

**FOR
AGENDA**

SM/07/219
Correction 1

July 13, 2007

To: Members of the Executive Board

From: The Secretary

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

The attached corrections to SM/07/219 (6/25/07) have been provided by the staff:

Mischaracterizations of the Views of the Authorities

Page 9, para. 16, line 4: for clarification the authorities have asked staff to replace “exchange rate volatility to be excessive and potentially damaging to” with “that a market overreaction could have potentially adverse consequences for”

Factual Errors Not Affecting the Presentation of Staff’s Analysis or Views

Page 1, bullet 6, line 2: after “Banco Central de Chile (BCC).” add new sentence “Mr. A. Rojas, Senior Advisor to the Executive Director, also attended the meetings.”

Page 7, para. 11, line 6 for “GDP in each of the next four years).” read “GDP in each of the next three years).”

Page 9, para. 17, second sentence for “The government’s savings under the structural surplus rule have been managed by the BCC since March 2007.” read “The assets accumulated in the two funds created under the 2006 Fiscal Responsibility Law have been managed by the BCC since March 2007.”

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

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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INTERNATIONAL MONETARY FUND

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. A Rojas, Senior Advisor to the Executive Director, also attended the meetings. Mr. Rodlauer (WHD) participated in the final discussions, and Mr. Singh joined the concluding videoconference with Minister Velasco.

Contents

Page

Executive Summary	3
I. Introduction.....	5
II. Outlook and Risks.....	5
III. Macroeconomic Policy Framework.....	7
IV. Bridging the Income Gap With Advanced Economies	9
V. Staff Appraisal	11
Box	
1. Reforming the Pension System.....	14
Figures	
1. Overview.....	4
2. Delinking the Economy from Copper.....	15
3. Corporate Financial Indicators.....	16
4. Household Finance.....	17
5. Trade Performance.....	18
6. Capital Account and Foreign Portfolios	19
7. Financial Market Developments	20
8. Banking Indicators	21
9. Monetary Policy Indicators.....	22
10. Fiscal Developments.....	23
11. Investment Climate	24
12. Productivity and Labor Markets	25
13. Financial Market Structure	26
Tables	
1. Selected Economic Indicators.....	27
2. Summary Operations of the Central Government	28
3. Summary Operations of the Public Sector.....	29
4. Indicators of External Vulnerability	30
5. Balance of Payments.....	31
6. External Debt and Debt Service.....	32
7. Social Demographic Indicators.....	33
Annex	
I. Analytical Work and Technical Assistance	34

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 three 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 that a market overreaction could have potentially adverse consequences for 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 assets accumulated in the two funds created under the 2006 Fiscal Responsibility Law 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.