

**FOR
AGENDA**

SM/07/219

June 25, 2007

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Chile—Staff Report for the 2007 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2007 Article IV consultation with Chile, which is tentatively scheduled for discussion on **Monday, July 16, 2007**. This consultation was conducted under the streamlined procedures established under the Fund's Medium-Term Strategy. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of Chile indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Mr. Mühleisen (ext. 38686), Mr. Soderling (ext. 39707), and Mr. Walsh (ext. 35929) in WHD.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Tuesday, July 3, 2007; and to the European Commission, the European Investment Bank, and the Inter-American Development Bank, following its consideration by the Executive Board.

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CHILE

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the
2007 Consultation with Chile

Approved by Markus Rodlauer and G. Russell Kincaid

June 25, 2007

- ***Discussions for the 2007 Article IV consultation took place in Santiago and by videoconference during May 22-June 5, 2007.***
- ***Given the broad consensus on economic policies, and the absence of systemic issues, the 2007 Article IV consultation is streamlined.*** The last consultation was concluded on August 2, 2006. Brief summaries of ongoing background work are presented in a *Selected Issues* paper (see also Annex 1).
- ***Chile has accepted the obligations of Article VIII, Sections 2, 3, and 4,*** and maintains an exchange rate system free of restrictions on payments and transfers for current international transactions.
- ***Chile is a party to the Financial Action Task Force on Money Laundering in South America (GAFISUD)*** and to the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. An AML/CFT Assessment was conducted and approved by GAFISUD in 2006 (www.gafisud.org/pdf/InformeChile.pdf).
- The mission met with Governor Corbo, Finance Minister Velasco, Economy Minister Ferreiro, Labor Minister Andrade, other senior government officials; and representatives of financial institutions, the private sector, and academia.
- The staff team comprised Messrs. Mühleisen (head), Söderling, Monfort and Walsh (all WHD). M. Kumhof (RES) presented a paper at the Banco Central de Chile (BCC). Mr. Rodlauer (WHD) participated in the final discussions, and Mr. Singh joined the concluding videoconference with Minister Velasco.

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EXECUTIVE SUMMARY

Owing to strong institutions and sound economic policies, Chile has experienced two decades of economic stability and increasing living standards. The rules-based policy framework has helped preserve competitiveness during the recent copper boom. With trend growth at around 5 percent, further progress has been made in reducing poverty, although income inequality remains relatively high.

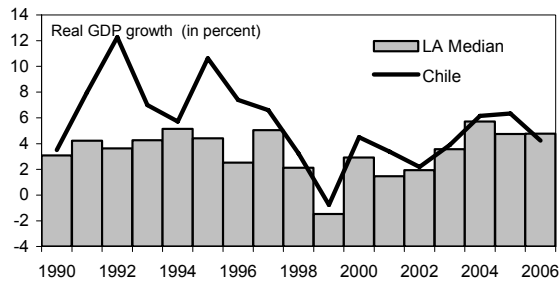
Following a strong performance in the first quarter, growth is expected to reach 5¾ percent in 2007, with the output gap likely to close in 2008. Fiscal policy remains anchored by the structural surplus rule; as the government has paid down debt and moved into a net creditor position, the structural surplus target has been lowered from 1 to ½ percent of GDP as of 2008. Given the strong growth outlook, monetary policy will likely tighten gradually as excess capacity is absorbed. The exchange rate is assessed to be broadly in line with fundamentals.

This streamlined consultation has focused on two key areas, reaffirming a broad consensus with the authorities:

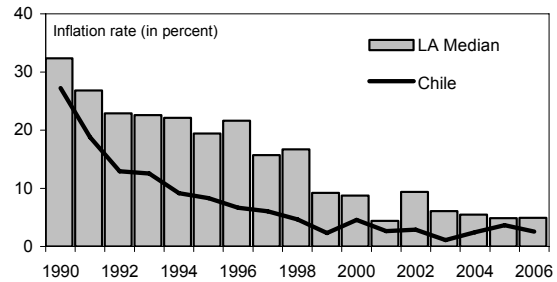
- ***The macroeconomic policy framework.*** The authorities remain committed to the well-tested policy framework consisting of a freely floating exchange rate, an inflation targeting framework, and responsible fiscal policy as embedded in the structural surplus rule. Successful implementation of this framework has created increasing room for addressing social priorities, which the authorities intend to pursue in an incentive-compatible manner, accompanied by further increases in transparency.
- ***Bridging the income gap with advanced economies.*** Policies to raise long-term growth prospects focus on education, job-specific human capital, and innovation. Financial sector reforms are aimed at increasing depth and competition in Chile's financial sector, and integrating Chile further into the global financial system.

Figure 1. Overview

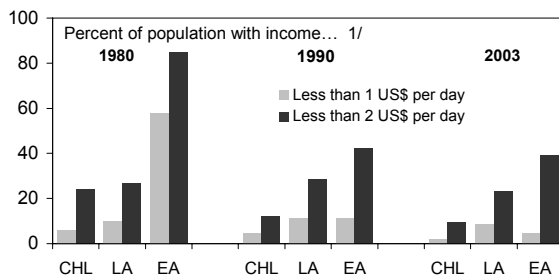
Chile has grown faster than many Latin American countries...



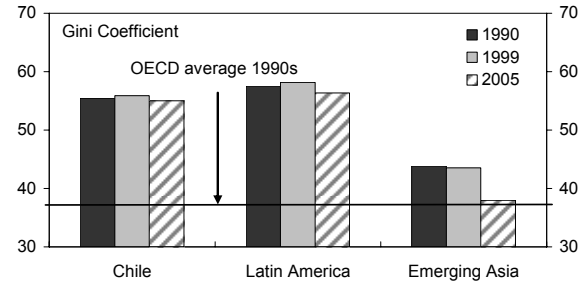
...while being at the forefront of introducing price stability to the region.



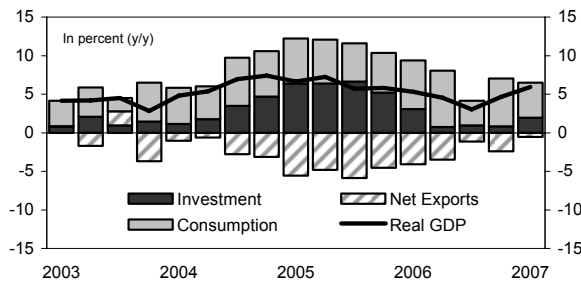
Substantial progress has been achieved in poverty reduction...



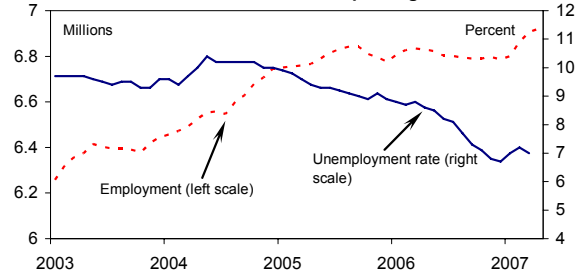
...but income inequality remains high.



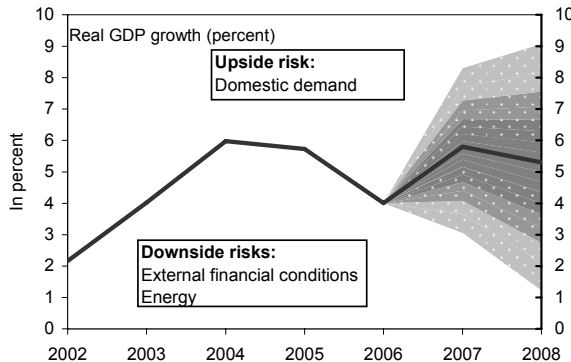
Growth is rebounding strongly from a soft patch in 2006...



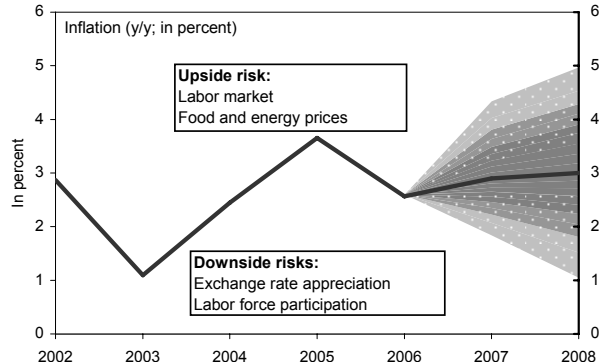
...and labor market conditions are improving.



Growth is expected to exceed potential, with risks broadly balanced...



...while risks to the inflation outlook are mildly on the upside.



Source: Haver, WDI, Economic Commission for Latin America Social Panorama (2006), and Fund Staff estimates.

1/ Chart is based on World Bank definition; this may differ from national poverty lines.

I. INTRODUCTION

1. ***Over the past fifteen years, Chile's consistent economic reforms and prudent macroeconomic policies have delivered strong growth and low inflation.*** Per capita income tripled in U.S. dollar terms since 1990 and the poverty rate was cut by two-thirds, to about 14 percent. Growth was fastest during the mid-1990s, but has slowed somewhat in recent years amid stagnant employment, less FDI inflows, and declining labor productivity growth. Moreover, extreme poverty persists—although mitigated by well-targeted social programs—and income inequality remains relatively high.
2. ***Key elements of Chile's economic policies have been institutionalized, increasing transparency and reducing volatility.*** With its open economy and liberal trade regime, the macroeconomic policy framework—a floating exchange rate, inflation targeting and a structural fiscal surplus rule—has been geared toward reducing economic volatility from shocks. These policies have helped maintain the economy's competitiveness despite the high price volatility of copper, Chile's main export product, and provide increasing room to address social priorities.
3. ***Domestic consensus on the policy framework remains solid.*** President Bachelet took office in March 2006 with a strong mandate to strengthen social policies within a sound macroeconomic framework. The government enjoys a majority in both houses of Congress, and although it has grappled recently with a complex overhaul of Santiago's public transit system, it is actively pushing forward an ambitious reform agenda. In May, the President announced a reduction in the structural surplus target from 1 to ½ percent of GDP in 2008, with additional resources to be devoted primarily to education.
4. ***The discussions have reaffirmed a broad consensus on economic policies and reform priorities between the authorities and the Fund*** (last year's Board discussion is summarized in PIN No. 06/97).

II. OUTLOOK AND RISKS

5. ***Following a strong rebound in the first quarter of 2007, growth is projected at about 5¾ percent this year.*** The completion of some large capital projects has boosted productive capacity, and consumer demand remains strong, underpinned by favorable labor market conditions and buoyant consumer credit growth.¹ Growth is also underpinned by a supportive fiscal and monetary policy stance, and a broad-based rise in exports.² With potential growth estimated at 5 percent, Fund and central bank staff expect the output gap to

¹ Staff analysis suggests that credit growth in Chile is less affected by the cycle than by structural developments, such as rising department store lending to low and middle-income households.

² Staff estimates of the fiscal impulse (Table 2) are preliminary and work in progress.

| Economic Outlook | | | | | | |
|---|------|------|------|--------------|---------------------|------|
| (In annualized percent change from previous period; unless otherwise indicated) | | | | | | |
| | 2003 | 2004 | 2005 | Est. 2006 | Projections 2007 | 2008 |
| Real GDP | 4.0 | 6.0 | 5.7 | 4.0 | 5.8 | 5.3 |
| Net exports (contribution) | -0.6 | -1.2 | -5.0 | -2.2 | -1.5 | -0.8 |
| Total domestic demand | 4.9 | 7.5 | 11.0 | 6.0 | 7.1 | 5.8 |
| Private consumption | 4.2 | 7.0 | 7.9 | 7.1 | 6.8 | 5.8 |
| Public consumption | 2.5 | 6.1 | 5.3 | 3.6 | 7.8 | 6.6 |
| Private fixed investment | 6.5 | 10.5 | 23.2 | 3.3 | 6.3 | 5.5 |
| Public fixed investment | -0.4 | 5.7 | 11.2 | 10.9 | 20.9 | 9.8 |
| Inventories (contribution) | 0.6 | 0.1 | 0.5 | 0.1 | 0.0 | 0.0 |
| Unemployment rate (percent) | 9.5 | 10.0 | 9.3 | 7.9 | ... | ... |
| Consumer price index | 2.8 | 1.1 | 3.1 | 3.4 | 2.8 | 3.0 |
| General government fiscal balance (in percent of GDP) | -0.4 | 2.1 | 4.7 | 7.8 | 6.1 | 2.9 |
| Current account balance (in percent of GDP) | -1.1 | 2.2 | 1.1 | 3.6 | 3.4 | 0.8 |
| Memorandum items: | | | | | | |
| Output Gap | -2.5 | -0.9 | -0.1 | -1.1 | -0.3 | 0.0 |
| Copper price (US\$/pound) | 0.8 | 1.3 | 1.7 | 3.1 | 2.7 | 2.0 |

close in 2008 (from around 1 percent at end-2006) and inflation to return to the 3 percent target.

6. ***Risks to the outlook appear broadly balanced.*** The baseline forecast implies some softening in the pace of expansion toward the end of the year, but there is a possibility that the already strong domestic momentum could receive a further boost from improving labor market conditions. On the other hand, drought conditions and interruptions in gas deliveries from Argentina pose risks to electricity production; rises in oil and food prices would reduce disposable income; and tightening global liquidity might dampen domestic credit expansion.

7. ***Supply shocks and diminishing excess capacity could present upside risks to inflation.*** Strong import growth has helped contain price increases, and overall labor cost growth has been moderate despite a strong pickup in hourly wages. Stronger demand conditions could imply a more rapid closing of the output gap, although officials at the Banco Central de Chile (BCC) were optimistic that a procyclical rise in labor participation would limit pressure on unit labor costs.

8. ***Banks are profitable and highly capitalized, and the financial system appears well prepared to weather an external shock.*** Reflecting sound economic fundamentals and the government's strong balance sheet, staff analysis suggests that a drop in global risk appetite to the lows of 1998 could push up Chile's EMBI spread only by a modest 70 basis points. While this would also increase private sector financing costs, Chilean banks and corporates

are in a better position to accommodate external shocks than in the past. Based on model simulations, risks in the banking sector would remain well below 1998.³

9. ***With Chile accounting for a third of global copper production, spillover effects to the rest of the world center around the mining outlook.*** Labor disputes and technical problems slowed production in 2006, but completion of several labor contracts and investment projects should propel output toward its projected medium-term growth rate of 3 percent per year. Water and environmental constraints could eventually limit the pace of expansion, but Chile's copper deposits are deemed large enough to sustain production for longer than in most other countries with non-renewable resources.

III. MACROECONOMIC POLICY FRAMEWORK

Fiscal policy

10. ***Fiscal policy remains well anchored by the structural surplus rule.*** The authorities emphasized that Chile's long-standing prudent fiscal policy had created the space for the moderate reduction in the structural surplus target. They firmly expected the 2008 budget to be consistent with overall macroeconomic stability, with the amount of the expenditure increase determined—under the rules-based framework—mainly by the long-term reference price for copper and projected revenues at potential GDP growth.⁴ The authorities had noted some recent weakness in VAT collections which, if sustained, would affect projected revenue—and thus spending—for next year.

11. ***Looking ahead, the authorities intend to maintain a positive surplus target in part to fund future pension costs.*** The government is committed to put between 0.2 and ½ percent of GDP per year into a public pension fund, depending on the size of the actual fiscal surplus, to help finance the proposed pension reform (see below). The ongoing program of recapitalizing the BCC balance sheet will continue as planned (by ½ percent of GDP in each of the next four years).

12. ***Efforts are underway to raise further the effectiveness of government spending.*** While pointing to the exemplary success of Chile's fiscal expenditure framework, officials noted the importance of spending additional resources in a cost-effective way. To that end, the government announced steps to improve public financial management, including through new agencies supervising public investment and education, impose tighter coordination over regional spending, and the introduction of a new fiscal transparency law. The officials

³ Banking sector vulnerabilities were modeled using a contingent claims approach developed jointly by BCC and Fund staff (BCC, *Financial Stability Report*, Fall 2006).

⁴ The estimates for the reference price for copper and potential GDP growth are provided by independent expert commissions.

| General Government Budget: Staff Projections (In percent of GDP) | | | | | | |
|---|------|------|------|------|------|------|
| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
| Revenue | 23.3 | 22.8 | 23.9 | 25.8 | 28.1 | 27.4 |
| Mining Revenue | 0.6 | 1.1 | 3.6 | 5.1 | 8.9 | 7.2 |
| Expenditure | 24.5 | 23.3 | 21.8 | 21.1 | 20.4 | 21.3 |
| Investment | 3.8 | 3.6 | 3.4 | 3.4 | 3.3 | 3.6 |
| Surplus | -1.2 | -0.4 | 2.1 | 4.7 | 7.8 | 6.1 |
| Net Assets | -7.9 | -6.7 | -4.1 | 0.1 | 7.5 | 12.0 |
| <i>Memorandum item:</i> | | | | | | |
| Nonmining Balance | -1.8 | -1.5 | -1.5 | -0.4 | -1.1 | -1.1 |

welcomed the staff's proposal to shift to a medium-term expenditure framework to tie annual budget decisions more closely to the government's strategic objectives.

Monetary and exchange rate policy

13. ***Monetary policy will likely tighten gradually as excess capacity is absorbed.*** As the economy slowed in 2006, the BCC first paused the tightening cycle underway since 2004, and then lowered interest rates by 25 basis points in early 2007. With recent data pointing to a strong and broad-based recovery, policy may have to resume a gradual tightening course in the months ahead. Long-term interest rates have ticked upwards in recent weeks, and many analysts expect a resumption of rate increases. As in the past, the BCC will take into account all available information in gauging the inflation outlook and any needed policy response, including the impact of the announced reduction in the fiscal surplus target.

14. ***Monetary policy has been successful in anchoring inflation expectations firmly around the 3 percent policy target, despite major shifts in the terms of trade.*** To increase transparency, the BCC in January adjusted its inflation target to "around 3 percent, with a tolerance range of \pm one percentage point" to focus attention on the previous mid-point of the target range.⁵ The authorities welcomed a staff suggestion to conduct periodic pre-determined reviews of the inflation targeting framework.

15. ***The value of the peso is broadly in line with fundamentals.*** Despite a sizeable nominal appreciation against the U.S. dollar, the real effective exchange rate has appreciated only moderately since the onset of the copper boom in 2004. Staff's empirical work (including CGER analysis and a background study of the performance of non-copper exports) shows that competitiveness remains adequate.

⁵ The previous target consisted of a range of 2–4 percent over a time horizon of meeting the target of 12–24 months. The new time horizon is set to "around 2 years."

16. ***The authorities confirmed their commitment to maintaining a floating exchange rate.*** Given the strong external position and upward pressure on the peso, the government is advancing part of the planned increase in foreign investment limits for pension funds.⁶ The authorities reiterated their policy of not intervening in the foreign exchange market except if they judged exchange rate volatility to be excessive and potentially damaging to the economy.

17. ***In light of the strong buildup in foreign assets, the authorities are developing a long-term strategy for the allocation of those funds.*** The government's savings under the structural surplus rule have been managed by the BCC since March 2007. A recent assessment of the management of foreign exchange reserves found the BCC to be in observance of the IMF *Guidelines for Foreign Exchange Reserve Management* and having adequate institutional capacity in this area.

IV. BRIDGING THE INCOME GAP WITH ADVANCED ECONOMIES

18. ***Building on well-developed institutions and strong governance, Chile has set its sights on raising long-term growth to close the income gap with industrialized countries*** (table below). To address key factors limiting Chile's growth potential and further reduce vulnerabilities to external shocks, the government is pursuing an ambitious structural reform agenda, including in education, pensions, innovation, and the financial sector. Integrating Chile's financial sector system more closely with global capital markets will play an important role in strengthening competitive forces and catalyzing reforms in other sectors.

Human capital and the labor market

19. ***Education will be the prime beneficiary of the reduced fiscal target.*** Most of the freed-up funds will be used to raise the value of student vouchers, and an education reform bill submitted to Congress aims at raising quality and improving access especially for low-income households. The government has also launched initiatives to improve the climate for entrepreneurship and innovation, particularly for small and medium-sized enterprises (SMEs).

20. ***A major pension reform is to raise benefits, improve coverage, increase returns to saving, and encourage participation in the formal labor market.*** The proposed reform includes a universal public pension pillar and aims at boosting participation of low-income groups and the self-employed (Box 1). Although public benefits will be substantially increased, the authorities were confident that the additional cost of the new system, netted

⁶ Under the pension reform plan, the investment limit is to be raised gradually from 30 to 80 percent of pension fund assets. In May, the government announced legislation to raise the limit to 45 percent.

| Chile—Selected Institutional Rankings | | | | | |
|---|---------------------|-----------------|-----------------------|--------------------|----------|
| Index (Publisher) | Per-centile Ranking | Overall Ranking | Latin America Ranking | Countries Surveyed | Date |
| Governance Indicators | | | | | |
| Freedom in the World (Freedom House) | n.a. | Free | 1 | 193 | Jan 2007 |
| Index of Economic Freedom (Heritage Foundation) | 7 | 11 | 1 | 157 | Jan 2007 |
| Economic Freedom of the World (The Fraser Institute) | 15 | 20 | 1 | 130 | Sep 2006 |
| Corruption Perceptions Index (Transparency International) | 12 | 20 | 1 | 163 | Nov 2006 |
| Press Freedom Index (Reporters without borders) | 29 | 49 | 5 | 168 | Oct 2006 |
| Freedom of the Press Index (Freedom House) | 34 | 66 | 4 | 195 | May 2007 |
| Economic and Financial Indicators | | | | | |
| Emerging market investment attractiveness (Wilshire) | 8 | 2 | 1 | 27 | Apr 2007 |
| Doing Business (World Bank) | 17 | 28 | 3 | 165 | Sep 2006 |
| Global Competitiveness Index (WEF) | 22 | 27 | 1 | 125 | Sep 2006 |
| Total Wealth per Capita (World Bank) | 27 | 32 | 4 | 118 | Sep 2005 |
| World Competitiveness Yearbook (IMD International) | 55 | 26 | 1 | 61 | 2006 |
| Globalization Index (A.T. Kearney/Foreign Policy) | 62 | 34 | 2 | 55 | Dec 2006 |
| High Technology Indicators | | | | | |
| Sixth Annual Global e-Government Study (Brown) | 17 | 34 | 1 | 198 | Aug 2006 |
| IT Network Readiness Index (WEF) | 25 | 31 | 1 | 122 | Mar 2007 |
| The Power of Access Index (FedEx) | 43 | 32 | 1 | 75 | May 2006 |
| Social and Environmental Indicators | | | | | |
| State of the World's Mothers (Save the Children) | 15 | 19 | 2 | 125 | May 2006 |
| Human Development Index (UNDP) | 21 | 38 | 2 | 177 | Nov 2006 |
| Quality of Life Index (International Living) | 25 | 49 | 9 | 193 | Jan 2007 |
| Worldwide Quality-of-Life Index (The Economist) | 28 | 31 | 1 | 111 | Nov 2004 |
| Environmental Sustainability Index (Yale/Columbia Univ.) | 29 | 42 | 9 | 146 | Jan 2005 |
| Source: Staff calculations. | | | | | |

against the cost of maintaining the current system, will be kept to a maximum of one percent of GDP per year.⁷

21. *Although employment growth has picked up, greater labor market flexibility would facilitate factor reallocation in response to external shocks and competitive pressures.* The authorities are currently building consensus for strengthening the social protection of workers and improving the unemployment insurance system. Staff noted that separation costs appeared high, and that instruments facilitating part-time employment were not being widely used.

22. *The results of a recent ROSC Update suggest that Chile's macroeconomic statistics are generally timely and of good quality.* The mission encouraged the authorities to improve the coverage of surveys on labor costs, capacity utilization, and prices, as well as other statistical data in line with practices in industrialized economies (see table).

⁷ Preliminary cost estimates by the staff are broadly in line with the authorities' calculations.

Statistical Issues and Macroeconomic Analysis

Chile subscribes to the Fund's Special Data Dissemination Standard. The results of a recent data ROSC Update suggest that the macroeconomic statistics are generally sound, and gain high marks for assurances of integrity, serviceability, and accessibility. However, compared to economic statistics of many industrial countries, some gaps remain.

| | |
|---|---|
| Labor market | Genuine unit labor cost data are not available, in part because of limited information on hours worked. Time series on wages by sector were discontinued in 2005. However, monthly indices of average compensation as well as of hourly labor cost are published. The two major unemployment surveys (by the University of Chile and the National Statistics Institute) could be improved to provide a consistent labor market picture. |
| National accounts | Despite the overall high quality of the national accounts, data on inventories and inventory prices tend to be erratic and hard to interpret, given that they are mainly estimated as residuals in the balancing of the supply and use table. Shifting the national accounts to chain price indexing would reduce base-year distortions and improve the statistical treatment of copper price fluctuations. |
| Producer data and price statistics | Capacity utilization data are not yet available on a time series basis. The CPI has limited geographic coverage, and its basket and weight structure remain outdated pending planned improvements. For the PPI, adjustments for quality differences are not made (in particular, the copper price collection procedure increases quality induced volatility), and missing prices are carried forward from the last observed price in most of the categories. |
| Fiscal data | Adoption of the Government Finance Statistics Manual 2001 (GFSM 2001) is a major improvement. However, the reconciliation of the fiscal balance with changes in government net debt could be improved, and timely high-frequency data on tax revenue by type of tax would help the analysis of revenue and general economic trends. Some gaps remain in the coverage of military debt, but efforts are underway to improve the legal framework for compiling such data. |
| Capital account data | Chile provides monthly information on portfolio investment flows, as well as assets and liabilities, in line with international statistical standards. A more detailed breakdown of portfolio flows, including on a gross basis as well as geographical basis, would assist economic analysis. |

Financial sector

23. *A second round of capital market reforms was passed into law in late May, and market participants generally welcomed the progress achieved in recent years.* Planned additional measures for 2007 include steps to internationalize the peso, further develop local markets, strengthen corporate governance and facilitate foreign investment. The mission agreed that providing smaller borrowers, including SMEs, with improved capital market access could unlock productive capacity and benefit innovation, and that care was needed to not impose effective ceilings on SMEs' size.

24. *The financial component of the pension reform could assist market development.* Broadening portfolio options for Pension Fund Administrators (AFPs) and raising their foreign investment limits could reduce excess demand for high-quality domestic assets, expose domestic borrowers to stronger competition, and help in the development of local markets. The authorities are planning a gradual approach to liberalization, with the pace depending on financial stability considerations and the capacity of AFPs to manage assets in a more complex financial environment.

V. STAFF APPRAISAL

25. *Reflecting its strong institutional framework and sound macroeconomic policies, Chile has experienced two decades of economic stability and increasing living standards.* Although trend growth remains below the level of the 1990s, Chile has rightly set its sights on eliminating poverty and closing the income gap with industrialized economies. Staff

supports the government's strategy of maintaining the macroeconomic framework while addressing social issues and implementing structural reforms to boost long-term growth.

26. ***Amid growing signs of a rebound, the economy is projected to expand by around 5¾ percent in 2007.*** Upside risks for domestic demand are balanced by concerns over energy supply and modest downside risks from the global outlook. Inflation is expected to rise toward the BCC's 3-percent target, and the peso is assessed to be broadly in line with fundamentals.

27. ***With inflation expectations firmly anchored, monetary policy appropriately supported the economy's recovery through the slowdown in 2006.*** Given strong output growth, monetary stimulus will likely be withdrawn in the coming months. The BCC's balance sheet has been strengthened, and the staff welcomes the government's commitment to continue to recapitalize the bank.

28. ***Fiscal policy remains well anchored by the structural surplus rule.*** A modest reduction in the surplus target is justified by the improvement in the government's net debt position. The staff welcomes the authorities' intention—supported by the rules-based system—to keep public expenditure increases consistent with macroeconomic stability. In order to cover future pension liabilities, the authorities are committed to maintaining a positive surplus target for the foreseeable future.

29. ***Ensuring high-quality public spending remains critical.*** Costs and benefits of new expenditure projects will need to be carefully weighed, and planned steps to improve the efficiency of government spending and increase transparency are well placed. Establishing a medium-term expenditure framework would allow annual budget decisions to be tied more closely to the government's strategic objectives.

30. ***The proposed pension reform addresses the main shortcomings of the current system, while maintaining many of its pioneering basic features.*** A key goal of the reform is to increase pension coverage and equity in the system. The authorities are confident that the overall cost of the reform can be kept within the projected amount of one percent of GDP per year, and that incentives to save will be unimpaired. The mission welcomes steps to gradually increase foreign investment limits for pension funds, which will allow them to optimize their portfolio allocation and is timely in view of the strong external position.

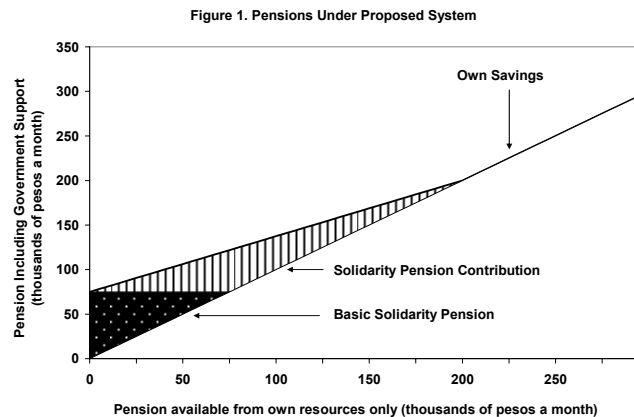
31. ***The government has launched welcome initiatives to boost human capital and innovation, and integrate Chile more closely into global capital markets.*** Improving education and reducing skills gaps will be key to raising long-term growth prospects. Targeted initiatives can be useful to help smaller enterprises if designed in a way that does not impose a ceiling on their future size. Financial sector reforms will play an important role in strengthening competitive forces and catalyzing reforms in other sectors.

32. *There is room to make labor markets more flexible*, and to strengthen incentives to participate in the labor market.
33. *It is recommended that the next Article IV consultation take place on the regular 12-month cycle.*

Box 1. Reforming the Pension System

The government's proposals for a comprehensive reform of Chile's 26-year old pension system focus on addressing several shortcomings. The system's coverage ratio is relatively low, in part because many workers have failed to accumulate the necessary 20 years' worth of contributions. Many women, in particular, are left without incomes in old age; and investment options have been constrained. The reform is a top priority for President Bachelet's government, and has been developed by a high-level commission of experts in a broad consultative process.

The cornerstone of the reform is the Basic Solidarity Pension (BSP), which introduces a universal pillar into Chile's privatized system. The reform creates a minimum pension for Chileans over 65 (equal to about one-fifth of the average wage) and provides means-tested subsidies to poor the poor. The proposal also subsidizes initial contributions by women and the young, while gradually enforcing participation among the self-employed.



The authorities are confident that overall incentives to work and save would not worsen under the new system, although some tradeoffs are typically unavoidable. In the new system, the marginal return on a dollar's worth of additional pension saving would be positive for all workers:

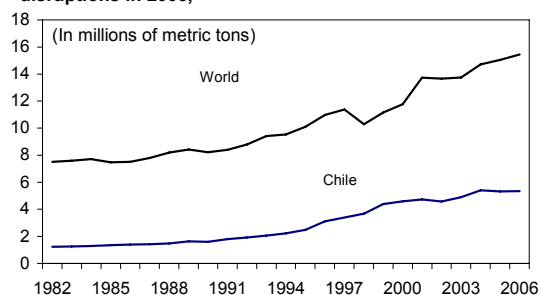
- Workers currently receiving the (flat) minimum pension guarantee do not obtain a higher pension for an additional dollar worth of pension savings. Under the new system, their marginal return would *increase* to 62.5 cents per dollar saved.
- Workers currently receiving more than the minimum pension guarantee would also face a marginal return of 62.5 cents (unless their pension income exceeds CLP 200,000 per month; see chart). In their case, however, the marginal return is *lower* than the 100 cents return they receive under the current system.

The reform also has a strong financial component, aimed at increasing competition among pension funds and raising real returns to pensioners. In addition to liberalizing investments rules for Pension Fund Administrators (AFPs), the reform boosts competition among AFPs by auctioning the right to serve new entrants and allowing domestic banks to enter the market.

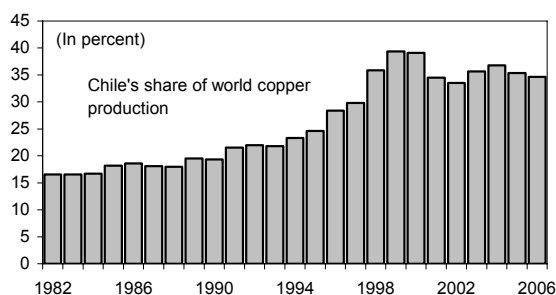
The government estimates the cost of the reform at around 1 percent of GDP per year, partly funded from returns on a pension fund accumulated with the help of structural government surpluses. Congressional debate of the reform is expected to last into 2008.

Figure 2. Delinking the Economy from Copper

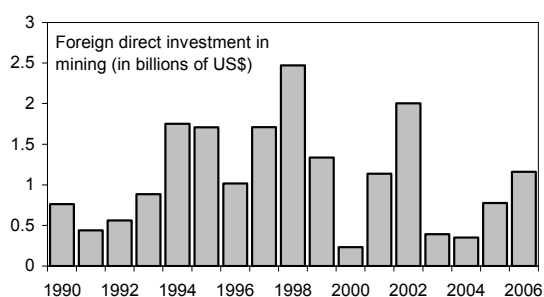
Although Chile's copper production was hurt by disruptions in 2006,



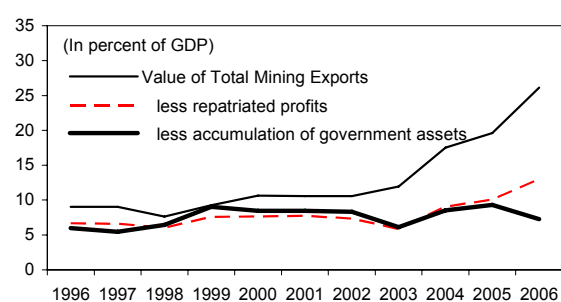
...Chile remains the world's largest copper producer.



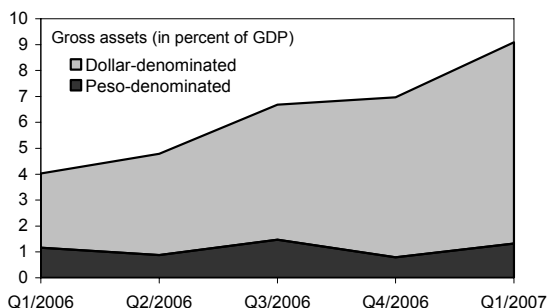
With strong participation by foreign companies,



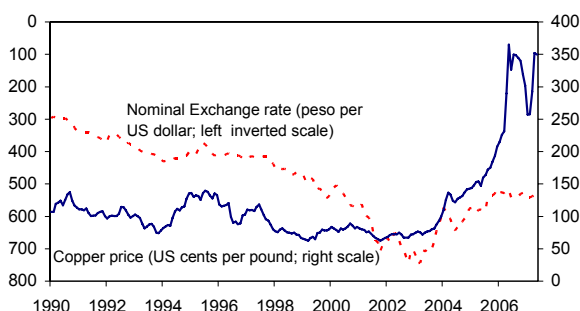
...only part of mining revenues have remained in Chile.



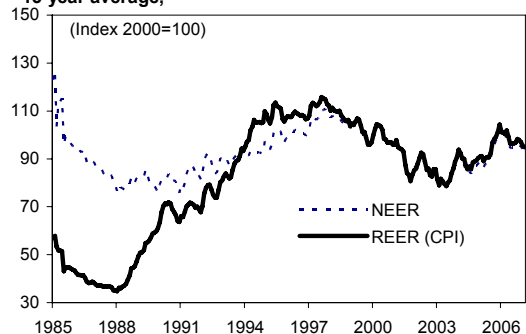
Beginning in 2006, the government has been shifting all copper revenues and most other assets abroad,



...which has curbed peso appreciation despite a surge in copper prices.



The real effective exchange rate has remained close to its 15-year average,



...and the correlation between GDP growth and copper prices has declined.

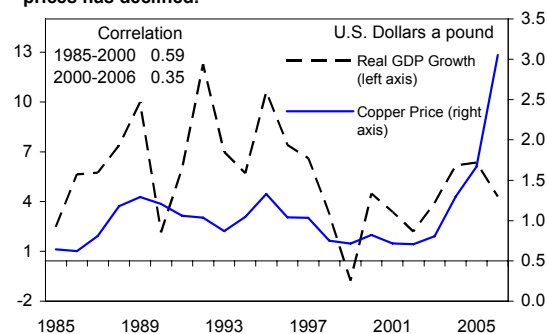
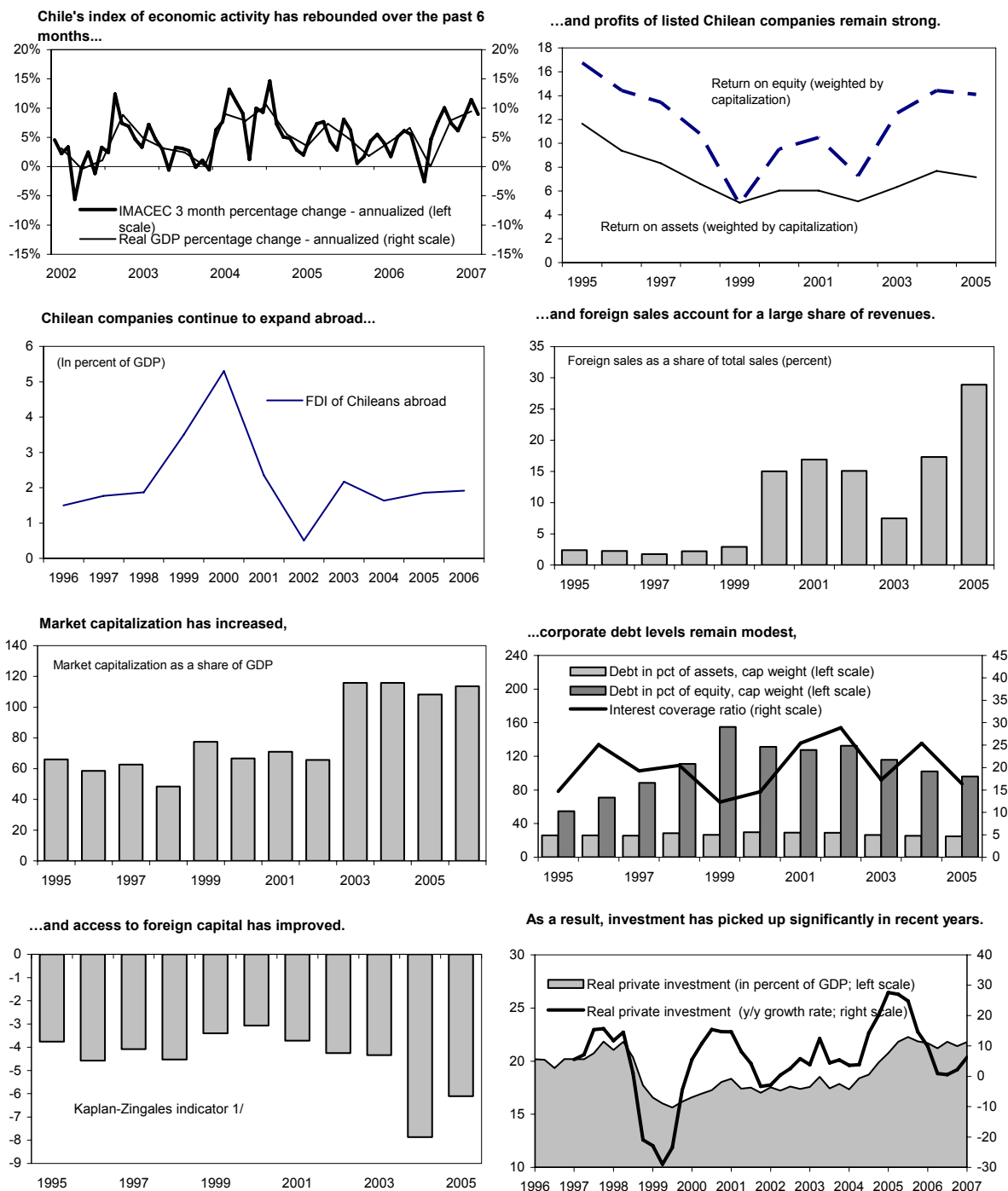


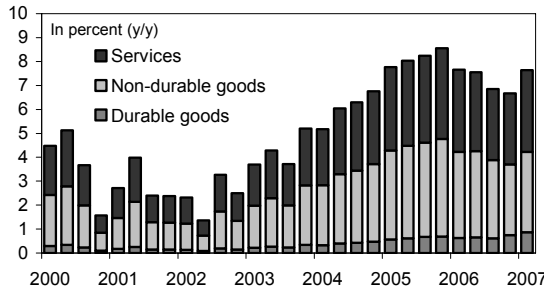
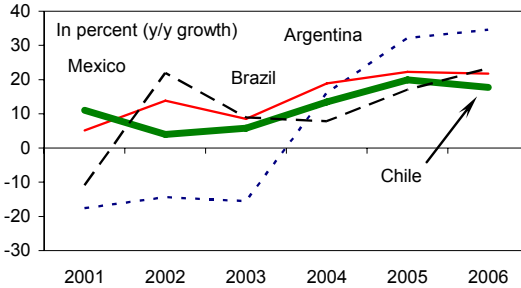
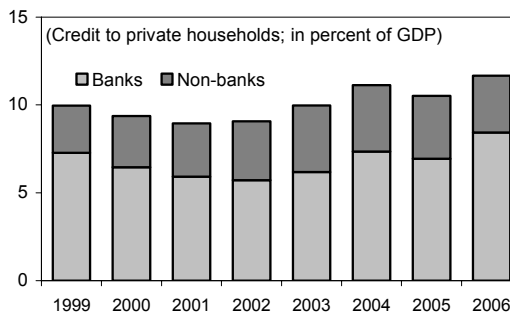
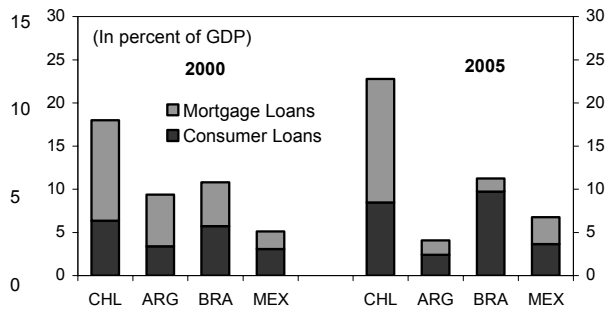
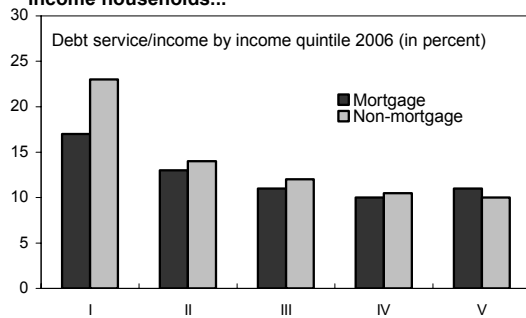
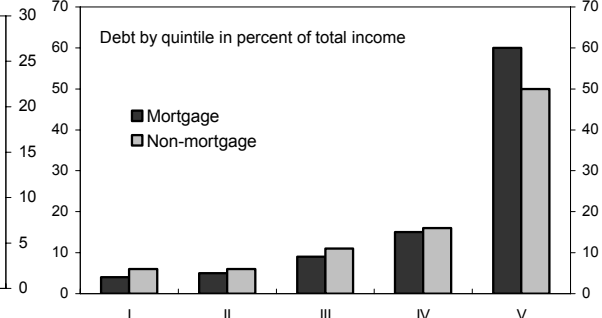
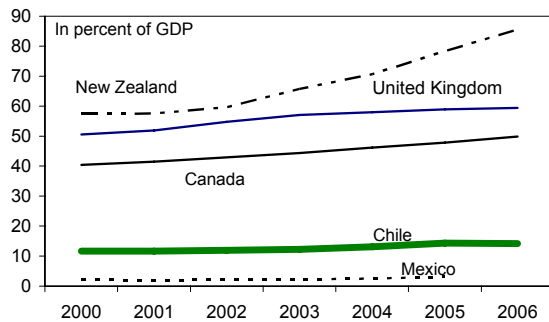
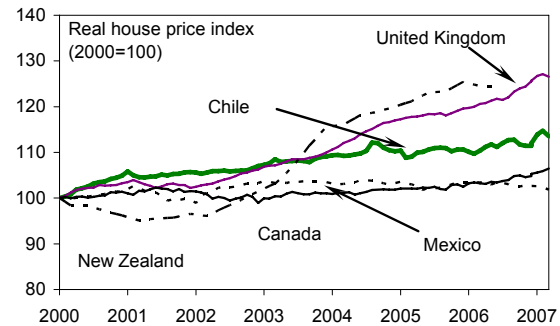
Figure 3. Corporate Financial Indicators



Source: Bloomberg, Chilean Authorities and Fund staff estimates.

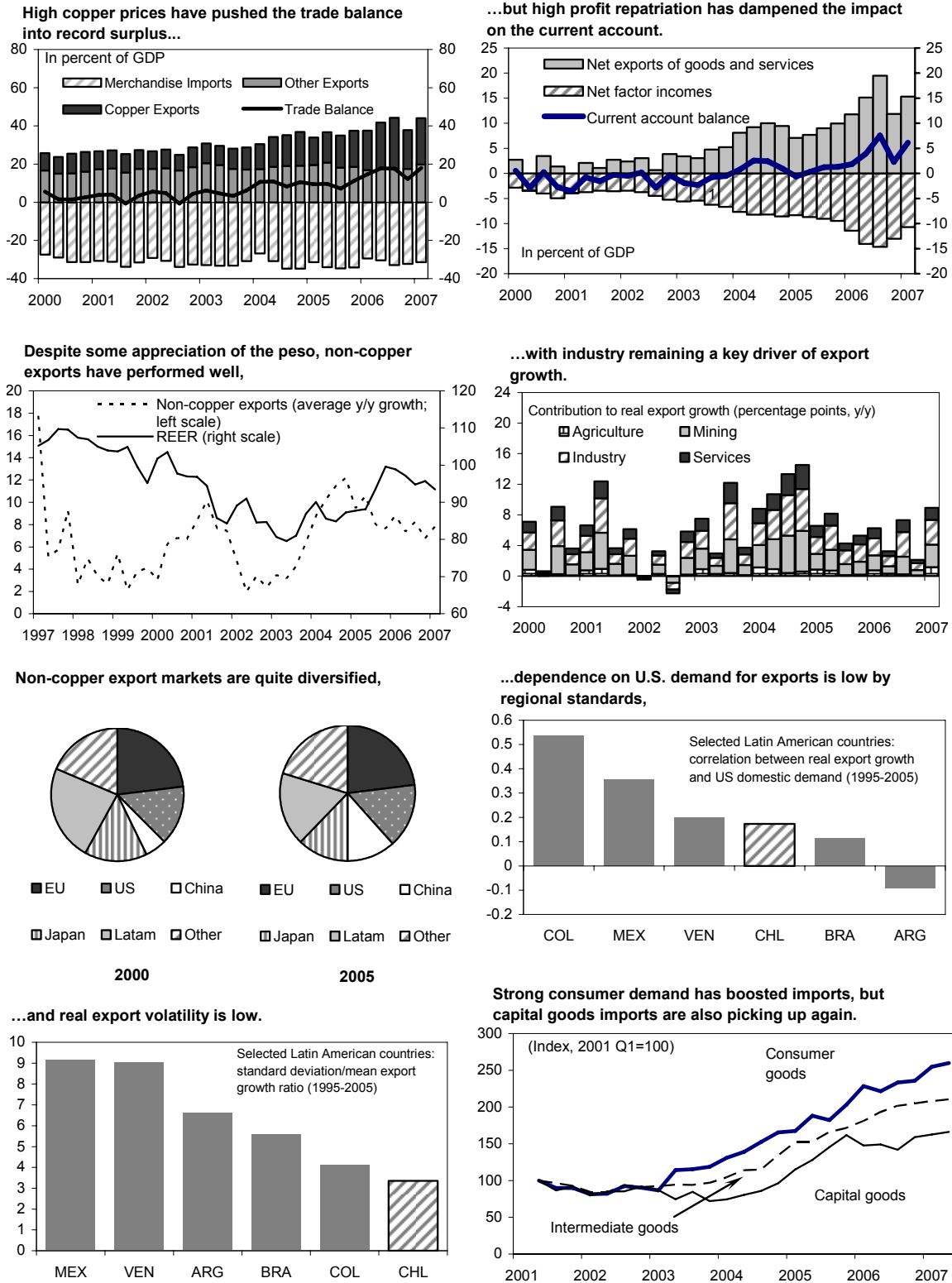
1/ The Kaplan-Zingales indicator measures constraints to external finance. A lower statistic implies fewer constraints.

Figure 4. Household Finances

Consumption remains buoyant...**...partially funded by increased credit to private households.****Banks are facing stronger competition from credit card lending by department stores.****Household debt levels have increased moderately.****Debt service burden is mainly a concern for low-income households...****...who account only for a small share of outstanding household debt.****Mortgage lending is low by international standards...****...and real house price appreciation has been modest.**

Source: Haver, National Authorities and Fund Staff estimates.

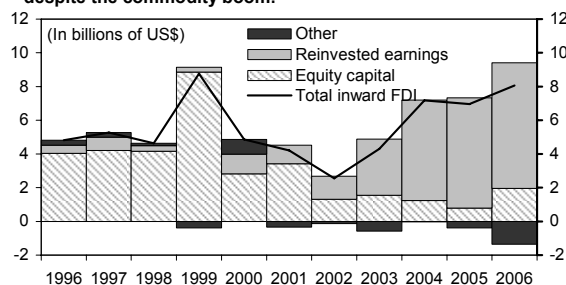
Figure 5. Trade Performance



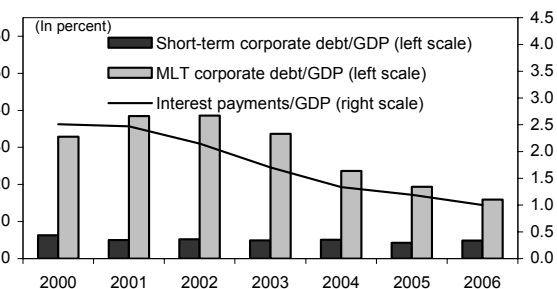
Sources: Haver, World Trade Organization, and Fund staff estimates.

Figure 6. Capital Account and Foreign Portfolios

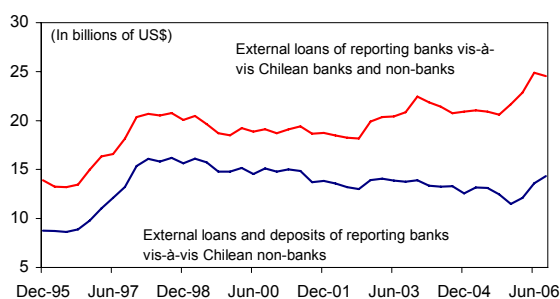
New foreign direct investment in Chile has remained low, despite the commodity boom.



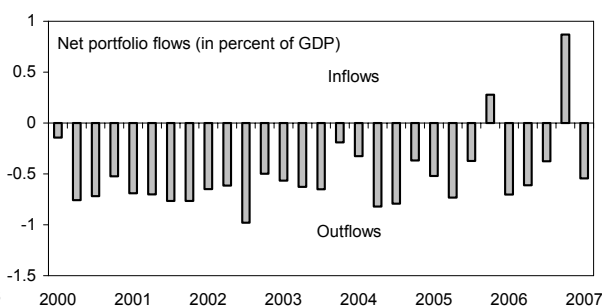
Although Chilean enterprises are borrowing less abroad,



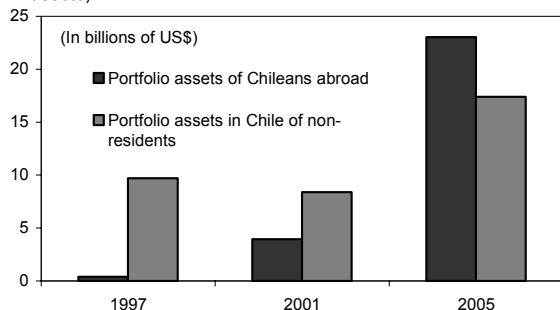
...external borrowing by domestic banks has increased, partly as a result of foreign banks entering the market.



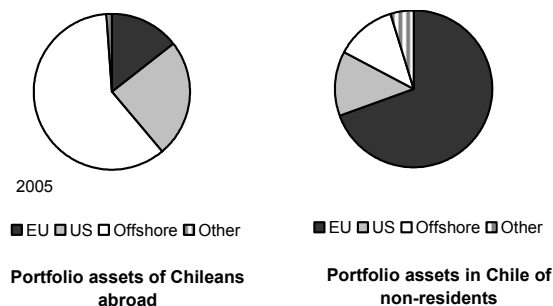
Net portfolio flows were largely outward in recent years,



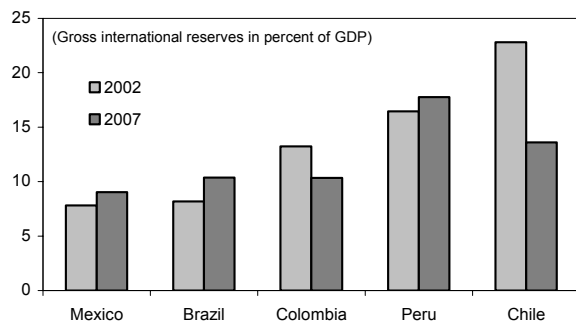
...resulting in a significant accumulation of foreign portfolio assets,



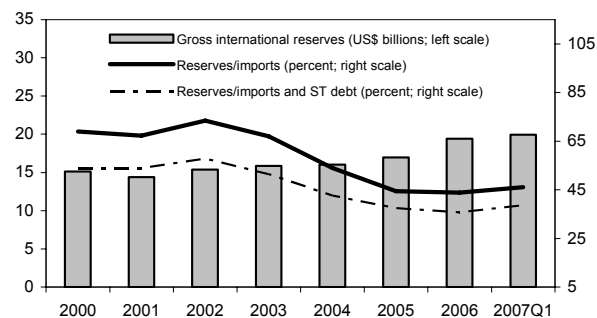
...which are largely invested through European offshore centers.



The BCC's reserve holdings have declined relative to GDP...

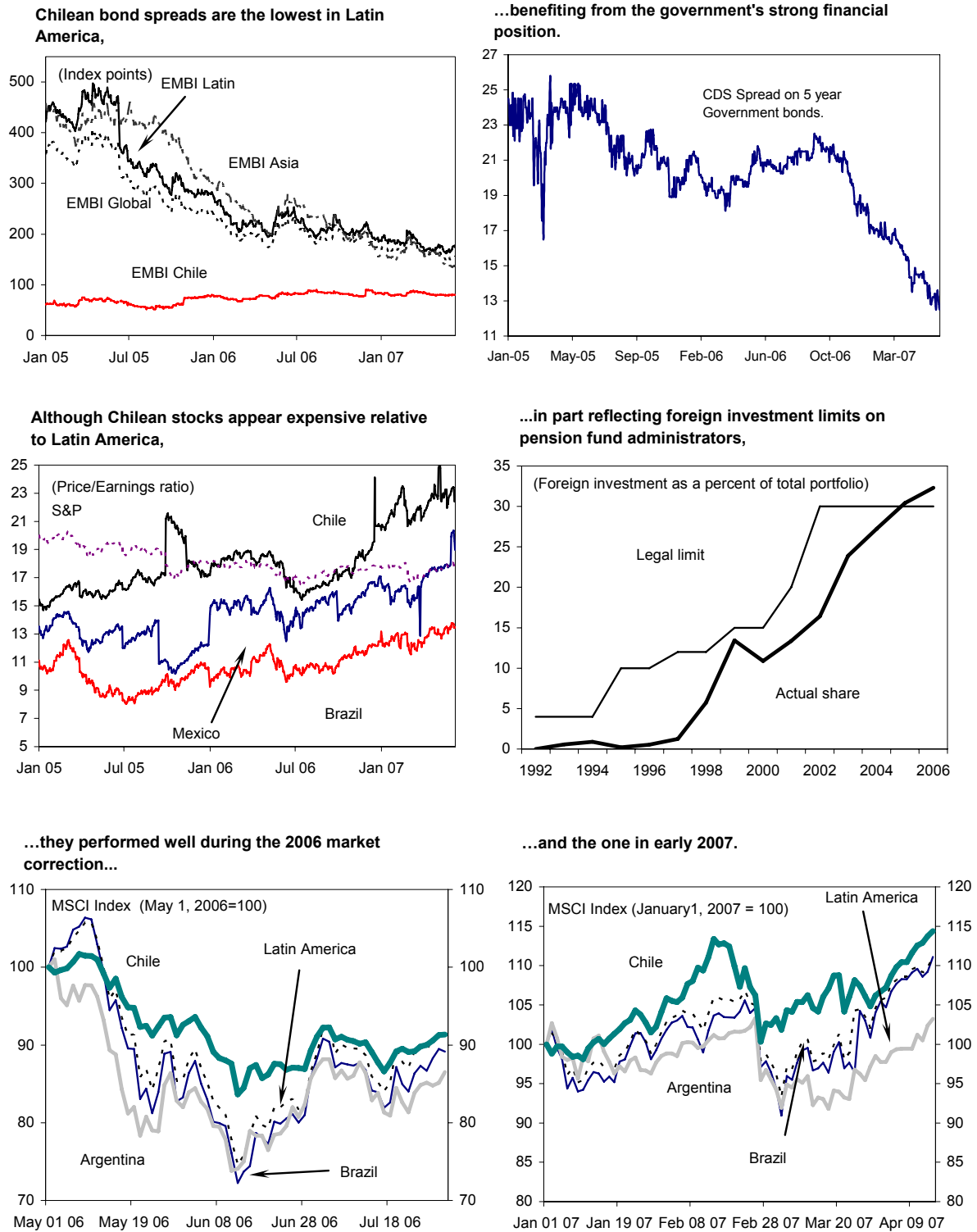


...but reserve coverage remains at a favorable level.



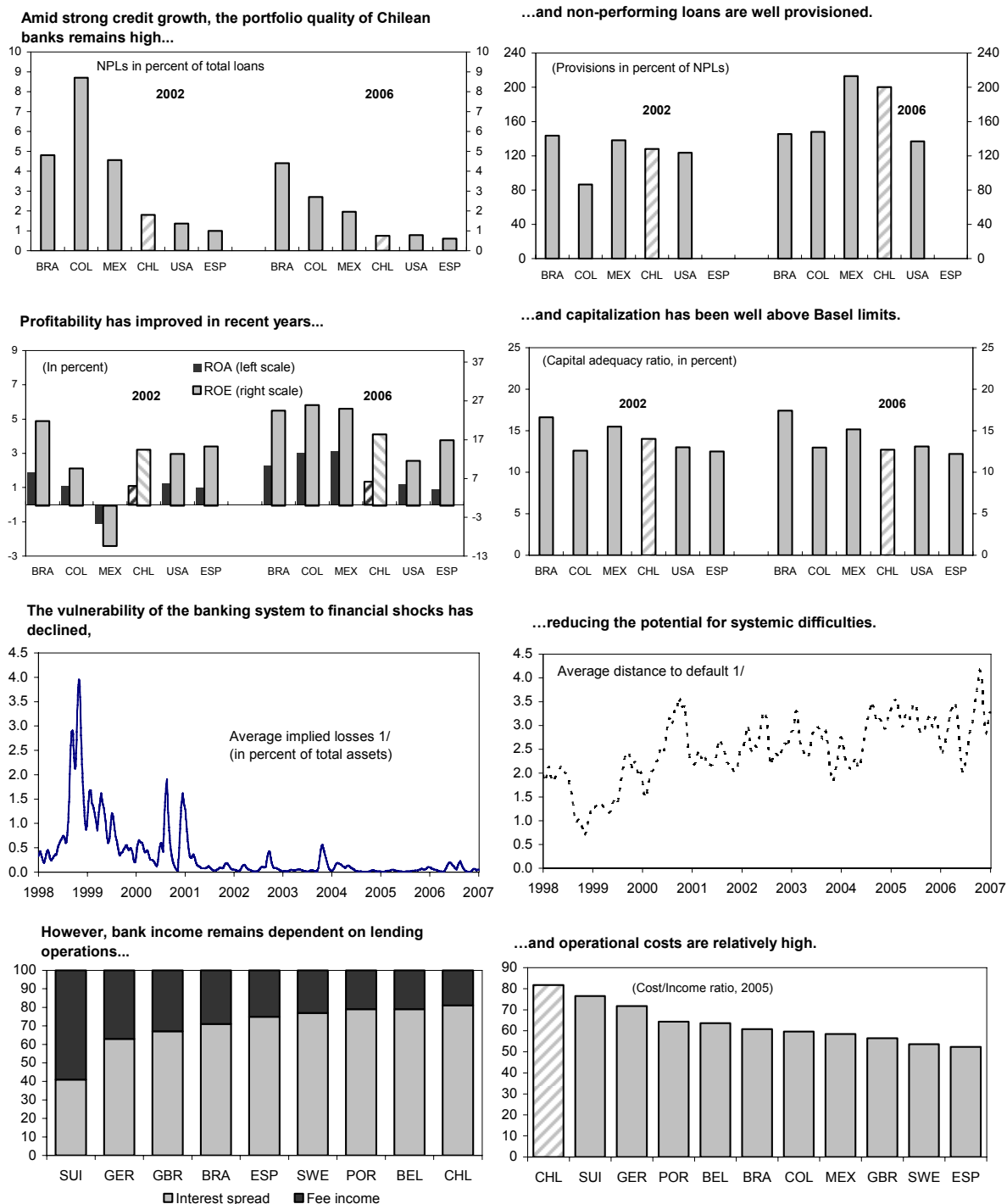
Source: Chilean Authorities and Fund staff estimates.

Figure 7. Financial Market Developments



Source: Bloomberg, Bankscope, Bank of International Settlements, IFS, and Fund Staff estimates.

Figure 8. Banking Indicators

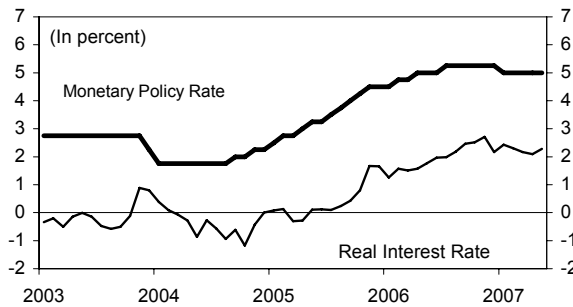


Source: Fund staff estimates.

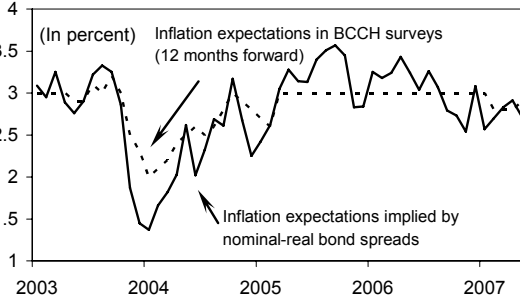
1/ Average implied losses and distance to default measures are derived from a contingent claims model for the Chilean banking system. Distance to default refers to the number of standard deviations by which implied bank assets exceed default levels. Average implied losses are the probability-weighted losses of the banking sector averaged over the next year.

Figure 9. Monetary Policy Indicators

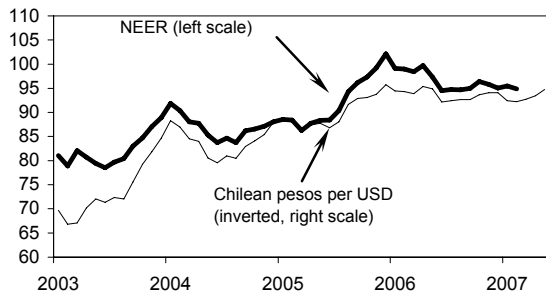
The Central Bank of Chile lowered its policy rate in January 2007...



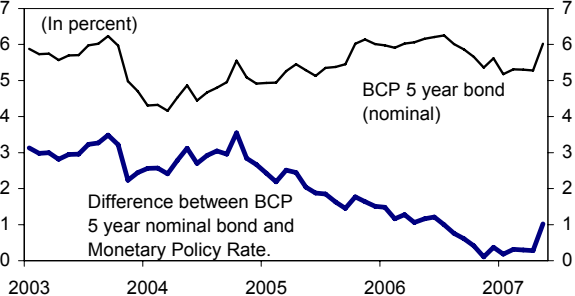
...amid moderating inflation expectations,



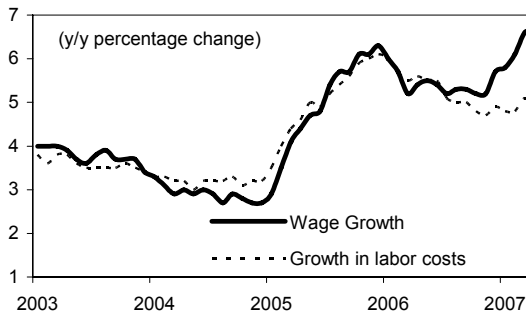
...and nominal peso appreciation.



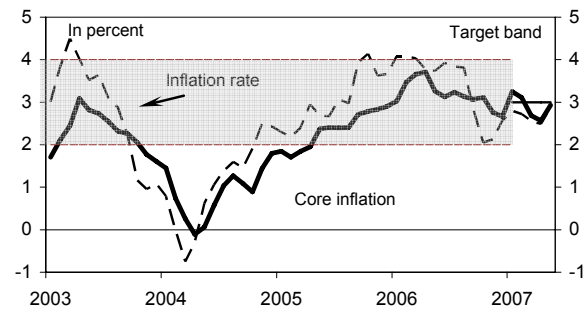
The yield curve was flattening until recently, when long rates increased.



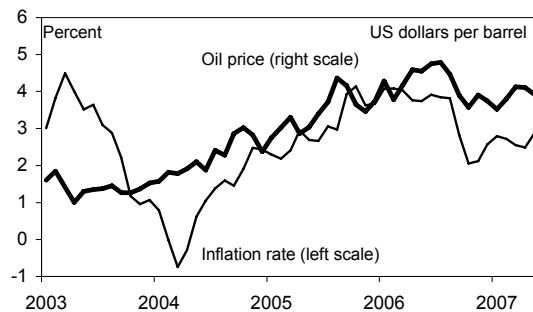
Despite increasing wage costs,



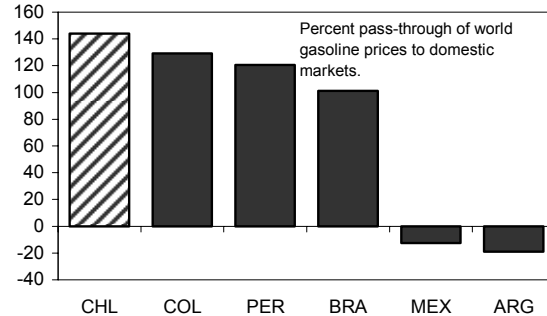
...inflation remains near the 3-percent target.



Energy price volatility remains a risk.



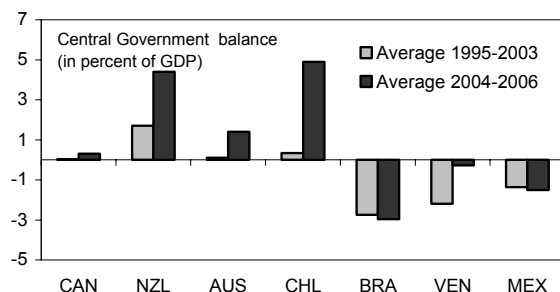
Oil price pass-through in Chile is relatively high compared to other countries.



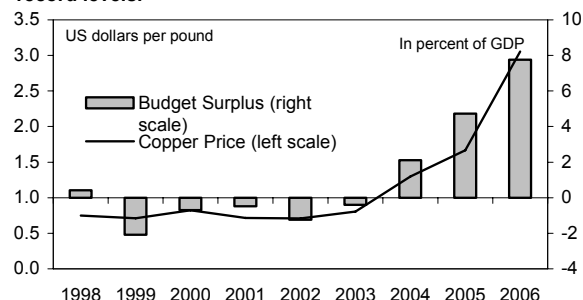
Source: Haver and Fund staff estimates.

Figure 10. Fiscal Developments

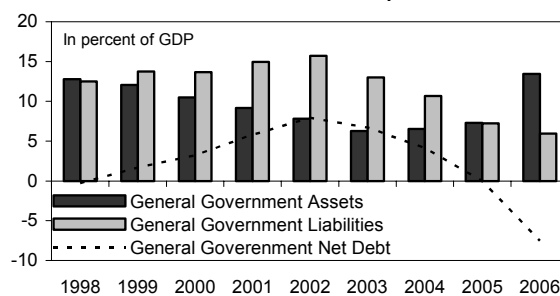
Building on a prudent fiscal policy framework,



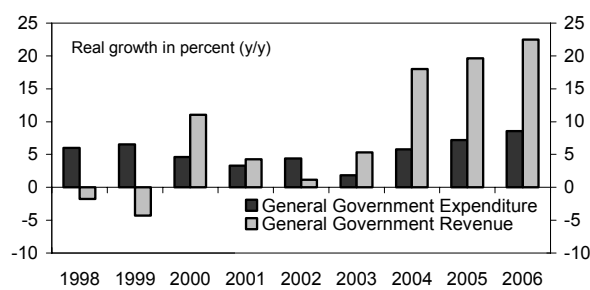
...the budget surplus has tracked rising copper prices to record levels.



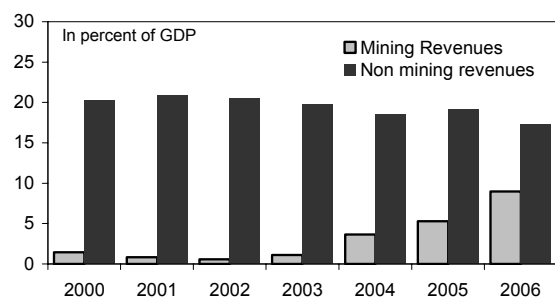
Rising surpluses have allowed the government to pay down debt and move into a net creditor position.



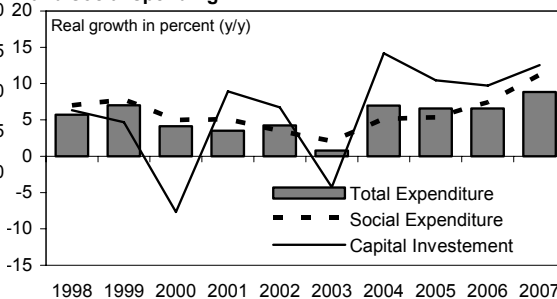
The structural surplus rule has limited expenditure increases while revenues have risen sharply...



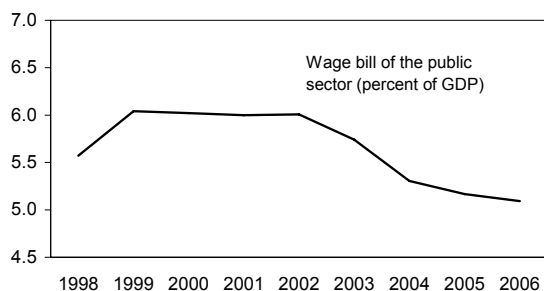
...notwithstanding a slowdown in nonmining revenues.



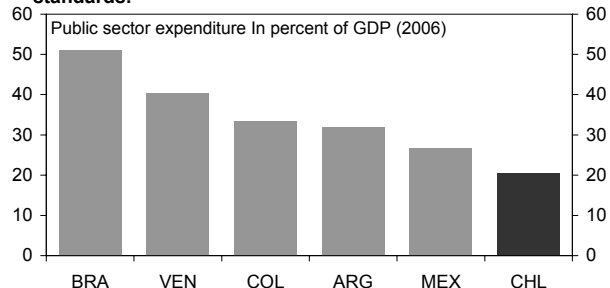
Government expenditure is focused on public investment and social spending.



Public employment costs have been contained;

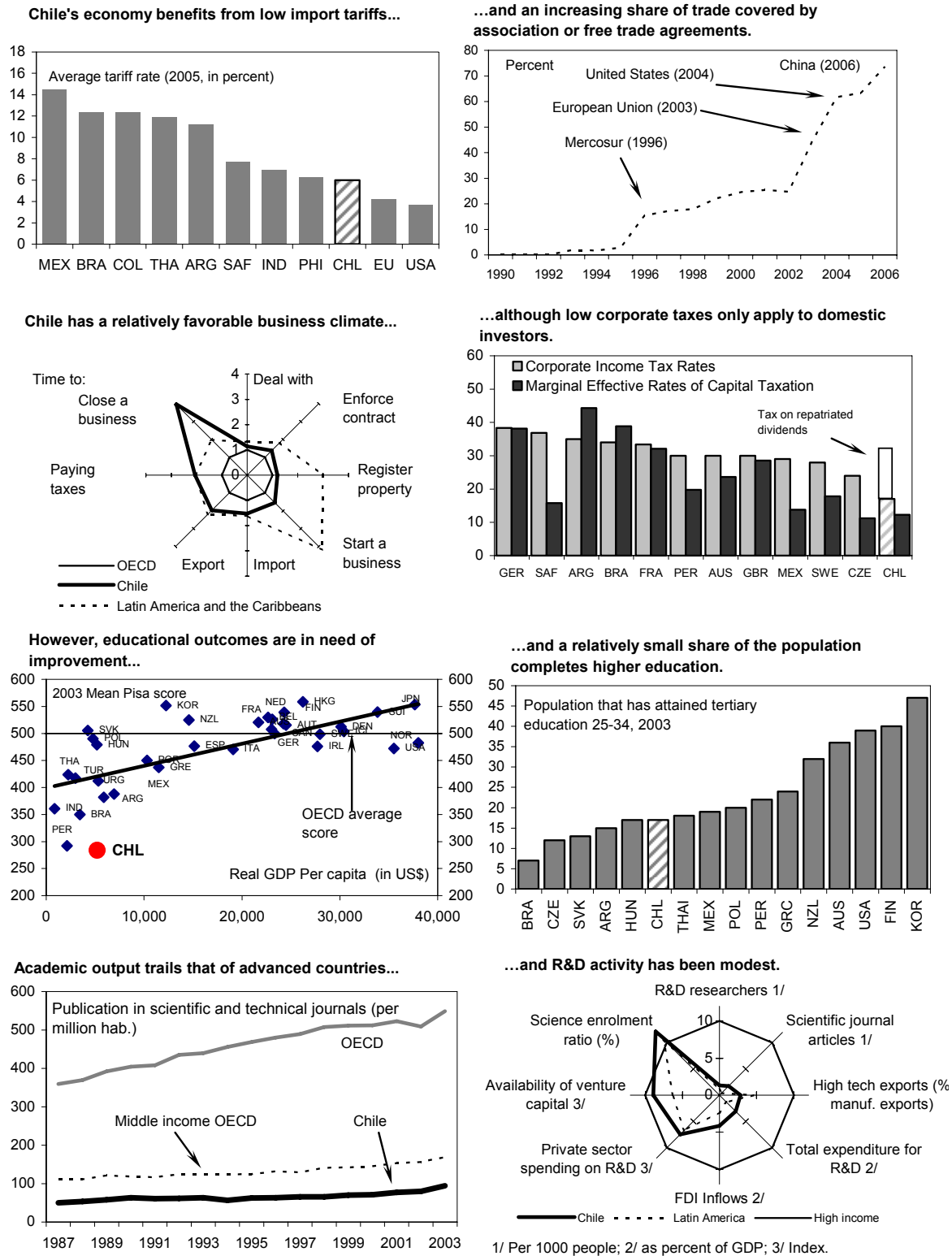


...indeed, Chile's public sector remains small by regional standards.



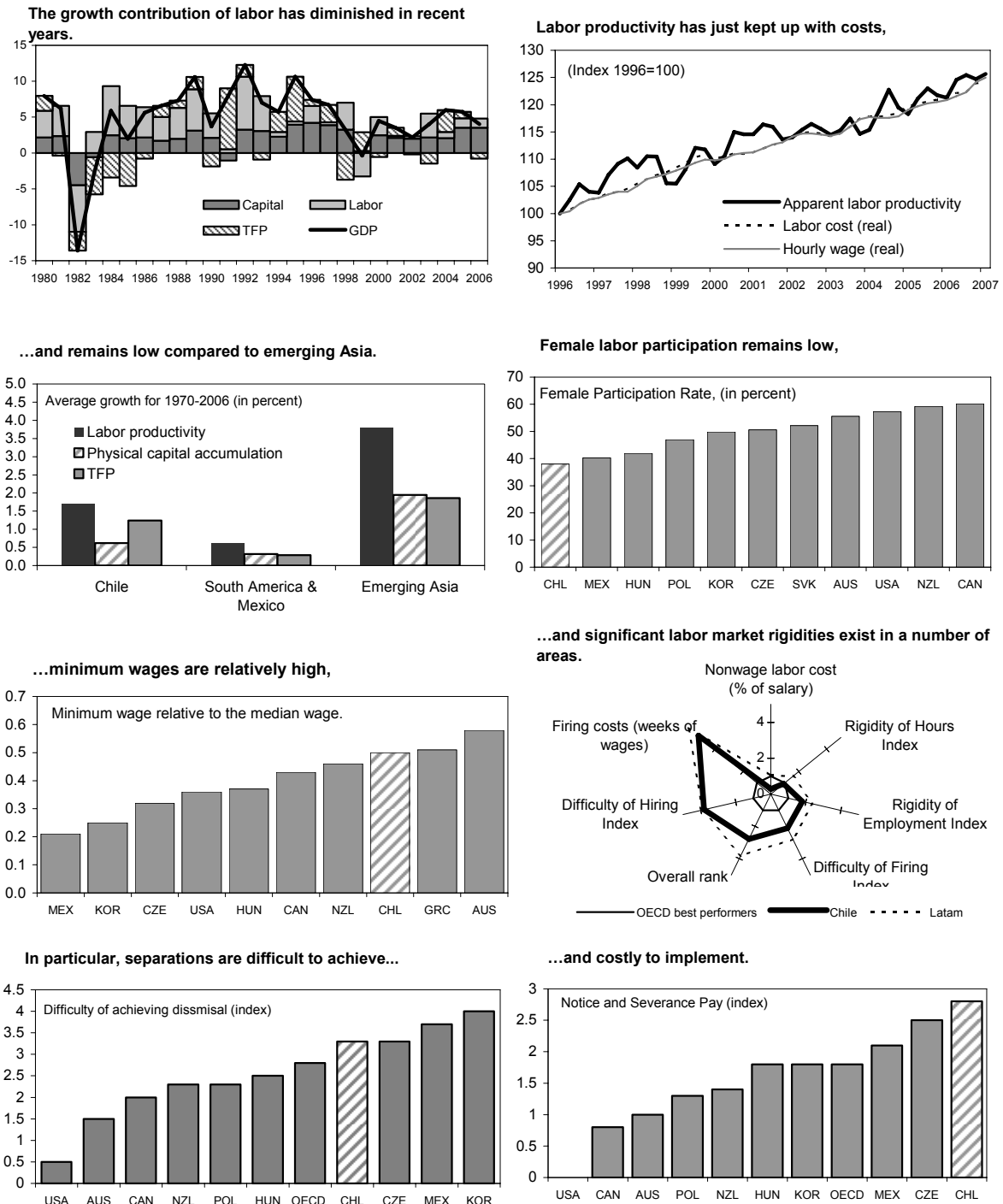
Source: Chilean Authorities and Fund staff estimates.

Figure 11. Investment Climate



Source: World Trade Organization (2005), KPMG (2006), CD Howe (2006), World Bank Doing Business Data (2006).

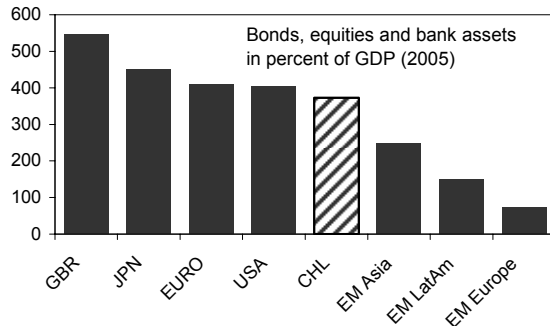
Figure 12. Productivity and Labor Markets



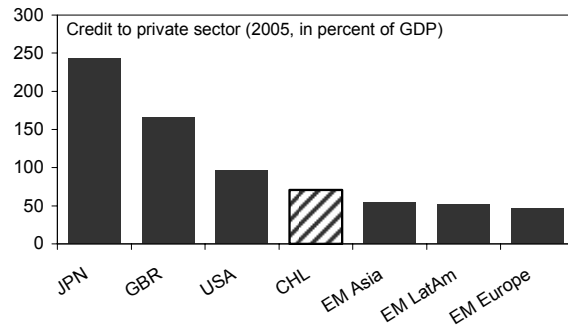
Source: World Trade Organization (2005), KPMG (2006), CD Howe (2006), OECD (2003), World Bank Doing Business Data (2006). Emerging Asia includes: China, Indonesia, Korea, Malaysia, Myanmar, the Philippines, Singapore and Thailand (weighted average).

Figure 13. Financial Market Structure

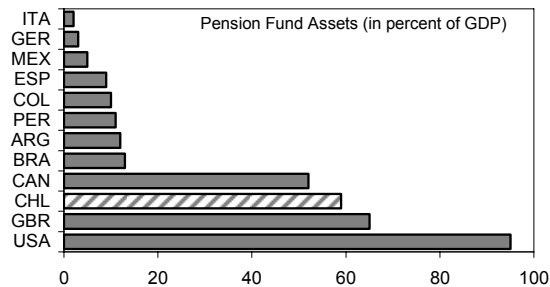
The depth of Chile's financial sector compares well with other emerging economies...



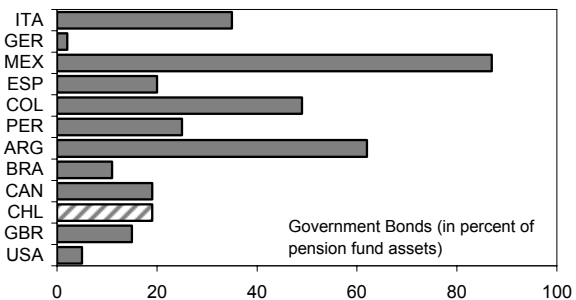
...including the availability of credit to the private sector.



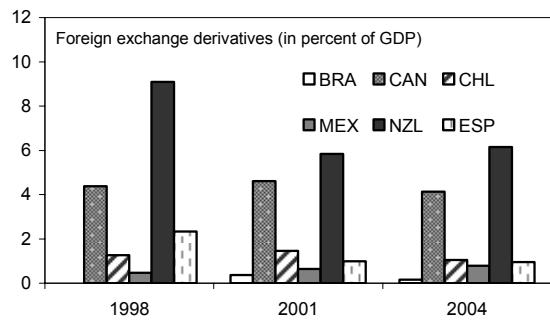
Chile's pension funds are major players in the market;



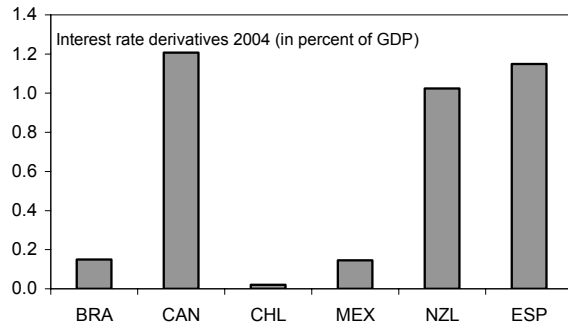
...only a relatively small part of their assets is placed in government bonds.



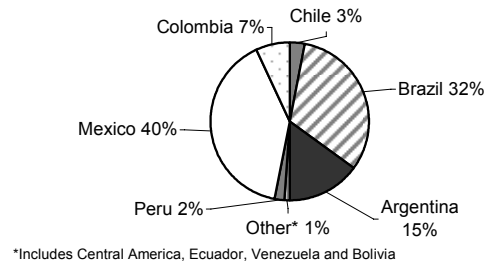
Derivatives markets in Chile focus mostly on the exchange rate...



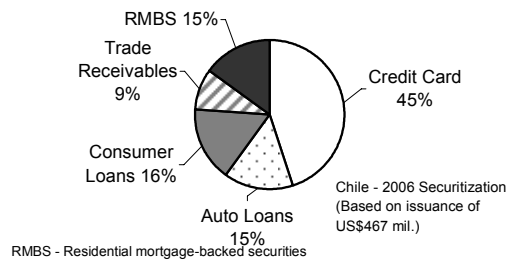
...while interest rate derivatives are just emerging.



Chile accounts for a small part of Latin American securitization activity...



...and credit card-related issuances dominate.



Source: Bloomberg, Bankscope, Bank of International Settlements, IFS, World Federation of Exchange Rates and Fund Staff Estimates.

Table 1. Chile: Selected Economic Indicators

| | 2003 | 2004 | 2005 | 2006 | Projections | |
|--|---|-------|-------|-------|-------------|-------|
| | | | | | 2007 | 2008 |
| | (Annual percentage change) | | | | | |
| Production and prices | | | | | | |
| Real GDP | 4.0 | 6.0 | 5.7 | 4.0 | 5.8 | 5.3 |
| Total domestic demand | 4.9 | 7.5 | 11.0 | 6.0 | 7.1 | 5.8 |
| Consumption | 4.0 | 6.8 | 7.5 | 6.6 | 7.0 | 5.9 |
| Private | 4.2 | 7.0 | 7.9 | 7.1 | 6.8 | 5.8 |
| Public | 2.5 | 6.1 | 5.3 | 3.6 | 7.8 | 6.6 |
| Investment | 8.4 | 9.8 | 23.0 | 4.4 | 7.3 | 5.7 |
| Private | 6.5 | 10.5 | 23.2 | 3.3 | 6.3 | 5.5 |
| Public | -0.4 | 5.7 | 11.2 | 10.9 | 20.9 | 9.8 |
| Inventories 1/ | 0.6 | 0.1 | 0.5 | 0.1 | 0.0 | 0.0 |
| Net exports 1/ | -0.6 | -1.2 | -5.0 | -2.2 | -1.5 | -0.8 |
| Consumer prices | | | | | | |
| End of period | 1.1 | 2.4 | 3.7 | 2.6 | 2.9 | 3.0 |
| Average | 2.8 | 1.1 | 3.1 | 3.4 | 2.8 | 3.0 |
| GDP deflator | 6.1 | 7.7 | 7.9 | 11.7 | 0.8 | -2.8 |
| Real wages | 0.9 | 1.8 | 1.9 | 2.0 | ... | ... |
| Unemployment rate (annual average) | 9.5 | 10.0 | 9.3 | 7.9 | ... | ... |
| Output gap (percent) | -2.4 | -0.9 | -0.1 | -1.1 | -0.3 | 0.0 |
| Money, credit, and interest rates | | | | | | |
| Broad money | 3.6 | 10.6 | 12.0 | 11.4 | ... | ... |
| Credit to the private sector | 11.4 | 14.8 | 15.4 | 17.7 | ... | ... |
| Three-month interest rate 2/ | 2.8 | 1.8 | 3.5 | 4.8 | 5.02 | ... |
| | (Billions U.S. dollars, unless otherwise indicated) | | | | | |
| Balance of Payments | | | | | | |
| Current account | -0.8 | 2.1 | 1.3 | 5.3 | 5.2 | 1.3 |
| In percent of GDP | -1.1 | 2.2 | 1.1 | 3.6 | 3.4 | 0.8 |
| Trade Balance | 3.7 | 9.6 | 10.8 | 22.2 | 19.4 | 11.0 |
| Exports of Goods | 21.7 | 32.5 | 41.3 | 58.1 | 58.7 | 53.6 |
| Copper Exports | 7.8 | 14.7 | 18.9 | 32.3 | 29.8 | 23.2 |
| In percent of total exports | 36.1 | 45.3 | 45.7 | 55.6 | 50.7 | 43.2 |
| Imports of Goods | 17.9 | 22.9 | 30.5 | 35.9 | 39.4 | 42.6 |
| Oil Imports | 2.0 | 2.7 | 3.6 | 4.6 | 4.8 | 5.5 |
| In percent of total imports | 11.3 | 11.9 | 11.8 | 12.9 | 12.1 | 12.9 |
| | (Annual percentage change) | | | | | |
| Exports | 19.2 | 50.1 | 27.0 | 40.7 | 1.0 | -8.6 |
| Imports | 13.6 | 27.8 | 33.0 | 17.7 | 9.6 | 8.4 |
| Terms of trade | 9.7 | 22.1 | 10.8 | 31.0 | -5.4 | -15.3 |
| Real effective exchange rate | 13.4 | -3.7 | 11.9 | -5.2 | ... | ... |
| Net FDI (in percent of GDP) | 3.7 | 5.9 | 4.0 | 3.6 | 3.9 | 3.8 |
| | (In percent of GDP) | | | | | |
| Saving and investment | | | | | | |
| Gross domestic investment | 21.1 | 20.1 | 22.4 | 20.4 | 20.9 | 22.1 |
| Public | 2.3 | 2.1 | 2.1 | 2.1 | 2.4 | 2.7 |
| Private | 17.8 | 17.0 | 18.6 | 17.2 | 17.6 | 18.6 |
| Change in inventories | 1.0 | 1.0 | 1.7 | 1.1 | 0.8 | 0.8 |
| National savings | 20.1 | 22.2 | 23.5 | 24.0 | 24.2 | 22.9 |
| Public 3/ | 2.5 | 4.8 | 7.5 | 10.8 | 9.2 | 6.2 |
| Private | 17.5 | 17.3 | 16.0 | 13.2 | 15.2 | 16.7 |
| External savings | 1.1 | -2.2 | -1.1 | -3.6 | -3.4 | -0.8 |
| Public sector finance | | | | | | |
| Net debt | 13.3 | 11.0 | 7.7 | -1.7 | -4.5 | -5.0 |
| Excluding public enterprises | 7.2 | 5.5 | 2.5 | -7.3 | -11.2 | -12.6 |
| Gross debt 4/ | 44.4 | 39.0 | 30.4 | 26.0 | 25.3 | 25.1 |
| Central government | 13.0 | 10.7 | 7.2 | 5.9 | 5.2 | 4.5 |
| Central government balance | -0.2 | 2.1 | 4.6 | 7.7 | 6.0 | 2.9 |
| External Debt | | | | | | |
| Gross external debt | 58.2 | 45.4 | 37.8 | 33.1 | 31.0 | 30.1 |
| Public | 12.5 | 10.3 | 8.0 | 7.4 | 6.5 | 5.8 |
| Private | 45.7 | 35.1 | 29.8 | 25.7 | 24.5 | 24.3 |
| Memorandum items | | | | | | |
| Nominal GDP (in billions of US\$) | 74.0 | 95.8 | 119.0 | 145.8 | 152.6 | 156.0 |
| Copper prices (in US\$ per pound) | 0.81 | 1.30 | 1.67 | 3.05 | 2.72 | 2.04 |
| Nominal Exchange Rate (average) | 691.4 | 609.5 | 559.8 | 530.3 | ... | ... |

Sources: Central Bank of Chile, Ministry of Finance, Haver Analytics, and Fund staff estimates.

1/ Contribution to growth.

2/ Nominal rates, in percent per annum, period average, on 90-day central bank promissory notes. 2007 refers to June 8, 2007

3/ Gross saving of the general government sector, including the deficit of the central bank.

4/ Gross consolidated debt of the public sector (central bank, non-financial public enterprises, and general government). For comparability purposes, does not include securitized liabilities from pre-1981 pension system totaling 9.5 percent of GDP at end-2006.

Table 2. Chile: Summary Operations of the Central Government
(In percent of GDP)

| | 2002 | 2003 | 2004 | 2005 | 2006 | Proj. ^{1/} 2007 |
|-------------------------------------|------|------|------|------|------|-----------------------------|
| Overall balance | -1.2 | -0.2 | 2.1 | 4.6 | 7.7 | 6.0 |
| Non-Mining Balance | -1.8 | -1.3 | -1.5 | -0.6 | -1.1 | -1.2 |
| Total revenue | 21.1 | 20.8 | 22.0 | 23.7 | 25.9 | 25.1 |
| Taxes | 16.7 | 15.9 | 15.6 | 16.8 | 17.1 | 16.8 |
| Nonmining | 16.6 | 15.7 | 15.0 | 15.4 | 14.0 | 14.4 |
| Mining-related | 0.1 | 0.2 | 0.6 | 1.4 | 3.1 | 2.4 |
| Codelco revenues | 0.5 | 0.9 | 3.0 | 3.7 | 5.7 | 4.8 |
| Income on assets | 0.6 | 0.6 | 0.4 | 0.3 | 0.5 | 1.1 |
| Social contributions | 1.5 | 1.4 | 1.4 | 1.4 | 1.4 | 1.4 |
| Grants | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 |
| Other | 1.7 | 1.8 | 1.5 | 1.3 | 1.1 | 0.9 |
| Total expenditure | 22.4 | 21.0 | 19.9 | 19.1 | 18.2 | 19.1 |
| Consumption | 6.1 | 5.8 | 5.7 | 5.6 | 5.4 | 5.3 |
| Social benefits | 5.5 | 5.3 | 4.9 | 4.6 | 4.3 | 4.3 |
| Subsidies and grants | 5.9 | 5.5 | 5.1 | 5.0 | 4.8 | 5.6 |
| Interest payments | 1.2 | 1.1 | 1.0 | 0.8 | 0.7 | 0.6 |
| Other | 0.2 | 0.2 | 0.1 | 0.0 | 0.0 | 0.0 |
| Gross investment | 2.2 | 2.0 | 1.8 | 1.8 | 1.8 | 2.1 |
| Defense | 1.6 | 1.3 | 1.4 | 1.3 | ... | ... |
| Non-defense | 0.6 | 0.6 | 0.4 | 0.5 | ... | ... |
| Net capital transfers | 1.2 | 1.1 | 1.3 | 1.3 | 1.3 | 1.2 |
| Net Assets | -7.9 | -6.7 | -4.1 | 0.1 | 7.5 | 12.0 |
| Gross Debt | 15.7 | 13.0 | 10.7 | 7.2 | 5.9 | 5.2 |
| Peso-denominated Assets | 7.8 | 6.3 | 6.5 | 7.3 | 8.0 | 7.9 |
| Foreign currency-denominated Assets | 0.0 | 0.0 | 0.0 | 0.0 | 5.5 | 9.2 |
| Net Assets of the Public Sector 2/ | -5.5 | -7.2 | -5.5 | -2.5 | 7.3 | 11.2 |
| Memorandum Items | | | | | | |
| Nonmining Structural Balance | -1.3 | -0.9 | -1.4 | -0.5 | -1.0 | -1.1 |
| Fiscal Impulse 3/ | 0.1 | -0.4 | 0.6 | -0.9 | 0.6 | 0.2 |
| Nominal GDP (trillions of pesos) | 46.3 | 51.2 | 58.4 | 66.6 | 77.3 | 82.5 |
| Output Gap | -2.6 | -2.5 | -0.9 | -0.1 | -1.1 | -0.3 |

Sources: Ministry of Finance (DIPRES) and staff estimates.

1/ Based on the 2007 Budget and updated staff estimates, including copper price assumption of US\$2.72.

2/ Includes general government and Central Bank.

3/ Change in nonmining structural balance (-), adjusted for the impact of copper prices on the GDP deflator. Staff is working on more refined measures of fiscal impulse in Chile, including the impact of domestic versus foreign transactions.

4/ Excludes interest payments and income from government assets.

Table 3. Chile: Summary Operations of the Public Sector
(In percent of GDP)

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | Proj. 2007 |
|--|------|------|------|------|------|------|---------------|
| I. Central government | | | | | | | |
| Balance | -0.5 | -1.2 | -0.2 | 2.1 | 4.6 | 7.7 | 6.0 |
| Total revenue | 21.8 | 21.1 | 20.8 | 22.0 | 23.7 | 25.9 | 25.1 |
| <i>of which:</i> intragovernmental receipts | 1.1 | 1.1 | 1.0 | 0.8 | 0.8 | 0.8 | 0.8 |
| Total expenditures 1/ | 22.3 | 22.4 | 21.0 | 19.9 | 19.1 | 18.2 | 19.1 |
| <i>of which:</i> intragovernmental transfers | 1.0 | 1.0 | 0.9 | 0.7 | 0.8 | 0.8 | 0.8 |
| Current | 18.9 | 18.9 | 17.9 | 16.8 | 16.0 | 15.1 | 15.8 |
| Capital | 3.4 | 3.5 | 3.1 | 3.1 | 3.1 | 3.0 | 3.3 |
| II. Municipalities 2/ | | | | | | | |
| Balance | 0.0 | 0.0 | 0.0 | 0.0 | 0.2 | 0.0 | 0.0 |
| Total revenue | 3.3 | 3.3 | 3.1 | 2.7 | 2.9 | 3.0 | 3.1 |
| <i>of which:</i> intragovernmental receipts | 1.0 | 1.0 | 0.9 | 0.7 | 0.8 | 0.8 | 0.8 |
| Total expenditures | 3.2 | 3.3 | 3.1 | 2.7 | 2.7 | 3.0 | 3.0 |
| <i>of which:</i> intragovernmental transfers | 1.1 | 1.1 | 1.0 | 0.8 | 0.8 | 0.8 | 0.8 |
| Current | 2.8 | 2.8 | 2.7 | 2.4 | 2.4 | 2.7 | 2.7 |
| Capital | 0.4 | 0.4 | 0.4 | 0.4 | 0.3 | 0.3 | 0.3 |
| III. Central bank | | | | | | | |
| Balance | -1.2 | -1.2 | -0.8 | -0.6 | -0.5 | -0.2 | -0.1 |
| Net operating balance | -0.1 | -0.1 | 0.0 | 0.0 | 0.0 | -0.1 | -0.1 |
| Net interest balance 1/ | -1.1 | -1.2 | -0.7 | -0.6 | -0.4 | -0.2 | 0.0 |
| IV. State-owned enterprises (non-financial) | | | | | | | |
| Balance | 0.9 | -0.3 | -0.4 | 1.0 | 1.1 | 2.0 | 1.8 |
| Total revenue | 11.0 | 11.6 | 10.6 | 14.1 | 12.1 | 13.3 | 13.3 |
| <i>of which:</i> intragovernmental receipts | 0.1 | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 |
| Total expenditures | 10.1 | 11.9 | 11.1 | 13.1 | 11.0 | 11.4 | 11.5 |
| <i>of which:</i> intergovernmental transfers | 1.3 | 1.2 | 1.6 | 3.7 | 4.2 | 6.2 | 5.3 |
| Current | 9.1 | 9.8 | 9.4 | 11.4 | 9.0 | 9.5 | 9.6 |
| Capital | 0.9 | 2.1 | 1.7 | 1.7 | 2.0 | 1.8 | 1.9 |

Sources: Ministry of Finance (DIPRES), Central Bank of Chile, and staff estimates.

1/ Includes the effects of valuation changes (inflation) to the stock of UF debt and accrued interest on Treasury debt.

2/ On a cash basis.

Table 4. Chile: Indicators of External Vulnerability
(In percent; unless otherwise indicated)

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | Proj. 2007 |
|--|-------|-------|-------|-------|-------|-------|-------|---------------|
| Financial indicators | | | | | | | | |
| M3 (percent change) | 11.7 | 10.3 | 6.3 | 3.7 | 10.6 | 11.9 | 11.4 | ... |
| less pension funds' deposits (annual percentage change) | 10.4 | 9.6 | 3.9 | 6.2 | 6.6 | 10.8 | 27.9 | ... |
| Private Sector Credit to GDP | 61.3 | 65.6 | 66.8 | 64.3 | 65.1 | 66.5 | 66.4 | ... |
| 90-day central bank promissory note (nominal) interest rate (avg.) | 10.8 | 7.2 | 3.9 | 2.8 | 1.8 | 3.5 | 4.8 | ... |
| Share of foreign currency deposits in total deposits | 5.6 | 6.7 | 6.3 | 6.1 | 5.7 | 5.5 | 5.8 | ... |
| Share of foreign currency loans in total credit | 11.6 | 13.7 | 14.5 | 10.3 | 10.0 | 10.0 | 10.3 | ... |
| External indicators | | | | | | | | |
| Exports, U.S. dollars (annual percentage change) | 11.9 | -4.9 | -0.5 | 19.2 | 50.1 | 27.0 | 40.7 | 1.0 |
| Imports, U.S. dollars (annual percentage change) | 16.0 | -3.9 | -3.9 | 13.6 | 27.8 | 33.0 | 17.7 | 9.6 |
| Terms of trade (annual percentage change) | 4.5 | -7.2 | 3.8 | 9.7 | 22.1 | 10.8 | 31.0 | -5.4 |
| REER (end of period, percent change) | -2.2 | -10.1 | -6.9 | 13.4 | -3.7 | 11.9 | -5.2 | ... |
| Exchange rate (pesos per US\$, period average) | 539 | 635 | 689 | 691 | 610 | 560 | 530 | ... |
| Current account (percent of GDP) | -1.2 | -1.6 | -0.9 | -1.1 | 2.2 | 1.1 | 3.6 | 3.4 |
| Financial account less reserves accumulation (percent of GDP) | 1.6 | 0.7 | 1.0 | 0.6 | -2.4 | 0.3 | -2.2 | -0.7 |
| Gross official reserves (in US\$ billion) 1/ | 15.1 | 14.4 | 15.4 | 15.9 | 16.0 | 17.0 | 19.4 | 16.9 |
| Gross official reserves, months of imports of goods and services | 8.5 | 8.3 | 7.8 | 6.4 | 5.0 | 4.6 | 4.8 | 3.9 |
| Gross official reserves to broad money | 21.2 | 21.6 | 23.5 | 23.5 | 19.0 | 16.5 | 16.0 | ... |
| Gross official reserves to short-term external debt 2/ | 147.6 | 144.8 | 134.4 | 125.4 | 115.6 | 111.8 | 117.0 | 118.7 |
| Total external debt (percent of GDP) | 49.4 | 56.2 | 60.2 | 58.2 | 45.4 | 37.8 | 33.1 | 31.0 |
| Of which: external public sector debt | 8.0 | 8.9 | 10.7 | 12.5 | 10.3 | 8.0 | 7.4 | 6.5 |
| Total external debt to exports of goods and services | 159.6 | 172.0 | 179.5 | 161.1 | 112.9 | 93.2 | 73.5 | 70.2 |
| External interest payments to exports of goods and services | 8.1 | 7.6 | 6.4 | 4.7 | 3.3 | 2.9 | 2.2 | 2.0 |
| External amortization payments to exports of goods and services | 18.2 | 19.5 | 27.4 | 21.6 | 19.9 | 12.3 | 16.3 | 6.7 |
| Financial market indicators | | | | | | | | |
| Stock market index (in US\$; period average) 3/ | 668 | 590 | 483 | 601 | 832 | 1105 | 1278 | 1648 |
| Sovereign long-term foreign-currency debt rating (end of period) | | | | | | | | |
| Moody's | Baa1 | Baa1 | Baa1 | Baa1 | Baa1 | Baa1 | Baa1 | ... |
| S&P | A- | A- | A- | A- | A | A | A | ... |
| Fitch Ratings | A- | A- | A- | A- | A- | A | A | ... |

Sources: Central Bank of Chile, Haver Analytics, WEO, and Fund staff estimates.

1/ Gold valued at end-period market prices.

2/ As measured by the central bank; includes amortization of medium/long-term debt due during the following year, but not trade credits.

3/ Morgan-Stanley Capital International index (Dec/1987=100). 2007 data averaged up to end-May.

Table 5. Chile: Balance of Payments

| | 2004 | 2005 | 2006 | Projections | | | | | |
|---|-------|-------|-------|-------------|-------|-------|-------|-------|-------|
| | | | | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
| (In percent of GDP) | | | | | | | | | |
| Current account | 2.2 | 1.1 | 3.6 | 3.4 | 0.8 | -1.2 | -1.9 | -1.9 | -1.8 |
| <i>Excluding copper</i> | -13.2 | -14.8 | -18.6 | -16.1 | -14.0 | -12.8 | -11.7 | -10.9 | -10.0 |
| Trade balance | 10.0 | 9.1 | 15.2 | 12.7 | 7.1 | 3.6 | 1.9 | 1.4 | 1.0 |
| Exports | 33.9 | 34.7 | 39.8 | 38.5 | 34.4 | 31.7 | 30.0 | 29.3 | 28.5 |
| Copper | 15.4 | 15.9 | 22.2 | 19.5 | 14.8 | 11.6 | 9.8 | 9.0 | 8.1 |
| Non-copper | 24.9 | 24.7 | 22.8 | 24.6 | 25.2 | 26.1 | 26.2 | 26.3 | 26.4 |
| Imports | -23.9 | -25.6 | -24.6 | -25.8 | -27.3 | -28.0 | -28.1 | -27.9 | -27.6 |
| Net services | -0.8 | -0.5 | -0.6 | -0.5 | -0.5 | -0.6 | -0.6 | -0.4 | -0.3 |
| Net income | -8.2 | -8.9 | -13.3 | -10.6 | -7.4 | -5.8 | -4.9 | -4.4 | -4.0 |
| Net transfers | 1.1 | 1.5 | 2.3 | 1.8 | 1.7 | 1.6 | 1.6 | 1.5 | 1.5 |
| Capital Account Balance 1/ | -2.4 | 0.3 | -2.2 | -5.1 | -0.8 | 1.2 | 1.9 | 1.9 | 1.8 |
| Foreign investment (net) | 5.9 | 4.0 | 3.6 | 3.9 | 3.8 | 3.9 | 3.8 | 3.7 | 3.7 |
| Direct Investment Abroad | -1.6 | -1.9 | -1.9 | -1.9 | -2.0 | -2.0 | -2.0 | -2.0 | -2.0 |
| Direct Investment in Chile | 7.5 | 5.8 | 5.5 | 5.7 | 5.8 | 5.9 | 5.8 | 5.7 | 5.7 |
| Portfolio investment (net) | -3.5 | -2.2 | -6.4 | -7.8 | -4.2 | -2.4 | -1.5 | -1.6 | -1.7 |
| Financial Derivatives | -0.1 | -0.1 | 0.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Other Investments | -4.4 | -0.4 | 0.0 | -0.6 | -0.4 | -0.4 | -0.4 | -0.3 | -0.2 |
| Reserves Assets | 0.2 | -1.4 | -1.4 | 1.7 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Chg. in official reserves (billions of USD, increase -) | -0.2 | -0.9 | -2.5 | 2.6 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Central bank operations with commercial banks | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Other 3/ | -0.2 | -0.9 | -2.5 | 2.6 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| (In months of imports of goods and services) | | | | | | | | | |
| Gross official international reserves 2/ | 5.0 | 4.6 | 4.8 | 3.9 | 3.6 | 3.4 | 3.3 | 3.1 | 3.1 |
| (Annual change in percent) | | | | | | | | | |
| Copper export prices | 57.1 | 33.6 | 75.3 | -12.3 | -25.2 | -22.2 | -14.3 | -6.7 | -7.1 |
| Copper export volume | 19.7 | -4.0 | -2.1 | 4.6 | 4.2 | 4.1 | 4.0 | 4.6 | 4.5 |
| Agricultural exports volume | 7.3 | 8.5 | 3.7 | 7.9 | 5.0 | 4.0 | 4.0 | 4.6 | 4.5 |
| Industrial exports volume | 14.9 | 11.3 | 5.0 | 10.1 | 7.5 | 7.0 | 6.0 | 5.7 | 5.5 |
| Total export prices | 30.8 | 20.8 | 37.6 | -5.3 | -14.3 | -9.5 | -4.3 | -0.2 | 0.1 |
| Total export volume | 14.7 | 5.2 | 2.4 | 7.6 | 6.9 | 6.3 | 5.5 | 5.2 | 5.0 |
| Total import price | 7.0 | 9.0 | 5.1 | 0.1 | 1.2 | 1.0 | 1.3 | 1.3 | 1.4 |
| Total import volume | 19.7 | 21.4 | 11.9 | 10.8 | 7.2 | 6.2 | 5.4 | 5.3 | 5.2 |
| Terms of trade | 22.1 | 10.8 | 31.0 | -5.4 | -15.3 | -10.4 | -5.5 | -1.5 | -1.3 |
| Real GDP | 6.0 | 5.7 | 4.0 | 5.8 | 5.3 | 5.0 | 5.0 | 5.0 | 5.0 |
| (In percent of GDP) | | | | | | | | | |
| Gross domestic investment | 20.1 | 22.4 | 20.4 | 20.9 | 22.1 | 22.8 | 23.1 | 23.0 | 23.0 |
| Public sector | 2.1 | 2.1 | 2.1 | 2.4 | 2.7 | 2.8 | 2.8 | 2.8 | 2.9 |
| Private sector and inventory change | 18.0 | 20.3 | 18.3 | 18.5 | 19.4 | 20.1 | 20.3 | 20.2 | 20.1 |
| External current account balance | 2.2 | 1.1 | 3.6 | 3.4 | 0.8 | -1.2 | -1.9 | -1.9 | -1.8 |
| Gross national savings | 22.2 | 23.5 | 24.0 | 24.2 | 22.9 | 21.6 | 21.2 | 21.1 | 21.2 |
| Public sector 4/ | 4.8 | 7.5 | 10.8 | 9.2 | 6.2 | 6.0 | 5.9 | 5.5 | 5.5 |
| Private sector | 17.3 | 16.0 | 13.2 | 15.2 | 16.7 | 15.7 | 15.3 | 15.7 | 15.7 |
| Total external debt (end of period) | 45.4 | 37.8 | 33.1 | 31.0 | 30.1 | 29.2 | 27.9 | 26.5 | 25.0 |
| Memorandum items: | | | | | | | | | |
| Copper price (LME; U.S. cents per pound) 5/ | 130 | 167 | 305 | 272 | 204 | 159 | 136 | 127 | 118 |
| Volume of copper exports (2004=100) | 120 | 115 | 113 | 118 | 123 | 128 | 133 | 139 | 145 |

Sources: Central Bank of Chile, Haver Analytics, and Fund staff estimates.

1/ Includes errors and omissions.

2/ Gold at market valuation. End-year stock of reserves in relation to imports of the following year.

3/ "Other" variations in reserves largely reflect changes in deposits by commercial banks and the government with the central bank, as well as the repayment of foreign currency bonds, completed in 2006.

4/ Net of estimated losses of the central bank.

5/ Updated staff forecasts.

Table 6. Chile: External Debt and Debt Service

| | 2002 | 2003 | 2004 | 2005 | 2006 | Projections 2007 |
|---|-------------|-------------|-------------|-------------|-------------|---------------------|
| (In billions of U.S. dollars, end of period) | | | | | | |
| Total debt outstanding 1/ | 40.5 | 43.1 | 43.5 | 45.0 | 48.2 | 47.3 |
| <i>Of which:</i> external private debt | 33.3 | 33.8 | 33.7 | 35.5 | 37.5 | 37.4 |
| <i>Of which:</i> external public debt | 7.2 | 9.3 | 9.8 | 9.6 | 10.7 | 9.9 |
| Medium- and long-term debt | 34.9 | 35.9 | 35.7 | 37.9 | 38.2 | 37.2 |
| Public sector | 6.3 | 7.9 | 9.1 | 8.7 | 9.4 | 8.5 |
| <i>Of which:</i> central government | 3.6 | 4.6 | 4.7 | 4.0 | 4.2 | 3.4 |
| Private sector | 28.6 | 28.0 | 26.6 | 29.2 | 28.9 | 28.6 |
| Financial sector | 2.6 | 3.1 | 3.8 | 6.0 | 5.5 | 5.3 |
| Non-financial sector | 26.0 | 24.9 | 22.7 | 23.1 | 23.4 | 23.4 |
| Short-term debt 1/ | 5.7 | 7.2 | 7.9 | 7.1 | 10.0 | 10.1 |
| Residual maturity basis | 11.4 | 12.6 | 13.9 | 15.2 | 16.6 | 14.2 |
| Total debt service | 7.6 | 7.0 | 8.9 | 7.4 | 12.2 | 5.9 |
| Amortization | 6.2 | 5.8 | 7.7 | 5.9 | 10.7 | 4.5 |
| Interest | 1.4 | 1.3 | 1.3 | 1.4 | 1.5 | 1.4 |
| (In percent of GDP) | | | | | | |
| Total external debt, end-period 1/ | 60.2 | 58.2 | 45.4 | 37.8 | 33.1 | 31.0 |
| <i>Of which:</i> external private debt | 49.5 | 45.7 | 35.1 | 29.8 | 25.7 | 24.5 |
| <i>Of which:</i> external public debt | 10.7 | 12.5 | 10.3 | 8.0 | 7.4 | 6.5 |
| Gross change (in percent) | 4.0 | -2.0 | -12.8 | -7.6 | -4.8 | -2.1 |
| Gross change of nominal stock (in percent) | 5.1 | 6.3 | 1.0 | 3.4 | 7.2 | -2.0 |
| Interest payments on external debt | 2.1 | 1.7 | 1.3 | 1.2 | 1.0 | 0.9 |
| (In percent of exports of goods and services) | | | | | | |
| Debt-service payments | 33.8 | 26.3 | 23.2 | 15.2 | 18.5 | 8.7 |
| <i>Of which:</i> interest | 6.4 | 4.7 | 3.3 | 2.9 | 2.2 | 2.0 |
| Total external debt outstanding 1/ | 179.5 | 161.1 | 112.9 | 93.2 | 73.5 | 70.2 |
| (In billions of U.S. dollars) | | | | | | |
| Memorandum items: | | | | | | |
| Gross international reserves | 15.4 | 15.9 | 16.0 | 17.0 | 19.4 | 16.9 |
| GDP 2/ | 67.3 | 74.0 | 95.8 | 119.0 | 145.8 | 152.6 |

Sources: Central Bank of Chile, Haver Analytics, and Fund staff estimates.

1/ Original maturity basis; end of period basis.

2/ At current prices and exchange rates.

Table 7. Social and Demographic Indicators

| | | | |
|--|--------|--|------|
| GDP (2006) | | Poverty rate (2006) | |
| Chilean pesos (billions) | 77,384 | Indigent | 3.2 |
| U.S. dollars (billions) | 145.9 | Poor, not indigent | 10.5 |
| Per capita (U.S. dollars) | 8,909 | | |
| Population and Country Information (2005) | | Health | |
| Total (in millions) | 16.4 | Population per physician (2003) | 916 |
| Urban population (in percent of total) | 87.6 | Population per hospital bed (2002) | 385 |
| Area (thousand sq. km.) | 756.1 | | |
| Density (per sq. km) | 21.7 | | |
| Annual rate of growth, 1997-2006 | 1.3 | | |
| Population characteristics (2005) | | Access to electricity (2003) | |
| Life expectancy at birth (years) | 78.2 | Percent of population | 98.9 |
| Crude birth rate (per thousand) | 15.7 | Urban (2003) | 99.7 |
| Crude death rate (per thousand) | 5.4 | Rural (2003) | 74.6 |
| Infant mortality rate (per 1000 births) | 8.0 | | |
| Mortality rate (ages 1-4, per 1000) | 10.0 | | |
| Income distribution (2003) | | Access to safe water (2003) | |
| Percent of total income received: | | Percent of population | 93 |
| By richest 10 percent of households | 45.0 | Urban | 99 |
| By poorest 20 percent of households | 3.8 | Rural | 58 |
| Gini coefficient | 54.9 | | |
| Distribution of labor force, in percent of total (2006) | | Education (2003) | |
| Agriculture and fishing | 11.7 | Adult literacy rate (2006) | 96 |
| Mining | 1.3 | Gross enrollment rates, percent of the age group | |
| Industry | 12.2 | Primary education (2004) | 100 |
| Construction | 7.7 | Secondary education (2004) | 89 |
| Services, Public Utilities, and Trade | 67.1 | Tertiary education (2004) | 43 |

Sources: Haver Analytics, INE, World Bank, Encuesta CASEN, and staff estimates.

Annex I. Chile: Analytical Work and Technical Assistance

1. Ongoing Background Work

Chile's Structural Fiscal Balance Rule: A Model Based Evaluation

The paper analyzes Chile's structural fiscal rule using the IMF's Global Integrated Monetary and Fiscal Model (GIMF) to determine which parameters would minimize inflation and output volatility in a stochastic environment. It does so along two dimensions, first by comparing the use of different fiscal instruments (taxes, transfers, spending), and second by allowing for a more or less countercyclical response to excess tax or copper revenue.

Application of Contingent Claims Analysis to Chile

A background paper for the consultation produces risk indicators based on equity and debt data for seven major Chilean banks. It extends the CCA model by tying the returns on banking-sector assets to macroeconomic variables. The results suggest that banks are quite heterogeneous in their responsiveness to foreign and exchange-rate shocks and sensitivity to interest-rate changes. The paper also presents scenarios to see how bank capitalization is affected by various macroeconomic shocks.

Credit Cyclicity: A Cross-Country Comparison

This paper studies the determinants of credit cyclicity and compares Chile with 19 other emerging markets and advanced countries. Using both country-specific and panel VARs, the study focuses on the effects of financial frictions and financial development on the degree of pro-cyclicality of credit.

Trade Performance, Trade Liberalization and Competitiveness

This study analyses recent developments of non-copper exports and imports, in particular the impact of exchange rate movement and of trade liberalization. The analysis is conducted by means of a vector error correction model (VECM) using quarterly data for 1990-2006. Trade elasticities for Chile are also compared to those of other Latin American countries.

2. Recent Technical Assistance

Risk Management and Contingent Claims Analysis

The BCC and Fund staff collaborate closely in the area of contingent claims analysis and identification of domestic and external vulnerabilities. This has included several missions as well as a paper in the BCC's Financial Stability Report co-written with Fund staff.

Assessing the Institutional Aspects of Reserves Management

The BCC was appointed as the government's fiscal agent in the management of the Economic and Social Stabilization Fund and of the Pensions Reserve Fund in March 2007. An MCM mission has been assessing the BCC's compliance with Fund management reserves management guidelines in April 2007, the results of which are reported in this report.

3. Past Background Work

Toward Improving the Data and Procedures Used in Current Analysis and Forecasting at the Central Bank of Chile (2006 Selected Issues Paper)

Deepening Liquidity in Chilean Fixed-Income Markets (2006 Selected Issues Paper)

Public Sector Debt and Market Development (2006 Selected Issues Paper)

The Experience of Poverty Reduction in Chile (2006 Selected Issues Paper)

Assessing the Long-Run Shortfalls of the Chilean Pension System (2005 Selected Issues Paper)

Competition in the Chilean Banking Sector: A Cross-Country Comparison (2005 Selected Issues Paper)

Perspectives on Chile's Private External Debt (2005 Selected Issues Paper)

Experience with Public-Private Partnerships (2005 Selected Issues Paper)
