions while foregoing new contributions.

Control over the public sector deficit is a major element of the program's demand management. To this effect, the authorities intend to reduce the public sector deficit to the equivalent of 1.7 per cent of GDP in 1983 and to approach equilibrium in 1984. The reduction in the 1983 deficit is to be achieved through cuts in real terms in both current and capital spending by the general government and public enterprises and by sizable increases in the rates and tariffs on goods and services sold by public enterprises. The wage bill of the general government is projected to decline in real terms as nominal wage increases are expected to be below the anticipated rate of inflation. General government current revenues are projected to decline by 5.3 per cent of GDP between 1982 and 1983 principally because of the impact of the recession on income tax receipts and import duty payments.

To monitor and control the size of the public sector deficit, the authorities' financial program for 1983 includes limits on the total net indebtedness--domestic as well as foreign--of the nonfinancial public sector. In addition, with a view to controlling future spending, 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.

Within the constraints imposed by the public sector program, the authorities have extended existing employment programs and initiated new ones. The minimum employment program, which pays workers one half the minimum wage, continues to remain open to all who apply without limiting the number of workers per family unit. In August 1982, approximately 220,000 were employed in this program. In June 1982, the Government reinstated a program which provides a subsidy for new workers taken on by industry. By September, approximately 22,000 workers were employed under this scheme. Effective October 1, 1982, a new labor intensive public works program was initiated benefiting heads of family units. During the first month 100,000 workers were employed at the minimum wage. The fiscal plan for 1983 provides for a continuation of these programs. Moreover, the investment plan for the coming year has been tailored to contribute to employment creation.

2. Monetary policy

The economic recession in Chile led to a number of business failures which in turn caused difficulties and considerable strain to the financial system.

To help ensure that domestic financial intermediaries would henceforth operate on a sound basis the authorities in late 1981 introduced a system of loan classification and required banks to set aside special reserves against all loans that are not ranked in the highest two categories.^{1/} In addition, restrictions were put into effect on lending to a financial intermediary's own enterprises and on the amount of lending

^{1/} See Section III.3 of the Recent Economic Developments paper.

to a single enterprise.^{1/} 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 purchase the "bad-loan" portfolios of financial institutions 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 the uncollected portion of these loans over ten years.

The sizable depreciation of the peso in the June-September 1982 period worsened the financial plight of an important segment of the private sector and threatened anew the stability of the financial system. To help ease the financial squeeze, the Central Bank in early September initiated the sale of foreign exchange for debt service payments at a preferential rate of exchange, and in mid-October announced a series of measures designed to facilitate the renegotiation of the private sector's outstanding loans with the domestic financial system. A number of bank regulations were relaxed and the Central Bank announced its intention to provide a rediscount line for medium-term loans.

To contain Central Bank net credit expansion within acceptable limits, the authorities intend to limit the expansionary effects of the above-described measures through open market sales of Central Bank paper, a reduction in existing sectorial credit lines, a neutralization of a previously announced reduction in legal reserve requirements on public sector deposits, and a build-up of special public sector deposits in the Central Bank.

The authorities anticipate that the above measures will be adequate to contain the expansion of Central Bank net credit in the remaining months of 1982 to a level consistent with achievement of their net international reserve target for December 31, 1982. Nevertheless, if required, they are prepared to tighten credit conditions further to help meet the reserve target. The Central Bank net credit program through December 31, 1982 also takes into account the anticipated receipt of approximately US\$550 million of balance of payments support loans by a number of public sector entities. The proceeds from these loans are to be placed in frozen deposits with the Central Bank.

The monetary program for 1983 assumes a modest recovery of economic growth, no further decline in the real demand for money, and allows for a US\$485 million decline in net international reserves. The program is consistent with a deceleration of inflation in 1983 to approximately one half that of 1982. Within these constraints, the Central Bank intends to provide rediscount lines to agriculture and construction and to maintain the preferential exchange rate for debt servicing. Central Bank net credit to the public sector is programed to be zero.

^{1/} The Central Banking Department has recently provided technical assistance to review the system and recommend any needed improvements.

Projections of financial flows for the consolidated financial system are particularly difficult, given the uncertainties of the current Chilean situation. The policies contained in the monetary program suggest that during 1983 overall net domestic credit will expand by 40 per cent in relation to the starting stock of liabilities to the private sector. The expansion will be supported principally by the growth in liabilities to the private sector as net foreign borrowing by the banks is expected to be minor. Because of the public sector's limited use of domestic credit, credit to the private sector will represent virtually all 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 in the period April-July 1982 the authorities relaxed and then abolished the limits on the terms of export prefinancing credits and import credits. At that time, a uniform reserve requirement on foreign borrowing (with maturities of less than six years) of 5 per cent was established in replacement of multiple reserve requirements,^{1/} and banks were permitted to relend their foreign borrowing in pesos.

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 this 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 current account deficit of the balance of payments.

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

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

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. These 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 in public and private employment 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.^{1/} 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, the four-year program of real wage increases has been postponed, and nominal wage increases for 1983 are expected to be well below the projected rate of inflation.

These actions in the wage field are expected to contribute to growth and employment and to sustain the real depreciation of the peso.

4. External sector policies

As noted above, since September 29, 1982 the policy of the authorities with respect to exchange rate management has been to maintain the real value of the peso over time. This policy, which the authorities intend to maintain, will be one of the main instruments in the restoration of balance of payments equilibrium.

As a result of the exchange rate actions taken in the June-September 1982 period and the supporting demand management and incomes policies that have been adopted, the authorities expect to limit the net official reserve loss during 1982 to US\$1.1 billion, but the program accommodates a larger net reserve loss in the event of a shortfall from the US\$550 million in balance of payments support loans programed for 1982. For 1983 the program targets a net international reserve loss of US\$485 million, with the current account balance of payments deficit projected to decline by US\$900 million to US\$1.6 billion (7.2 per cent of GDP). For 1984, the program calls for balance of payments equilibrium.

Because of the sluggishness of world demand and the fact that the exchange rate adjustment was delayed until midyear, the value of exports is projected to decline by 4 per cent in 1982. They are expected to rise by 17 per cent in 1983, in response to higher world commodity prices and demand as well as to the improvement in Chile's competitiveness. The value of imports is expected to fall by some 44 per cent in 1982 because of the decline in economic activity, the depreciation of the peso, and overstocking. A further decline in imports of 5 per cent is projected for 1983.

^{1/} At the present time legislation is being considered which would establish the nominal wage floor at the start of a new contract period at a level equivalent in real terms to the level existing at the beginning of the previous collective contract period.

A major element contributing to the current account deficit is net interest payments on Chile's external public and private debt, the stock of which totaled US\$15 billion at the start of 1982. Net interest payments are estimated to amount to US\$2.1 billion in 1982 and are projected to rise to US\$2.2 billion (10 per cent of GDP) in 1983 on the assumption of an average U.S. prime interest rate of 13 per cent.

The opening of the economy via the elimination of 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 features of the authorities' economic policy. They are intent on maintaining these features over the longer term notwithstanding the temporary imposition of a number of measures which increase the level of protection and restrictiveness of Chile's exchange and trade system. Legislation introduced in 1981 which provides for countervailing duties in the case of dumping, is being applied with caution. In November 1982, after careful scrutiny, dumping was established in the case of 12 products. Instead of applying countervailing duties, which might trigger a retaliatory response, the authorities opted to raise tariffs on these imports by an average of 17 percentage points for 180 days. During this period the authorities hope to reach an agreement with the exporting countries which subsidize these products. In addition, the tariff on powdered milk was raised by about 25 percentage points. The value of the products subject to tariff increases cover about 5 per cent of Chile's overall imports.

In late September 1982 at the time of the establishment of the present exchange rate regime, the authorities reinstated limitations on the sale of exchange for foreign travel; these limitations had been removed on August 6, 1982 when the peso was allowed to float. Sale of exchange for travel to neighboring countries was limited to US\$1,000 per voyage, and to other countries to US\$3,000 per voyage. Sale of exchange for other invisibles, including student expenses and medical treatment was limited to US\$1,000 per month per person. Requests for larger amounts if justified, are authorized by the Central Bank. These provisions were changed on December 4, 1982, when sale of exchange for travel to most Latin American and Caribbean countries was limited to US\$300 per trip, and to all other countries to US\$1,200 per trip. At the same time, sale of exchange for personal expenditures, which had been available without any effective control for an amount of US\$1,000 per month, was reduced to US\$200 per month subject to appropriate documentation. Requests for larger amounts, if justified, are authorized by the Central Bank.

As was mentioned already, on September 3, 1982 the authorities introduced a preferential exchange rate applying to the servicing of external debts contracted before August 6, 1982. Initially both external public and private debt service benefited under this scheme. In November, the scheme was made applicable only to debt service payments of the private sector and of those public entities with private participation. The preferential rate was fixed at Ch\$49.623 per U.S. dollar on August 6, 1982 and was adjusted thereafter daily on the basis of the

previous month's rate of change in the consumer price index. As the spread between the preferential and the official exchange rate is approximately 24 per cent, this scheme involves a multiple currency practice. The authorities strongly defended the introduction of the preferential rate as a necessary measure to forestall the bankruptcy of a large segment of private industry, commerce, and the financial system. The measure was intended to be of a temporary nature and the program calls for the unification of the exchange system through the elimination of the preferential rate by the end of 1983. However, the authorities expect that after that date a number of enterprises and financial institutions may still be affected by debt service payment difficulties. In this event, relief would be provided by means other than through the exchange system--for instance through the tax system.

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.

The reduction over time of restrictions on capital flows, together with the adoption of a fixed exchange rate, contributed to a very rapid expansion in external indebtedness by the private sector in the 1978-81 period. In relation to GDP the private external debt rose from 10 per cent in 1978 to 25 per cent in 1981. A further rise to 37 per cent of GDP is expected to take place in 1982, mainly because of a sharp decline in the U.S. dollar value of GDP owing to the adjustment of the exchange rate for the Chilean peso. The debt service burden of the private sector rose even more rapidly as interest rates rose sharply in international markets during these years. The service on private medium- and long-term external debt rose from 7 per cent of exports of goods and services in 1978 to a projected 42 per cent in 1982. In contrast, public sector net external borrowing, which was very heavy in the late 1960s and early 1970s, has been quite moderate in recent years; in December 1983 outstanding external public debt with a maturity of one year or more is projected to amount to 28-1/2 per cent of GDP, approximately the same as at the end of 1978. At the same time, the burden of external public debt service has been falling over time; service payments on the public debt in 1983 are projected at 20 per cent of exports of goods and nonfactor services compared with 28 per cent in 1978.^{1/} (Table 6 provides an overview of external debt operations.)

5. Performance criteria

The authorities' financial program for the first year of the standby arrangement includes four quantitative performance criteria (Table 7). The first is a target for the net international reserves of the Central Bank, performance under which will be tested quarterly starting with December 31, 1982. For the purpose of this target, balance of payments

^{1/} Debt service projections through 1986 are shown in Appendix III, Table 10.

Table 6. Chile: External Medium- and Long-Term
Debt Operations, 1978-83

	1978	1979	1980	1981	Est. 1982	Proj. 1983
(In millions of U.S. dollars)						
<u>Public sector (net)</u> ^{1/}	686	399	-30	-166	1,046	941
Disbursements	1,459	1,311	842	1,004	1,537	1,451
Amortization ^{2/}	-773	-912	-878	-1,170	-491	-510
<u>Private sector (net)</u>	580	1,166	2,124	3,479	735	18
Disbursements	751	1,580	2,694	4,102	1,462	1,243
Amortization ^{2/}	-171	-414	-570	-623	-727	-1,225
<u>Medium- and long-term debt outstanding</u>	5,923	7,507	9,413	12,553	14,334	15,293
Public sector	4,353	4,771	4,720	4,415	5,461	6,402
Private sector	1,570	2,736	4,693	8,138	8,873	8,891
<u>Debt service payments</u>	1,120	1,543	2,146	2,529	3,194	3,641
Amortization payments ^{3/}	737	949	1,233	1,107	1,218	1,735
Interest payments	383	594	913	1,422	1,976	1,906
Public sector	(289)	(359)	(435)	(487)	(579)	(655)
Private sector	(94)	(235)	(478)	(935)	(1,397)	(1,251)
(In per cent)						
Debt service/exports of goods and nonfactor services	35.4	31.3	36.0	47.7	63.5	63.6
Of which: public debt service	(28.2)	(19.6)	(18.4)	(19.1)	(21.3)	(20.3)
Interest payments/exports of goods and nonfactor services	12.1	12.0	15.3	26.8	39.3	33.3
Debt/GDP	38.5	36.2	34.3	38.2	59.6	68.5
Public sector	(28.3)	(23.0)	(17.2)	(13.4)	(22.7)	(28.7)
Private sector	(10.2)	(13.2)	(17.1)	(24.8)	(36.9)	(39.8)
<u>Memorandum items</u>						
Interest on short-term debt (millions of US\$) ^{4/}	113	166	239	489	504	601
As a per cent of exports of goods and nonfactor services	3.6	3.4	4.0	9.1	10.0	10.5

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

^{1/} Includes the Central Bank and the Banco del Estado, as well as publicly guaranteed debt.

^{2/} Includes prepayments.

^{3/} Excludes prepayments.

^{4/} Includes interest on IMF credit.

Table 7. Chile: Quantitative Performance Criteria for Period Through December 31, 1983

	Stock on		Limits and Targets for				
	1981	1982	1982	1983			
	Dec. 31	June 30	Oct. 1- Dec. 31	Jan. 1- Mar. 31	Apr. 1- June 30	July 1- Sept. 30	Oct. 1- Dec. 31
(In billions of Chilean pesos)							
Net domestic assets of the Central Bank <u>1/</u>	-132.84 <u>2/</u>	-107.61 <u>2/</u>	-16.15 <u>2/</u>	-6.00 <u>3/</u>	4.10 <u>3/</u>	13.25 <u>4/</u>	23.95 <u>4/</u>
Outstanding indebtedness of the nonfinancial public sector <u>5/</u>	316.18 <u>2/</u>	338.6 <u>2/</u>	375.0 <u>2/</u>	437.0 <u>4/</u>	452.0 <u>4/</u>	459.0 <u>4/</u>	455.0 <u>4/</u>
(In millions of U.S. dollars)							
Net international reserves of the Central Bank <u>5/6/</u>	3,186.8	2,870.4	1,537.0	1,307.0	1,177.0	1,052.0	1,052.0
Contracting and guaranteeing of external debt by the nonfinancial public sector <u>7/</u>	--	--	2,050.0	2,050.0	2,050.0	2,050.0	2,050.0

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

1/ Defined as the difference between (i) the sum of the Central Bank's liabilities to the private sector, its medium- and long-term foreign liabilities, and the counterpart deposits of the balance of payments support loans contracted during 1982/83 by CODELCO, other public enterprises, and the Banco del Estado, and (ii) the net international reserves of the Central Bank.

2/ For purposes of calculating these stocks and limits, all foreign currency entries are valued at the accounting rate of Ch\$69 per U.S. dollar.

3/ For purposes of calculating these limits, all foreign currency entries are valued at the accounting rate of Ch\$74 per U.S. dollar.

4/ For purposes of calculating these limits, all foreign currency entries are valued at the accounting rate of Ch\$77 per U.S. dollar.

5/ The limits on the outstanding indebtedness of the nonfinancial public sector, and the targets for the net international reserves of the Central Bank are tested at the end of each period.

6/ For purposes of calculating the net international reserve targets, the counterpart deposits of the balance of payments support loans contracted during 1982-83 by CODELCO, other public enterprises, and Banco del Estado, are to be treated as international reserve liabilities.

7/ Refers to external debt with maturity above 12 months and below 120 months.

support loans expected to be contracted by public sector entities in the final months of 1982 or early 1983, possibly in an amount of US\$550 million, are to be treated as international reserve liabilities.

The second performance criteria is a limit on the total stock of debt of the nonfinancial public sector, performance under which also will be tested quarterly starting with December 31, 1982. This performance criterion measures the total deficit of the nonfinancial public sector, regardless of whether it is financed domestically or from abroad.

The third 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 October 1, 1982-December 31, 1983.

A fourth performance criterion is the ceiling on the net domestic assets of the Central Bank of Chile, to be tested continuously throughout the period October 1, 1982-December 31, 1983. For the purpose of this ceiling the net domestic assets of the Central Bank of Chile are defined as the difference between (1) the sum of its liabilities to the private sector and its medium- and long-term foreign liabilities; and (2) its net international reserves as defined above.

In addition to these quantitative performance criteria the program also contains as performance clauses (1) the unification of the exchange rate system by December 31, 1983; (2) 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 (3) 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 beginning of 1982 was in a deep recession. The downturn in activity reflected the recessionary conditions prevailing in the industrialized world, which led to a sharp fall in demand for Chile's main export commodities, a tapering off of private capital inflows, and the decline in Chile's international competitiveness. The decline in net private capital inflows reflected not only world market conditions but also a series of business failures and bank difficulties in Chile. In this setting, real GDP contracted, unemployment rose abruptly, and imports fell sharply.

The authorities concluded that balance of payments adjustment, accompanied by a satisfactory rate of economic growth, could not be achieved on the basis of the existing exchange rate. Consequently, the

fixed exchange rate was abandoned in June 1982. During the subsequent three months the peso depreciated by 40 per cent and a flexible exchange rate policy was implemented with the objective of maintaining the real external value of the peso. Supporting policies in the areas of fiscal, monetary, and wage policies have been adopted 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. The deficit, which at one point 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, increases in public sector tariffs, and sales of public sector assets. The staff welcomes these policies which, together with an austere public sector wage adjustment, are expected to result in a reduction of the public sector deficit in 1983 to less than 2 per cent in relation to GDP. However, with inflation accelerating in the second half of 1982, wage pressures are bound to become strong in 1983; these pressures will have to be resisted if the programmed public sector improvement is to be achieved.

A principal source of international reserve loss in Chile in the last quarter of 1981 and the first half of 1982 was the extension of Central Bank credit to domestic financial intermediaries experiencing difficulties. More recently the reduction of private foreign debt facilitated by a strong expansion of Central Bank credit has resulted in a further loss in international reserves. The authorities have moved to re-establish confidence in the domestic financial system and economic management. They have initiated a system of prudential controls over operations of financial intermediaries, established a scheme permitting banks, in effect, to write off their "bad loans" over a ten-year period, and implemented a program of relief for private enterprises and financial institutions burdened by high debt service payments. The staff recognizes the need for such action, but it would stress the importance of tight credit management by the Central Bank and of ensuring that Central Bank support of the private sector and financial institutions be temporary and strictly circumscribed so as to protect the international reserve target of the financial program.

In view of the uncertainties in world capital markets and the difficulties being experienced by private enterprises and financial intermediaries in Chile, financial conditions in Chile will have to be monitored closely. Accordingly, the authorities should 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 fully supports the authorities' determination to continue to allow free interest rates to allocate efficiently credit flows and promote growth in domestic savings.

The abandonment of wage indexation and lowering of the wage floor for collective bargaining, together with the depreciation of the peso, should be instrumental in restoring economic growth and reducing unemployment. The staff agrees with the authorities that the opening up of the Chilean economy via the elimination of restrictions on payments and transfers for current international transactions and the reduction of import duties to a uniform 10 per cent, has been a major factor in the high economic growth of the past few years. The recent tightening of the regulations governing the sale of foreign exchange for travel and a number of invisible transactions constitute exchange restrictions, and thus represent a step backward in this regard. However, the authorities intend to administer these regulations so as to permit all bona fide applications for exchange to be approved routinely and expeditiously.

The introduction of a preferential exchange rate for external debt service payments was intended to alleviate the debt service burden of the private sector. The temporary nature of this measure would seem to be assured by the inclusion in the program of a provision for the elimination by the end of the first program year of the multiple currency practice inherent in the preferential exchange rate.

Chile's stabilization program is being undertaken at a time of unsettled domestic and world financial market conditions, which add an important element of uncertainty and risk to the program to those that would surround it under more normal circumstances. Despite this additional complication, the staff believes that the authorities' policies, if implemented with resolve and with due regard for changes in conditions, will be adequate to achieve the objectives of the program.

V. Proposed Decision

The following draft decisions are proposed for adoption by the Executive Board:

Stand-By Arrangement

1. The Government of Chile has requested a stand-by arrangement for a period of two years from 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.

Article IV Consultation

1. The Fund takes this decision relating to Chile's exchange measures subject to Article VIII, Section 2, and 3, in the light of the 1982 Article IV Consultation with Chile concluded under Decision 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.

Fund Relations with Chile

Date of membership: December 31, 1945.

Quota: SDR 325.5 million.

Fund holding of Chilean pesos:	As of November 30, 1982	<u>Millions of SDRs</u>	<u>Per Cent of Quota</u>
	Total holdings	260.8	80.1
	(Of which correspond- ing to oil facility)	(5.7)	(1.7)

SDR position:	As of November 30, 1982	<u>Millions of SDRs</u>	<u>Per Cent of Net Cumulative Allocation</u>
	Net cumulative allocation	121.9	100.0
	Holdings	(17.7)	(14.5)

Exchange rate: The exchange rate for the Chilean peso in terms of the U.S. dollar is adjusted daily on the basis of the difference between the change of the consumer price index of the previous month and the world rate of inflation. The Central Bank intervenes in the market to maintain the exchange rate within a band of 2 per cent above and below the reference rate. On November 30, 1982 the rate was Ch\$70.44 per U.S. dollar. A preferential exchange rate applies to the servicing of private sector debt contracted before August 6, 1982. This exchange rate stood at Ch\$56.34 per U.S. dollar on November 30, 1982.

Gold distribution: 135,220.043 fine ounces.

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 (June 1982)	11.5 million
Annual rate of population increase (1977-82)	1.7 per cent
Unemployment rate (September 1982--Greater Santiago)	23.9 per cent

GDP (1981) SDR 27,871 million

GDP per capita (1981) SDR 2,468

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	18.0
Imports of goods and services	32.5
Central government revenues	24.3
Central government expenditures	22.0
External public debt (end of year)	13.7
Saving	7.8
Investment	22.0
Money and quasi-money (end of year)	35.8

<u>Annual changes in selected economic indicators</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>
		(per cent)		
Real GDP per capita	6.6	6.7	5.7	3.6
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	26.9
Investment	109.2	58.2	61.4	27.6
Consumption	67.5	55.7	36.1	26.7
GDP deflator	56.5	46.3	29.0	13.6
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 (banking system)	77.0	61.9	60.9	40.7
Money	67.0	58.7	56.4	-3.1
Quasi-money	82.5	63.4	62.9	59.9
Net domestic bank assets 1/	68.3	65.0	77.2	70.3
Credit to public sector (net)	-16.8	-12.0	-28.1	-12.4
Credit to private sector	94.5	88.4	106.0	84.1
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

<u>Central government finances</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>
	<u>(millions of Chilean pesos)</u>			
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

<u>Balance of payments</u>	<u>(millions of U.S. dollars)</u>			
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	-626
Balance on current and transfers accounts	-1,088	-1,189	-1,971	-4,652
Official capital (net)	655	449	85	272
Private capital (net)	1,291	1,802	3,080	4,397
Errors and omissions	-145	-4	50	50
Allocation of SDRs	--	29	30	28
Overall balance	713	1,087	1,274	95
Valuation adjustment	--	--	-30	-90
Change in net official reserves (increase -)	-713	-1,087	-1,244	-5

<u>International reserve position 2/</u>	<u>Dec. 31 1980</u>	<u>Dec. 31 1981</u>	<u>Sept. 30 1982</u>
	<u>(millions of U.S. dollars)</u>		
Central Bank (gross)	3,459.6	3,496.0	2,229.6
Central Bank (net)	3,182.2	3,186.8	2,118.4
Rest of banking system (net)	-900.2	-1,151.9	-1,196.8

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.

Summary of the Financial Program for the First Period
of the Stand-By Arrangement 1/

I. Major Assumptions

1. Real GDP is estimated to decline by 12.8 per cent in 1982, as a result of a decline in manufactured output, construction, commerce and other services. On the basis of strong growth in agriculture, fishing, and mining, and a recovery of manufacturing, commerce, and other services, real GDP is projected to increase by 4 per cent in 1983. A growth rate of 5 per cent is projected for 1984.
2. Real exports are estimated to increase by 5.6 per cent in 1982 and 7.0 per cent in 1983. Real imports are estimated to decline by 44.3 per cent in 1982, and by a further 11 per cent in 1983. The terms of trade are anticipated to deteriorate by 9.1 per cent in 1982, but to improve by 4.3 per cent in 1983.
3. The real stock of money and quasi-money,^{2/} which during the nine months ending September 1982 had declined by about 11.5 per cent,^{3/} is estimated to decline by a further 3.5 per cent during the last quarter of 1982. During 1983, the real stock of money and quasi-money is projected to increase by 4 per cent. Real currency holdings are estimated to decline by 22 per cent in 1982 and to remain constant in 1983.
4. The net domestic assets of the financial system are estimated to increase by 30 per cent in 1982 and by 40 per cent in 1983. Net domestic credit to the nonfinancial public sector is estimated to increase by 5 per cent during 1982 but to remain constant in 1983. Credit to the private sector is estimated to increase by 5 per cent in 1982 and by 56 per cent in 1983.^{4/} Measured in relation to its own initial stock, real credit to the private sector would decline by 10 per cent in 1982 and would remain about constant in 1983.

II. Targets

1. Consumer prices are projected to increase at an annual rate of 42 per cent in the second half of 1982. However, as virtually no inflation took place in the first half of 1982, domestic inflation for 1982

^{1/} Actual, estimated, and projected data on the macroeconomic flows and selected economic and financial indicators for the period 1980-83 are presented in Tables 8 and 9.

^{2/} Nominal stock of money and quasi-money deflated by changes in the consumer price index.

^{3/} On a seasonally adjusted basis.

^{4/} All of the previous increases are expressed in relation to the outstanding stock of liabilities to the private sector.

as a whole is estimated at 19.6 per cent. During 1983, consumer prices are projected to increase by 25 per cent. A reduction of inflation is targeted for 1984.

2. The overall balance of payments, which registered a deficit of US\$1,068 billion during the nine months ended September 1982 is projected to register an additional deficit of US\$32 million in the last quarter of 1982, assuming that US\$550 million in balance of payments support loans are obtained and disbursed. Any shortfall from this level of disbursements would be reflected in a correspondingly greater deficit. For 1983, the overall balance of payment deficit is projected at US\$485 million, with most of this deficit projected during the first half of 1983. For 1984, balance of payments equilibrium is targeted. The overall balance of payments outcome is measured in terms of changes in the net international reserves of the Central Bank.

3. The current account deficit of the balance of payments which reached the equivalent of 14.2 per cent of GDP in 1981 is projected to decline to about 10.5 per cent of GDP in 1982 and to about 7 per cent of GDP in 1983.

III. Principal Elements of the Program for 1983

1. Fiscal policy

The overall deficit of the nonfinancial public sector is to be limited to 4.0 per cent of GDP in 1982 and to be reduced to 1.7 per cent in 1983.

The expected improvement in the public sector deficit in 1983, amounting to 2.3 per cent of GDP, reflects the following:

	Effect as per cent of GDP
(a) <u>General government:</u>	<u>2.0</u>
Reduction in current expenditure	7.1
Net fall in current revenue, principally on account of lower receipts from income taxes and import duties, partially offset by larger transfers from public sector enterprises	-5.3
Reduction in net capital expenditures	0.2
(b) <u>Public enterprises</u>	<u>0.3</u>
Net improvement in operation surplus mainly on account of higher rates and prices on goods and services provided by these enterprises.	2.2
Larger transfer of taxes and operating surpluses to general government	-1.3
Higher net capital expenditures	-0.6
(c) <u>Net total improvement</u>	<u>2.3</u>

2. Monetary policy

a. After expanding by 32 per cent ^{1/} during the first half of 1982, the net domestic assets of the Central Bank expanded by a further 53 per cent during the third quarter of 1982. For the remainder of 1982 the net domestic asset expansion of the Central Bank would be limited to 29 per cent, and for 1983 as a whole to 33 per cent. As performance criteria the financial program includes quarterly limits on the net domestic assets of the Central Bank. These limits, which are subject to continuous testing, cover the period October 1, 1982-December 31, 1983. The financial program also includes as performance criteria, quarterly targets for the net international reserves of the Central Bank. These targets would be tested quarterly, beginning December 31, 1982.

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

c. The supervision of the operations of the financial intermediaries will continue to be strengthened.

^{1/} In relation to the outstanding stock of base money at the beginning of the period.

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.^{1/} All other indexation and wage floor arrangements for the public and private sectors have been abolished.

b. During 1983, nominal wage increases for public sector employees are expected to be below the projected rate of inflation.

4. External sector policies

a. On September 29, 1982, the authorities established a referential exchange rate of Ch\$66.00 per U.S. dollar. It was announced that during the following six months, the exchange rate would be adjusted daily, with the rate of depreciation based on the difference between the previous month's domestic rate of inflation and the external rate of inflation, estimated at 1 per cent per month. The Central Bank would intervene in the exchange market to maintain the market exchange rate within a band of 2 per cent either way of the daily reference rate. Beyond this six month period, the authorities also intend to maintain the real value of the peso.

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

c. As performance criteria, the financial program includes limits on the contracting and guaranteeing by the nonfinancial public sector of external loans with maturities above 12 months and below 120 months. These limits would be tested continuously beginning October 1, 1982.

d. The program also contains as nonquantitative performance clauses (1) the unification of the exchange rate system by December 31, 1983, (2) 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 (3) a review to reach understandings on the policies and performance criteria relating to the second year of the stand-by arrangement.

^{1/} Legislation has been introduced which would modify the wage floor as described earlier in this report.

Table 8. Chile: Macroeconomic Flows

(As per cent of GDP)

	1980	1981	Est. 1982	Proj. 1983	1984
<u>I. Balance of Payments</u>					
<u>Current account surplus or deficit (-)</u>	-7.2	-14.2	-10.3	-7.2	-4.7
Trade balance	-2.7	-7.9	-0.6	4.5	5.9
Net factor payments	-3.4	-4.3	-8.9	-10.0	-9.5
Other services and transfers	-1.1	-2.0	-2.0	-1.7	-1.1
<u>Capital account</u>	11.7	14.2	5.7	5.0	4.7
Private capital and financial					
public sector	11.8	11.6	3.7	3.3	...
Nonfinancial public sector	-0.1	2.6	2.0 ^{1/}	1.7	...
<u>Net official international reserves (increase -)</u>	-4.5	--	4.6	2.2	--
<u>II. Public Sector</u>					
<u>Public sector savings</u>	10.6	5.5	-0.4	2.2	3.7
<u>Capital revenue</u>	2.0	3.6	2.6	2.1	2.1
<u>Capital expenditure</u>	7.0	7.9	6.2	6.0	6.0
<u>Overall surplus or deficit (-)</u>	5.6	1.2	-4.0	-1.7	-0.2
Net foreign financing	-0.1	2.6	2.0 ^{1/}	1.7	...
Net domestic financing	-5.5	-1.4	2.0	--	...
<u>III. Saving and Investment</u>					
<u>Gross domestic investment</u>	20.7	22.0	15.4	15.5	15.5
Public sector	5.1	5.3	5.5	5.0	5.0
Private sector	15.6	16.7	9.9	10.5	10.5
<u>Investment = savings</u>	20.7	22.0	15.4	15.5	15.5
External savings	7.2	14.2	10.3	7.2	4.7
Gross national savings	13.5	7.8	5.1	8.3	10.8
Public sector	(10.8)	(5.5)	(-0.4)	(2.2)	(3.7)
Private sector	(2.7)	(2.3)	(5.5)	(6.1)	(7.1)
<u>Memorandum item</u>					
Annual growth rate of real GDP	7.5	5.3	-12.8	4.0	5.0

^{1/} Excludes external loans obtained by the nonfinancial public sector to provide balance of payments support to the Central Bank. These are included in the private capital and financial public sector flows.

Table 9. Chile: Selected Economic and Financial Indicators, 1980-83

	1980	1981	Est. 1982	Proj. 1983
<u>(Annual per cent changes, unless otherwise specified)</u>				
National income and prices				
GDP at constant prices	7.5	5.3	-12.8	4.0
GDP deflator	29.0	13.6	8.6	37.8
Consumer prices (average)	35.1	19.7	9.4	28.3
Consumer prices (Dec.-Dec.)	31.2	9.5	19.6	25.0
External sector (on the basis of U.S. dollars)				
Exports, f.o.b.	22.7	-15.8	-4.0	17.1
Imports, c.i.f.	30.5	19.9	-44.3	-5.5
Non-oil imports, c.i.f.	39.2	22.6	-44.7	-5.4
Export volume	8.6	-4.3	5.6	7.0
Import volume	10.9	18.1	-44.3	-11.0
Terms of trade (deterioration -)	-4.0	-13.5	-9.1	4.3
Nominal effective exchange rate (depreciation -) ^{1/}	8.7	27.7	-38.8	-17.5
Real effective exchange rate (depreciation -) ^{2/}	16.9	13.5	-29.7	--
General government operations				
Revenue	35.4	25.1	-8.3	7.0
Total expenditure (excluding amortization)	34.7	37.3	5.2	3.4
Money and credit				
Net domestic assets ^{3/}	81.2	69.9	29.8	40.2
Public sector	(-24.2)	(-11.3)	(5.2)	(--)
Private sector	(109.2)	(95.3)	(14.9)	(56.1)
Money and quasi-money (M2)	70.6	41.9	1.8	30.0
Interest rate (effective annual rate, short-term deposit rate)	37.4	40.9
<u>(In per cent of GDP)</u>				
Public sector savings	10.6	5.5	-0.4	2.2
Overall public sector surplus or deficit (-)	5.6	1.2	-4.0	-1.7
Domestic financing	(-5.5)	(-1.4)	(2.0)	(--)
Foreign financing	(-0.1)	(2.6)	(2.0) ^{4/}	(1.7)
Gross domestic investment	20.7	22.0	15.4	15.5
Gross national savings	13.5	7.8	5.1	8.3
Current account deficit	7.2	14.2	10.3	7.2
Medium- and long-term public and private external debt (end of year)	34.3	38.2	59.6	68.5
Debt service ratio (in per cent of exports of goods and nonfactor services)	36.0	47.7	63.5	63.6
Interest payments (in per cent of exports of goods and nonfactor services)	15.3	26.8	39.3	33.3
<u>(In millions of U.S. dollars, unless otherwise specified)</u>				
Overall balance of payments	1,274	98	-1,100	-485
Gross official reserves (months of imports) (end of year)	6.7	5.7	6.4 ^{5/}	5.3 ^{5/}
Gross official reserves (months of current payments)	5.0	3.9	3.2 ^{5/}	2.6 ^{5/}
External payments arrears (defaults) (end of year)	--	--	--	--

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

^{1/} At the end of the year.^{2/} On the basis of consumer prices.^{3/} In per cent of liabilities to the private sector at the beginning of the period. Estimates for 1982-83 based on an accounting rates of Ch\$69.0 = US\$1 and Ch\$77.0 = US\$1, respectively.^{4/} Excludes external loans obtained by the nonfinancial public sector to provide balance of payments support.^{5/} Excludes projected net use of IMF credits.

Table 10. Chile: Projected Service of External Debt (1982-86)^{1/}

(In millions of U.S. dollars)

	Est.	Projected			
	1982	1983	1984	1985	1986
Debt service payments	3,194	3,641	3,407	4,219	4,209
Amortization	1,218	1,735	1,795	2,802	3,087
Public sector	(491)	(510)	(500)	(557)	(722)
Private sector	(727)	(1,225)	(1,295)	(2,245)	(2,365)
Interest	1,976	1,906	1,612	1,417	1,122
Public sector	(579)	(655)	(675)	(635)	(582)
Private sector	(1,397)	(1,251)	(937)	(782)	(540)

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

^{1/} Medium- and long-term debt in foreign currencies. Projections for 1984, 1985, and 1986 are on the basis of the projected stock of debt outstanding at the end of 1983.

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 500 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 May 15, 1983, the equivalent of SDR 176 million until August 15, 1983, the equivalent of SDR 230 million until November 15, 1983, the equivalent of SDR 284 million until February 15, 1984, the equivalent of SDR 338 million until May 15, 1984, the equivalent of SDR 392 million until August 15, 1984, and the equivalent of SDR 446 million until November 15, 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 arrangement 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 until December 31, 1983 in which:

- (i) the data at the end of the preceding period indicate that the net international reserve target described in Table 1 of the memorandum annexed to the attached letter has not been observed, or
- (ii) the data at the end of the preceding period indicate that the limit on the total indebtedness of the nonfinancial public sector described in Table 2 of the memorandum annexed to the attached letter has not been observed, or
- (iii) the limit on the contracting and guaranteeing of external debt by the public sector described in Table 3 of the memorandum annexed to the attached letter is not observed, or
- (iv) the limit on the net domestic assets of the Central Bank of Chile described in Table 4 of the memorandum annexed to the attached letter is not observed, or

(b) After December 31, 1983, if the exchange system has not been unified as stated in paragraph 14, or if Chile retains the existing restriction on payments for travel and other invisible transactions referred to in paragraph 13 of the memorandum annexed to the attached letter, and if suitable performance criteria 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 criteria, 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 stand-by 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 stand-by 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 stand-by 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 stand-by 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
December , 1982

Mr. Jacques de Larosiere
Managing Director
International Monetary Fund
700 19th Street, N.W.
Washington, D.C. 20431

Dear Mr. de Larosiere:

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, that resulted in a suboptimal allocation of resources and contributed 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 estimated at about 600 per cent according to the consumer price index. During that year, severe commodity shortages appeared, 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 reign 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 in 1976, notwithstanding the 1974 oil crisis, and the sharp fall in world copper prices that followed. Thereafter, Chile entered a period of rapid economic growth and a strong balance of payments performance that 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 to international levels became a main objective of economic policy. The reduction of inflation was sought through a sound fiscal policy and a fixing of the 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, the decline in inflation was not accompanied by a corresponding deceleration in wage increases, because indexation of wages was linked to past rates of inflation. 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. By late 1981, the economy entered into a severe recession; import demand adjusted sharply downward and the unemployment rate rose to an unacceptably high level. The economic downturn and high labor costs caused business failures that in turn endangered a number of financial institutions. These developments pointed to the necessity of combining domestic demand policies with a depreciation of the peso in order to speed up the process of domestic cost adjustment. In the period from mid-June to late-September 1982, the peso was depreciated from Ch\$39 to Ch\$66 per U.S. dollar. Since then, our policy is to maintain the real value of the peso in terms of the U.S. dollar within a narrow band through Central Bank intervention in the exchange market.

5. The depreciation of the peso and the change in exchange rate policy are consistent with the strategy of the Chilean Government to promote adjustment and economic recovery by relying on market forces and price incentives to guide resource allocation in the economy. The improved competitive position is expected to lead to a strong export expansion which will be the principal stimulus to an economic recovery. In support of this strategy and these policies, that 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 500 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. In any event, the Government will consult with the Managing Director midway through 1983 on the policies affecting demand management and the exchange system. Also, on or before December 31, 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,

Carlos Caceres
President
Central Bank of Chile

Rolf Luders
Minister of Finance
and Economy

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 hyperinflation, an extremely weak balance of payments, and a severe drop in output. With the policies of stabilization and structural change adopted by the Government that 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 to international levels became a main objective of economic policy. A substantial reduction in inflation was achieved principally through a sound fiscal policy. In mid-1979 a fixed relationship between the Chilean peso and the U.S. dollar was established. However, lags in the adaptation of expectations and the sharp depreciation of the U.S. dollar allowed inflation to continue at a high rate for some time. In late 1980 inflation began to decline markedly, a development to which the subsequent appreciation of the U.S. dollar contributed. However, with the decline in inflation, the wage indexation mechanism resulted in a sharp increase in real wages and particularly in wages measured in U.S. dollars. This gave rise to concern about employment and Chile's international competitiveness.

3. The international economic slowdown severely 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 that accounts for 50 per cent of Chile's export earnings, and affected other exports as well. In addition, beginning 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, and of a growing concern for the size of the current account balance of payments deficit. As a consequence, real GDP declined sharply, interest rates soared, the unemployment rate more than doubled to over 20 per cent, and the level of imports dropped precipitously.

4. By early 1982, it became imperative to adjust Chile's cost-price relationship and thus to restore its international competitiveness to promote the reallocation of resources to the tradable goods sector. Initially this objective was pursued exclusively through domestic demand policies. In mid-June it was decided to supplement these policies with a depreciation of the peso and the removal of wage indexation. The depreciation was accompanied by the announcement of an exchange rate schedule covering the following 12 months. Continued heavy net official reserve losses led to the floating of the peso in early August accompanied by Central Bank intervention to dampen excessive movements in the external value of the peso. In late September 1982, the Central Bank announced a reference exchange rate for the peso in terms of the

U.S. dollar and undertook to intervene in the exchange market to maintain the value of the peso in real terms. This policy will be maintained during the period of the present economic program.

5. The program strategy is to allow the improved competitive situation that has come with the exchange rate adjustment to produce economic recovery and an expansion in employment opportunities, in a framework of a satisfactory balance of payments performance and a gradual reduction in the rate of inflation from the sharp increase in the price level that occurred in the wake of the June-September depreciation. The size of Chile's external indebtedness and the changing conditions in the world financial markets indicate that Chile will need to rely more heavily than in the past on its own savings capacity to finance the economic recovery. Hence, the program contemplates a sizable reduction in Chile's net use of foreign resources to a level that is considered sustainable over the medium term. However, in the very short term re-establishing foreign and domestic confidence in our policies may take longer than anticipated, and net capital flows may turn negative. The Government considers that there is a risk that such a shortfall might occur, and produce a larger than anticipated reserve loss in the immediate future. However, this will not jeopardize the net international reserve target shown in Table 1 for 1983 as a whole, as the Government is confident that the policies described here will provide a sound basis for a resumption of positive capital flows during the year.

6. The depreciation of the peso is expected to result in a sharp increase in the price level in the second semester of 1982. Demand management for the program period has been designed to bring down the rate of price increase while providing adequate support for an economic recovery that is expected to be concentrated in the tradable goods sectors.

7. The finances of the public sector were adversely affected by the recession in 1982. The fall in copper revenue and import duty collections gave rise to a potentially large public sector deficit. To reduce the deficit to a manageable level, the Government took strong fiscal actions, including the introduction of major income and property tax surcharges, and excise tax and increases in public sector tariffs.

In recognition of the acute unemployment situation, the Government, within the constraints of the fiscal budget, has made room for a number of employment programs. The minimum employment program has been extended, a number of new projects with a high labor content have been initiated, and a temporary subsidy has been created for additional workers hired by private enterprises.

The expectation is that for 1983 as a whole the overall net borrowing requirement of the nonfinancial public sector will be approximately 4 per cent of GDP; this net borrowing requirement is projected to be reduced to 1.7 per cent of GDP in 1983, on the basis of a concerted effort to contain the growth of expenditures and further increases in

public sector tariffs. 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 2.

8. 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. These ceilings are shown in the annexed Table 3.

9. 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 intends to support the fiscal stance with a cautious monetary policy to help 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 4.

10. Market determined 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. Interest rates will continue to be determined by the market. Another important step in ensuring a stable flow of financial savings has been the creation of privately owned social security funds that 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 non-bank borrowers have been given access to the short-term capital market abroad.

11. 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 that 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.

12. A critical element in improving the cost-price relationship and Chile's international competitiveness is the area of wage determination. In recognition of the fact that real wages in Chile were at an unsustainable level, all wage indexation has been abolished, the wage floor for private sector collective bargaining contracts has been reduced, and public sector remunerations at the higher levels have been cut.

13. The elimination of restrictions on payments and transfers for current international transactions and the progressive reduction of import duties to 10 per cent have been features of the Government's economic policies. The Government intends to maintain these features over the longer term. However, Chile's difficult balance of payments position has required the temporary tightening up of the regulations governing the sale of exchange for a number of invisible transactions with the objective of impeding unauthorized capital outflows. The Government will review the administration of these regulations to ensure that they will not restrict or unduly delay payments for travel or other invisible transactions.

14. The large depreciation of the peso in 1982, caused considerable hardship for private enterprises and the financial system, already seriously weakened by the recession and a large foreign indebtedness. To alleviate the severe difficulties of the financial system and prevent the bankruptcy of a large number of enterprises the Government took the following measures. In July the Central Bank announced that it would exchange the past-due loan portfolio of the financial institutions for new interest-bearing Central Bank notes with a repurchase provision spread over a maximum period of ten years. During this period, all operational income of the financial institutions will be allocated to the repurchase of these loans from the Central Bank. This measure contributed to stabilizing the domestic financial market. In late August, the Central Bank announced that it would sell foreign exchange for all debt service payments with respect to debt outstanding as of August 6, 1982, at a special rate of Ch\$50 per U.S. dollar, adjustable over time by the domestic rate of inflation. The Government intends to unify the exchange system by the end of 1983 but will maintain its commitment to provide relief to enterprises and financial institutions affected by debt service payment difficulties.

Table 1. Chile: Targets of the Net International
Reserves of the Central Bank

(In millions of U.S. dollars)

	Targets
March 31, 1983	1,307
June 30, 1983	1,177
September 30, 1983	1,052
December 31, 1983	1,052

NOTE: For the purpose of calculating the performance under this target, the counterpart deposits of the balance of payments support loans contracted during 1982-83 by public enterprises, and the Banco del Estado are to be treated as international reserve liabilities.

Table 2. Chile: Limits on Total Indebtedness of the
Nonfinancial Public Sector

(In billions of pesos)

	Limits
March 31, 1983 <u>1/</u>	437
June 30, 1983 <u>1/</u>	452
September 30, 1983 <u>1/</u>	459
December 31, 1983 <u>1/</u>	455

1/ U.S. dollar component valued at US\$1=Ch\$77.

Table 3. 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
October 1, 1982-December 31, 1983	2,050

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

2/ Excludes foreign external debt of the Central Bank, Banco del
Estado, and SINAP.

Table 4. Chile: Ceilings on the Net Domestic Assets
of the Central Bank

(In billions of pesos)

	Ceilings
January 1-March 31, 1983 <u>1/</u>	-6.00
April 1-June 30, 1983 <u>1/</u>	4.10
July 1-September 30, 1983 <u>2/</u>	13.25
October 1-December 31, 1983 <u>2/</u>	23.95

1/ U.S. dollar component valued at US\$1=Ch\$74.

2/ U.S. dollar component valued at US\$1=Ch\$77.