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February 4, 1988

To: Members of the Executive Board
From: The Secretary
Subject: Chile - Review Under Extended Arrangement

Attached for consideration by the Executive Directors is the staff report for the review under the extended arrangement for Chile, which will be brought to the agenda for discussion on a date to be announced. Draft decisions appear on pages 27-29.

Mr. Hardy (ext. 7158) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

INTERNATIONAL MONETARY FUND

CHILE

Review Under the Extended Arrangement

Prepared by the Western Hemisphere Department

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

Approved by S. T. Beza and Eduard Brau

February 3, 1988

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I. Introduction

A mission visited Santiago in the period November 10-27, 1987 ^{1/} to review the implementation of economic policies during 1987 under the extended arrangement for SDR 750 million which was approved on August 15, 1985 (EBS/85/122) and to reach understandings on economic policies and objectives for the remaining period of the arrangement, which runs through August 15, 1988. On July 31, 1987, the Executive Board completed the 1987 Article IV consultation with Chile and the review under the second year of the extended arrangement, and approved certain multiple currency practices and exchange restrictions (EBM/87/113). All purchases available under the arrangement have been made as scheduled, the most recent on November 13, 1987. The last three purchases, each for SDR 50 million, are subject to completion of the present review as well as to observance of performance criteria for end-December 1987, end-March 1988, and end-June 1988.

As of December 31, 1987 outstanding Fund credit to Chile amounted to SDR 1,032.5 million (234 percent of Chile's quota of SDR 440.5 million), of which 24 percent corresponded to purchases under the Compensatory Financing Facility. If the remaining purchases under the extended arrangement are made, outstanding Fund credit at the end of the arrangement would be equivalent to 237 percent of quota (Table 1). Additional information on Chile's relations with the Fund and on projected purchases under the extended arrangement is presented in Appendix I.

Chile's adjustment program has also been supported during the last three years by three Structural Adjustment Loans from the World Bank totaling US\$750 million. On December 15, 1987 the World Bank Executive Board approved the third Structural Adjustment Loan for Chile, and the first disbursement under this loan, equivalent to US\$125 million, took place on December 18, 1987. Appendix II summarizes World Bank operations in Chile.

II. Background

1. Performance under the extended arrangement

The major objectives of the medium-term program supported by the extended arrangement were to strengthen the external position and lay the basis for sustained economic growth. The current account deficit of the balance of payments was targeted to decline from US\$2.1 billion in

^{1/} The mission comprised Mr. Hardy (Head), Ms. Brenner, Messrs. Leimone, Rennhack (all WHD), and Rodlauer (ETR), and Miss Rowles (Secretary-WHD). Mr. Donoso, the Executive Director for Chile, took part in the discussions. Mr. Lee, the Fund resident representative in Santiago, assisted the mission.

Table 1. Chile: Projected Fund Position, December 1987 - August 14, 1988

	Outstanding Dec. 31, 1987	Operations During Third Year		
		Jan. 1988	Feb. 1988- April 1988	May 1988- Aug. 14, 1988
(In millions of SDRs)				
Transactions under tranche policies (net)		-15.3	16.6	49.2
Purchases		--	50.0	100.0
Ordinary resources		--	16.7	33.3
Enlarged access resources		--	33.3	66.7
Repurchases		15.3	33.4	50.8
Ordinary resources		10.2	30.0	31.9
Enlarged access resources		5.1	3.4	18.9
Transactions under special facilities (net)		-36.9	--	--
Purchases		--	--	--
Repurchases		36.9	--	--
Total Fund credit outstanding (end-of-period)	1,032.5	980.2	996.8	1,046.0
Under tranche policies	925.0	909.7	926.3	975.5
Special facilities 1/	107.5	70.6	70.6	70.6
(As percent of quota)				
Total Fund credit outstanding (end-of-period)	234.4	222.5	226.3	237.5
Under tranche policies	210.0	206.5	210.2	221.5
Special facilities 1/	24.4	16.0	16.0	16.0

Source: Fund staff estimates.

1/ Compensatory financing facility.

1984 to US\$1 billion in 1987, or from 10.7 percent of GDP to 4.8 percent of GDP. 1/ Total external debt was expected to rise from US\$17 billion to US\$21.4 billion by the end of 1987 but to stay about constant in terms of GDP and to decline from 410 percent to 353 percent of exports. To achieve a sizable increase in investment while reducing Chile's reliance on foreign borrowing, domestic savings were expected to rise from about 13 percent of GDP in 1984 to 22 percent in 1987. Financial policies supporting these efforts were intended to bring the non-financial public sector close to balance in 1987. Attainment of these objectives was expected to be compatible with real growth of about 3 percent a year and a gradual reduction of inflation from 23 percent in 1984 to 15 percent in 1987.

The external current account deficit in 1987 turned out some US\$100 million lower than targeted, and total external debt has been kept about level since 1984, ending 1987 some US\$2.4 billion below the amount envisaged at the outset of the arrangement. The debt/export ratio has improved more rapidly than planned and total debt service payments (after rescheduling) in relation to exports of goods and non-factor services have declined steadily from 59 percent in 1984 to an estimated 32 percent in 1987, with interest payments falling from 48 percent to 27 percent of exports.

The progress in reducing Chile's external debt burden reflected not only the narrowing of the external current account deficit and the strong growth of exports, but also the relatively large-scale use of debt/equity swaps and other special mechanisms for debt conversion. From mid-1985 through September 1987 some US\$2.3 billion, or about 12 percent of Chile's total outstanding external debt, was extinguished through these mechanisms. The bulk of the debt reduction (US\$1.7 billion) has taken place under arrangements that do not provide for remittance rights, with the remainder accounted for by debt-equity conversions which carry remittance rights after four years.

Domestic savings have risen strongly, almost reaching the targeted 21 percent of GDP in 1987, and public sector savings (5.3 percent of GDP in 1987) reached the rate that had been planned. Public sector fixed investment in 1987 was about 0.8 percent of GDP higher than originally projected, but the overall public sector deficit was less than 1 percent of GDP and in line with revised program targets. Moreover, real GDP growth in 1985-87 averaged 4.5 percent a year, significantly higher than projected. Growth was led by a strong performance of exports, with the volume of noncopper exports rising by 35 percent over the last three years. Inflation declined in 1986 as planned but accelerated in 1987 to 21.5 percent, partly in reflection of some special factors explained below.

The achievement of more rapid growth than originally envisaged, while keeping Chile's external debt and debt service within the intended

1/ EBS/85/122, Supp. 3, p. 22.

bounds, has been facilitated by flexible exchange rate management, as well as favorable developments in the terms of trade and in international interest rates. The peso depreciated by about 20 percent in real effective terms from mid-1985 to September 1987, bringing the cumulative depreciation since the end of 1981 to more than 50 percent and boosting noncopper exports. Chile's terms of trade improved by about 10 percent over the three-year period, compared with a projected improvement of about 4 percent. The average price of copper in 1987 turned out quite close to the original program projection, while other export prices improved more and import prices, especially the price of oil, were lower than projected. Although international interest rates rose in 1987, they were still about 2 percentage points lower than assumed in the original program.

All performance criteria under the extended arrangement were met through September 1987 (Table 2). The end-December 1987 performance criteria on net international reserves and net domestic assets of the Central Bank and on short-term external indebtedness of the public sector were met with significant margins. End-1987 data for the other quantitative performance criteria are not yet available, but based on developments through the end of November it is estimated that all quantitative criteria for the end of 1987 were observed. Chile entered 1987 with margins, compared with the program, of US\$104 million on net international reserves and US\$90 million on use of short-term external credit by the public sector; during 1987 these margins rose to US\$144 million and US\$245 million, respectively.

2. Economic developments in 1987

Real GDP is estimated to have grown by about 5 1/2 percent in 1987 for the second year in a row (Table 3). Export growth remained buoyant and domestic investment continued to expand strongly (26 percent in real terms) supported by rising domestic savings (Table 4). The growth of real income was bolstered by a continuing improvement in the terms of trade, as the average price of copper rose by about 30 percent. Real per capita consumption grew by an estimated 3 percent, similar to the increase in 1986, after having declined slightly in 1984-85.

The rate of unemployment fell to 8.5 percent in September-November 1987 from 9.7 percent in the same period of the previous year. Excluding the public employment programs, which have been gradually phased down, employment expanded at about the same rate as output in 1987. Real wages, which increased by 2 percent in 1986, fell by about 1 percent in the nine months through September 1987. Inflation (measured by the CPI) rose to 21.5 percent during 1987 compared with 17.4 percent during 1986 and a projected 16 percent under the program. The acceleration in inflation during 1987 reflected the rise in the prices for oil and other imports in U.S. dollar terms and the effects of an unanticipated real depreciation of the Chilean peso; in addition,

Table 2. Chile: Quarterly Quantitative Criteria and Performance under the Economic Program for 1987

	Program Base	Limits and Targets for 1987			
	December 31 1986	Jan. 1- Mar. 31	Apr. 1- June 30	July 1- Sept. 30	Oct. 1- Dec. 31
(In billions of Chilean pesos)					
<u>Net domestic assets of the Central Bank 1/</u>					
Limit	770	824	828	923	945 2/
Actual	...	791	802	886	917
Margin	...	33	26	37	28
<u>Cumulative overall deficit of the nonfinancial public sector 3/</u>					
Limit	...	24	33	59	57 2/
Actual	...	23	14	14	...
Margin	...	1	19	45	...
(In millions of U.S. dollars)					
<u>Net international reserves of the Central Bank 3/</u>					
Target	1,089	839	1,003	710	910 4/
Actual	...	977	1,104	869	1,054
Margin	...	138	101	159	144
<u>Contracting, guaranteeing, and rescheduling of external debt by the public sector 5/</u>					
Limit	...	600	1,200	1,200	1,200
Actual	...	21	509	659	...
Margin	...	579	691	541	...
Of which: debt with maturity of more than one year and less than five years					
Subceiling	...	190	190	190	190
Actual	...	8	9	30	...
Margin	...	182	181	160	...
<u>Stock of short-term external debt owed by the nonfinancial public sector and the Banco del Estado</u>					
Limit	990	1,055	1,055	1,055	1,055
Actual	...	875	872	833	810
Margin	...	180	183	222	245

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

1/ Defined as the difference between (i) the sum of the Central Bank's liabilities to the private sector and its medium- and long-term foreign liabilities, and (ii) the net international reserves of the Central Bank.

2/ This limit (target in the case of the overall deficit of the nonfinancial public sector) has been reduced by the amount of the November 1987 deposit in the Copper Stabilization Fund of US\$26.3 million, equivalent to Ch\$5.9 billion at the accounting exchange rate of the fourth quarter 1987.

3/ Tested at the end of each period.

4/ This target has been increased by the amount of the deposit in the Copper Stabilization Fund of US\$26.3 million in November 1987.

5/ Refers to external debt with maturity of more than 12 months and less than 120 months.

Table 3. Chile: Main Economic Indicators 1984-88

(Percentage changes unless otherwise specified)

	1984	1985	1986	1987		1988
				Prog.	Rev. Proj.	Prog.
Real GDP	6.3	2.4	5.7	5.0	5.4	4.5
Real private consumption	1.2	-1.1	4.9	5.0	4.9	5.3
Real wages <u>1/</u>	-3.8	1.9	2.1
Import volume	15.7	-11.4	11.8	2.1	21.9	2.5
Export volume	0.1	13.5	7.9	2.7	4.9	7.6
Terms of trade	-4.7	-7.3	9.0	-12.3	9.0	-2.8
Consumer price index <u>1/</u>	23.0	26.4	17.4	16.0	21.5	17.0
Nominal exchange rate <u>1/2/</u>	-31.0	-30.8	-11.0	-9.3	-13.3	-10.7
Real effective exchange rate <u>1/2/</u>	-12.8	-21.5	-5.2	-1.9	-8.2 <u>3/</u>	--
Unemployment (as percent of labor force) <u>4/</u>	14.0	12.0	8.8

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

1/ Twelve months ended December.

2/ U.S. dollars per peso; decline indicates depreciation of Chilean peso.

3/ From December 1986 to September 1987.

4/ Unemployment in the fourth quarter of each year. The survey methodology was changed as of the fourth quarter of 1985. Hence, the data for 1985-87 are not comparable to data for previous years.

Table 4. Chile: Macroeconomic Flows

(In percent of GDP) 1/

	1984	1985	Est. 1986	1987		Prog. 1988
				Prog. 2/	Proj.	
I. Balance of Payments 3/						
Current account balance	-10.7	-8.3	-6.5	-5.2	-4.8	-4.7
Trade balance	1.5	5.3	6.5	5.2	5.8	6.2
Exports	19.0	23.7	24.9	24.7	27.0	26.8
Imports	-17.5	-18.4	-18.4	-19.5	-21.2	-20.7
Net factor payments	-10.2	-11.9	-11.2	-8.7	-8.6	-8.8
Other services and transfers	-2.1	-1.7	-1.8	-1.7	-2.0	-2.0
Capital account balance	10.3	8.3	7.4	4.1	4.0	5.9 4/
Nonfinancial public sector	2.7	4.0	2.6	3.3	2.4	2.6
Financial system	6.6	6.0	0.4	-3.1	-3.6	-1.7
Public sector 4/	7.2	5.3	1.9	-2.0	-2.1	-0.3
Rest	-0.6	-0.6	-1.4	-1.1	-1.5	-2.0
Private capital and other	1.0	-1.6	4.4	3.9	5.2	5.0
Of which: purchase of public debt	(--)	(0.5)	(2.5)	(1.9)	(1.9)	(1.0)
Net official reserves (increase -)	0.4	—	-0.9	1.1	0.8	-1.2
II. Aggregate Expenditure, Savings, and Investment						
Aggregate domestic expenditure	101.1	97.2	95.9	97.0	96.8	96.4
Consumption	87.4	83.5	81.5	81.2	79.9	79.9
Gross domestic investment	13.6	13.7	14.4	15.8	16.9	16.5
Nonfinancial public sector	6.4	7.0	7.5	7.4	7.3	6.9
Private sector and inventories	7.3	6.7	6.9	8.4	9.7	9.6
External savings	10.7	8.3	6.5	5.2	4.8	4.7
National savings	2.9	5.4	8.0	10.6	12.1	11.8
Nonfinancial public sector	0.6	3.8	4.6	4.7	5.3 (4.8) 5/	5.1
Private sector	2.4	1.6	3.3	5.9	6.8 (7.3)	6.8
Domestic savings	13.1	17.3	19.2	19.3	20.6	20.6
III. Nonfinancial Public Sector						
Savings	0.6	3.8	4.6	4.8	5.3 (4.8) 5/	5.1
Net capital revenue	1.5	0.6	1.0	1.0	1.2	1.1
Capital expenditure	6.4	7.0	7.5	7.4	7.3 (7.0)	7.0
Overall balance	-4.4	-2.6	-1.9	-1.6	-0.8 (-1.0) 5/	-0.8
Financing	4.4	2.6	1.9	1.6	0.8	0.8
External	2.7	4.0	2.6	3.3	2.4	2.6
Domestic	1.7	-1.4	-0.7	-1.7	-1.7 (-1.4)	-1.8
Of which: financial system	(2.8)	(-1.0)	(-1.3)	(-1.2)	(-1.0)	(-1.7)
IV. Underlying Basic Data						
Real GDP (annual percent change)	6.3	2.4	5.7	5.0	5.4	4.5
Nominal GDP (billions of pesos)	1,893	2,577	3,250	3,978	4,110	5,208
Nominal GDP (billions of U.S. dollars, at average market exchange rates)	19.2	16.0	16.8	18.4	18.7	20.8
Average market exchange rates (pesos per U.S. dollar)	98.5	160.9	192.9	216.6	219.4	249.9
Copper price (U.S. cents per pound)	62.5	64.3	62.3	65.0	76.8	75.0
U.S. prime rate (in percent)	12.0	9.9	7.5	8.0	8.0	9.0
Consumer prices (12-month percent change)	23.0	26.4	17.4	16.0	21.5	17.0
Consumer prices (period average change)	19.9	30.7	19.5	18.1	19.9	18.6

Sources: Chilean authorities; and Fund staff estimates.

1/ Components may not add to totals due to rounding.

2/ As presented in EBS/87/148, July 6, 1987.

3/ As percent of GDP in U.S. dollars at average market exchange rates.

4/ Retiming of interest payments recorded as capital inflows to original debtors.

5/ Figure in parentheses is comparable to 1988 figure, i.e., adjusted for privatization of three enterprises.

heavy flooding resulted in a runup of food prices in the middle quarters of the year. Demand pressures early in the year also may have played a role.

Following a steady reduction from 4.4 percent of GDP in 1984 to 1.9 percent in 1986, the deficit of the nonfinancial public sector in 1987 is estimated to have declined further to 0.8 percent of GDP, compared with a revised program target of 1.6 percent of GDP, as a revenue overperformance more than offset an overrun in expenditure (Table 5 and Chart 1). The deficit was financed by net foreign borrowing, and the public sector's net domestic indebtedness was reduced. Total revenues rose to an estimated 33.8 percent of GDP in 1987, compared with a program projection of 32.4 percent, as a result of higher tax collections (particularly on international trade) and an improved operating surplus of the public enterprises stemming mainly from higher copper prices. In addition, sales of shares of enterprises held by CORFO (the Development Corporation) proceeded slightly faster than programmed, with cash receipts from such sales reaching Ch\$36 billion (0.9 percent of GDP). Total expenditure is estimated at 34.5 percent of GDP in 1987, compared with a program projection of 33.9 percent of GDP, with the difference accounted for mainly by higher than expected outlays on goods and services and interest payments.

Because of concern about inflation and the rapid growth of imports in early 1987, the authorities raised the discount rate several times and took other steps to tighten credit, and M1 1/ fell by about 2 percent in real terms during 1987 (Table 6 and Chart 2). Nominal interest rates rose by about 5 percentage points in the course of 1987, while real rates rose by about 1 1/2 percentage points, broadly in line with the increase in international interest rates (Chart 3). Broad money (M7) 2/ increased by about 35 percent in nominal terms and 10 percent in real terms during 1987. Much of this increase reflected the continued rapid accumulation of deposits by the private social security funds, but there was also a substantial increase in other private sector holdings of financial assets. In April 1987 the preferential exchange rate and swap subsidies that had been provided by the Central Bank were virtually eliminated; as a result, the Central Bank's operating surplus rose from 0.6 percent of GDP in 1986 to 3.4 percent in 1987. 3/

1/ Currency, demand deposits, and cashier's checks.

2/ Consists of M1 plus savings deposits, central bank notes, letters of credit, foreign currency deposits, and treasury notes held by the private sector, including holdings by the private social security funds.

3/ These figures include accrued interest of 5 percent a year on the purchase by the Central Bank of substandard portfolio from commercial banks. This portfolio is to be repurchased by commercial bank shareholders from profits. Excluding these interest receipts, the surplus is estimated at 0.1 percent of GDP in 1986 and 2.6 percent in 1987.

Table 5. Chile: Operations of the Consolidated Nonfinancial Public Sector

(In percent of GDP) 1/

	1984	1985	1986	1987 1/ Prog.	1987 2/ Proj.	1988 2/ Proj.	
<u>Total revenue</u>	<u>33.5</u>	<u>34.9</u>	<u>34.0</u>	<u>32.4</u>	<u>33.8</u>	<u>33.0</u>	<u>32.4</u>
General government current revenue	21.7	21.6	21.7	20.0	20.9	21.0	20.2
Taxes on income and property	4.6	3.7	3.7	3.3	4.1	4.4	4.4
Taxes on goods and services	14.4	15.1	15.8	15.5	16.1	16.1	15.8
Taxes on international trade	3.3	3.6	3.0	3.2	3.5	3.5	3.5
Social security tax	2.8	2.4	2.5	2.3	2.3	2.3	2.1
Other tax (net of IVA rebate)	-1.1	-1.7	-1.8	-1.9	-2.3	-2.4	-2.4
Nontax revenue	4.7	5.4	4.8	4.5	4.3	4.3	4.0
Enterprise transfers to general government	-7.0	-7.0	-6.4	-6.9	-7.1	-7.1	-7.2
<u>Operating surplus of the public enterprises</u>	<u>10.3</u>	<u>12.8</u>	<u>11.3</u>	<u>11.3</u>	<u>11.7</u>	<u>10.8</u>	<u>11.1</u>
Of which: CODELCO	3.1	4.9	4.4	4.3	5.8	5.8	6.2
ENAP	5.0	5.6	3.9	4.1	4.0	4.0	3.8
<u>Net capital revenue</u>	<u>1.5</u>	<u>0.6</u>	<u>1.0</u>	<u>1.1</u>	<u>1.2</u>	<u>1.2</u>	<u>1.1</u>
Revenue	3.4	3.3	4.0	3.6	3.8	3.9	3.1
Less: financial investment	-2.0	-2.7	-3.0	-2.5	-2.6	-2.6	-2.0
<u>Total expenditure</u>	<u>37.9</u>	<u>37.5</u>	<u>35.9</u>	<u>33.9</u>	<u>34.5</u>	<u>34.1</u>	<u>33.2</u>
General government current outlays	30.8	29.5	27.2	25.5	26.0	26.0	24.8
Wages and salaries	6.4	5.8	5.3	4.7	4.8	4.8	4.8
Goods and services	3.4	3.2	3.0	2.8	3.3	3.3	2.8
Social security payments to private recipients	10.1	9.0	8.7	8.3	8.1	8.1	8.0
Transfer and subsidy payments to private sector	8.2	8.0	7.6	7.0	6.9	6.9	6.8
Interest on public debt	2.4	3.2	2.4	2.5	2.7	2.7	2.3 3/
Other	0.2	0.3	0.3	0.2	0.2	0.2	0.1
<u>Enterprise transfers to private sector</u>	<u>0.8</u>	<u>1.0</u>	<u>1.1</u>	<u>1.0</u>	<u>1.2</u>	<u>1.1</u>	<u>1.4</u>
<u>Capital formation</u>	<u>6.4</u>	<u>7.0</u>	<u>7.5</u>	<u>7.4</u>	<u>7.3</u>	<u>7.0</u>	<u>7.0</u>
General government	2.7	3.1	3.3	3.5	3.5	3.5	3.4
Public enterprises	3.7	3.9	4.3	4.0	3.8	3.5	3.6
<u>Overall surplus or deficit (-)</u>	<u>-4.4</u>	<u>-2.6</u>	<u>-1.9</u>	<u>-1.6</u>	<u>-0.8</u>	<u>-1.0</u>	<u>-0.8</u>
<u>Financing</u>	<u>4.4</u>	<u>2.6</u>	<u>1.9</u>	<u>1.6</u>	<u>0.8</u>	<u>1.0</u>	<u>0.8</u>
External	2.7	4.0	2.6	3.3	2.4	2.4	2.6 4/
Internal	1.7	-1.4	-0.7	-1.7	-1.7	-1.4	-1.8
<u>Memorandum items</u>							
Public sector borrowing requirement	5.8	3.2	2.9	2.7	2.0	2.2	1.9
Current account surplus 5/	0.6	3.8	4.6	4.8	5.3	4.8	5.1

Sources: Ministry of Finance; and Fund staff estimates.

1/ Including Pacific Steel Co., Chilectra Generacion, and SOQUIMICH.

2/ Excluding Pacific Steel Co., Chilectra Generacion, and SOQUIMICH.

3/ Includes the general government's share of interest in 1988 subject to retiming.

4/ Includes US\$100.4 million for the retiming of interest payments owed by the public sector in 1988.

5/ General government current revenue plus operating surplus of public enterprises minus general government current outlays minus enterprise transfers to private sector.

Table 6. Chile: Monetary Indicators 1/

	1984	1985	1986	Prog. 1987	Proj. 1987	Prog. 1988
A. Central Bank						
(Change in millions of U.S. dollars)						
Net international reserves <u>2/</u>	-82.0	4.0	154.0	-205.0 <u>3/</u>	-140.0	254.0
Medium- and long-term foreign liabilities <u>4/</u>	825.0	798.0	617.0	237.0	217.0	159.0
(Percentage change)						
Net domestic assets <u>5/</u>	164.0	172.2	118.5	102.7	71.3	4.7
Liabilities to the private sector <u>6/</u>	20.7	21.8	33.3	20.2	24.2	22.3
B. Financial System						
(Change in millions of U.S. dollars)						
Net international reserves	619.0	-206.0	-58.0	-175.0	-275.0	180.0
Medium- and long-term foreign liabilities <u>8/</u>	1,971.0 <u>7/</u>	745.0	-139.0	-249.0	-660.0	-667.0
(Percentage change) <u>9/</u>						
Net domestic assets	112.1	135.3	51.0	41.6	53.3	28.1
Of which: credit to the public sector (net) <u>10/</u>	9.7	-3.7	-3.9	-2.8	-2.7	-4.4
Credit to the private sector	76.3	68.1	42.0	37.7	39.2	34.1
Liabilities to the private sector <u>11/</u>	31.4	53.0	35.0	28.0	38.5	26.6
Memorandum items						
Inflation rate (CPI)	23.0	26.4	17.4	16.0	21.5	17.0
Change in official exchange rate (pesos per U.S. dollar) <u>12/</u>	46.0	40.9	11.8	12.2	16.3	12.0
Change in real currency <u>13/</u>	-0.5	-1.9	16.3	5.3	2.6	5.6
Change in real M1 <u>13/ 14/</u>	-1.8	-2.4	19.8	5.7	-2.3	6.1
Change in real M7 (broad money) <u>13/</u>	5.7	19.6	14.2	9.1	10.5	8.0
Change in real (M7 - AFP) <u>13/ 15/</u>	0.5	14.6	11.8	5.0	9.2	4.5

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

1/ Based on end-of-period data.

2/ Program definition. Based on cross-parities of December of preceding year for 1983-87.

3/ Program targets adjusted to reflect the financing package obtained for 1987-88.

4/ Program definition. Includes SAL and cofinancing disbursements; excludes foreign liabilities due to deposits placed by the private and public sectors in the Central Bank on account of the rescheduling agreements with foreign banks.

5/ As percent of liabilities to the private sector at the beginning of the period. Foreign currency flows during each period are valued at the accounting exchange rates of the program.

6/ Consists primarily of currency in the hands of the public. Excludes central bank notes (pagares), which are treated as a negative item in net domestic assets.

7/ Flow includes the conversion of short-term foreign liabilities to medium-term foreign liabilities.

8/ Excludes SAL and cofinancing.

9/ As percent of liabilities to private sector at beginning of period.

10/ Excludes holdings of treasury notes on account of the 1983-86 capitalization of the Central Bank.

11/ Consists of currency in the hands of the public, demand deposits, savings deposits, central bank notes, letters of credit, and foreign currency deposits.

12/ End-of-period.

13/ Deflated by changes in the CPI.

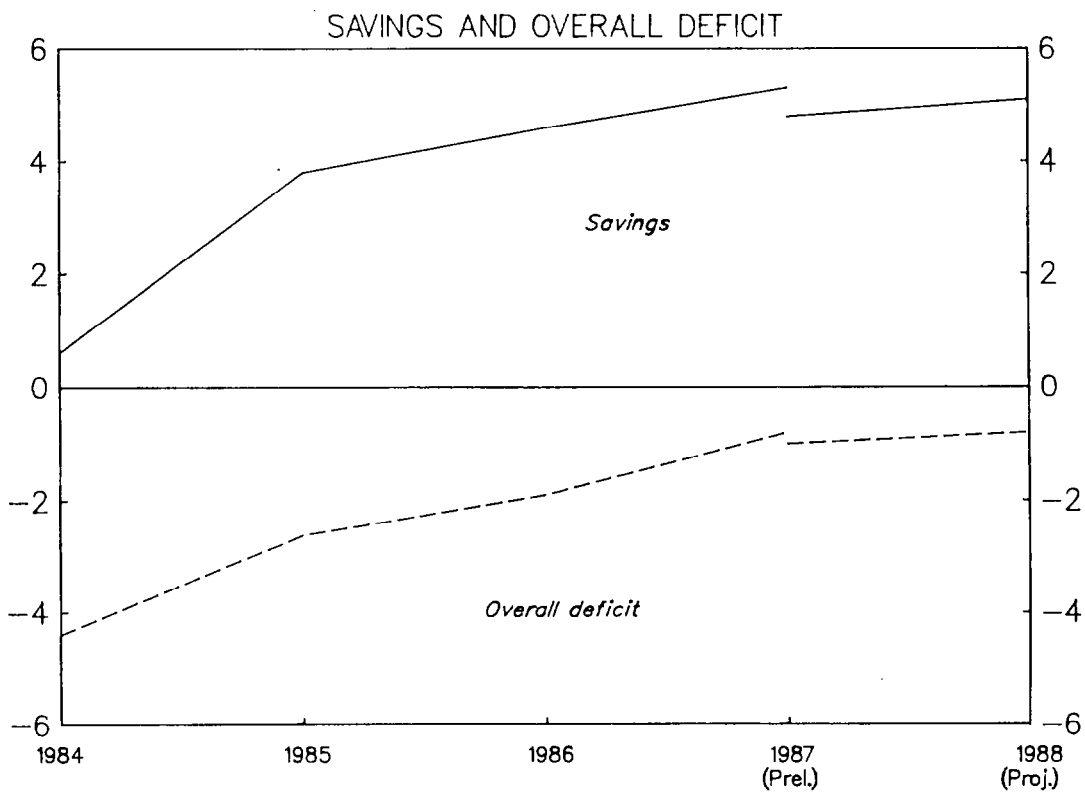
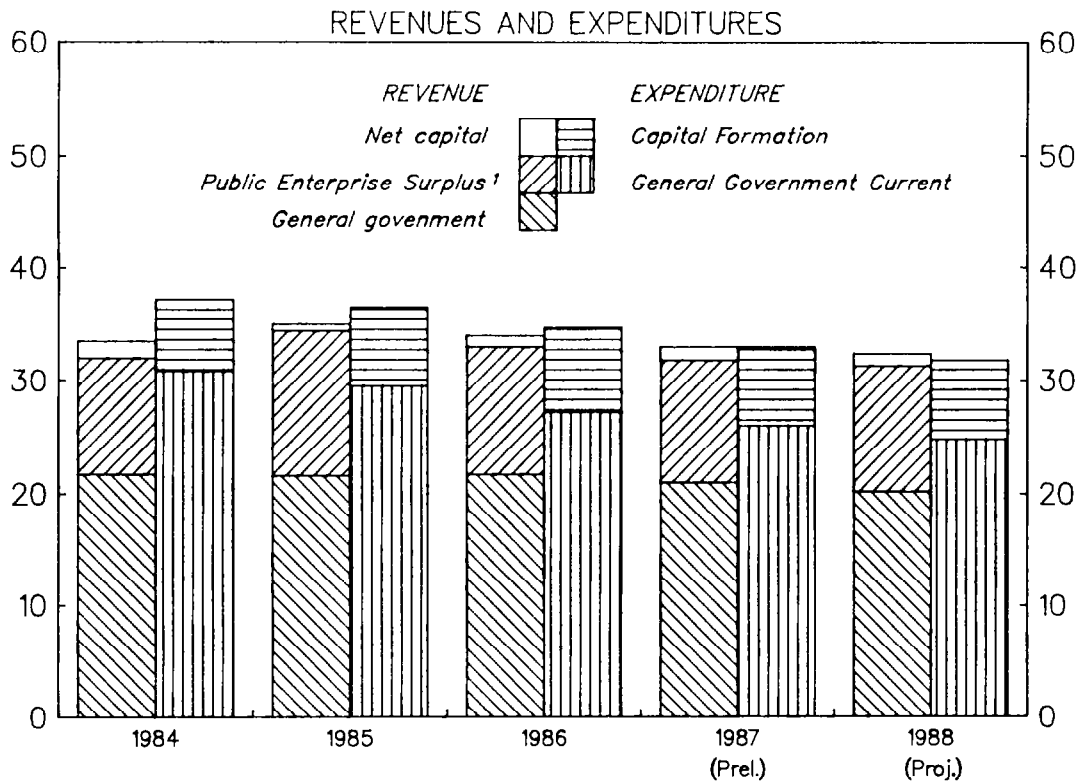
14/ Currency, demand deposits and cashier's checks.

15/ Broad money, M7, less holdings of M7 by the pension funds (AFP).

CHART 1
CHILE

OPERATIONS OF THE NONFINANCIAL PUBLIC SECTOR

(Percent of GDP)

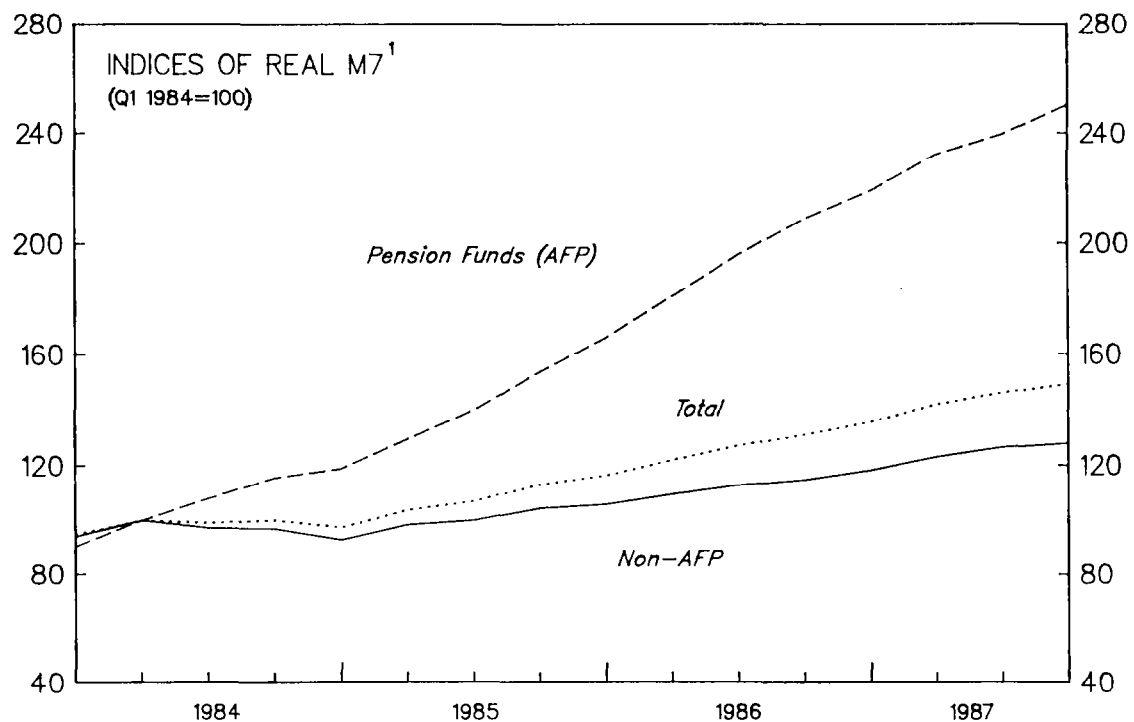
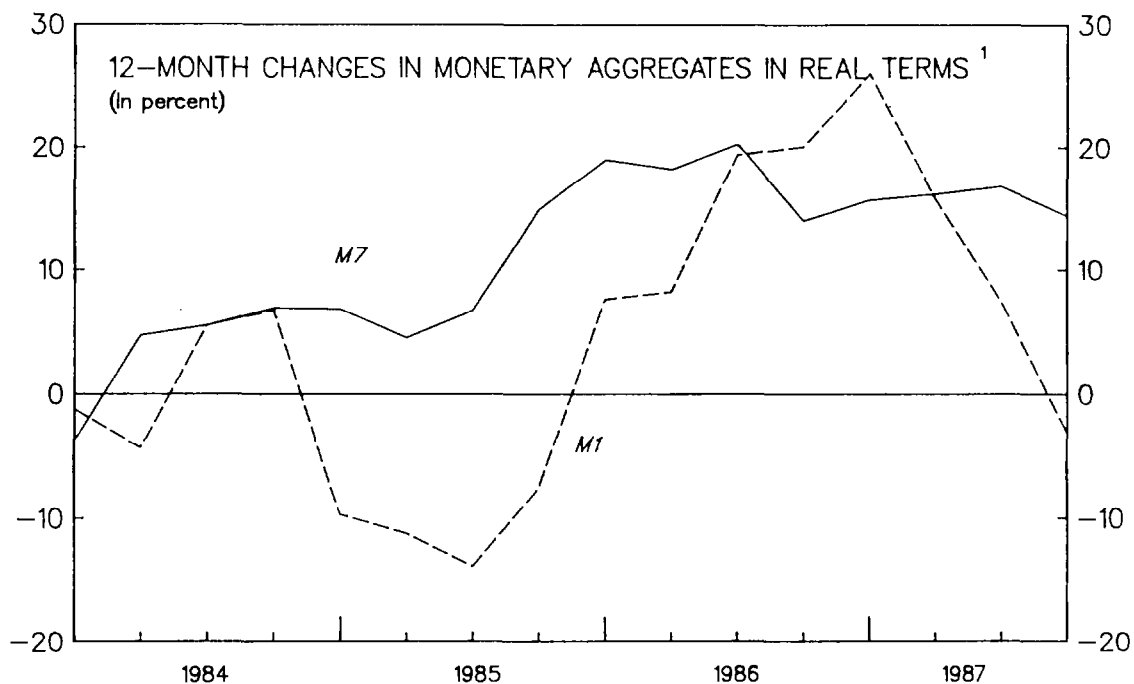


Sources: Ministry of Finance and Fund staff estimates.

¹ After tax and transfer payments and receipts.



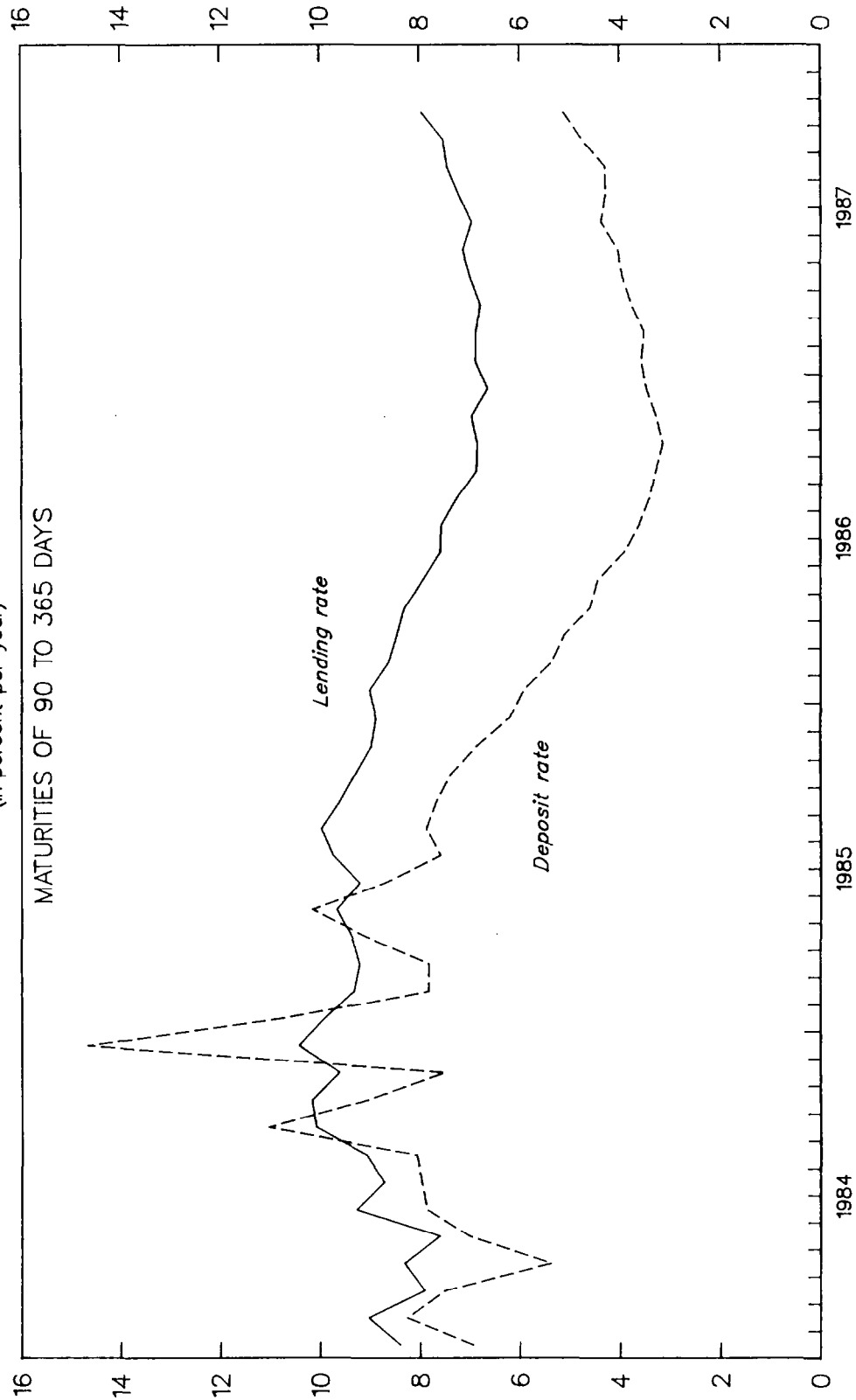
CHART 2
CHILE
MONETARY INDICATORS



Sources: Central Bank of Chile and Fund staff estimates.
¹ Deflated by the consumer price index.



CHART 3
CHILE
REAL INTEREST RATES'
(in percent per year)
MATURITIES OF 90 TO 365 DAYS



Source: Central Bank of Chile.
1 Interest rate paid over and above changes in the consumer price index.



In 1987 the authorities continued their policy of depreciating the Chilean peso daily in relation to the U.S. dollar, on the basis of the difference between domestic and estimated external inflation. This policy led to a real effective depreciation of about 9 percent during 1987, as inflation in Chile's trading partners turned out to be higher than had been assumed (Chart 4). At the beginning of 1988, the authorities lowered customs duties across the board from 20 percent to 15 percent and at the same time depreciated the Chilean peso against the U.S. dollar by 4 percent.

After declining from US\$2.1 billion in 1984 to US\$1.1 billion in 1986, the external current account deficit narrowed to an estimated US\$0.9 billion in 1987, about US\$60 million lower than projected in the last review (Table 7 and Chart 5). Export earnings rose to over US\$5 billion from US\$4.2 billion in 1986, and were some US\$0.5 billion higher than projected in July 1987. Part of the increase reflected the strong rise in copper prices during the second half of 1987. Noncopper exports also grew strongly, with volume and prices each rising by about 9 percent. Led by capital and intermediate goods, imports rose sharply in 1987, especially during the first half of the year when import volume was more than 30 percent higher than in the corresponding period of 1986. In the second half of the year, helped by the tightening of credit policy, the growth of imports slowed, with the increase in volume in relation to one year earlier falling to 6 percent.

Net capital inflows (including errors and omissions) are estimated to have declined to about US\$750 million in 1987 from US\$1.2 billion in 1986; this difference reflected the absence of new balance of payments loans from commercial banks in 1987, whereas in 1986 there had been a disbursement of US\$370 million. The outstanding short-term external debt of the nonfinancial public sector and the Banco del Estado declined by about US\$90 million, compared with a projected decline of US\$23 million.

The overall balance of payments shifted from a surplus of US\$154 million in 1986 to a deficit of US\$140 million in 1987; however, the latter was US\$65 million smaller than had been programmed. At the end of 1987 gross reserves amounted to a little more than US\$3 billion (with gold valued at US\$300 per ounce), equivalent to over nine months of merchandise imports. Total external debt at the end of 1987 was about US\$19 billion, or 102 percent of GDP, and interest payments in 1987 were equivalent to 8.5 percent of GDP (Table 8).

III. The Economic Program for 1988

Although the short-term outlook for Chile has improved with the rise of copper prices to their highest level in six years, the medium-term balance of payments outlook is still difficult because of Chile's large external debt burden. The program for 1988 has been designed in

Table 7. Chile: Balance of Payments, 1984-88

(In millions of U.S. dollars)

	1984	1985	1986	1987		1988
				Prog. 1/	Proj.	Prog.
<u>Current account</u>	<u>-2,060</u>	<u>-1,329</u>	<u>-1,091</u>	<u>-950</u>	<u>-892</u>	<u>-970</u>
Trade balance	293	849	1,100	956	1,079	1,282
Exports	3,650	3,804	4,199	4,528	5,046	5,588
Copper	1,604	1,789	1,757	1,851	2,145	2,304
Other	2,046	2,015	2,442	2,677	2,901	3,284
Imports	-3,357	-2,955	-3,099	-3,527	-3,967	-4,306
Nonfinancial services	-497	-338	-388	-407	-473	-529
Financial services	-1,955	-1,901	-1,887	-1,590	-1,601	-1,830
Transfers	99	61	85	92	103	107
<u>Capital account</u>	<u>1,790</u>	<u>1,504</u>	<u>1,238</u>	<u>658</u>	<u>937</u>	<u>1,224</u>
Direct investment	67	189	312	360	609	390
Debt conversion	—	63	255	300	503	330
Other	67	127	57	60	106	60
Extraordinary amortization 2/	—	-371	-969	-800	-1,311	-800
Counterpart, debt conversion 3/	—	244	714	500	808	470
Medium- and long-term capital, net	1,124	1,051	787	672	738	553
Disbursements	1,612	1,471	1,217	1,003	1,027	980
Project lending	792	632	573	778	802	855
Multilateral	341	363	208	328	277	376
Other	451	269	365	450	525	479
IBRD structural adjustment loan	—	125	275	225	225	125
New commercial bank money	820	714	369	—	—	—
Refinancing	1,019	1,827	2,260	1,532	1,532	2,384
Foreign banks	1,019	1,760	2,194	1,447	1,447	2,312
Foreign governments	—	67	66	85	85	72
Scheduled amortization	-1,507	-2,247	-2,691	-1,863	-1,821	-2,811
Short-term capital	599	390	393	-73	93	147
Commercial credits	-6	49	120	-123	74	79
Other 4/	605	341	273	50	19	68
Retiming interest payments	—	—	—	—	—	465
<u>Errors and omissions</u>	<u>188</u>	<u>-171</u>	<u>8</u>	<u>86</u>	<u>-185</u>	<u>—</u>
<u>Overall balance of payments</u> <u>(program definition) 5/</u>	<u>-82</u>	<u>4 6/</u>	<u>154 6/</u>	<u>-205</u>	<u>-140</u>	<u>254</u>
<u>Valuation adjustment</u>	<u>-31</u>	<u>-16</u>	<u>-69</u>	<u>-30</u>	<u>-35</u>	<u>—</u>
<u>Change in official reserves</u> <u>(increase -)</u>	<u>113</u>	<u>12</u>	<u>-85</u>	<u>235</u>	<u>175</u>	<u>-254</u>

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

1/ As set forth in EBS/87/148 (7/6/87).

2/ Prepayment of debt through purchases abroad of Chilean external debt at a discount; counter entries are made under "counterpart, debt conversion".

3/ Inflows that are counterpart entry to prepayment of debt under Chapter XVIII and related arrangements.

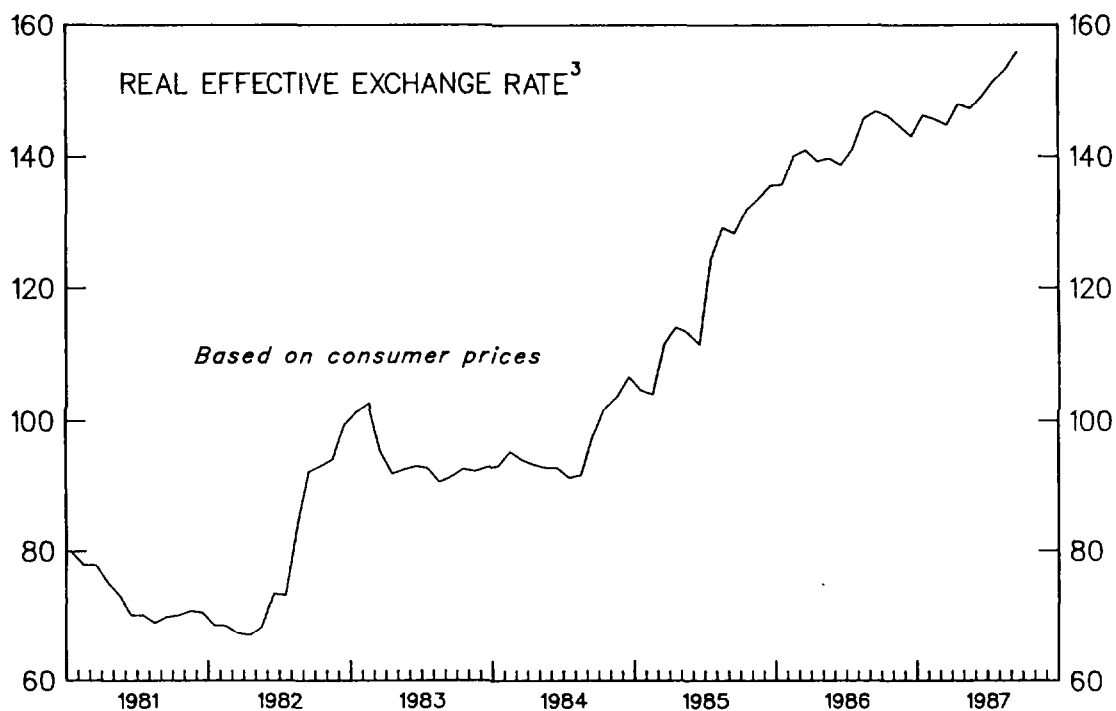
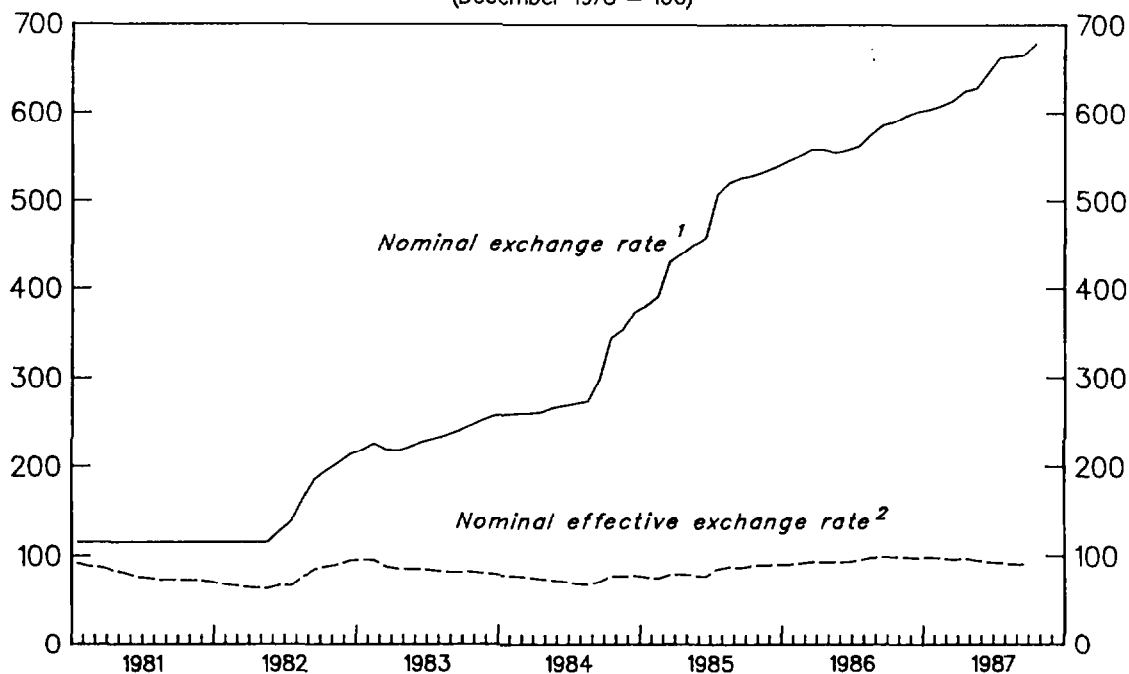
4/ Includes changes in medium- and long-term assets held overseas by Chilean residents.

5/ Program definition, using accounting exchange rates.

6/ Includes an adjustment to net international reserves for a provision of US\$15 million to cover cash payments related to the rescheduling agreement with Chile's main official creditors which were effected in early 1986.

CHART 4 CHILE EXCHANGE RATE INDICES

(December 1978 = 100)



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

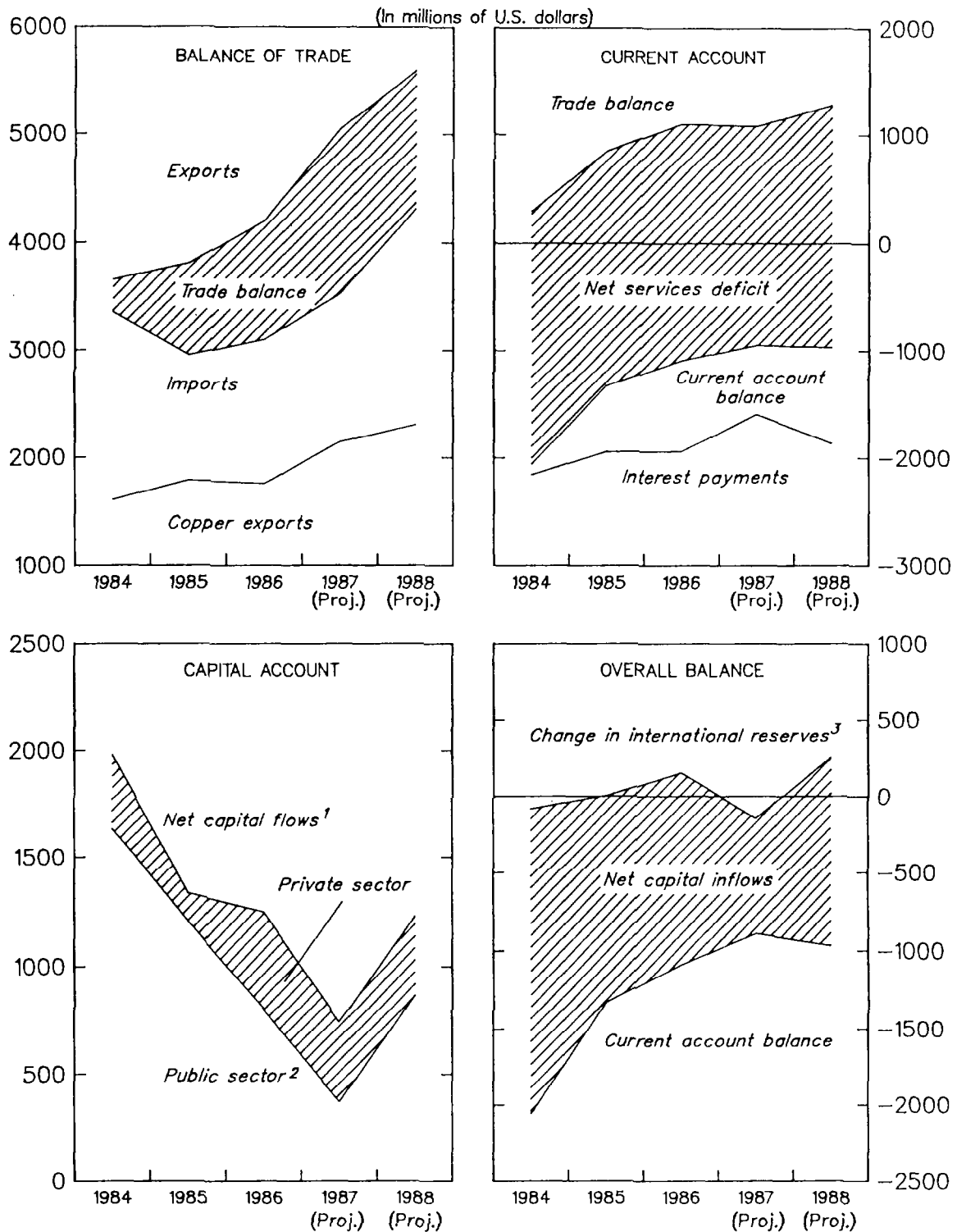
¹ Pesos per U.S. dollar at end of period. Increase means depreciation.

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

³ Nominal exchange rate adjusted by weighted indices of prices and exchange rates of major trading partners.



CHART 5 CHILE BALANCE OF PAYMENTS



¹Including errors and omissions.

²Excludes debt conversions; In 1988, Includes retiming of interest on public sector debt.

³Program definition, (increase +).

Table 8. Chile: External Debt, 1984-88

	1984	1985	1986	1987		1988
				Prog. 1/	Proj.	Prog.
(In millions of U.S. dollars)						
<u>Medium- and long-term debt outstanding end-period</u>	<u>16,963</u>	<u>17,650</u>	<u>17,768</u>	<u>17,744</u>	<u>17,356</u>	<u>17,108</u>
International organizations						
Outstanding end-period	935	1,425	1,905	2,358	2,374	2,768
Drawings	(341)	(488)	(483)	(553)	(556)	(501)
Amortization	(34)	(38)	(47)	(99)	(87)	(107)
Interest payments	(59)	(101)	(180)	(214)	(238)	(256)
Official lenders						
Outstanding end-period	614	639	647	694	642	634
Drawings	(--)	(61)	(24)	(17)	(17)	(18)
Amortization	(73)	(29)	(41)	(29)	(22)	(26)
Interest payments	(25)	(21)	(33)	(19)	(25)	(34)
Private banks and financial institutions						
Outstanding end-period	14,226 2/	14,482	14,080	13,387	12,943	12,128
Drawings	(1,086)	(781)	(447)	(61)	(70)	(65)
Amortization 3/	(127)	(246)	(130)	(58)	(57)	(80)
Interest payments	(1,560)	(1,438)	(1,355)	(1,030)	(981)	(1,183)
Other						
Outstanding end-period	1,187	1,104	1,136	1,305	1,397	1,579
Drawings	(165)	(140)	(261)	(372)	(384)	(396)
Amortization	(254)	(107)	(213)	(145)	(123)	(214)
Interest payments	(150)	(67)	(80)	(83)	(78)	(53)
<u>Short-term debt outstanding end-period 4/</u>	<u>1,434 2/</u>	<u>1,343</u>	<u>1,574</u>	<u>1,631</u>	<u>1,638</u>	<u>1,791</u>
Net drawings 4/	(-865) 2/	(-92)	(231)	(57)	(64)	(153)
Interest payments 5/	(364)	(316)	(292)	(272)	(273)	(337)
<u>Total debt outstanding end-period</u>	<u>18,397</u>	<u>18,993</u>	<u>19,342</u>	<u>19,374</u>	<u>18,994</u>	<u>18,899</u>
<u>Total amortization payments 3/</u>	<u>488</u>	<u>420 6/</u>	<u>431 6/</u>	<u>331</u>	<u>289</u>	<u>427</u>
<u>Total interest payments</u>	<u>2,158</u>	<u>1,943</u>	<u>1,940</u>	<u>1,618</u>	<u>1,595</u>	<u>1,863</u>
<u>Total debt service 3/</u>	<u>2,646</u>	<u>2,363</u>	<u>2,371</u>	<u>1,949</u>	<u>1,884</u>	<u>2,290</u>
(In percent of GDP)						
<u>Memorandum items</u>						
Total external debt, end-period	95.7	118.6	114.8	105.5	101.7	92.5
Interest payments on external debt	11.2	12.1	11.5	8.8	8.5	9.1
(In percent of exports of goods and nonfactor services)						
Debt service payments after rescheduling 7/	58.9	52.9	47.1	36.0	31.5	34.6
Interest payments	48.0	43.5	38.6	29.9	26.7	28.2
Total external debt outstanding at year-end 8/	409.4	424.9	384.5	358.1	317.8	285.7

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

1/ As set forth in EBS/87/148 (7/6/87).

2/ Reflects US\$1,160 million reclassified from short-term and long-term debt.

3/ After refinancing. Excludes extraordinary amortization through purchase of debt at discount of US\$371 million in 1985, US\$969 million in 1986, US\$1,311 million estimated for 1987, and US\$800 million projected for 1988.

4/ Excludes short-term liabilities of the Central Bank.

5/ Includes interest payable to the IMF and the BIS.

6/ Excludes amortization payments to Banco Andino as follows: 1983, US\$236 million; 1985, US\$100 million; and 1986, US\$50 million.

7/ Excludes IMF repurchase obligations.

8/ Excludes use of Fund credit.

the context of a medium-term framework which aims at strengthening the public finances and progressively reducing the external current account deficit and debt burden, while maintaining output growth of 3-4 percent a year.

The program for 1988 is based on a real GDP growth of 4.5 percent and a slowing of inflation during the year to 17 percent. In the balance of payments, it aims at limiting the current account deficit to US\$970 million or 4.7 percent of GDP (see Tables 4 and 7), and at achieving an overall surplus of US\$0.25 billion, which would leave gross international reserves about unchanged. Following the step depreciation of early 1988 in connection with the across-the-board tariff reduction, the Chilean peso will continue to be adjusted by the difference between domestic inflation and inflation in Chile's trading partners. Government spending policy will remain cautious, and the overall deficit of the nonfinancial public sector (redefined to exclude certain enterprises that were privatized in 1987) is to be reduced to 0.8 percent of projected GDP in 1988 from 1 percent of GDP in 1987. Monetary policy has been designed to be consistent with the balance of payments and inflation objectives of the program.

The program incorporates a mechanism (the Copper Stabilization Fund, CSF ^{1/}) designed to smooth the effects of fluctuations in copper prices. Under this mechanism, an increasing proportion of incremental export earnings of the State Copper Company (CODELCO) will be put into official international reserves if copper prices rise above a benchmark price of US\$0.75 a pound, which is considered to be the long-run price and is used for the program fiscal and balance of payments projections. If the actual price is less than 4 U.S. cents a pound above the benchmark, no deposit is to be made into the Fund; for the next 6 U.S. cents a pound, half of the difference must be deposited; and for any amount over 10 U.S. cents a pound, all the incremental earnings are to be put into the Stabilization Fund. The mechanism is symmetrical for downward price deviations, except that withdrawals are limited to the accumulated balance in the Fund (US\$26 million at end-1987). The quantitative performance criteria for net international reserves, net domestic assets of the Central Bank and the public sector deficit are to be adjusted accordingly. The exports of CODELCO represent about 80 percent of Chile's copper exports. The operation of this mechanism is illustrated below:

^{1/} The CSF was originally set up as part of the World Bank SAL.

<u>Price c.i.f.</u> <u>U.S. cent/lb.</u>	<u>Total</u> <u>Incremental</u> <u>Exports</u>	<u>Incremental</u> <u>Revenue to</u> <u>CODELCO</u>	<u>Deposits to</u> <u>CSF</u>
<u>(In millions of U.S. dollars)</u>			
0.75	--	--	--
0.80	162.3	125.9	12.6
0.85	324.5	251.8	75.5
0.90	486.8	377.7	201.4
0.95	649.0	503.5	327.3
1.00	811.3	629.4	453.2
1.15	1,298.1	1,007.1	830.8

It should be noted that since mid-1987 copper prices have risen sharply, apparently reflecting short-term supply constraints, and in late January 1988 were around US\$1.10-1.20 a pound.

1. Fiscal policy

Fiscal policy in 1988 aims at lowering the overall deficit of the public sector (as newly redefined) by 0.2 percentage point of GDP to 0.8 percent of GDP. 1/ Public sector savings are expected to improve from 4.8 percent of GDP to 5.1 percent of GDP, while public investment is projected to remain constant at about 7 percent of GDP. With external financing estimated at 2.6 percent of GDP, the public sector is expected to reduce further its net domestic indebtedness by the equivalent of 1.8 percentage points of GDP.

Total revenue of the redefined public sector is expected to fall from 33 percent of GDP in 1987 to 32.4 percent in 1988, owing to reductions in certain taxes and to a further decline in social security tax receipts resulting from the ongoing privatization of the social security system. 2/ These revenue losses would be partly offset by a higher operating surplus of CODELCO on account of a projected increase of about 8 percent in the volume of copper shipments in 1988. CODELCO's surplus is calculated on

1/ The coverage of the public sector has been revised for 1988 to reflect the privatization in 1987 of three enterprises previously held by CORFO. Using the same coverage, the overall public sector deficit in 1987 amounted to 1.0 percent of GDP, as these three entities had a combined overall surplus of 0.2 percent of GDP that year.

2/ Since 1980, Chile has been transforming the social security system from one administered by the public sector on a pay-as-you go basis to one operated by the private sector in which the amount an individual can draw depends on his previous contributions. During the transition, which will take several years, the Government has continued to pay previously acquired pension rights while the bulk of new pension contributions are accruing to the private funds, which are accumulating large financial surpluses.

the basis of the benchmark price which, as explained above, appears to be conservative; hence, CODELCO's surplus may turn out to be considerably higher than estimated in the program. The Government plans to continue with its program to privatize enterprises, and expects to receive about Ch\$44 billion (0.9 percent of GDP) in 1988 from sales of shares in public entities, compared with Ch\$36 billion in 1987.

Total public expenditure is projected to fall by about 1 percentage point of GDP in 1988 to slightly over 33 percent of GDP, reflecting a decline in general government current expenditure. The wage policy for the general government aims at adjusting average wages in line with inflation, except for some special wage payments tied to the privatization of the social security system. ^{1/} The authorities plan to maintain or reduce slightly total employment in the central government. In all, total wages and salaries of the general government are expected to rise about in line with nominal GDP. Transfers and subsidies and purchases of goods and services by the general government are expected to decline in relation to GDP, in part because of an expected reduction of purchases of surplus domestic wheat. Interest payments by the general government would fall in reflection of the continuing reduction in domestic debt.

The fiscal projections of the program do not take account of the effect of the reduction in import duties and in other taxes carried out in January 1988. The staff estimates that these measures taken together would lower revenue by Ch\$30-40 billion in 1988 (around 0.6 percent of GDP), but on present expectations this revenue loss would be offset by additional copper revenues. Nonetheless, the authorities have stated that they are prepared to adopt compensating measures if needed to reach the fiscal targets of the program.

2. Monetary policy

The program for 1988 assumes that demand for private financial assets (M7) will grow by 26 percent, or 8 percent in real terms (see Table 6), largely reflecting the continued rapid build-up of financial savings of the private social security funds. Excluding these funds, private sector real financial holdings are projected to increase by 4.5 percent, in line with the growth of real GDP.

The Central Bank's monetary program is based on a growth of narrow money of about 24 percent in nominal terms or 6 percent in real terms during 1988. Consistent with these assumptions and the reserve target

^{1/} The base for calculating the social security taxes and pension contributions of government employees has been changed to include the value of benefits as well as wage income. Because this revision would imply a reduction in the take-home pay of government employees, the Government will provide an additional adjustment in wages to maintain the level of take-home pay.

of the program, the net domestic assets of the Central Bank in 1988 are projected to increase by only 5 percent with respect to its liabilities to the private sector at the beginning of the period (see Table 6). Monetary management will be based on limiting central bank credit creation in line with this target, with interest rates continuing to be determined in the market.

Since the financial crisis of 1983-84, when the Central Bank had to provide large scale support to the domestic financial system, domestic debt refinancing programs are being gradually wound down and subsidized credit operations have been largely eliminated. During 1988 the Central Bank does not plan to establish any new special credit programs.

3. External policies and outlook

a. Balance of payments

On the basis of the benchmark price of copper, the program would hold the external current account deficit roughly constant in terms of GDP at 4.7 percent (US\$970 million) in 1988. Net capital inflows are expected to rise to about US\$1,220 million from US\$750 million in 1987, reflecting balance of payments support from commercial banks in the form of interest retiming. The 1987 debt rescheduling agreement with commercial banks provided for the retiming of the interest payment period from six months to one year, with effect from the second half of 1988; payments would revert to a six-monthly schedule between 1991 and 1993. As a result of this provision, in 1988 there would be a postponement of interest payments amounting to US\$465 million which in the balance of payments presentation would be recorded as a capital inflow (see Table 7).

The baseline program for 1988 envisages a widening of US\$200 million in the trade surplus, to about US\$1.3 billion. Exports are projected to increase by about 11 percent in U.S. dollar terms, reflecting a 7 percent increase in copper exports and a 13 percent rise in non-copper exports. Copper shipments are expected to increase by about 8 percent, and the volume of noncopper exports by 7 1/2 percent, led by continued strong growth of fruit and forestry exports. Following the sharp rise of imports in 1987, the growth of non-oil import volumes is expected to slow to about 3 percent in 1988, reflecting the winding down of construction at a large petrochemical project and a slowdown in the rate of inventory accumulation. Net factor payments, including accrued interest, are projected to rise by US\$230 million in 1988, owing to higher market interest rates.

In the capital account, direct investment inflows are projected to decline in 1988 due to the near completion of the petrochemical project referred to above. Disbursements on medium- and long-term loans to the public sector would remain at about the level of 1987 (US\$1 billion), as an increase in project lending from multilateral institutions (IBRD and IDB) would be approximately matched by a decline in SAL disbursements from US\$225 million in 1987 to US\$125 million in 1988. Total debt

relief is estimated at US\$2.85 billion, including US\$72 million from official creditors, US\$2.3 billion in rescheduled commercial bank principal maturities, and US\$465 million from the retiming of interest mentioned above. ^{1/}

The reserve targets of the program were designed to accommodate a gradual reduction in the current account deficit while smoothing out fluctuations in the amount of external balance of payments support and maintaining gross reserves about constant at about US\$3 billion (with gold valued at US\$300 per ounce), or 9 months of merchandise imports. Consistent with this approach, the drawdown of net reserves of about US\$140 million in 1987 is to be more than made up by an increase of US\$254 million in 1988. The 1988 reserve targets are to be adjusted upwards by accruals to the Copper Stabilization Fund, and up to US\$500 million may be used for debt buyback operations (see below).

b. External debt

The authorities continue to view Chile's large external debt and high debt burden as a major area of vulnerability. Therefore, they attach great importance to efforts to reduce over time the ratio of external debt to GDP and to exports, and to secure the needed amounts of external financing on adequate terms so as to improve the debt structure. In addition to curbing new external borrowing, since 1985 the authorities have utilized special mechanisms for reducing their external debt through various conversion schemes, as noted above. Some US\$800 million of debt conversions is projected for 1988, including US\$330 million of debt/equity conversions with remittance rights.

The authorities are also giving consideration to the use of international reserves either to purchase existing bank claims on Chile directly in the secondary market or to collateralize a Chilean bond which would be exchanged for existing medium-term Chilean bank debt at a discount. The authorities believe this to be an appropriate use of reserves, particularly if there were to be a build-up of reserves because of higher copper prices. Accordingly, the program includes a provision under which up to US\$500 million of international reserves could be used for such operations: US\$200 million through a reduction of the basic reserve target and US\$300 million against the upward adjustments to reserves associated with the build-up of balances in the Copper Stabilization Fund. This would in effect allow the use of the margins on international reserves and short-term external debt that were accumulated during 1987 while still achieving the goals for international reserves of the original program.

Under the program, limits have been placed on new foreign borrowing through the remainder of the program period. Moreover, the Government

^{1/} For a more detailed description of the financing package for 1987-88, see EBS/87/102 (5/12/87).

remains committed not to guarantee any private external debt, except for drawings under the trade facility provided by commercial banks. Excluding a buyback operation, Chile's total external debt is projected to decline from 102 percent of GDP at end-1987 (318 percent of exports of goods and services) to 93 percent at end-1988 (286 percent of exports). These ratios could decline faster if Chile carries out substantial debt exchange operations.

c. Medium-term outlook

The staff has revised the medium-term balance of payments projections presented in EBS/87/148 (7/6/87) to reflect the balance of payments outturn for 1987 and changes in the external economic environment (Table 9). The assumptions underlying the revised medium-term projections are shown in Statistical Appendix Table 12. The latest projections maintain or slightly improve the targets for the main debt indicators, with the debt/GDP ratio projected to fall to 74 percent in 1992, the debt/exports ratio to 212 percent and the debt service ratio (before rescheduling) falling to 42 percent of exports of goods and nonfactor services in 1992, from 74 percent in 1988. Achievement of these targets appears to be better assured because exports are expected to be more buoyant than in the earlier projections.

The scenario suggests that a gradual reduction in the external current account deficit to about 2 1/2 percent of GDP (US\$700 million) in 1992 could be considered as sustainable: it would be consistent with output growth of 3-4 percent a year and with maintenance of an adequate level of reserves. Achievement of this reduction would require a further strengthening in the public finances. The residual financing requirements in 1989-90 would average about US\$330 million a year, about as projected earlier. After 1990, with the planned resumption of principal payments under the 1987 refinancing arrangements with commercial banks, financing gaps may increase substantially. However, if new commercial bank lending or refinancing were to cover bank amortization falling due, the gap would be quite small.

The medium-term outlook is highly sensitive to the assumptions on copper prices and interest rates. Should copper prices average 5 U.S. cents a pound more (less) than assumed in the baseline scenario, exports in 1988-92 would be some US\$200 million a year higher (lower); any one percentage point change in international interest rates would have an effect on the current account of a similar magnitude.

Table 9. Chile: Balance of Payments--Medium-Term Projections, 1987-1992

	1987	1988	1989	1990	1991	1992
<i>(In millions of U.S. dollars)</i>						
Trade balance	1,079	1,282	1,453	1,594	1,854	2,107
Exports	5,046	5,588	6,216	6,809	7,557	8,341
Imports	-3,967	-4,306	-4,764	-5,214	-5,703	-6,234
Nonfactor services and transfers	-370	-422	-467	-508	-553	-602
Factor services	-1,601	-1,830	-1,890	-1,970	-2,077	-2,207
<u>Balance on current account</u>	<u>-892</u>	<u>-970</u>	<u>-905</u>	<u>-884</u>	<u>-776</u>	<u>-702</u>
Direct investment (excluding debt conversion)	106	60	150	165	182	200
Other capital flows	831	1,164	448	483	-824	-729
Medium- and long-term, net	738	552	261	320	-870	-811
Disbursements	1,028	979	958	1,026	1,099	1,178
Project lending	803	854	958	1,026	1,099	1,178
Multilateral institutions	277	376	422	439	458	478
Suppliers' credits and other	525	479	536	587	641	700
IBRD SAL	225	125	--	--	--	--
Refinancing	1,532	2,384	1,935	1,631	-115	-64
Scheduled amortization <u>1/</u> <u>2/</u>	-1,821	-2,811	-2,632	-2,337	-1,854	-1,925
Retiming	--	465	--	--	-132	-112
Short-term, net <u>3/</u>	-92	147	187	163	178	194
Errors and omissions	-185	--	--	--	--	--
Financing gap	--	--	356	301	1,494 <u>4/</u>	1,307 <u>4/</u>
<u>Change in official reserves (increase -)</u>	<u>140</u>	<u>-254</u>	<u>-50</u>	<u>-65</u>	<u>-75</u>	<u>-75</u>
<i>(In percent of GDP)</i>						
Current account deficit	4.8	4.7	4.1	3.7	3.0	2.5
Interest payments on external debt	8.5	9.1	8.6	8.1	7.1	7.1
Of which: IMF charges	0.5	0.4	0.4	0.3	0.2	0.2
Use of Fund credit outstanding at year-end	7.2	6.2	4.9	3.7	2.6	1.7
Total external debt outstanding at year-end (excluding IMF)	101.7	92.5	88.0	83.6	79.0	74.2
<i>(In percent of exports of goods and nonfactor services)</i>						
Total debt service payments <u>5/</u>	63	74	64	56	45	42
Of which:						
IMF repurchases and charges	7	5	4	3	3	2
Debt service payments after rescheduling	39	40	39	36	46	43
Interest payments	27	28	26	24	22	20
Of which: IMF charges	2	1	1	1	1	--
Total external debt outstanding at year-end (excluding IMF)	318	286	265	249	230	212
<i>(In weeks of imports of goods and services)</i>						
Net official international reserves <u>6/</u>	11	12	11	11	10	10
Gross official international reserves <u>6/</u>	22	20	18	15	14	12

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

1/ After allowance for reduction in future amortization because of actual and projected debt conversion of US\$2.7 billion in 1985-1987.

2/ Excludes extraordinary amortization (through purchases of Chilean external debt at a discount).

3/ Excludes errors and omissions.

4/ Of this total, US\$1,110 million in each year would emerge from amortizations on debt to foreign commercial banks on previous concerted lending and restructuring packages and US\$132 million in 1991 and US\$112 million in 1992 from the scheduled revision of interest payments to six-monthly periods. If these obligations are refinanced, the financing gaps would be reduced to US\$252 million in 1991 and US\$85 million in 1992.

5/ Including IMF charges and repurchases.

6/ Gold valued at US\$300 per ounce.

d. Ability to service financial obligations to the Fund

Assuming no new financial arrangements from the Fund after expiration of the EFF, ^{1/} repurchases over the next five years would average the equivalent of US\$200 million a year, reducing net use of Fund credit from 235 percent of quota in mid-1988 to about 89 percent of quota in 1992. Debt service obligations to the Fund, including charges, would decline from the equivalent of 5 percent of exports of goods and non-factor services in 1988 to 2.4 percent in 1992, with annual repurchases and charges amounting to about 10 percent of gross reserves at the beginning of each year. In view of Chile's past record in meeting its obligations to the Fund, and taking into account the prospects of a continued reduction in Chile's overall debt burden and its relatively comfortable reserve position, it is not expected that Chile will experience difficulties in making repayments to the Fund over the medium term.

e. Exchange and trade system

Chile maintains a fairly open exchange and trade system, with a competitive exchange rate, few exchange restrictions, a uniform import tariff level at 15 percent, and a liberal regime for foreign investment--including attractive provisions for debt/equity conversions. The authorities are planning to maintain a liberal exchange and trade system, which they regard as fundamental to the sustained growth of the economy. There remain some restrictions, however, that are described below.

The minimum 120-day financing requirement for imports represents an exchange restriction subject to approval under Article VIII. At the inception of the arrangement, the authorities undertook to eliminate this restriction by end-1986, but in view of difficulties in assembling the external financing for their program they proposed (and the Board approved) that elimination be postponed to December 31, 1987. The authorities have now proposed a further change in the schedule whereby the financing requirement would be eliminated in five semi-annual steps, starting on or before June 30, 1988 and ending in mid-1990. The first step would exempt imports of up to US\$5,000 (representing about 8 percent of total import value) from the requirement, followed by a successive widening of the exemption to US\$10,000, US\$20,000, and US\$50,000, before full elimination in mid-1990. It is envisaged that the proposed schedule may be advanced or delayed depending on the experience in the

^{1/} It may be noted, however, that Chile's agreements with foreign banks and official bilateral creditors stipulate that the EFF be followed by either enhanced surveillance or an agreement for use of general Fund resources in the upper credit tranches, and that in the attached letter the authorities indicate that Chile plans to request an arrangement involving use of the Fund's general resources following the expiration of the EFF arrangement in August 1988.

early stages of the process, as well as on the evolution of the external economic environment.

The spread between the exchange rates in the official and the parallel markets, in which some current invisible transactions take place, constitutes a multiple currency practice subject to approval under Article VIII; this spread has declined somewhat since late 1986 but still is about 4 percent. Also, Chile continues to grant preferential exchange rate treatment for certain external debt service payments, although the amounts involved have been progressively reduced and are now negligible. ^{1/}

IV. Performance Criteria for 1988

The set of quantitative performance criteria for the remaining period of the extended arrangement is the same as in the past, including the adjustments related to the operations of the Copper Stabilization Fund (Table 10). However, as noted above, the program for 1988 contains a new feature which allows the use of up to US\$500 million of reserves to buy back Chile's external debt.

As explained in previous staff reports, there is an issue as regards the treatment, for the purpose of setting quantitative performance criteria, of the sizable margins that have emerged under the program since 1986 (see Table 2). If these margins were carried over, the operational significance of the quantitative performance criteria would be weakened. At the same time, it has to be recognized that the emergence of margins resulted at least to some extent from the prudent policies followed by the authorities, who argue that they should not be penalized by excluding the carry-over of margins. In the last review of the program (EBS/87/148), it was decided to set performance criteria for 1987 that would allow use of the margins accumulated in 1986 in case of unexpected developments and in consultation with the staff, even though the policies were expected to produce somewhat more favorable results (Chart 6). The performance criteria for net international reserves and net domestic assets of the Central Bank and the limit on public sector use of short-term external credit for 1988 have been set on the basis of the estimated actual values for December 31, 1987 plus the end-1986 margins; this in effect took away the bulk of the additional margins built up during 1987 (Chart 7).

^{1/} The preferential treatment now applies to interest payments of less than US\$1 million a year and total outstanding principal of about US\$12 million. This practice requires approval under Article VIII, Section 3.

CHART 6
CHILE

QUANTITATIVE PERFORMANCE CRITERIA AND PROGRAM 1987

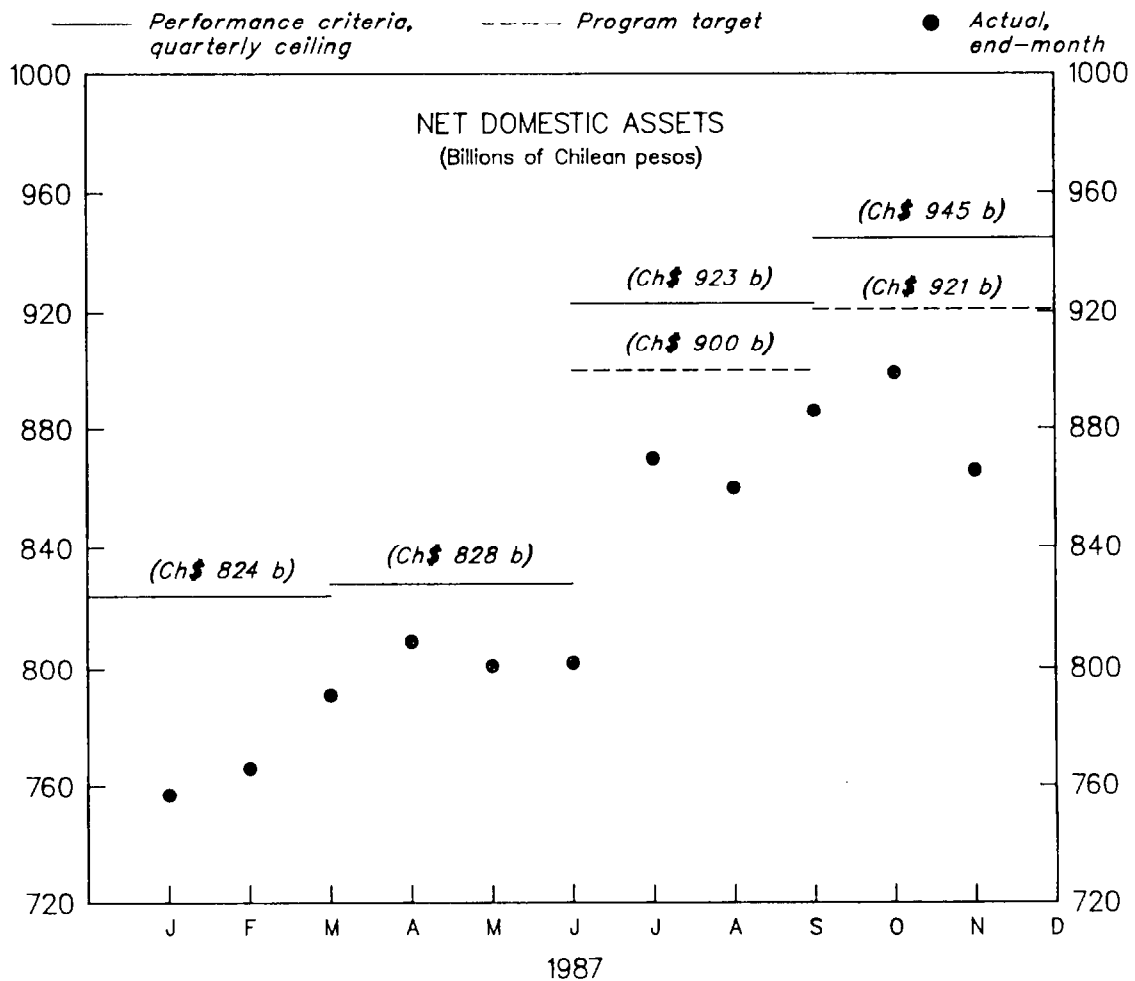
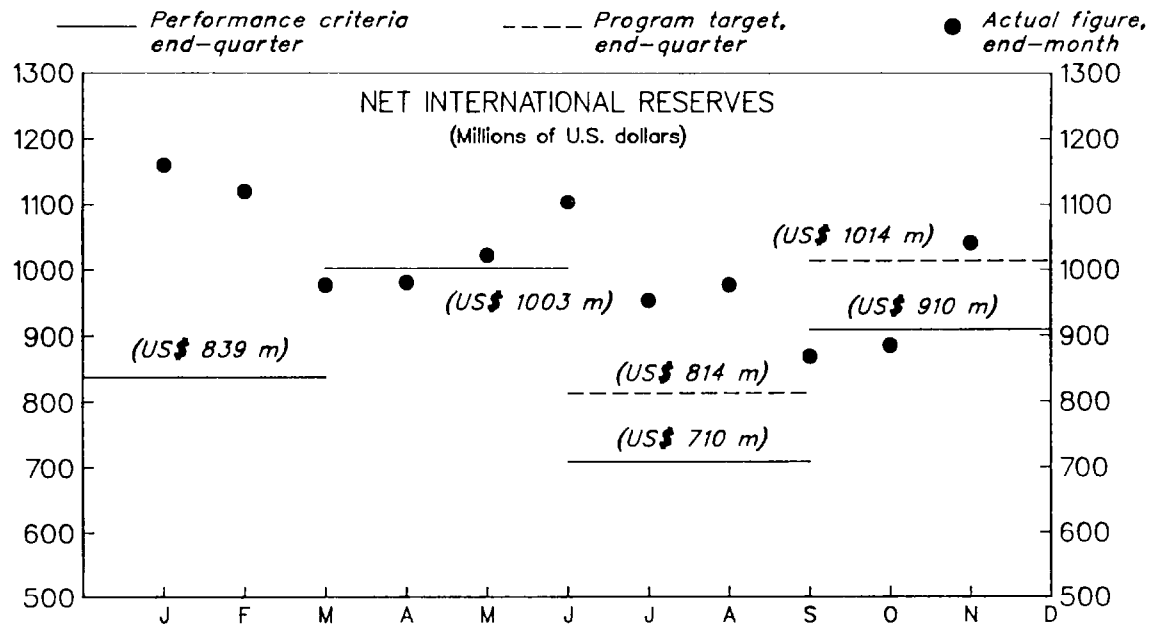
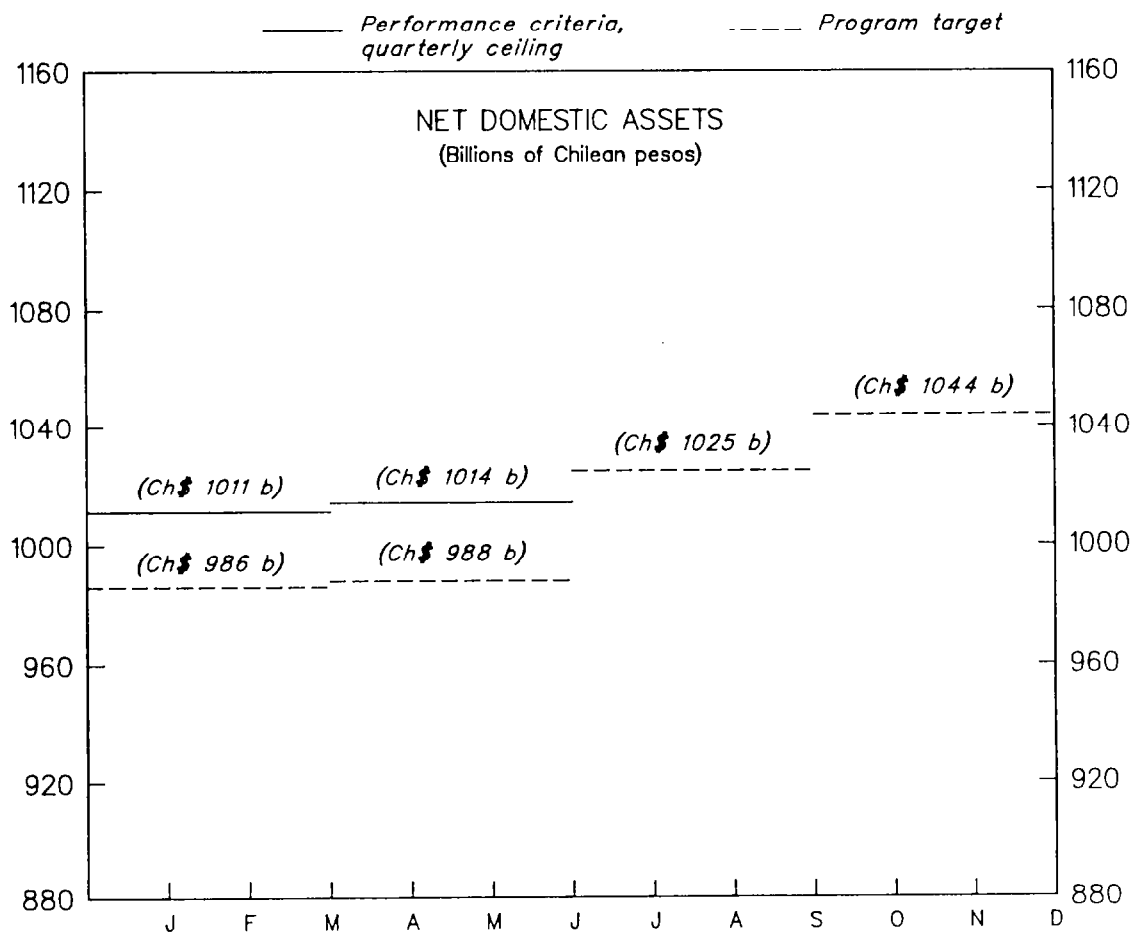
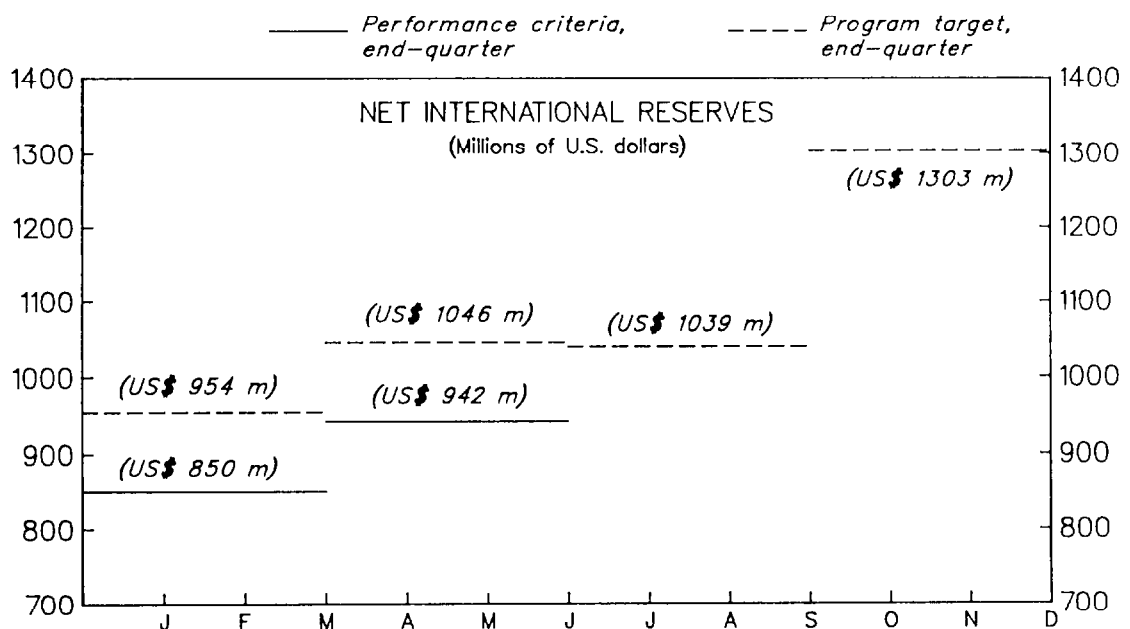




CHART 7
CHILE

QUANTITATIVE PERFORMANCE CRITERIA AND PROGRAM 1988



1988

Table 10. Chile: Proposed Quantitative Criteria for the Period January 1 through June 30, 1988

	Program Base December 31, 1987	Limits and Targets	
		Jan. 1- March 31	June 1- June 30

(In billions of Chilean pesos)			
Net domestic assets of the Central Bank <u>1/</u>	990	1,011 <u>2/</u>	1,014 <u>2/3/4/</u>
Cumulative overall deficit of the nonfinancial public sector <u>5/</u>	—	3.8 <u>2/</u>	16.6 <u>2/4/</u>

(In millions of U.S. dollars)			
Net international reserves of the Central Bank <u>5/</u>	945	850 <u>6/</u>	942 <u>6/7/</u>
Contracting, rescheduling, and guaranteeing of foreign debt by the public sector <u>8/</u>	—	600	600
Of which: debt with maturity of more than one year and less than five years	—	190	190
Stock of short-term external debt owed by the nonfinancial public sector and the Banco del Estado	952	992	992

Sources: Memorandum on the Economic Policies of Chile; and Fund staff estimates.

1/ Defined as the difference between (i) the sum of the Central Bank's liabilities to the private sector, and medium- and long-term foreign liabilities, and (ii) the net international reserves of the Central Bank.

2/ To be adjusted downward for any excess in the balance of the Copper Stabilization Fund (CSF) at end-March 1988 above the projected level of US\$80 million.

3/ This ceiling may be adjusted upward by the equivalent of up to US\$200 million to the extent that reserves are used for buying back external debt. This ceiling may also be adjusted upward by the equivalent of up to US\$300 million for any use of reserves accruing to the CSF above the projected level at end-March 1988 of US\$80 million, to the extent such reserves are used for buying back external debt.

4/ To be adjusted downward (upward) for any increase (decrease) in deposits in the CSF during April-June 1988.

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

6/ This target may be adjusted downward by up to US\$200 million to the extent that reserves are used for buying back Chile's external debt. This target will also be (a) adjusted upward for any excess in the balance of the CSF at end-March 1988 above the projected level of US\$80 million, and (b) adjusted downward by up to US\$300 million for any use of reserves accruing to the CSF above the projected level at end-March 1988 of US\$80 million, to the extent that such reserves have been used for buying back Chile's external debt.

7/ To be adjusted upward (downward) for any increase (decrease) in deposits in the CSF during April-June 1988.

8/ Refers to external debt with maturity of more than 12 months and less than 120 months.

V. Staff Appraisal

During recent years, under the economic program that has been supported by the EFF arrangement, Chile has implemented major structural reforms: import duties have been lowered and made uniform, the tax system has been overhauled, the financial system has been put on a more solid basis, and the social security system and several public enterprises have been privatized. Also, aided by appropriate fiscal and monetary policies and a flexible exchange rate policy, domestic savings and investment have risen, and the growth of output has picked up while inflation has remained relatively moderate. With the strong growth of exports, limited recourse to new external borrowing, debt restructuring, and the relatively large-scale use of debt conversion mechanisms, significant progress has been made in reducing Chile's external debt service obligations, thereby strengthening the basis for sustained growth. Nonetheless, the foreign debt burden remains heavy, and Chile's external position consequently is still vulnerable.

In 1987 Chile observed all quantitative performance criteria under the EFF arrangement and all purchases available to date have been made as scheduled. The overall public sector deficit was reduced to less than 1 percent of GDP, credit policies were restrained, and the current account deficit of the balance of payments narrowed to 4.8 percent of GDP, while real GDP rose by about 5 1/2 percent for the second year in a row. However, there was slippage on inflation as consumer prices rose by 21.5 percent compared with a target of 16 percent.

The program for 1988 maintains the policy thrust followed in the past several years, which has served Chile well. The public sector deficit is to be limited to no more than 0.8 percent of GDP and the external current account deficit to no more than 4.7 percent of GDP; inflation is planned to decline to around 17 percent, with real GDP growing by around 4 1/2 percent. The program has been drawn up on the basis of a benchmark copper price of US\$0.75 a pound but provides that an increasing portion of the additional revenues that result when the copper price exceeds this benchmark be allocated to international reserves. Above a price of US\$0.85 a pound, all the incremental revenues accruing to the public sector would be saved, with the public sector deficit being correspondingly reduced. The copper price in late January 1988 was around US\$1.10-1.20 a pound, and if prices remain substantially above the benchmark, the fiscal and balance of payments positions in 1988 would be much stronger than postulated in the program.

The overall public sector deficit has declined markedly since 1984, and the authorities are seeking to reduce it further in 1988. Expenditure policy continues to be cautious, and the tax burden is being reduced. The recent reduction in import tariffs will probably be covered this year by additional copper revenues. Nonetheless, the authorities should be prepared to adopt compensating fiscal measures if conditions in the world copper market turn around sharply. The Government is continuing its policy of reducing the direct involvement

of the public sector in economic activity through the privatization of public enterprises, a policy that can be expected to improve efficiency and enhance growth over the medium term.

The tightening of monetary policy in 1987 and the attendant increase in domestic interest rates were needed to help restrain inflationary pressures and moderate the growth of imports. The Central Bank will need to continue pursuing a cautious credit policy in 1988 to achieve the targeted reduction in inflation.

The continuation of the exchange rate policy of depreciating the peso by the differential between domestic and foreign inflation, supported by a prudent wage policy, can be expected to protect the external competitiveness of the Chilean economy. Moreover, the recent across-the-board reduction in tariffs, accompanied by a 4 percent depreciation of the Chilean peso, will further improve resource allocation and strengthen the export orientation of the economy.

The terms of Chile's external debt have improved and the rate of growth of the debt has declined, aided by mechanisms for external debt conversion. Nonetheless, efforts to reduce Chile's dependence on foreign borrowing and improve the debt structure must be maintained. In this context, the staff would support some use of reserves for buying back Chile's external debt, provided that this can be arranged in ways that are consistent with the cooperative approach to the international debt problem and that the original goals of the program as regards net international reserves are maintained. Such an operation can be expected to further reduce Chile's debt burden and thus accelerate the return to normal market borrowing.

Chile maintains a relatively open exchange and trade system with a competitive exchange rate, almost no restrictions, a uniform tariff level of 15 percent, and a liberal regime for foreign investment. However, the authorities have not felt able thus far to eliminate the exchange restriction arising from the 120-day minimum financing requirement on imports as planned, and have now proposed a new schedule for the phased removal of this restriction by mid-1990. Also, multiple currency practices still arise from the size of the spread between the exchange rates in the official and the parallel market and from the preferential exchange rate applicable to the servicing of existing debt obligations with original value under US\$50,000, although the latter has little significance. Given the past and planned progress by Chile toward eliminating exchange restrictions and multiple currency practices, the staff recommends their approval until August 15, 1988 or the next Article IV consultation, whichever is earlier.

The staff views the commitment of the authorities to maintain certain agreed margins on net international reserves, net domestic assets of the Central Bank and outstanding short-term public external debt as important to the achievement of the program objectives. Although the quantitative performance criteria would allow use of these

margins, financial policies in 1988 have been designed on the assumption that they would not be used. The authorities have stated that these margins would be used only to deal with major unexpected developments, and that they will hold discussions with the Fund staff if their use should appear necessary.

In summary, the authorities are to be commended for the comprehensive and consistent macroeconomic and structural policies they have pursued in the past several years, which have been a major factor behind Chile's improved economic performance. The staff is of the view that the policies the authorities intend to follow in 1988 are appropriate for the achievement of the objectives being sought. However, Chile still may face sizable financing gaps after 1988, and it will be important to continue to design policies consistent with the goal of reducing the external debt burden.

VI. Proposed Decisions

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

I. Extended Arrangement

1. Chile has consulted with the Fund in accordance with paragraph 3(d) of Decision No. 8663 (87/113)) adopted July 31, 1987 and paragraph 4 of the extended arrangement for Chile (EBS/85/122, Sup. 3) in order to reach understandings regarding the policies relating to the second half of the third-year program, to establish suitable performance criteria for the remaining period of the arrangement, and to reach understandings regarding circumstances in which purchases can be resumed by Chile.

2. The letter dated December 29, 1987 from the President of the Central Bank and the Minister of Finance, together with the annexed Memorandum on the Economic Policies of Chile, shall be attached to the extended arrangement, and the letters dated July 9, 1985, January 20, 1986, June 18, 1986, December 15, 1986, and June 30, 1987, together with the respective annexed Memoranda on the Economic Policies of Chile, and the letter of May 11, 1987, shall be read as supplemented and modified by the letter dated December 29, 1987, together with its annexed Memorandum on the Economic Policies of Chile.

3. Accordingly, Chile will not make purchases under the extended arrangement:

(a) during any period after January 31, 1988 in which the data at the end of the preceding calendar quarter indicate that:

(i) the cumulative limit on the overall deficit of the nonfinancial public sector, as specified in paragraph 6 and Table 1 of the memorandum annexed to the attached letter of December 29, 1987; or

(ii) the target on the international reserves of the Central Bank, as specified in paragraph 7 and Table 3 of the memorandum annexed to the attached letter of December 29, 1987 are not observed; or

(b) during any period after January 31, 1988 in which:

(i) the ceiling on the net domestic assets of the Central Bank, as specified in paragraph 7 and Table 2 of the memorandum annexed to the attached letter of December 29, 1987; or

(ii) the ceiling on the stock of short-term external debt owed by the nonfinancial public sector and the Banco del Estado, as specified in paragraph 12 and Table 5 of the memorandum annexed to the attached letter of December 29, 1987; or

(iii) the ceilings on the contracting, rescheduling and guaranteeing of external debt by the public sector, as specified in paragraph 12 and Table 4 of the memorandum annexed to the letter of December 29, 1987 are not observed; or

4. Purchases under this extended arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 600 million until February 15, 1988, the equivalent of SDR 650 million until May 15, 1988, and the equivalent of SDR 700 million until August 10, 1988.

5. The Fund decides that the review contemplated in paragraph 3(d) of Decision No. 8663-(87/113) adopted July 31, 1987 is completed and that Chile may resume purchases under the

completed and that Chile may resume purchases under the arrangement, notwithstanding that the intentions with regard to certain exchange restrictions and multiple currency practices specified in paragraph 4(a)(viii) and (ix) of the arrangement were not carried out.

II. Exchange Restrictions and Multiple Currency Practices

1. Chile maintains multiple currency practices and exchange restrictions as described in EBS/88/22. In view of the intentions of the authorities to eliminate these practices and restrictions, the Fund grants approval of the exchange restriction related to the 120-day deferment period for import payments and the multiple currency practices until August 15, 1988 or the date of the next Article IV consultation with Chile, whichever is earlier.

Table 11. Chile: Operations of the Consolidated Nonfinancial Public Sector

(In billions of Chilean pesos)

	1984	1985	1986	1987 1/ Prog.	1987 1/ Proj.	1987 2/ Proj.	1988 2/ Proj.
<u>Total revenue</u>	<u>635.0</u>	<u>900.5</u>	<u>1,103.3</u>	<u>1,289.5</u>	<u>1,382.5</u>	<u>1,353.6</u>	<u>1,663.0</u>
<u>General government current revenue</u>	<u>411.6</u>	<u>555.7</u>	<u>705.4</u>	<u>793.9</u>	<u>855.3</u>	<u>861.5</u>	<u>1,038.6</u>
Taxes on income and property	87.6	94.8	121.8	131.9	168.5	178.2	223.7
Taxes on goods and services	272.1	388.6	513.9	616.0	657.6	657.6	812.1
Taxes on international trade	62.2	93.9	97.9	125.5	142.2	142.2	179.7
Social security tax	53.1	62.4	81.4	91.3	92.5	92.5	108.0
Other tax (net of IVA rebate) ..	-20.7	-42.8	-57.4	-76.1	-93.1	-96.6	-121.3
Nontax revenue	89.8	140.2	157.3	178.1	178.1	178.1	206.5
Enterprise transfers to general government	-132.5	-181.4	-209.5	-272.6	-290.5	-290.5	-370.1
<u>Operating surplus of the public enterprises</u>	<u>195.9</u>	<u>329.9</u>	<u>365.8</u>	<u>451.3</u>	<u>478.7</u>	<u>442.3</u>	<u>568.0</u>
Of which: CODELCO	57.8	126.1	144.5	171.1	239.6	239.6	316.2
ENAP	94.4	143.5	126.7	161.2	163.9	163.9	195.1
<u>Net capital revenue</u>	<u>27.5</u>	<u>14.9</u>	<u>32.1</u>	<u>64.3</u>	<u>48.5</u>	<u>49.8</u>	<u>56.4</u>
Revenue	65.0	84.9	130.9	144.3	156.5	157.8	159.4
Less: financial investment	-37.5	-70.0	-98.8	-100.0	-108.0	-108.0	103.0
<u>Total expenditure</u>	<u>717.5</u>	<u>967.6</u>	<u>1,164.9</u>	<u>1,352.4</u>	<u>1,414.6</u>	<u>1,395.0</u>	<u>1,702.8</u>
<u>General government current outlays</u>	<u>582.1</u>	<u>761.3</u>	<u>884.8</u>	<u>1,014.8</u>	<u>1,065.2</u>	<u>1,065.2</u>	<u>1,270.7</u>
Wages and salaries	122.0	150.5	172.0	187.8	196.6	196.6	245.5
Goods and services	64.3	82.7	96.7	112.4	134.8	134.8	144.7
Social security payments to private recipients	191.7	232.2	283.7	329.6	332.4	332.4	410.5
Transfer and subsidy payments to private sector	154.7	205.9	247.2	279.2	283.5	283.5	346.4
Interest on public debt	45.1	83.0	77.0	97.7	110.1	110.1	116.3
Other	4.3	7.0	8.2	8.1	7.8	7.8	7.3
<u>Enterprise transfers to private sector</u>	<u>14.8</u>	<u>25.4</u>	<u>35.5</u>	<u>41.4</u>	<u>50.8</u>	<u>43.9</u>	<u>72.4</u>
<u>Capital formation</u>	<u>120.6</u>	<u>180.9</u>	<u>244.6</u>	<u>296.1</u>	<u>298.6</u>	<u>285.9</u>	<u>359.7</u>
General government	50.4	80.0	106.2	137.6	141.7	141.7	176.5
Public enterprises	70.2	100.9	138.4	158.5	156.9	144.2	183.2
<u>Overall surplus or deficit (-)</u>	<u>-82.5</u>	<u>-67.1</u>	<u>-61.6</u>	<u>-62.9</u>	<u>-32.1</u>	<u>-41.4</u>	<u>-39.8</u>
<u>Financing</u>	<u>82.5</u>	<u>67.1</u>	<u>61.6</u>	<u>62.9</u>	<u>32.1</u>	<u>41.4</u>	<u>39.8</u>
External 4/	50.8	106.3	85.3	130.8	100.0	100.0	135.6
Internal	31.7	-39.2	-23.7	-52.2	-67.9	-58.6	-95.8
<u>Memorandum items</u>							
Public sector borrowing requirement	110.0	82.0	93.7	105.3	80.6	91.2	96.2
Current account surplus 5/	10.6	98.9	150.9	189.0	218.0	194.7	263.5
Nominal GDP (in billions of Chilean pesos)	1,893	2,577	3,249	3,840	4,096	4,096	5,130

Sources: Ministry of Finance; and Fund staff estimates.

1/ Including Pacific Steel Co., Chilectra Generacion, and SOQUIMICH.

2/ Excluding Pacific Steel Co., Chilectra Generacion, and SOQUIMICH.

3/ Includes the general government's share of interest in 1988 eligible to retiming.

4/ Includes US\$100.4 million for the retiming of interest payments owed by the public sector in 1988.

5/ General government current revenue plus operating surplus of public enterprises minus general government current outlays minus enterprise transfers to private sector.

Table 12. Chile: Assumptions Underlying the Medium-Term Projections

	1987	1988	1989	1990	1991	1992
<u>(U.S. cents per pound)</u>						
Copper prices	76.8	75.0	78.8	82.3	86.0	89.0
<u>(Thousands of metric tons)</u>						
Volume of copper exports	1,365	1,472	1,575	1,632	1,746	1,843
CODELCO	1,062	1,142	1,229	1,268	1,364	1,442
Other	303	330	347	364	382	401
<u>(Thousands of barrels)</u>						
Petroleum imports	20,025	20,669	24,499	26,299	28,043	29,746
<u>(U.S. dollars per barrel)</u>						
Petroleum import price,						
f.o.b.	17.5	18.0	18.8	19.7	20.5	21.5
c.i.f.	18.8	19.3	20.2	21.1	22.1	23.1
<u>(Annual change in percent)</u>						
Noncopper export prices	9.3	5.4	4.5	4.5	4.5	4.5
Noncopper export volume	8.7	7.4	5.5	5.5	5.5	5.5
Total export price	14.5	2.9	4.8	4.6	4.6	4.6
Total export volume	4.9	7.6	6.1	4.7	6.1	5.5
Non-oil import prices	5.6	5.0	4.5	4.5	4.5	4.5
Nonfuel import volumes	23.8	2.5	4.4	4.4	4.4	4.4
Terms of trade	9.0	-2.8	0.4	0.1	0.1	0.1
Real GDP	5.4	4.5	3.5	3.5	3.5	3.5
<u>(In percent)</u>						
Interest rates						
U.S. Prime	8.0	9.0	9.0	9.0	9.0	9.0
LIBOR (six months)	6.5	7.9	8.0	8.0	8.0	8.0
<u>(Annual change in percent)</u>						
<u>Memorandum item</u>						
Partner countries' demand for non-oil imports	2.4	5.1	4.5	4.5	4.5	4.5

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

Chile - Fund Relations
(As of December 31, 1987)

I. Membership Status

- (a) Date of membership: December 31, 1945
(b) Status: Article VIII

A. Financial Relations

II. General Department

- (a) Quota: SDR 440.5 million.
(b) Total Fund holdings
of Chilean pesos: SDR 1,472.9 million or 334.4 percent of
quota.

- (c) Fund Credit to Chile:

	<u>Millions of SDRs</u>	<u>Percent of Quota</u>
Total	1,032.4	234.4
Under CFF	107.5	24.4
Credit tranche (SBA)	132.0	30.0
Extended Fund Facility	262.5	59.6
Enlarged access	530.4	120.4
Under standby	192.9	43.8
Under EFF	337.5	76.6

III. Current and Past Stand-by or Extended Arrangements and Special
Facilities

- (a) Extended arrangement:
(i) Duration: From August 15, 1985 to
August 14, 1988
(ii) Amount: SDR 750 million
(iii) Utilization: SDR 600 million
(iv) Undrawn balance: SDR 150 million

- (b) Stand-by arrangements in last ten years:

<u>Date of Approval</u>	<u>Duration</u>	<u>Amount</u>	<u>Actually Drawn</u>
January 1983	2 years	SDR 500 million	SDR 500 million

- (c) Recent use of Compensatory financing facility:
August 1985 SDR 70.6 million
January 1983 SDR 295 million

IV. SDR Department

	Millions of SDRs	Percent of Net Cumulative Allocation
SDR position: As of December 31, 1987		
Net cumulative allocation	121.9	100.0
Holdings	28.8	23.6

V. Financial obligations to the Fund

	Overdue Financial Obligations 12/31/87	Principal and Interest Due		
		1988	1989	1990
Principal	--	199.8	155.1	153.6
Repurchases	--	199.8	155.1	153.6
Trust Fund repayments	--	--	--	--
Charges and interest including SDR and Trust Fund (provisional)	--	68.5	58.2	48.4
<u>Total</u>	--	<u>268.3</u>	<u>213.3</u>	<u>202.0</u>

B. Nonfinancial Relations

VI. Exchange Rate Arrangement: The Chilean peso is pegged to the U.S. dollar. The official rate is adjusted daily on the basis of a monthly schedule linked to the Chilean rate of inflation during the previous month less the world rate of inflation relevant for Chile, currently estimated at 0.4 per month. The official rate on December 31, 1987 was Ch\$234.05 per U.S. dollar.

Chile maintains a multiple currency practice arising from a subsidy on certain foreign debt service payments by the private sector on foreign debt in amounts of less than US\$50,000 contracted before August 6, 1982. The size of the spread between the exchange rates in the official market and the parallel market, in which a number of current invisible transactions take place, also constitutes a multiple currency practice. Chile maintains an exchange restriction arising from the 120-day minimum financial requirement for imports.

VII. Last Review: On July 31, 1987, the Executive Board completed a review under the extended arrangement with Chile, including the establishment of performance criteria through December 1987. The text of the Board decision related to multiple currency practices and exchange restrictions is as follows:

1. The Fund takes this decision relating to Chile's exchange measures subject to Article VIII, Sections 2 and 3, in the light of the 1987 Article IV consultation with Chile conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Chile maintains multiple currency practices and exchange restrictions as described in EBS/87/148. In view of the intentions of the authorities to eliminate these practices and restrictions, the Fund grants approval until December 31, 1987 of the exchange restriction related to the 120-day deferment period for import payments, and grants approval of the other multiple currency practices until February 29, 1988 or the conclusion of the midyear review of the third-year program under the extended arrangement, whichever is earlier.

VIII. Technical Assistance: No technical assistance has taken place since August 1985.

IX. Resident Representative: A resident representative has been stationed in Chile since November 1982. Mr. Chee Sung Lee will be replaced by Mr. Jorge Guzmán in March 1988.

X. Schedule of Proposed Purchases during remaining Period of the Extended Arrangement

Amount	Scheduled Availability Date	Conditions necessary for purchase <u>1/</u>
SDR 50 million	After February 14, 1988	Compliance with quantitative performance criteria as of December 31, 1987 and completion of the midyear review of the third year program.
SDR 50 million	After May 14, 1988	Compliance with quantitative performance criteria as of March 31, 1988.
SDR 50 million	After August 9, 1988	Compliance with quantitative performance criteria as of June 30, 1988.

1/ Other than generally applicable conditions under the arrangement and nonquantitative performance criteria (including the performance clause on the exchange and trade system).

Chile: Relations with World Bank Group

1. Statement of bank loans and IDA credits (as at September 30, 1987)

Loan or Credit Number	Fiscal Year	Borrower	Purpose	Amounts (less cancellations)		
				Disbursed		Undisbursed
				Bank	IDA	
(US\$ million)						
29 loans and one credit fully disbursed				902.6	22.9 ^{1/}	--
1832	1980	Chile	Water supply	32.4	--	0.4
2297	1983	Chile	Highway Reconstruction II	128.0	--	23.5
2481	1984	Chile	Agricultural credit	56.0	--	46.3
2482	1984	Chile	Housing	80.0	--	14.6
2504	1985	Chile	Public sector management	11.0	--	10.0
2589	1985	Chile	Road sector	140.0	--	96.1
2606	1985	Chile	Industrial financing restructuring	100.0	--	80.8
2613	1985	CORFO	Small and medium industry	40.0	--	33.0
2651	1986	EMOS	Water supply and sewer	60.0	--	58.8
2652	1986	ESVAL	Water supply and sewer	6.0	--	5.9
2832	1987	CORFO	Hydroelectric	95.0	--	95.0
2833	1987	ENDESA	Power Transmission	21.5	--	21.5
<u>Total</u>				<u>1,672.5</u>	<u>22.9</u>	<u>485.9</u>
of which has been repaid				271.6	6.2	
<u>Total now outstanding</u>				<u>1,400.9</u>	<u>16.7</u>	
Amount sold				7.2		
of which has been repaid				<u>7.2</u>		
<u>Total now held by Bank and IDA</u>				<u>1,393.7</u>	<u>16.7</u>	

^{1/} Includes exchange rate adjustments. The original amount of the credit was US\$19 million.

2. Statement of IFC investments (as at September 30, 1987)

	Loan	Equity	Total
(In millions of U.S. dollars)			
<u>Total gross commitments</u>	<u>132.75</u>	<u>12.35</u>	<u>145.10</u>
Less cancellations, terminations, repayments and sales	82.84	0.78	83.62
<u>Total commitments now held by IFC</u>	<u>49.91</u>	<u>11.57</u>	<u>61.49</u>
<u>Total undisbursed</u>	<u>35.00</u>	<u>5.92</u>	<u>40.92</u>

3. IBRD Disbursement forecast CY87-CY88

	CY87	CY88
Gross disbursements from approved loans, including SAL II	180.6	122.1
Gross disbursements from probable loans, including SAL III	125.0	144.0
<u>Total gross disbursements</u>	<u>305.6</u>	<u>266.1</u>
<u>Amortization</u>	<u>31.3</u>	<u>38.1</u>
<u>Net disbursements</u>	<u>274.3</u>	<u>228.0</u>

4. Recent IBRD technical assistance

Besides the usual assistance to the ministries to prepare financeable investment projects and sector programs, the IBRD is financing specific technical assistance to the Ministry of Housing and Urbanization to study and improve the present housing mechanisms. In addition, through a Public Sector Management Project, approved in 1985, the IBRD is financing activities aimed at improving public sector decision-making and the quality of information and statistics, as well as potential for export development. The project so far is financing improvements in social pricing used by ODEPLAN, export potential by small producers and the efficiency of PROCHILE, the Government's export promotion agency. A review of public employment programs has just gotten underway and assistance for improving INE's household surveys and the regional ministerial offices for education and housing are soon to begin. In the context of the second SAL, the Government is also reviewing the efficiency and effectiveness of the health service system.

5. IBRD views on the investment program

Results of the World Bank public investment reviews are being discussed with the Government and incorporated in SAL-related dialogue. The investment program includes high-return, well justified projects in general, fully consistent with the Government's effort to accelerate exports and improve the efficiency of the economy. Chile's Planning Office, which reviews most investment proposals, has an excellent system of project analysis. Two investment projects with limited economic justification--an island port and a new Santiago subway line--have been deferred. New investments are planned to support mineral export expansion during 1987-90 and a national commission is defining an investment program to develop the infrastructure and facilities needed to support major increases in forest industry exports. The Bank has encouraged both of these initiatives and is prepared to provide financial support for eventual investments in these fields. Road sector investments are to concentrate on cost-saving maintenance and rehabilitation. A program for financial rehabilitation is being considered by the Government and, when approved, could be supported by a proposed Bank loan.

6. Recent economic and sector missions

- (a) A mission visited Chile in July 1987 to conduct an appraisal for a SAL III.
- (b) A mission visited Chile in September 1987 for a post-appraisal discussion of SAL III.

Chile: Selected Economic and Financial Indicators, 1984-88

	1984	1985	1986	1987		1988
				Prog. 1/	Proj.	Prog.
(Annual percent changes, unless otherwise specified)						
National income and prices						
GDP at constant prices	6.3	2.4	5.7	5.0	5.4	4.5
GDP deflator	14.3	32.8	19.4	17.1	20.0	21.2
Consumer prices (average)	19.9	30.7	19.5	18.1	19.9	18.6
Consumer prices (end of period)	23.0	26.4	17.4	15.9	21.5	17.0
External sector (on the basis of U.S. dollars)						
Exports, f.o.b.	-4.7	4.2	10.4	7.8	20.2	10.8
Imports, f.o.b.	18.0	-12.0	4.9	15.3	28.0	8.5
Non-oil imports, f.o.b.	20.6	-14.1	12.5	15.1	26.8	8.8
Export volume	--	13.5	7.9	2.7	4.9	7.6
Import volume	15.7	-13.5	11.8	2.1	21.9	2.5
Terms of trade (deterioration -)	-4.7	-7.3	9.0	-12.3	9.0	-2.7
Nominal effective exchange rate (depreciation -) 2/	1.9	-13.7	-7.1	...	-2.2 3/	-10.8
Real effective exchange rate (depreciation -) 2/4/	-12.8	-21.5	-5.2	...	-8.2 3/	--
General government operations						
Revenue	23.8	32.2	25.7	16.7	25.1	22.3
Total expenditure (excluding amortization)	26.1	33.0	17.8	16.3	21.8	19.9
Money and credit						
Net domestic assets 5/	112.1	135.3	51.0	41.6	53.3	28.1
Public sector	9.7	-3.7	-3.9	-2.8	-2.7	-4.4
Private sector	76.3	68.1	42.0	37.7	39.2	34.1
Money and quasi-money	31.4	53.0	35.0	28.0	38.5	26.6
Interest rate (effective annual short-term deposit rate)	26.1	31.6	19.0	21.8	26.9	22.2
Velocity (GDP/broad money)	2.6	2.3	2.2	2.1	2.0	2.0
(In percent of GDP)						
Nonfinancial public sector savings	0.6	3.8	4.6	4.7	5.3/4.8 6/	5.1
Overall nonfinancial public sector surplus or deficit (-)	-4.4	-2.6	-1.9	-1.6	-0.8/-1.0 6/	-0.8
Net domestic financing	1.7	-1.4	-0.7	-1.7	-1.7/-1.4 6/	-1.8
Net foreign financing	2.7	4.0	2.6	3.3	2.4	2.6
Gross domestic investment	13.6	13.7	14.4	15.8	16.9	16.5
Gross national savings	2.9	5.4	8.0	10.6	12.1	11.8
Current account deficit (-)	-10.7	-8.3	-6.5	-5.2	-4.8	-4.7
Medium- and long-term public and private external debt (end of year)	88.2 7/	110.2	105.5	96.9	92.6	82.1
Debt service ratio (in percent of exports of goods and nonfactor services) 8/	58.9	52.9	47.1	36.0	31.5	34.6
Interest payments (in percent of exports of goods and nonfactor services)	48.0	43.5	38.6	29.9	26.7	28.2
(In millions of U.S. dollars, unless otherwise specified)						
Overall balance of payments	-82.0	3.8	154.0	-205.0	-140.0	254.0
Gross official reserves (months of imports f.o.b.) (end of year)	8.5	10.2	9.7	8.4	7.8	7.1
Gross official reserves (months of current payments)	4.0	4.9	4.7	4.5	4.3	3.8
External payments arrears (defaults) (end of year)	--	--	--	--	--	--

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

1/ As set forth in EBS/87/148 (7/6/87).

2/ Based on end-of-year exchange rates.

3/ January-September 1987.

4/ On the basis of consumer prices.

5/ In percent of liabilities to the private sector at the beginning of the period. Based on end-of-period actual exchange rates. Includes the impact of foreign financing channelled through the banking system.

6/ Redefined to exclude three enterprises.

7/ Includes US\$1.2 billion of short-term debt that was consolidated to a medium-term loan in early 1984.

8/ After rescheduling.

Chile: Summary of the 1988 Economic Program

I. Major Assumptions

1. Real GDP is expected to grow at an annual rate of 4.5 percent.
2. The volume of copper exports is projected to increase by 7.8 percent, that of noncopper exports by 7.4 percent, and that of imports by 2.5 percent.
3. The average price of copper is projected at US\$0.75 per pound compared with US\$0.768 in 1987, while noncopper export prices are expected to rise by 5.4 percent. Average import prices are expected to rise by 5.9 percent. Under these assumptions, the terms of trade would deteriorate by 2.8 percent.
4. For calculating Chile's interest payments in 1988, the U.S. prime lending rate is projected to average 9.0 percent a year and the LIBOR 8.0 percent a year.
5. Real financial assets held by the nonfinancial private sector (excluding the private social security funds) are projected to increase in line with real GDP. Real financial assets held by the private social security funds are estimated to grow by 18 percent. The net domestic assets of the financial system are projected to increase (with respect to their 1987 base) by 14 percent. Credit to the private sector is expected to increase by 22 percent, while net credit to the public sector is expected to decrease.

II. Targets

1. The rate of inflation as measured by the December to December change in the consumer price index is expected to decline from 21.5 percent in 1987 to 17 percent in 1988.
2. The current account deficit of the balance of payments is expected to rise from US\$892 million in 1987 to US\$970 million in 1988, while the trade surplus is projected to rise from US\$1,079 million in 1987 to US\$1,282 million in 1988.
3. The overall balance of payments as measured by the change in the net international reserves of the Central Bank is expected to register a surplus of US\$254 million in 1988.

III. Principal Elements of the Program

1. Exchange rate and other external policies

a. To help ensure the balance of payments and growth objectives of the program, the authorities will continue to implement a flexible exchange rate policy. During 1988, the peso will be devalued daily on the basis of the difference between domestic inflation in the previous month and the external rate of inflation relevant for Chile, currently estimated at 0.4 percent a month.

b. The authorities are committed to maintaining the current trade system, which is virtually free of quantitative and other nontariff restrictions on imports, and not to increase the uniform tariff rate (which was recently lowered) during the remainder of the program.

2. Wage policy

The authorities intend to follow a policy of wage restraint in the public sector, to abstain from interfering with wage negotiations in the private sector, to maintain flexible labor markets, and to encourage labor mobility. Civil servants' nominal wages were increased by an average of 13 percent in September 1987, and no further general wage increase is expected until mid-1988.

3. Fiscal policy

The program envisages a reduction in the overall deficit of the nonfinancial public sector, excluding the three enterprises privatized in 1987, from 1.0 percent of GDP in 1987 to 0.8 percent of GDP in 1988. Public sector savings are projected at 5.1 percent of GDP in 1988, while public investment in 1987 would be equivalent to 7.0 percent of GDP.

4. Monetary policy

The Central Bank of Chile will keep the growth of net domestic assets within the limits established under the program. It will also abstain from expanding special programs involving subsidies or establishing new ones.

5. External debt policies

The main elements of the medium-term debt strategy of the authorities are: a policy of promoting export growth that would allow for the servicing of external debt in an orderly manner; control of new external indebtedness to reduce over time the ratio of external debt to GDP; a concerted effort to shift financing from foreign bank loans to credits from multilateral and official sources; limitation of the use of short-term debt; and avoidance of the extension of official guarantees on private external debt.

CHILE

Area and population

Area	756,626 square kilometers
Population (1987 est.)	12.4 million
Population density	16.4 persons per square kilometer
Annual rate of population increase (1983-86)	1.7 percent
Unemployment rate (September-November 1987)	8.5 percent
Life expectancy at birth (1984)	70.1 years
Infant Mortality (aged under 1)	2.2 percent
Population per physician	1,000
Primary school enrollment (1983)	111.0 percent
Pupil-teacher ratio	33.2
Calorie intake as percent of requirement (1983)	105.5
Per capita protein intake (grams per day)	66.7

GDP per capita (1987)

SDR 1,169

GDP (1987 est.)

SDR 14.5 billion
US\$18.7 billion
Ch\$ 4,110 billion

	1984	1985	1986	Est. 1987
<u>Origin of GDP</u>				
Agriculture, forestry, and fishing	9.3	9.6	9.9	9.6
Mining and quarrying	8.7	8.7	8.4	7.9
Manufacturing	20.7	20.4	20.8	20.9
Construction	5.1	5.8	5.5	5.8
Commerce	16.9	16.7	16.8	17.0
Other	39.4	38.8	38.6	38.8

Ratios to GDP

Exports of goods and services	25.0	29.2	31.2	32.8
Imports of goods and services	36.3	37.8	38.1	38.2
Current account of the balance of payments	-10.7	-8.3	-6.5	-4.8
General government revenues	29.9	29.0	28.9	28.6
General government expenditures	33.4	32.7	30.5	29.4
Public sector savings	0.6	3.8	4.6	5.3
Public sector overall surplus or deficit (-)	-4.4	-2.6	-1.9	-0.8
External debt (end of year) 1/	95.7	118.6	114.8	101.7
Gross national savings	2.9	5.4	8.0	12.1
Gross domestic investment	13.6	13.7	14.4	16.9
Money and quasi-money (end of year)	38.3	43.1	46.1	50.5

Annual changes in selected indicators

Real GDP per capita	4.6	0.8	3.9	3.6
Real GDP	6.3	2.4	5.7	5.4
GDP at current prices	21.5	36.1	26.1	26.4
Domestic expenditures (at current prices)	26.3	30.9	24.4	27.6
Investment	68.8	36.9	32.7	47.8
Consumption	21.5	30.0	23.1	24.0
GDP deflator	14.3	32.8	19.4	20.0
Consumer prices (annual averages)	19.9	30.7	19.5	19.9
General government revenues	23.8	32.2	25.7	25.1
General government expenditures	26.1	33.0	17.8	21.8
Money and quasi-money	31.4	53.0	35.1	38.5
Money	12.0	11.3	41.3	18.3
Quasi-money	35.9	60.9	34.3	41.3
Net domestic assets of the financial system 2/	112.1	135.3	51.0	53.3
Credit to the nonfinancial public sector (net)	9.7	-3.7	-3.9	-2.7
Credit to private sector	76.3	68.1	42.0	39.2
Merchandise exports (f.o.b., in U.S. dollars)	-4.7	4.2	10.4	20.2
Merchandise imports (f.o.b., in U.S. dollars)	18.0	-12.0	4.9	28.0

	1984	1985	1986	Est. 1987
<u>General government finances</u>	(billions of pesos)			
Revenues	565.3	747.1	939.4	1,174.8
Expenditures	632.5	841.3	991.0	1,206.8
Current account surplus or deficit (-)	-38.0	-24.3	30.1	80.8
Overall surplus or deficit (-)	-67.2	-94.2	-51.6	-32.0
External financing (net)	14.2	78.8	75.1	n.a.
Internal financing (net)	53.0	15.4	-23.5	n.a.
<u>Balance of payments</u>	(millions of U.S. dollars)			
Merchandise exports (f.o.b.)	3,650	3,804	4,199	5,046
Merchandise imports (f.o.b.)	-3,357	-2,955	-3,099	-3,967
Investment income (net)	-1,955	-1,901	-1,887	-1,601
Other services and transfers (net)	-398	-277	-303	-370
Balance on current account	-2,060	-1,329	-1,091	-892
Official capital (net) <u>3/</u>	1,634	1,204	807	370
Private capital (net)	156	300	430 <u>4/</u>	567 <u>4/</u>
Errors and omissions	188	-171	8	-185
Valuation adjustment	-31	-16	-69	-35
Change in net official reserves (increase -) <u>5/</u>	113	12	-85	175
<u>International reserve position <u>6/</u></u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	
	(millions of SDRs)			
Central Bank (gross)	2,418.8	2,283.6	2,055.2	
Central Bank (net)	1,132.6	999.4	969.6	
Rest of banking system (net) <u>7/</u>	-72.0	-241.0	-336.2	

1/ Public and private, including short-term debt.

2/ Changes as percent of liabilities to the private sector at the beginning of the period. Based on end-of-period exchange rates.

3/ Includes Banco del Estado.

4/ Includes prepayment of debt through purchases abroad of Chilean external debt at a discount.

5/ Includes valuation changes.

6/ Gold valued at US\$42.22 per ounce. SDRs are valued at end-of-period rates with respect to the U.S. dollar. In the balance of payments, the change in net international reserves is based on stocks in which the SDR components are valued at the exchange rate of the base period.

7/ Includes position of banks liquidated in January 1983. Net amounts included are SDR 19.2 million on December 31, 1984, SDR 18.5 million on December 31, 1985, and SDR 18.2 million on December 31, 1986.

Santiago, Chile
December 29, 1987

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Camdessus:

1. The attached memorandum on economic policies reviews the progress in the implementation of our medium-term economic program that has been supported by an extended arrangement from the International Monetary Fund, and sets out the policy intentions and the quantitative targets and ceilings for the remaining period of the arrangement.
2. All quantitative performance criteria under the arrangement through the third quarter of 1987 have been observed and Chile has made all available purchases to date.
3. The Government of Chile believes that the policies described in the attached memorandum on economic policies are adequate to achieve the objectives of the program. During the remaining period of the arrangement, the authorities of Chile will consult with the Fund on the adoption of any measures that may be appropriate, in accordance with the policies of the Fund on such consultations.
4. The Government of Chile intends to seek a further arrangement involving use of the Fund's general resources following the expiration of the current arrangement in August 1988.

Yours truly,

Enrique Seguel Morel
President
Central Bank of Chile

Hernan Buchi Buc
Minister of Finance

Memorandum on the Economic Policies of Chile

1. Performance under the medium-term economic program of the Government since 1985 has been encouraging. Real GDP has grown at 5-6 percent a year in both 1986 and 1987, led by exports and fixed investment, and unemployment has declined from 12 percent in 1985 to less than 10 percent. The current account deficit of the balance of payments has improved steadily, falling to an estimated US\$890 million (4.8 percent of GDP) in 1987 from US\$1.3 billion (8.3 percent of GDP) in 1985. Net external debt has been held about level over the last three years and the net international reserve position at end-1987 is expected to be US\$60 million higher than targeted in May 1987. The overall deficit of the nonfinancial public sector declined from 2.6 percent of GDP in 1985 to an estimated 0.8 percent in 1987, and the net domestic assets of the Central Bank have been held below the program ceilings. Under the flexible exchange rate policy the peso depreciated in real terms by about 5 percent in January-September 1987 following a cumulative depreciation of 26 percent during 1985-86. However, in the area of prices there has been some slippage, as the rate of inflation in 1987 is now projected at 23 percent as against a target of 16 percent. This acceleration mainly reflected the sharp increase in oil prices, the depreciation of the Chilean peso in real effective terms in 1987, and higher food prices resulting from severe flooding.

2. In an effort to curb inflation and to moderate the growth of demand and imports, which were both rising at unsustainable rates in early 1987, monetary policy was tightened. The discount rate was raised several times and the rate of growth of M1 was held well below that of nominal GDP. Reflecting these measures, domestic interest rates rose by about 2 percentage points in real terms during 1987 after having fallen steadily during 1986.

3. The medium-term economic program of the Government of Chile is designed to secure steady economic growth together with a continued strengthening of the external accounts. Economic policies for 1988 have been framed within a longer term perspective that foresees a gradual decline relative to GDP in the balance of payments current account deficit and in Chile's external debt burden. Given the still difficult medium-term balance of payments outlook, and the continued uncertainty in world financial markets, the Government has decided to set aside some of the gains that may emerge in 1988 from the temporary rise in world copper prices, which have recently reached levels in excess of US\$1.10 per pound. Thus, if copper prices turn out significantly above the reference level of US\$0.71 a pound f.o.b. in 1988, the proceeds will be set aside in the Copper Stabilization Fund and the targets and ceilings of the program will be adjusted accordingly as described in the attached tables. Under the provisions of the Copper Stabilization Fund, no deposit is made for the first 4 cents of deviation; for the next 6 cents, half of the difference is taken into account; above 10 cents, the adjustment amounts to the full difference between the actual average price and the projected reference price.

4. Financial policies in 1988 have been designed to be consistent with a targeted rate of growth of GDP of 4-5 percent in real terms, further gains in employment and per capita consumption, and a decline in the rate of inflation to about 17 percent. These policies are also consistent with maintaining the margins under the program that existed at the end of 1986 on net international reserves and net domestic assets of the Central Bank, and a margin of US\$75 million on the public sector use of short-term external credit. In any event, the Chilean authorities will discuss with the Fund staff any deviation of the flows of net international reserves and net domestic assets of the Central Bank and the public sector use of short-term external credit, for 1987 and 1988 from those presently projected.

5. The program for 1988 targets an external current account deficit of US\$970 million (4.7 percent of GDP). As a result of agreements reached with external commercial banks, official creditors and multilateral institutions, the financing gap for 1987-88 has been closed. The Paris Club rescheduling arrangement with official creditors will provide an expected US\$72 million of debt relief in 1988. A third World Bank SAL of US\$250 million is expected to be approved shortly; under this loan US\$125 million is expected to be disbursed in 1987 and the remainder in 1988. In addition, commercial banks have provided an estimated US\$465 million financing, through a retiming of interest payments, and have rescheduled all principal obligations falling due through 1990.

6. Further progress in strengthening the external position while maintaining steady economic growth requires continued cautious fiscal and monetary policies. Accordingly, the overall deficit of the non-financial public sector, as redefined to exclude the newly privatized enterprises, will be reduced to about 0.8 percent of GDP from an estimated 1.0 percent of GDP in 1987. Despite the loss of savings of the privatized enterprises and an increase in costs due to a change in the base for contributions to the social security system, which together amount to 0.9 percent of GDP, public sector savings are projected to remain unchanged at about 5.1 percent of GDP. General government current revenue and current expenditure will decline slightly in relation to GDP. Public sector fixed investment is expected to stay roughly constant at 7 percent of GDP. Capital revenue from further privatization of public enterprises is projected at Ch\$44 billion (0.9 percent of GDP). The projection of the public sector deficit assumes that all external interest payments associated with the retiming are paid as originally scheduled. To the extent that external conditions turn out more favorably than presently projected without triggering an increase in deposits in the Copper Stabilization Fund, the Government of Chile will seek to improve public savings and investment. To the extent that the Copper Stabilization Fund accumulates deposits the overall fiscal position will improve correspondingly. Consistent with the 1988 fiscal targets, limits have been established on the cumulative overall deficit of the nonfinancial public sector for March 31, 1988 and June 30, 1988 covering the period through the end of the arrangement, as described in attached Table 1.

7. In the area of monetary policy the Central Bank will restrain the expansion of its net domestic assets according to the limits set out in attached Table 2. In addition, targets have been established for the net international reserves of the Central Bank as set forth in attached Table 3. The Central Bank intends to maintain an operating surplus based on the current structure of its balance sheet. In operating the monetary program, the Central Bank will adapt its policies as needed to achieve the program targets for growth, inflation, and net international reserves.

8. Interest rates will continue to be determined by market forces. The Central Bank eliminated the practice of announcing the indicative rate in mid-1987. To deepen the financial markets the Central Bank has introduced financial instruments with floating interest rates and has approved regulations to encourage other financial institutions to follow suit.

9. The Government's wage policy aims at maintaining external competitiveness, reducing unemployment, and lowering the rate of inflation. In line with this policy the Central Government increased nominal wages effective September 1, 1987 by an average of 13 percent, the first increase since November 1986. At the same time the minimum wage was also increased by 12 percent. Wage negotiations in the private sector continue to be based on collective bargaining or individual agreement and are free from Government interference.

10. To maintain external competitiveness, the peso will continue to be depreciated daily on the basis of the difference between domestic inflation in the previous month and the external rate of inflation relevant for Chile, currently estimated to be 5 percent a year. In implementing this policy, the Government will follow domestic and foreign price developments on a month-to-month basis in order to avoid significant variations in the real effective value of the peso.

11. Chile's adjustment effort has been reflected in a reduction in the external current account deficit in recent years. This in turn has helped reduce the reliance on foreign savings and improve the country's ability to service its external debt. In addition there has been an increase in nondebt-creating capital flows, through special mechanisms to facilitate external debt conversion. Between mid-1985 and September 30, 1987 through these mechanisms, Chile's debt with external commercial banks was reduced by US\$2.3 billion, or some 13 percent of total medium- and long-term external debt outstanding at the end of 1985. As a result, total external debt has been maintained about level over the last three years and the debt burden was reduced considerably. These policies will continue in 1988.

12. In line with the external debt management policies of the Government, limits have been established on the contracting, rescheduling, and guaranteeing of external debt of the public sector with maturities of more than one year and up to ten years, with a sublimit on maturities up

to five years, as described in attached Table 4. Limits have also been established on the outstanding stock of short-term debt of the nonfinancial public sector and the Banco del Estado, as described in attached Table 5. In addition, the Government will continue to limit its guarantee on private external debt to drawings under the trade facility provided by commercial banks and to those obligations of the private financial sector outstanding as of January 31, 1983 and subject to restructuring in the context of the 1987 financing package.

13. In recent years the Government of Chile made significant progress in reducing the scope of multiple currency practices and restrictions on payments and transfers for current international transactions. The remaining multiple currency practice arising from the preferential exchange rate applicable for outstanding debt obligations with original value of US\$50,000 or less has been almost eliminated. The Government remains committed to the elimination of the restriction arising from the required 120-day deferment period for import payments, which elimination had been scheduled to take place by December 31, 1987. However, because of the continued constraints on the availability of external financing and the medium-term outlook for the balance of payments, the Government of Chile intends to phase out this restriction over time, and requests that the Fund eliminate the associated performance criterion. As a first step, the minimum financing requirement will be lifted for transactions of up to US\$5,000, estimated to represent 8 percent of total imports c.i.f., by June 30, 1988. Over the following two years the coverage of imports exempt from the financing requirement will be raised progressively until the requirement has been eliminated by mid-1990. This timetable will be accelerated if in the judgment of the authorities and the Fund staff international conditions are significantly more favorable than those assumed in the medium term program as presently defined. Conversely, the timetable may be extended if the authorities and the Fund staff consider that international conditions are significantly less favorable than had been anticipated.

Table 1. Chile: Cumulative Limits on the Overall
Deficit of the Nonfinancial Public Sector

(In billions of pesos)

	Limits
January 1-March 31, 1988	3.8 <u>1/2</u> /
January 1-June 30, 1988	16.6 <u>1/2</u> /

1/ This limit shall be adjusted downward for any excess in the balance of the Copper Stabilization Fund at end-March 1988 above the projected level of US\$80 million. The limit for end-June will be adjusted downward (upward) for any increase (decrease) in deposits in the Copper Stabilization Fund. The Copper Stabilization Fund functions as follows: If the actual price of copper during any quarter deviates by less than four U.S. cents a pound from the benchmark price of seventy one U.S. cents a pound, f.o.b., there is no change in deposits in the Copper Stabilization Fund; for the next six U.S. cents a pound variation, half of the difference is to be deposited or drawn down; and for any deviation above ten U.S. cents a pound all of the difference is to be deposited or drawn down. Withdrawals may not exceed previous deposits. The volume to be used in determining the amounts of deposits/withdrawals are the actual quarterly exports of the State Copper Company, CODELCO.

2/ This limit shall be adjusted downward for any revenue in excess of Ch\$30 billion derived from the cash sale of stock by CORFO, its affiliates or other public enterprises (excluding transfers for certain indemnification payments related to agrarian reform claims) unless compensated by new credits to the private sector.

Table 2. Chile: Ceilings on the Net Domestic Assets
of the Central Bank 1/ 2/

(In billions of pesos)

Period	
December 31, 1987 (program base)	990
	<u>Ceilings</u>
January 1-March 31, 1988	1,011 <u>3/</u>
April 1-June 30, 1988	1,014 <u>3/4/</u>

1/ Defined as the difference between (a) the sum of currency, liabilities to the private sector and the Central Bank's medium- and long-term foreign liabilities and (b) the Central Bank's net international reserves, as specified in Table 3.

2/ The ceilings will be adjusted for the counterpart of change in the value of the estimated stock of net international reserves and of medium- and long-term foreign liabilities of the Central Bank for December 31, 1987 resulting from the revision of the accounting cross exchange rates between the U.S. dollar and other foreign currencies applicable for that date. For purposes of the ceilings, the medium- and long-term foreign liabilities of the Central Bank will include disbursements under any SAL loans obtained from the IBRD by the nonfinancial public sector. Further, all counterpart domestic liabilities resulting from the conversion of direct external debt of the Central Bank under Chapters XVIII and XIX of the foreign exchange compendium, from onlending/relending operations and from Central Bank purchases of its own external debt in secondary markets abroad will continue to be treated as medium- and long-term foreign liabilities of the Central Bank.

3/ This ceiling shall be adjusted downward for any excess in the balance of the Copper Stabilization Fund at end-March 1988 above the projected level of US\$80 million. This ceiling may be adjusted upward by the equivalent of up to US\$200 million to the extent that reserves are used for buying back external debt. This ceiling may also be adjusted upward by up to the equivalent of US\$300 million for any use of reserves accruing to the Copper Stabilization Fund above the projected level at end-March 1988 of US\$80 million, to the extent that such reserves are used for buying back external debt.

4/ This ceiling shall be adjusted downward for any increase during April-June in deposits in the Copper Stabilization Fund and upward for any decrease during April-June in deposits in the Copper Stabilization Fund.

Table 3. Chile: Targets for the Net International Reserves of the Central Bank 1/

(In millions of U.S. dollars)

<u>Date</u>	
December 31, 1987 (program base)	945
	<u>Targets</u>
March 31, 1988	850 <u>2/</u>
June 30, 1988	942 <u>2/3/</u>

1/ These targets shall be adjusted for any change in the value of the stock on December 31, 1987, resulting from the revision of the accounting cross exchange rates between the U.S. dollar and other foreign currencies applicable for that date.

2/ This target shall be adjusted upward for any excess in the balance of the Copper Stabilization Fund at end-March 1988 above the projected level of US\$80 million. This target may be adjusted downward by up to US\$200 million to the extent that reserves are used for buying back external debt. This target may also be adjusted downward by up to US\$300 million for any use of reserves accruing to the Copper Stabilization Fund above the projected level at end-March 1988 of US\$80 million, to the extent that such reserves are used for buying back external debt.

3/ This target shall be adjusted upward for any increase during April-June in deposits in the Copper Stabilization Fund and downward for any decrease during April-June in deposits in the Copper Stabilization Fund.

Table 4. Chile: Limit on the Stock of Short-Term
External Debt Owed by the Nonfinancial Public Sector
and the Banco del Estado 1/

(In millions of U.S. dollars)

<hr/> Period	
December 31, 1987 (program base)	952
	<u>Limit</u>
January 1-June 30, 1988	992

1/ Net of short-term foreign assets of the Banco del Estado,
excluding gold.

Table 5. Chile: Ceilings on the Contracting, Rescheduling,
and Guaranteeing of Foreign Debt by the Public Sector

(In millions of U.S. dollars)

	Ceiling <u>1/</u>	Subceiling <u>2/</u>
January 1-June 30, 1988	600	190

1/ Ceiling on the contracting, rescheduling, and guaranteeing of foreign debt with maturity of over 12 months and below 120 months.

2/ Subceiling on the contracting, rescheduling, and guaranteeing of foreign debt with maturity of over 12 months and below 60 months.