



EBS/82/228

CONFIDENTIAL

December 13, 1982

To: Members of the Executive Board
From: The Secretary
Subject: Chile - Use of Fund Resources - Compensatory Financing
Facility

Attached for consideration by the Executive Directors is a paper on a request expected to be received from Chile for a purchase equivalent to SDR 295.0 million under the compensatory financing facility. A draft decision appears on page 12.

This subject, together with the staff report for the 1982 Article IV consultation with Chile, and its request for a stand-by arrangement (EBS/82/227, 12/13/82) has been tentatively scheduled for discussion on Monday, January 10, 1983.

Att: (1)

INTERNATIONAL MONETARY FUND

CHILE

Use of Fund Resources--Compensatory Financing Facility

Prepared by the Research and Western Hemisphere Departments

(In consultation with the Exchange and Trade Relations,
Legal, and Treasurer's Departments)

Approved by Charles F. Schwartz and E.W. Robichek

December 10, 1982

The Managing Director has been informed that the Chilean authorities will shortly request a purchase of SDR 295.0 million (equivalent to 90.6 per cent of quota) under the compensatory financing decision. The request, the first by Chile since June 1976, is being made with respect to a shortfall in export earnings for the 12 months ended September 1982, and is expected to be considered by the Executive Board together with a request for a stand-by arrangement in the amount of SDR 500 million (equivalent to 153.6 per cent of quota). At present, Fund holdings of the member's currency are equivalent to 51.6 per cent of quota.

This paper, which is being circulated in advance of the formal request from Chile, is presented in four sections and an annex. It supersedes the CF paper for Chile (EBS/82/137) circulated last July. The sections deal with: (1) the balance of payments position and cooperation with the Fund; (2) estimation of the export shortfall; (3) causes of the shortfall and earnings prospects; and (4) staff appraisal and proposed decision. The relations of Chile with the Fund are summarized in the annex.

1. Balance of payments position and cooperation with the Fund

a. Balance of payments position ^{1/}

After five years of large balance of payments surpluses, Chile's balance of payments was in equilibrium in 1981 but registered a large deficit in 1982.

In 1981, the current account deficit widened to 14.2 per cent of GDP, from 7.2 per cent in 1980. Export earnings fell sharply, reflecting declines in the price of copper and other mineral exports (in particular silver and

^{1/} Balance of payments developments for 1981 and 1982 are reviewed in detail in the staff report for Article IV consultation and use of Fund resources under a stand-by arrangement (EBS/82/227, 12/13/82), which is presented to the Board jointly with this request.

Table 1. Chile: Summary Balance of Payments

(In millions of SDRs)

	1979	1980	1981	1982 Estimated
A. Current account	-920	-1,514	-3,945	-2,247
Trade balance	-275	-587	-2,203	136
Exports (f.o.b.)	(2,968)	(3,615)	(3,358)	(3,435)
Imports (f.o.b.)	(-3,243)	(-4,202)	(-5,561)	(-3,299)
Services (net)	-707	-1,014	-1,827	-2,473
Credits	(944)	(1,207)	(1,823)	(1,558)
Debits	(-1,651)	(-2,221)	(-3,650)	(-4,031)
Transfers	62	87	85	90
B. Capital account	1,741	2,432	3,960	1,253
Official	(265)	(65)	(231)	(951)
Private medium- and long-term	(1,195)	(1,944)	(3,267)	(1,247)
Private short-term	(281)	(423)	(462)	(-945)
C. Errors and omissions	-3	38	45	--
D. SDR allocation	23	23	23	--
E. Overall balance (A through D)	841	979	83	-994
F. Valuation adjustment	-23	44	162	188
G. Change in reserve position (increase -)	-818	-1,023	-245	806
Reserve position with Fund	--	27	--	...
Holdings of SDRs	1	-19	13	...
Central Bank gold and foreign exchange (net)	687	976	177	...
Use of Fund credit	130	39	55	...
Other liabilities	--	--	--	...
<u>Memorandum items:</u>				
Current account balance as per cent of GDP	-5.7	-7.2	-14.2	-10.3
Overall balance as per cent of GDP	5.2	4.6	0.2	-6.9
Gross international reserves (in millions of SDRs)	1,568	2,525	2,738	2,025
Gross international reserves (in months of imports (c.i.f.))	5.2	6.4	5.3	6.6
Gross international reserves (in months of current payments)	3.6	4.7	3.5	3.3

Sources: Data provided by the Chilean authorities; and Fund staff estimates.

The value of imports rose by 30 per cent, due in part to an appreciation of the Chilean peso in real terms, and at the same time interest payments on the private sector external debt rose sharply. These factors led to an increased current account deficit, financed by an unusually large inflow of medium- and long-term private capital.

In 1982, the current account deficit is estimated to decline to 10.3 per cent of GDP. Despite stagnating exports, the trade balance is expected to swing from an SDR 2.2 billion deficit in 1981 to an SDR 136 million surplus, principally because of a 44 per cent fall in the value of imports. Net factor service payments will amount to about 9.0 per cent of GDP in 1982, up from 4.3 per cent in 1981. The capital account of Chile's balance of payments is expected to deteriorate sharply in 1982, mostly because of a large reduction in the private capital inflow resulting from the uncertain domestic economic situation. Overall, Chile's balance of payments is expected to register an SDR 994 million deficit in 1982.

The gross international reserves of the Central Bank of Chile climbed from the equivalent of less than four weeks of imports at the end of 1975 to the equivalent of nine months of imports at the end of 1980. They rose further in 1981 (mostly because of the effects of the rise in the SDR value of Chile's U.S. dollar holdings), but their increase was outpaced by that of imports; at the end of 1981 Chile's gross reserves amounted to about five months of imports. In 1982 gross official reserves are projected to fall by SDR 713 million, which is approximately the amount of the decline through September 30. With an expected 44 per cent fall in imports, Chile's gross international reserves at the end of 1982 are expected to amount to about 6.5 months of imports. If reserves are calculated with reference to total current payments, rather than just imports--as would seem appropriate in view of the importance of interest payments on foreign debt--gross reserves at the end of 1981 amounted to 3 1/2 months of current payments, and are expected to decline slightly at the end of 1982.

b. Cooperation with the Fund

Since the proposed purchase under the CFF exceeds 50 per cent of quota, it may be approved only if the Fund is satisfied that Chile has been cooperating with it in efforts to find, where required, appropriate solutions for the member's balance of payments difficulties. Chile has had several stand-by arrangements with the Fund; the most recent, which terminated on March 18, 1976, was for a total of SDR 79 million. The authorities have adopted a financial program for the period ending December 1984 in support of which a stand-by arrangement is being proposed for Board consideration concurrently with this request for a compensatory financing purchase.

As discussed in the stand-by paper, Chile has recently established a multiple currency practice for a temporary period until December 1983. In that paper, it is proposed that the Fund approve this temporary practice. The staff is satisfied that the stricter test of cooperation required for the proposed purchase is met by this stabilization effort.

2. Estimation of the export shortfall

After expanding at an average annual rate of 30 per cent a year from 1977 to 1980, total export earnings have stagnated from 1979/80 to 1981/82. They are projected to recover by 14 per cent in 1982/83 and by 17 per cent in 1983/84.

Total exports in the shortfall year ended September 1982, based on actual data, amounted to SDR 3,429 million, roughly equal to the average export earnings realized in the two preceding years and 19 per cent less than average exports projected for the two post-shortfall years. On the basis of these export movements, the shortfall for the year ended September 1982 is estimated at SDR 295 million, which is the amount of the proposed purchase (Table 2).

Table 2. Chile: Estimation of the Export Shortfall

(In millions of SDRs)

	Years Ending September				
	1980	1981	1982	Projected Exports ^{1/}	
				1983	1984
Exports	3,474.9	3,381.2	3,429.4	3,900	4,560
Shortfall			295.0		
Proposed purchase			295.0		

^{1/} Based on the judgmental forecast of earnings given in Table 3.

3. Causes of the shortfall and export prospects

The total export shortfall of SDR 295 million consists largely of a shortfall of SDR 141.8 million in copper exports, which account for 46 per cent of total exports (Table 3). Smaller shortfalls are estimated for molybdenum (SDR 29.5 million), pinewood (SDR 27.4 million), pulp and cellulose products (SDR 9.7 million), and miscellaneous exports grouped under "other exports" (SDR 94.1 million).

The shortfall in copper earnings is entirely attributable to low prices in the shortfall year, which were 13 per cent below the average price of the two pre-shortfall years and 17 per cent below the average projected price for the two post-shortfall years (Table 4). Similarly, the shortfall in molybdenum is due entirely to low prices in the shortfall year, as increased output by Chile and other major producers resulted in a glut on the market in 1981/82. Lower prices were also primarily responsible for the shortfall in pulp and cellulose exports, mainly due to weak external

Table 3. Chile: Export Earnings and Shortfalls by Major Commodities

	Years Ending September					Shortfall	
	1979	1980	1981	1982	1983	1984	Geometric Arithmetic
Total	2,583.9	3,474.9	3,381.2	3,429.4	3,900	4,560	319.7
Copper	1,257.4	1,689.4	1,484.3	1,591.0	1,846	2,121	141.8
Iron ore	91.9	125.7	118.5	145.7	153	177	-3.2
Nitrates and iodine	42.6	62.4	69.2	75.2	75	89	-1.5
Molybdenum	278.7	245.0	213.0	181.4	186	237	29.5
Fishmeal	100.7	143.1	196.8	194.8	179	208	-12.0
Pinewood	75.4	143.0	106.9	86.2	104	138	27.4
Pulp and cellulose products	112.4	161.3	154.4	157.4	168	198	9.7
Others	624.8	905.0	1,038.1	997.7	1,189	1,392	94.1
	----- (In millions of SDRs) -----						
Total	34	-3	1	14	17		
Copper	34	-12	7	16	15		
Iron ore	37	-6	23	5	16		
Nitrates and iodine	46	11	9	--	19		
Molybdenum	-12	-13	-15	3	27		
Fishmeal	42	38	-1	-8	16		
Pinewood	90	-25	-19	21	33		
Pulp and cellulose products	44	-4	2	7	18		
Others	45	15	-4	19	17		
	----- (Percentage changes) -----						

Table 4. Chile: Value, Volume and Unit Value Indices by Major Commodities

(1982=100; In terms of SDRs)

	Value Share in Total Exports in 1982 (In per cent)	Years Ending September					Shortfall in Per Cent of Level in Shortfall Year	
		1979	1980	1981	1982	1983		
Value	70.9	81	106	96	100	112	130	8.2
Copper	46.4	79	106	93	100	116	133	8.7
Iron ore	4.2	63	86	81	100	105	121	-2.4
Nitrates and iodine	2.2	57	83	92	100	100	118	-2.1
Molybdenum	5.3	154	135	117	100	103	131	16.3
Fishmeal	5.7	52	73	101	100	92	107	-6.2
Pinewood	2.5	87	165	123	100	121	159	31.3
Pulp and cellulose products	4.6	71	102	98	100	107	126	6.1
Volume		83	94	89	100	101	106	-2.2
Copper		79	87	86	100	103	105	-4.1
Iron ore		114	132	103	100	102	104	7.6
Nitrates and iodine		124	140	121	100	100	108	12.8
Molybdenum		73	66	77	100	96	105	-12.5
Fishmeal		56	74	80	100	86	93	-13.9
Pinewood		144	188	127	100	116	140	31.1
Pulp and cellulose products		95	105	90	100	100	112	1.1
Unit value		97	113	109	100	110	123	10.8
Copper		101	121	108	100	113	127	13.4
Iron ore		55	66	79	100	103	117	-8.9
Nitrates and iodine		45	59	76	100	100	110	-13.2
Molybdenum		211	205	152	100	107	124	32.8
Fishmeal		92	100	126	100	107	115	9.2
Pinewood		61	88	97	100	104	114	0.2
Pulp and cellulose products		75	98	110	100	107	112	5.3

demand. The shortfall in pinewood exports, on the other hand, was due entirely to reduced volume caused primarily by the depressed condition of world construction activity. Finally, the shortfall in other exports was caused by an interruption of the rapid growth of this category of mostly nontraditional exports due to the world recession in 1981/82.

a. Copper

Exports of copper, which contributed about three quarters of total export earnings in the early 1970s, have diminished in relative importance in recent years, and in the shortfall year represented only 46 per cent of total exports. The estimated shortfall of SDR 141.8 million is due entirely to a decline in the world price of copper.

After reaching a cyclical peak in the first quarter of 1980, world copper prices began to decline owing to a weakness in demand resulting particularly from slowdowns in the transport, construction, and energy sectors in industrial countries. Because of the strengthening of the U.S. dollar vis-a-vis the SDR, the decline was more rapid in U.S. dollar terms than in SDR terms since 1980 (Table 5). The SDR unit value of Chile's exports declined by 11 per cent (17 per cent in U.S. dollars) in 1980/81 and by 7 per cent (14 per cent in U.S. dollars) in 1981/82, closely following movements in world prices. Export earnings declined by 12 per cent in 1980/81, but then increased by 7 per cent in 1981/82 as a 16 per cent volume increase more than offset an 8 per cent unit value decline. This volume increase was accomplished by drawing on stocks and raising production to normal levels after the strike-depressed level of 1980/81. Other major copper producers are reported also to have drawn down stocks during this period because of the high cost of holding stocks related to high interest rates, and many producers in industrial countries cut back output.

Earnings from copper exports are projected to increase by 16 per cent in 1982/83 and by another 15 per cent in 1983/84, reflecting primarily an expected recovery in price as demand rises. The price forecast for 1983/84 in U.S. dollar terms is still 15 per cent below the average price reached in 1979/80. Volume is forecast to increase by about 2 per cent per year with new investment in capacity at the Chuquicamata mine.

b. Iron ore

Earnings from iron ore exports have risen steadily in recent years to SDR 145.7 million in 1981/82, 19 per cent above the average of the two pre-shortfall years; an excess of SDR 3.2 million is estimated for iron ore. Chile's iron ore exports consist of two main products, ore and pellets. In recent years production has shifted in favor of pellets, which have a higher mineral concentration and consequently command a higher unit value. This has caused the unit value of Chile's total iron ore exports to increase more rapidly than the world price of iron ore and the volume of exports to decrease. With this change in the composition of iron exports now completed, unit values are forecast to increase at a more moderate annual rate of 8 per cent during 1982/83 and 1983/84, but export earnings are expected to maintain their upward trend.

Table 5. Chile: Recent Copper Price and Unit Value Movements

	Years Ended September			
	1979	1980	1981	1982
International price <u>1/</u>				
Cents/pound	82.5	100.8	82.7	69.4
Per cent change	(41)	(22)	(-18)	(-16)
.01 SDR/pound	63.9	77.2	68.3	61.6
Per cent change	(33)	(21)	(-12)	(-10)
Unit value				
Cents/pound	78.1	95.4	79.0	67.7
Per cent change	...	(22.15)	(-17.19)	(-14.30)
.01 SDR/pound	...	73.1	65.1	60.2
Per cent change	60.5	(20.83)	(-10.94)	(-7.53)

1/ London Metal Exchange, electrolytic wirebars, spot London (The Journal of Commerce, New York), average of daily quotations.

c. Nitrates and iodine

Exports of nitrates and iodine rose to SDR 75.2 million in 1981/82, equal to 2 per cent of total export earnings in 1981/82 and 14 per cent above the average of the two pre-shortfall years. This relatively strong performance resulted in an estimated excess of SDR 1.5 million. The outlook for 1982/83 is for a leveling off in exports, mainly due to projected low world agricultural prices and the consequent weak demand for fertilizers. In 1983/84 exports are expected to increase by 19 per cent in response to a projected recovery in world demand for fertilizers, slightly less than the 22 per cent average annual growth of the three pre-shortfall years.

d. Molybdenum

Molybdenum is used as an alloying element in the production of steel, cast iron, and nonferrous metals. In 1981, a serious oversupply situation developed in the world molybdenum market. Prices have reacted accordingly, dropping by about one third during 1981 and exhibiting continuing weakness in the first half of 1982. Major producers have recently begun cutting back production in an effort to bring supply more in line with demand.

Chile produces about 15 per cent of the world's molybdenum supply. Exports peaked in 1978/79 at SDR 278.7 million and then declined at an average annual rate of 14 per cent during the next three years because of falling world prices. A shortfall of SDR 29.5 million is estimated for 1981/82, entirely as a result of price factors. Molybdenum exports are projected to recover by 3 per cent in 1982/83 to SDR 186 million as output reductions by Chile and other major producers reverse the decline in prices which are projected to increase by 7 per cent in 1982/83. In response to a recovery in world demand in 1983/84, earnings are expected to increase by 27 per cent to SDR 237 million.

e. Fishmeal

Chile is a major supplier of fishmeal, accounting for about 20 per cent of world exports. The existence of a close substitute, soybean meal, limits the extent to which a major producer can influence fishmeal prices. In 1981/82, fishmeal exports contributed slightly less than 6 per cent of Chile's total export earnings.

Exports reached SDR 194.8 million in 1981/82, 16 per cent greater than the average of the two pre-shortfall years, resulting in an estimated excess of SDR 12 million. The increase in exports was due to the large catch in 1981 (20 per cent greater than 1980), which led to a buildup of stocks that were eventually drawn down in the first half of 1982. The increased volume in 1981/82 was partially offset by a 21 per cent decline in unit value due to increasing competition from soybean meal, which was declining in price.

Earnings are expected to decline by 8 per cent in 1982/83 from the abnormally high level in 1981/82, but a 16 per cent rate of growth is projected in 1983/84 in the expectation of strengthened world demand and higher prices.

f. Pinewood

Export earnings from pinewood dropped to SDR 86.2 million in 1981/82, 31 per cent below the average earnings for the two pre-shortfall years. The estimated shortfall of SDR 27.4 million was caused entirely by volume factors. The recession in world construction activity, notably in Japan, Chile's main export market, has resulted in a contraction of world trade in timber. The rapid increase in timber prices in the late 1970s, due mainly to world supply constraints in the face of increasing demand, appears to have ceased temporarily, but resistance to downward movements is evident, with prices increasing slightly in 1981/82. Chile has also been adversely affected by increasing competition from Canada, which is diverting exports from the depressed construction market in the United States to Far Eastern markets.

Pinewood exports in 1982/83 are projected to recover by 21 per cent. Increased competitiveness because of the recent devaluation is expected to enable Chile to recover its market share, especially in the Far East. Keen competition for markets is expected to moderate unit value increases in 1982/83 and 1983/84. Chile is well equipped to take advantage of the projected recovery in world construction activity in 1983/84, with acreage under pine having been expanded by about 20 per cent over the last few years. Pinewood exports are accordingly forecast to increase by 33 per cent in 1983/84, although they will still be below 1979/80 levels.

g. Pulp and cellulose products

The world pulp and paper industry has weakened considerably in the last few years, with capacity utilization falling from 95 per cent in 1979 to 89 per cent in the first half of 1982. Lower demand caused Chile's exports of pulp and cellulose products to drop by 4 per cent to SDR 154.4 million in 1980/81, and then increase by only 2 per cent in 1981/82. The estimated shortfall of SDR 9.7 million is attributable primarily to low prices.

Exports are projected to increase by 7 per cent in 1982/83 to SDR 168 million. Although unit values are forecast to increase by 7 per cent in 1982/83, volume is expected to remain at the same level as 1981/82. No recovery in export volume is projected, because world pulp inventories held by paper producers reached 1.8 million tons in the first half of 1982, 31 per cent above normal levels, and these are expected to be drawn down to normal levels during 1982/83. In 1983/84, Chile's exports are forecast to increase by 18 per cent, with recovery occurring in both volume and prices.

h. Other exports

Other exports, accounting for 29 per cent of total exports in the shortfall year and composed mainly of nontraditional products such as metal manufactures, fruit and vegetables, petrochemical products, silver, gold, fish, and miscellaneous manufactured goods, increased at an average annual rate of about 30 per cent during 1979 and 1980 before slowing down sharply in 1981 because of the world recession and the real effective appreciation of the peso. During the shortfall year, these exports declined by 4 per cent. Metal exports declined mainly because of weak world markets and lower prices for silver, gold and copper products. Agricultural and other nontraditional exports slowed down in response to depressed markets abroad and decreasing domestic competitiveness.

The estimated shortfall for other exports of SDR 94.1 million was caused by the decline of these exports in 1981/82, which is expected to be followed by a recovery of 19 and 17 per cent in the two post-shortfall years. The main factors expected to contribute to this growth are the recovery in world demand, increased competitiveness because of the depreciated exchange rate, improved metal prices, and investment in expanded acreage for fruit and vegetable exports due to come on stream in 1982/83.

4. Staff appraisal and proposed decision

The Chilean authorities are expected to request a purchase of SDR 295 million (equivalent to 90.6 per cent of quota) under the compensatory financing facility in respect of a shortfall for the same amount estimated on the basis of actual data for the year ended September 1982.

In 1981 Chile's current account deficit deteriorated sharply to 14.2 per cent of GDP from 7.2 per cent in 1980, due to a decline in export earnings and rises in imports and interest payments. With a continuing low level of exports estimated for 1982, along with a further rise in interest payments and a sharp decline in private capital inflows, Chile's overall balance of payments is projected to register a deficit of SDR 994 million, even though because of the recession in Chile and the depreciation of the peso, imports are estimated to decline by 44 per cent. Chile's gross international reserves, which had fallen by SDR 400 million during the period October 1981-September 1982, are projected to decline by SDR 713 million in 1982. The staff considers that the balance of payments need of Chile justifies the proposed purchase under the compensatory financing decision.

Although Chile has recently established a temporary multiple currency practice, for which the staff is recommending Executive Board approval, the staff considers that Chile has been cooperating with the Fund in efforts to find, where required, appropriate solutions for its balance of payments difficulties as evidenced by the adoption by Chile of a financial program under a stand-by arrangement which will be considered by the Board concurrently with the request for a CF purchase.

Export earnings in the shortfall year ending September 1982 were roughly equal to the average of the two pre-shortfall years and 19 per cent less than the average projected for the two post-shortfall years. The shortfall for the year ended September 1982 is estimated at SDR 295 million. The largest shortfall is estimated for copper (SDR 141.8 million); shortfalls are also estimated for molybdenum (SDR 29.5 million), pinewood (SDR 27.4 million), pulp and cellulose products (SDR 9.7 million), and other exports (SDR 94.1 million). Low prices related to weak world demand were entirely responsible for the shortfalls in copper and molybdenum exports. A decline in export volume, on the other hand, resulting from the recession in world construction activity, was responsible for the shortfall in pinewood exports. Having achieved a more competitive position through exchange rate depreciation and assuming the beginning of a recovery of demand in 1983, Chile's export earnings are expected to recover by 14 per cent in 1982/83 and by 17 per cent in 1983/84. The staff considers that the shortfall in Chile's export earnings, being related predominantly to weak world demand and low prices, was largely attributable to factors beyond Chile's control.

The request for a compensatory financing purchase is expected to include a statement that Chile will cooperate with the Fund in efforts to find, where required, appropriate solutions for its balance of payments difficulties. The staff considers that the expected request will meet all the requirements set forth in the compensatory financing decision. Accordingly, the following draft decision is proposed for adoption by the Executive Board after a duly authenticated request has been received:

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

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

Fund Relations with Chile

Date of membership: December 31, 1945.

Quota: SDR 325.5 million.

Fund holdings of Chilean pesos:	As of October 31, 1982	Millions	Per Cent
		<u>of SDRs</u>	<u>of Quota</u>
Total holdings		265.6	81.6
(Of which correspond- ing to oil facility)		(10.7)	(3.3)
SDR position:	As of October 31, 1982	Millions	Per Cent of
		<u>of SDRs</u>	<u>Net Cumulative</u>
			<u>Allocation</u>
	Net cumulative allocation	121.9	100.0
	Holdings	(22.9)	(18.8)

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 September 29, 1982 the rate was Ch\$66.00 per U.S. dollar. A preferential exchange rate applies to the servicing of debt contracted before August 6, 1982. This exchange rate stood at Ch\$51.77 per U.S. dollar on September 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).