FOR AGENDA

EBS/88/139

CONFIDENTIAL

July 15, 1988

To: Members of the Executive Board

From: The Secretary

Subject: Chile - Staff Report for the 1988 Article IV Consultation, Review Under and Lengthening of Extended Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1988 Article IV consultation with Chile and review and lengthening of the extended arrangement. Draft decisions appear on pages 23-25.

It is understood that the Executive Director elected by Chile will be requesting the Board for a waiver of the circulation period to enable this subject to be brought to the agenda for discussion on Friday, August 5, 1988.

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

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

CHILE

Staff Report for the 1988 Article IV Consultation, and Review under and Lengthening of Extended Arrangement

Prepared by the Western Hemisphere and the Exchange and Trade Relations Departments

(In consultation with the Fiscal Affairs, Legal, Research, and Treasurer's Departments)

Approved by S. T. Beza and Eduard Brau

July 14, 1988

Contents

Contents

I. Introduction

A mission visited Santiago in the period May 16-June 3, 1988 to conduct the 1988 Article IV consultation, review the implementation of economic policies under the SDR 750 million extended arrangement that was approved by the Board in August 1985 and is scheduled to expire in August 1988, and negotiate a one-year lengthening of the arrangement through August 15, 1989. The proposed prolongation would be for an additional SDR 75 million or 17 percent of quota. The representatives of Chile in the discussions included the Ministers of Finance, Economy, Labor, Mining, and Agriculture; the President and Vice President of the Central Bank; the Budget Director; and other senior officials of the Ministry of Finance, the Central Bank, various government agencies and public enterprises. The staff mission consisted of Messrs. Hardy (Head-WHD), Coelho (FAD), Leimone and Rennhack (both WHD), Rodlauer (ETR), and Ms. Greene (Secretary-EXR). The mission was assisted by Mr. Guzman, the resident representative in Santiago.

The last Article IV consultation with Chile was concluded by the Executive Board on July 30 1987, when the Board also completed the third annual review of the extended arrangement. On February 23, 1988 the Executive Board completed the most recent midyear review of the arrangement and approved certain multiple currency practices and exchange restrictions (EBM/88/25). Chile has accepted the obligations of Article VIII sections 2, 3, and 4.

In concluding the 1987 Article IV consultation, Executive Directors commended the efforts of the authorities to achieve the objectives of their medium-term economic program, particularly the strengthening of domestic savings and of the external current account. They noted the significant reduction in the overall deficit of the public sector, which was achieved through an improvement of public savings while maintaining capital expenditure. They also welcomed the tightening of monetary policy last year aimed at slowing inflation and the growth of imports, and emphasized the need to continue to follow a flexible exchange rate policy. Directors were satisfied with Chile's progress in alleviating its external debt burden, but noted that both external debt and debt service remained relatively high. Thus they urged the Chilean authorities to continue to reduce their dependence on foreign borrowing over the medium term.

Chile has made all purchases available to date under the extended arrangement, including the purchase based on the observance of the performance criteria at end-March 1988 (Table 1). A purchase is scheduled for August 1988 subject to observance of performance criteria for end-June. Purchases under the proposed lengthening will be subject to observance of performance criteria for end-September and end-December 1988 and end-March and end-June 1989, as well as the completion of a review by February 15, 1989.

Table 1. Chile: Performance under the Economic Program in the First Quarter of 1988

	Limits and Targets January 1-March 31
(In billions of Chilean pesos)	
Net domestic assets of the Central Bank 1/2/3/	
Limit	947
Actual	892
Margin	55
Cumulative overall balance of the nonfinancial public sector (deficit -) 2/4/5/	
Limit	16.5
Actual	99.0
Margin	82.5
(In millions of U.S. dollars)	
Net international reserves of the Central Bank 3/4/	
Target	853
Actual	1,122
Margin	269
Contracting, guaranteeing, and rescheduling of external debt by the public sector 6/	
Limit	600
Actual	54
Margin	546
Of which: debt with maturity of more than one year and less than five years	
Subceiling	190
Actual	3
Margin	187
Stock of short-term external debt owed by the nonfinancial public sector and the Banco del Estado	
Limit	992
Actual	832
Margin	160

Source: 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/ These ceilings have been adjusted by US$72 million (or Ch$17.3 billion), which is the excess of deposits in the Copper Stabilization Fund above the projected level of US$80 million.

3/ Adjusted for revisions in the base data for December 31, 1987.

4/ Tested at the end of each period.

5/ Measured by the change in net use of financing. Data on occasion may differ sharply from the measurement above the line.

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

As of June 30, 1988 outstanding Fund credit to Chile amounted to SDR 1,010.3 million (229.4 percent of Chile's quota of SDR 440.5 million), of which SDR 70.6 million corresponded to purchases under the Compensatory Financing Facility. The resources to be made available during the 12-month period of the lengthened arrangement amount to about half of the repurchases falling due during the period. If the remaining purchase under the EFF as well as the purchases under the proposed lengthening are made, outstanding Fund credit to Chile at the end of the program would fall to 220.3 percent of quota. 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 been supported during the last three years by Structural Adjustment Loans from the World Bank totaling US$750 million. The third such loan for US$250 million was approved in December 1987, and the final disbursement of US$125 million is scheduled for the fourth quarter of 1988. Appendix II summarizes World Bank operations in Chile.

II. Background

The Chilean authorities in recent years have been implementing policies designed to reduce the gap between domestic investment and national savings, while attaining an adequate rate of economic growth. Chile's economic recovery has been helped by a series of structural reforms that were put in place in the 1970s and 1980s. These included a broad-based tax reform, the privatization of the social security system, reforms to the educational and health systems, liberalization of the exchange and trade system, and adoption of a quasi-uniform external tariff and of a liberal foreign investment code. Since the inception of the EFF arrangement in 1985, import duties were reduced to 15 percent, the personal and corporate income tax simplified, the administration of the tax system strengthened, the financial system put on a sound basis through recapitalization and through the purchase by the Central Bank of its substandard loan portfolio, and a number of public enterprises have been privatized. Interest rates remained positive in real terms and the Chilean peso was depreciated in real effective terms by over 40 percent (Table 2).

During the period 1985-87, the overall deficit of the public sector fell sharply and domestic credit growth slowed. National savings rose strongly, helping to finance significant growth in investment in a period of declining use of foreign savings (Chart 1). This trend, together with a large amount of conversions of external debt, curtailed the growth of Chile's external debt. The sizable real depreciation of the Chilean peso helped to channel investment to the tradables sector, contributing to a 30 percent rise in total export volume in this period. Economic performance was also aided by an improvement in the terms of trade in 1986 and 1987, including a sharp increase in world copper prices since mid-1987.

Table 2. Chile: Main Economic Indicators 1984-89

	1984	1985	1986	Prel. 1987	Prog. 1988	Prog. 1989
(Percentage changes unless otherwise specified)						
Real GDP	6.3	2.4	5.7	5.7	5.0	5.0
Consumer price index 1/	23.0	26.4	17.4	21.5	11.0	8.0
Real wages 1/	3.8	1.9	2.1	1.8	...	...
Unemployment (as percent of labor force) 2/	14.0	12.0	8.8	7.9	...	...
Terms of trade	-6.7	-7.3	9.0	8.4	6.7	-10.4
Export volume	0.1	13.5	7.9	6.5	8.5	0.6
Import volume	15.7	-11.4	11.8	19.5	8.8	8.8
Real effective exchange rate 1/3/	-13.4	-30.0	-8.3	-11.1	--	--
Domestic credit 4/	112.1	135.3	51.0	55.3	11.7	12.1
(In percent of GDP)						
Investment	13.6	13.7	14.6	16.9	17.1	18.9
External savings	10.7	8.3	6.8	4.3	1.8	3.8
National savings	2.9	5.4	7.9	12.6	15.4	15.1
Public	0.6	3.8	4.6	5.3	6.1	4.7
Private	2.3	1.6	3.2	7.3	9.2	10.4
Overall public sector operations (deficit -)	-4.4	-2.6	-1.9	-0.4	1.1	-0.5
(In millions of U.S. dollars)						
Total external debt	18,397	18,993	19,342	18,874	18,076	17,540
Debt conversions	--	324	989	1,983	1,500	1,200

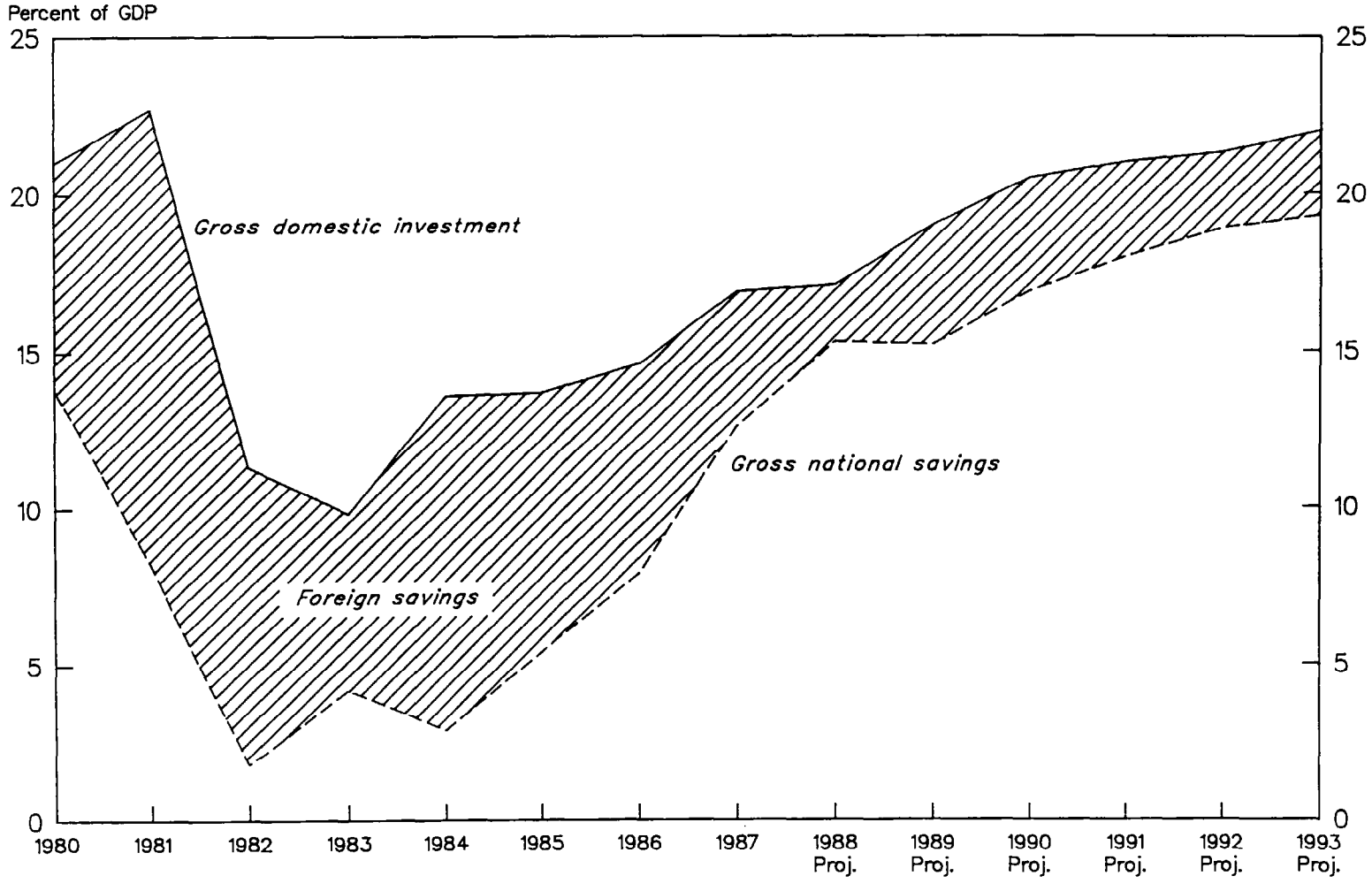
Sources: Central Bank of Chile; and Fund staff estimates.

1/ Twelve months ended December.
2/ Unemployment in the fourth quarter of each year.
3/ Decline indicates depreciation of Chilean peso.
4/ Change as percent of liabilities to the private sector at beginning of period.

CHART 1

CHILE

SAVINGS AND INVESTMENT



As a result, real GDP grew last year by 5.7 percent for the second consecutive year and the unemployment rate fell below 8 percent in the last quarter. Inflation, however, accelerated from 17 1/2 percent during 1986 to 21 1/2 percent in 1987, in part because of the real depreciation of the Chilean peso. The overall deficit of the nonfinancial public sector was reduced to 0.4 percent of GDP, significantly lower than the program target (1.2 percent of GDP), mainly as a result of the upsurge in copper prices and strong growth in revenues from other sources. The external current account deficit narrowed from 6.8 percent of GDP in 1986 to 4.3 percent in 1987, benefiting not only from rising copper prices but also from the continued strong growth in noncopper exports. Net official international reserves were well within program targets, and by the end of the year gross reserves were equivalent to about eight months of merchandise imports. In addition, almost US$2 billion of external debt was extinguished through Chile's debt conversion mechanisms, and Chile's total external debt fell from US$19.3 billion (115 percent of GDP) at end-1986 to US$18.9 billion (100 percent of GDP) at end-1987.

In the first quarter of 1988 the economy continued to perform well as a result of the strength of copper prices, noncopper exports, and investment. Real GDP grew by 5.2 percent from the first quarter of 1987 to the first quarter of 1988, reflecting very high growth in several sectors, particularly transport and industrial production, partly offset by declines in fish production and mining output. The unemployment rate was 8.7 percent in May, compared with 9.8 percent in May 1987, and in the first four months of this year real wages grew by 4.2 percent compared with the same period last year. The rate of inflation, as measured by the consumer price index fell to 15.6 percent in the year ended June 1988, helped by a moderate appreciation in the real effective value of the peso during this period, the lagged impact of the tight monetary policy last year, and declines in the prices of certain agricultural products.

The overall balance of the nonfinancial public sector registered a surplus of Ch$48 billion in the first quarter of 1988, 1/ or 0.9 percent of GDP, compared with an adjusted program target of Ch$16.5 billion. This performance reflected high capital revenues arising from the sale of 30 percent of the telephone company, buoyant tax revenues and continued tight control over current expenditure. Monetary aggregates grew faster than projected in the first part of the year, with narrow money rising by 36 percent through June on a 12 month basis, apparently reflecting a strong demand for money because of the drop in inflation.

The Chilean peso has continued to be depreciated vis-a-vis the U.S. dollar by the difference between domestic and estimated external inflation. Nonetheless, the real effective value of the peso, which had

---

1/ Measured from above the line: measured from the financing side the surplus in the first quarter was considerably larger.

depreciated by 11 percent in 1987, appreciated by about 6 percent in January-April, reflecting lower than estimated foreign inflation. The spread between the exchange rate in the parallel market and the official rate, which had averaged 5 percent in 1987, rose to about 20 percent in late April 1988, in part because of political uncertainty (a Presidential referendum is to be held in 1988) and modifications to the debt conversion mechanisms that are described more fully below. By end-June the spread had subsided to about 13 percent.

In the balance of payments, besides the impact of copper prices averaging about US$1.10 a pound (about double the level of one year earlier), noncopper exports rose by about 30 percent in January-May compared with the same period last year, helping to lower the current account deficit substantially. Imports (in U.S. dollar terms) rose by 17 percent in this period. Capital inflows were bolstered by higher foreign investment including direct investment of about US$120 million in the telephone company. As a result, net official international reserves increased by US$447 million through the end of June, compared with an adjusted program target of a gain of US$217 million. Conversions of external debt continued at a high rate, with over US$700 million converted in the period January-May.

III. The Economic Program for 1988-89

The authorities' medium term economic strategy is designed to maintain an adequate rate of economic growth by providing conditions conducive to exports and investment. At the same time, to continue to reduce Chile's debt overhang, the authorities aim to stimulate national savings, to narrow the external current account in relation to GDP, and to reduce external debt through debt conversion or buyback schemes. In addition to following prudent financial policies and preserving external competitiveness, the authorities intend to maintain and deepen the process of structural reform, and wish to retain the support of the Fund during this process. In particular, they intend to move further during the program period to reduce the size and scope of the public sector through tax and expenditure policies and privatization. This approach is designed to strengthen private savings and investment and to improve economic efficiency.

Financial policies are being based on the long-term price for copper with the Copper Stabilization Fund (CSF) 1/, sterilizing most of

---

1/ 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, 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 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, which is responsible for about 80 percent of total copper exports (see EBS/88/22, pp. 14-15).

the windfall gains from current high prices. Thus, the program targets for net international reserves, net domestic assets of the Central Bank, and the overall balance of the public sector have been based on the estimated long term trend price of copper of US$0.75 a pound in 1988 and US$0.78 a pound in 1989, and the targets will be adjusted for deposits in the CSF. In practice, copper prices are expected to average at least US$0.98 a pound this year and the windfall in copper export revenue would amount to about US$700 million, of which about US470 million would be deposited in the CSF. The remainder represents either the windfall to private copper exporters or the US$0.07 a pound margin in the CSF above the benchmark price for which there is no deposit requirement.

Economic policies for 1988-89 are designed to achieve real GDP growth of 5 percent a year and to reduce inflation to 11 percent in the year ended December 1988 and 8 percent during 1989. On the basis of projected actual copper prices, the external current account deficit in 1988 is expected to decline to 1.8 percent of GDP, and the overall surplus is projected to reach over US$900 million (4.5 percent of GDP). However, as copper prices are projected to return to their long run trend by next year, the current account deficit in 1989 is expected to rise to 3.8 percent of GDP, which would still represent a continuing trend of a reduction in the deficit when adjustment is made for the windfall gains from high copper prices in 1987-88. The overall balance of payments would show a surplus of US$100 million in 1989, taking the form mainly of net repayments to the Fund.

1. Fiscal policy

The authorities intend to hold the overall deficit of the nonfinancial public sector based on long-term trend copper prices roughly constant, at about 1/2 percent of GDP, with stable public savings and investment. In view of the significant improvement in the public sector deficit and public savings since 1984, the authorities believed that further gains in savings and investment should come from the private sector, and have been pursuing a tax and expenditure policy directed at diminishing the size and scope of the public sector. From 1984 to 1987 current expenditure of the General Government fell from 30.8 percent of GDP to 26.2 percent, while current revenue rose slightly in relation to GDP (Chart 2). In 1988 the authorities intend to lower current expenditure substantially in relation to GDP. Together with the part of the copper windfall that is not required to be sterilized, this expenditure restraint would enable the authorities to reduce taxes significantly this year and still meet their objectives for the overall balance of the public sector.

Based on a projected copper price of US$0.98 a pound in 1988, the overall balance of the public sector is projected to register a surplus of 1.1 percent of GDP and public savings to rise to about 6 percent of GDP (Table 3). This strong fiscal performance reflects an underlying deficit, calculated on the basis of a copper price of US$0.75 a pound, of about 0.5 percent of GDP and a surplus in the CSF amounting to

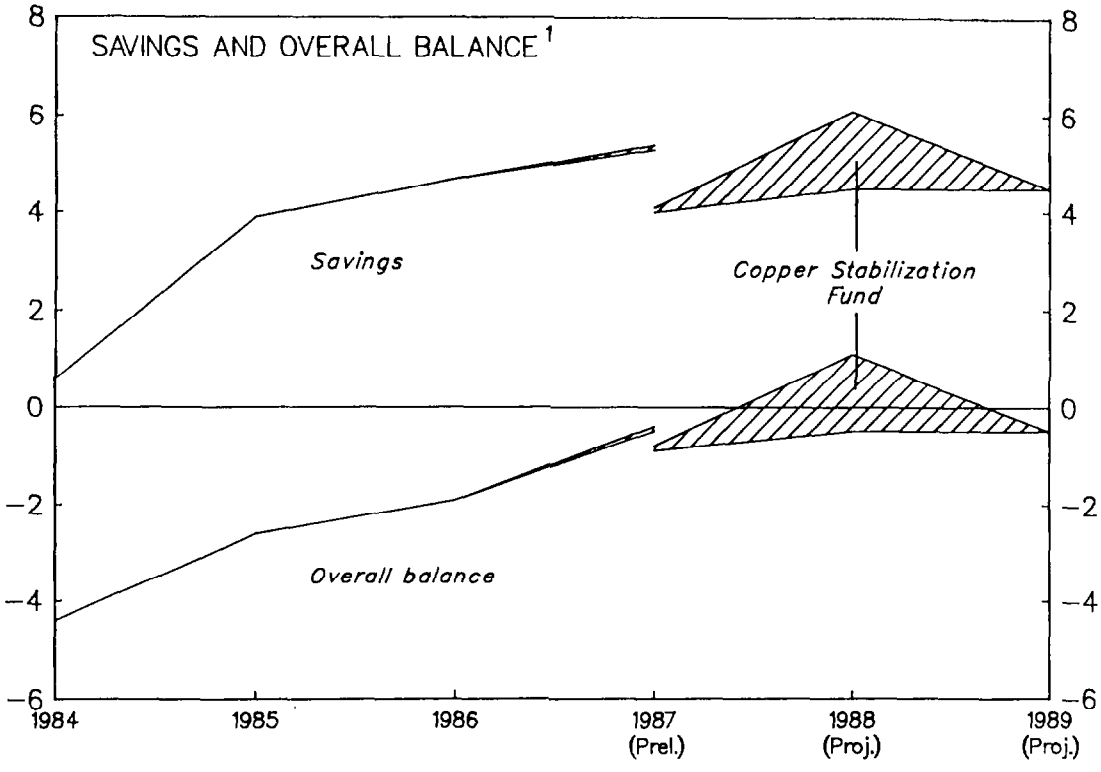
1.6 percent of GDP. The projected fiscal outcome incorporates the revenue impact of various tax reductions adopted since the beginning of 1988. Revenues from the sale of shares in public enterprises is programmed at just under 1 percent of GDP--about the level of recent years--but at the same time the process of privatization by itself is tending to raise the underlying public sector deficit, because the privatized enterprises had been generating small current and overall surpluses. The privatization of six entities in 1988 had the effect of lowering public savings by 1.3 percent of GDP and increasing the overall deficit by 0.4 percent of GDP.

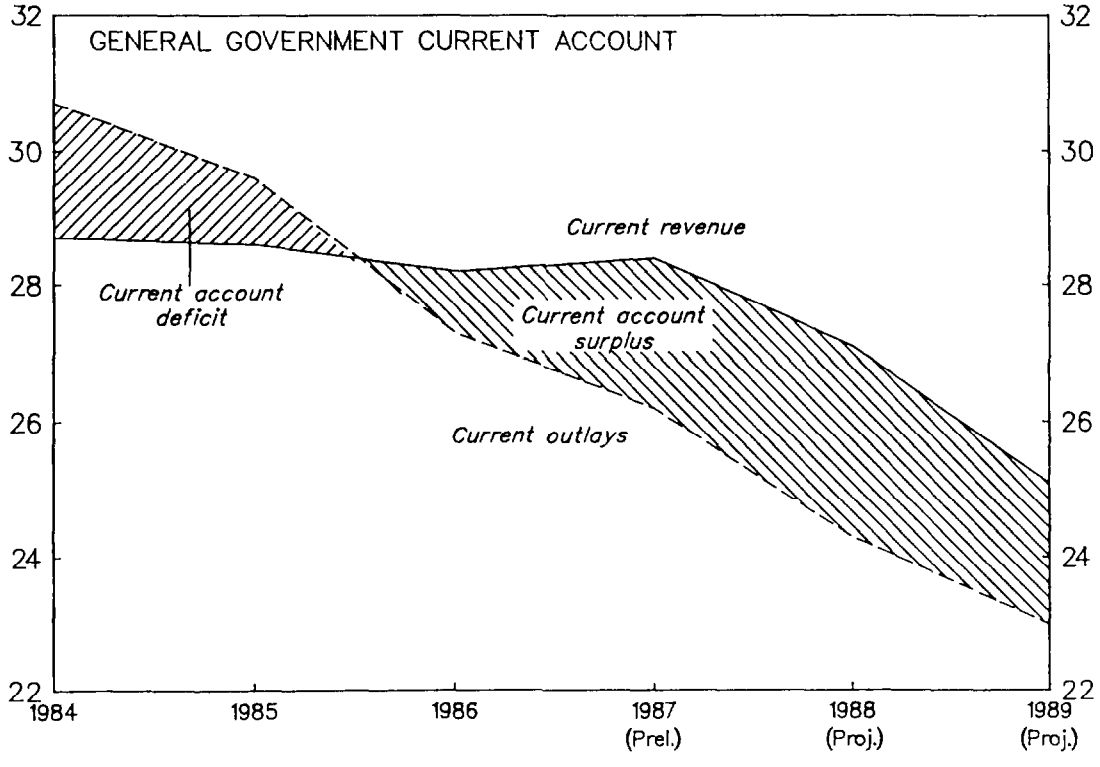
Total revenue of the public sector is projected to rise by 0.7 percentage points of GDP to 32.8 percent, with a decline in current revenues of the general government offset by an increased operating surplus of the public enterprises. Earlier this year the authorities reduced import tariffs from 20 percent to 15 percent, lowered some luxury taxes, and eliminated the variable tax on gasoline and the 2 percent tax on employers' wage bills, which together represented a loss of revenue of about 1 percent of GDP. In June 1988 the authorities lowered the value added tax from 20 percent to 16 percent, which is estimated to reduce total revenues by a further 0.7 percent of GDP this year and by 1.6 percent of GDP on an annual basis. Prior to this reduction, the VAT rate (which is very broadly applied) had been one of the highest in the world, ranking only behind Nigeria, Ireland, and Denmark.

Total expenditure is projected to decline by over 1 percentage point of GDP in 1988, mainly reflecting restraint on the growth of current expenditure of the general government. Wages and salaries of the general government on average are adjusted in line with inflation, leading to a decline as a share of GDP which is growing in real terms. Also, the Government continues to apply a policy of eliminating two jobs for every new job approved in the public sector. Purchases of goods and services and transfers and subsidy payments are expected to fall relative to GDP, because of the tight spending policy and because support purchases of wheat that occurred in 1987 will not be repeated in 1988. Interest payments will also fall in relation to GDP. As a result, current expenditure of the General Government is expected to decline from 26 percent of GDP in 1987 to 24 percent in 1988. Public investment is projected to rise slightly relative to GDP, reflecting higher outlays by the public enterprises.

For 1989, the authorities are committed to keeping the public sector deficit at 0.5 percent of GDP, the same as in 1988 when calculated on the basis of copper prices on their long-term trend. The expected revenue decline is expected to be more than compensated by lower current outlays in relation to GDP. Public capital formation is expected to remain constant as a share of GDP, reflecting the authorities' view that the present level of public investment is adequate and their policy of encouraging private sector investment in infrastructure such as ports, airfields, access roads, and irrigation.

CHART 2
CHILE
OPERATIONS OF THE NONFINANCIAL PUBLIC SECTOR
(Percent of GDP)





Sources: Ministry of Finance; and Fund staff estimates.
[1]The break in 1987 represents the impact of privatization.

Table 3. Chile: Operations of the Consolidated Nonfinancial Public Sector

(In percent of GDP)

	1984	1985	1986	1987 Prel.1/	1987 Prel.2/	1988 Rev.2/ Prog.3/	1989 Proj.
Total revenue	33.5	35.0	34.0	34.0	32.1	32.8	29.5
General government current revenue	21.7	21.6	21.7	21.4	22.1	19.7	19.6
Operating surplus of the public enterprises	10.3	12.8	11.3	11.4	9.1	12.0	8.8
Net capital revenue 4/	1.5	0.6	1.0	1.2	0.9	1.1	1.1
Total expenditure	37.9	37.6	35.9	34.3	32.9	31.7	30.0
General government current outlays 5/	30.8	29.5	27.2	26.2	26.2	24.3	23.0
Enterprise transfers to private sector	0.8	1.0	1.1	1.2	0.9	1.3	0.9
Capital formation	6.4	7.0	7.5	6.9	5.8	6.2	6.2
Overall surplus or deficit (-)	-4.4	-2.6	-1.9	-0.4	-0.8	1.1	-0.5
Financing	4.4	2.6	1.9	0.4	0.8	-1.1	0.5
External	2.7	4.1	2.6	1.2	1.2	2.3 6/	1.6
Internal	1.7	-1.5	-0.7	-0.8	-0.4	-3.4	-1.1
Memorandum items							
Public sector borrowing requirement	5.8	3.2	2.9	1.6	1.7	--	1.6
Current account surplus 7/	0.6	3.9	4.7	5.4	4.1	6.1	4.5
Overall deficit excluding copper windfall	-4.4	-2.6	-1.9	-0.8	-1.2	-0.5	-0.5

Sources: Ministry of Finance; and Fund staff estimates.

1/ Includes six privatized enterprises: CAP, Chilectra Generacion, SOQUIMICH, CTC, Entel, Iansa.

2/ Excludes six privatized enterprises.

3/ With average copper prices at U.S. 97.5 cents.

4/ Beginning in 1983, excludes lending to the private sector by CORFO, INDAP, and SERCOTEC up to program limits in connection with special lending programs of the IDB and IBRD.

5/ Includes monetary correction as part of interest payments.

6/ Includes US$100 million for the retiming of interest payments owed by the public sector in 1988.

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

2. Monetary policy

The authorities attributed the rapid rate of growth of narrow money in the first half of 1988 to an increase in the demand for real money balances that stemmed from the drop in the opportunity cost of holding money. Since interest rates are indexed, the slowdown in inflation led to a drop in nominal interest rates from 24 percent a year in the last quarter of 1987 to 10 percent a year in the first quarter of 1988. Real interest rates were lowered from 5.0 percent to 4.1 percent 1/ in late 1987-early 1988, partly (but not fully) mirroring the decline in world interest rates. The authorities said that they were prepared to tighten monetary policy in the event of a resurgence of inflation or higher than programmed imports.

The domestic credit program is consistent with a sharp slowdown in the growth of narrow money during the remainder of the year to 20 1/2 percent for the 12 months ending in December, and with the projected gain in net international reserves of the Central Bank (Table 4). The broadest monetary aggregate, M7, is projected to grow by 21 1/2 percent, reflecting continued strong growth in pension fund assets while the other components of M7 would rise in line with nominal GDP. This expansion of resources to the financial system would be consistent with a modest growth of credit to the private sector in real terms.

3. External policies and outlook

a. Exchange rate policy

The authorities are strongly committed to maintaining a competitive exchange rate as an incentive for the diversification of exports. However, the real effective depreciation of the peso last year had been more than they had originally intended because foreign inflation turned out higher than estimated. Thus, despite the moderate real appreciation in the first four months of 1988, the real effective value of the peso was still close to its most depreciated level since 1970 (Chart 3). The authorities consider that it would not be advisable to allow the peso to appreciate significantly from its current level. For this reason, through the mechanism of the CSF, they were using reserves to smooth out the fluctuations in copper prices, and plan to continue to depreciate the peso daily in relation to the U.S. dollar by the difference between domestic and estimated external inflation through the program period.

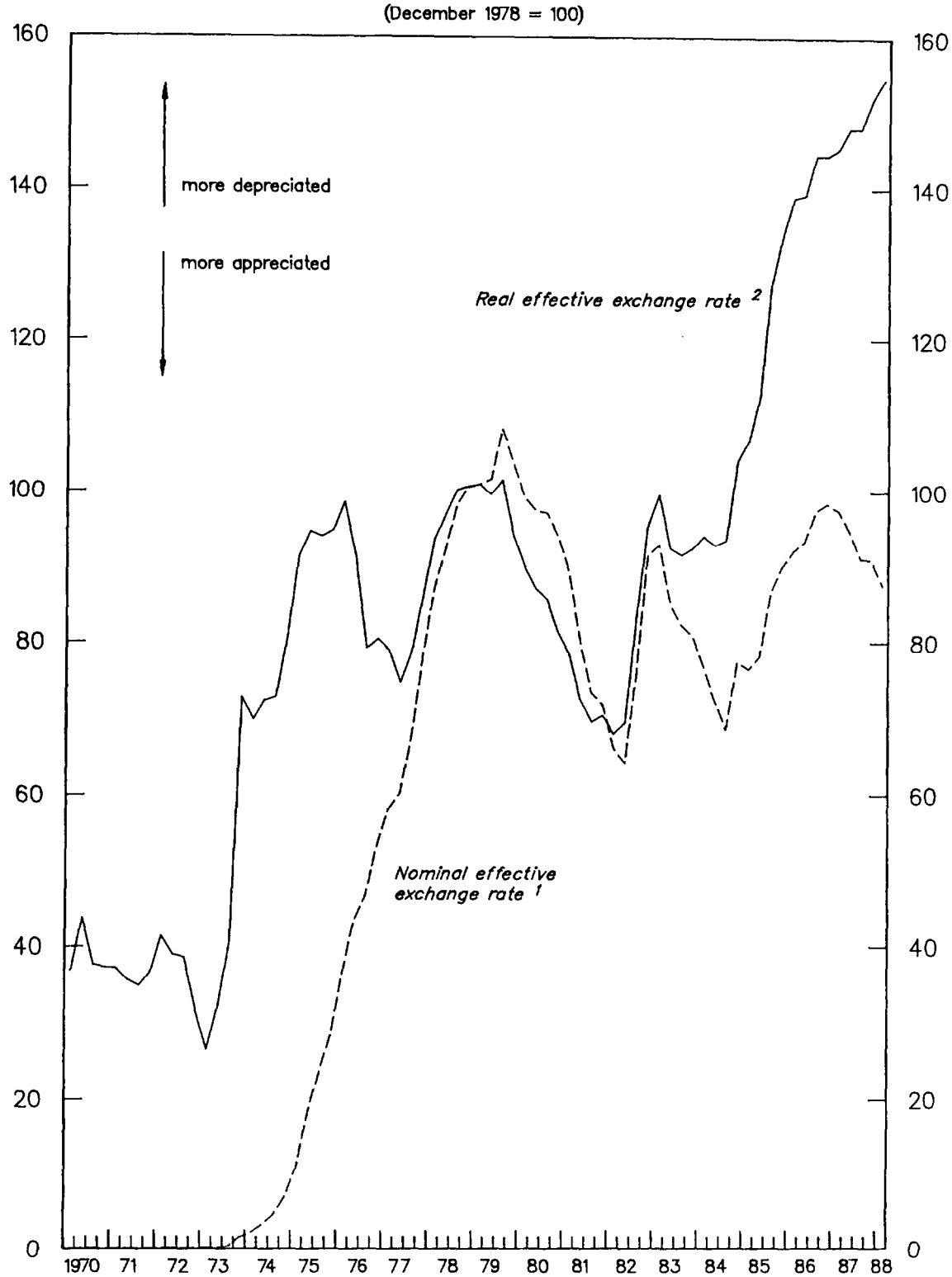
1/ Rates on 90-day adjustable open market instruments of the Central Bank (PRBC). Virtually all financial instruments in Chile are indexed.

CHART 3

CHILE

EXCHANGE RATE INDICES

(December 1978 = 100)



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

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

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

Table 4. Chile: Monetary Indicators 1/

	1984	1985	1986	Prel. 1987	Prog. 1988	Rev. Prog. 1989
A. Central Bank 2/						
(Change in millions of U.S. dollars)						
Net international reserves	-82.0	4.0	154.0	-139.5	943.0	100.0
Medium- and long-term foreign liabilities	825.0	798.0	617.0	237.2	178.9	45.0
(Percentage change)						
Net domestic assets 3/	164.0	172.2	118.5	92.0	-129.8	5.5
Liabilities to the private sector	20.7	21.8	33.3	23.4	22.1	13.4
B. Financial System						
(Change in millions of U.S. dollars)						
Net international reserves	619.0	-206.0	-58.0	-474.0	888.4	50.0
Medium- and long-term foreign liabilities	1,971.0	745.0	-139.0	-966.5	-638.8	-555.0
(Percentage change)						
Net domestic assets 4/	112.1	135.3	51.0	55.3	11.6	12.1
Of which: credit to the public sector (net)	9.7	-3.7	-3.9	-2.2	-5.7	-2.1
Credit to the private sector	76.3	68.1	42.0	39.7	28.6	14.0
Liabilities to the private sector	31.4	53.0	35.0	38.5	24.1	14.1
Currency	22.3	24.1	36.5	25.0	25.0	13.4
M1A	20.8	23.4	40.7	25.2	20.6	13.4
M7	30.0	51.2	34.1	40.0	21.6	13.4
Memorandum item						
Inflation rate (CPI)	23.0	26.4	17.4	21.5	11.0	8.0

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

1/ Based on end-of-period data.
2/ Based on program definitions.
3/ 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.
4/ As percent of liabilities to private sector at beginning of period.

b. Other external policies

The authorities believe that an open trade and payments system, coupled with a competitive exchange rate, will stimulate growth and diversification. In this connection they stressed the importance of a low uniform import tariff level as well as a liberal regime for foreign investment.

The authorities attributed the widening of the spread between the exchange rates in the official and parallel markets in recent months to the high volume of debt conversions and to increased political uncertainty ahead of the scheduled plebiscite. In March 1988, small mortgage debtors had been allowed to reduce their debts with profits gained by converting external debt. Initially these special conversions, estimated at about US$300 million, were to be carried out before end-June and seem to have caused a bunching of demand for foreign exchange in the parallel market. To alleviate the pressures in the parallel market, the Central Bank in March 1988 cut back and later suspended normal debt conversions through the bi-weekly Central Bank auctions. In late May the authorities extended the period for the mortgage-related operations until September and expanded the supply of foreign exchange available for these types of operations. As a result, the spread narrowed to about 13 percent in June. The authorities intend to proceed cautiously with reopening nonmortgage related debt conversions in order to contain pressures on the parallel market. They remain committed to follow policies that over time result in a convergence of rates between the official and parallel markets, but considered that fluctuations of the rate in the parallel market may help at times to discourage short-term capital outflows. The spread between the exchange rates in the official and the parallel markets, in which some current transactions take place, constitutes a multiple currency practice subject to approval under Article VIII.

The remaining exchange restriction is the 120-day deferment period for import payments. On June 30 this requirement was lifted for transactions up to US$5,000, as a first step in the plan to phase out this restriction by mid-1990. This timetable may be accelerated if external conditions are judged more favorable than was contemplated in late 1987 when the timetable was drawn up.

c. Balance of payments

The overall balance of payments surplus in 1988 is expected to reach over US$900 million, largely reflecting the impact of high copper prices (Table 5). 1/ The current account deficit is projected to decline to about US$370 million (1.8 percent of GDP), and net capital

---

1/ The reserve target for 1988, based on the long-term price of copper, is a gain of US$310 million. At an average copper price of US$0.98 a pound, the programmed reserve gain would be US$720 million.

Table 5. Chile: Balance of Payments, 1984-89

(In millions of U.S. dollars)

	1984	1985	1986	Prel. 1987	Proj. 1988	Prog. 1989
Current account	-2,060	-1,353	-1,110	-808	-368	-880
Trade balance	293	849	1,100	1,229	1,843	1,230
Exports	3,650	3,804	4,199	5,224	6,392	6,424
Copper	1,604	1,789	1,757	2,235	2,885	2,503
Other	2,046	2,015	2,442	2,989	3,507	3,921
Imports	-3,357	-2,955	-3,099	-3,994	-4,549	-5,195
Financial services	-1,955	-1,901	-1,862	-1,700	-1,813	-1,698
Other services and transfers	-398	-277	-349	-337	-398	-412
Capital account 1/	1,790	1,606	1,158	720	1,393	980
Direct investment	67	112	57	98	122	242
Medium- and long-term capital (net)	1,124	1,064	799	744	1,185	738
Disbursements 2/	1,612	1,471	1,219	1,055	1,626	1,405
Refinancing	1,019	1,827	2,260	1,532	2,384	1,935
Scheduled amortization	-1,507	-2,233	-2,680	-1,842	-2,825	-2,602
Short-term capital 3/	599	431	302	-122	86	—
Errors and omissions	188	-249	106	-52	-82	--
Overall balance of payments (program definition) 4/	-82	4	154	-140	943	100
Valuation adjustment	-31	-16	-66	-88	-1	--
Change in official reserves (increase -) 5/	113	12	-88	221	-942	-100
	(As percent of GDP)					
Memorandum item						
Current account						
Including copper windfall	-10.7	-8.3	-6.8	-4.3	-1.8	-3.8
Excluding copper windfall	-10.7	-8.3	-6.8	-6.1	-4.9	-3.8

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

1/ Debt conversions are assumed to have no impact on the capital account.
2/ Includes US$415 million for retiming of interest payments in 1988.
3/ Includes changes in medium- and long-term assets held overseas by Chilean residents.
4/ Excluding the effects of valuation adjustments (i.e., program definition)
5/ Actual change in reserves.

inflows are expected to increase substantially compared with 1987, helped by additional debt relief of some US$400 million through the retiming of interest payments to commercial banks. Total debt relief in 1988 is estimated at US$2.8 billion, of which US$72 million from official creditors and US$2.73 billion from the 1986-87 rescheduling arrangement with foreign commercial banks. Gross reserves (with gold valued at US$300 per ounce) are projected to increase to some US$3.8 billion or about ten months of merchandise imports.

In 1989 as copper prices are expected to decline to their long-term trend, the current account deficit is projected at US$880 million (3.8 percent of GDP), which represents a continued reduction of the underlying deficit 1/, and net international reserves are projected to increase by US$100 million.

The reduction in the current account deficit in 1988 reflects an increase in the trade surplus from US$1.2 billion in 1987 to a projected US$1.8 billion. Exports are projected to increase by about 22 percent in U.S. dollar terms, as copper export earnings rise by 29 percent and noncopper exports by 17 percent. Copper shipments are expected to increase by about 4 percent, while the volume of noncopper exports is projected to rise by about 7 percent, led by fruit and forestry exports. The growth of non-oil import volume is expected to slow to about 6 percent in 1988, and total imports in U.S. dollar terms are projected to rise by about 14 percent, less than half the rate of increase registered in 1987. Net factor payments are projected to rise by US$110 million in 1988 as higher market interest rates more than offset the effects of a net reduction of external debt.

d. External debt

The authorities plan to limit the growth of external debt through narrowing the current account deficit and converting a further US$1.5 billion of external debt in 1988. As a result, the total stock of external debt is expected to fall to about US$18 billion by the end of 1988, equivalent to some 86 percent of GDP and 237 percent of exports of goods and services (Table 6).

The authorities felt that debt conversion mechanisms have allowed Chile to benefit from the secondary market discount on its external debt and encouraged the swap of nonofficial foreign assets (including flight capital) for official external liabilities, thereby improving the structure of the country's foreign assets and liabilities. From 1985 through end-1988, some US$4.8 billion, or about 27 percent of medium- and long-term debt outstanding at end-1985, will have been extinguished through

---

1/ At the estimated long-term copper price, the current account deficit would have been over US$1.1 billion (6.1 percent of GDP) in 1987 and US$1,040 million (4.9 percent of GDP) in 1988 (see Table 5).

Table 6. Chile: External Debt

	1984	1985	1986	1987	Prel. 1988	Prog. 1989	Proj. 1990	1991	1992	1993
(In millions of U.S. dollars, end of period)										
Total debt outstanding 1/	18,397	18,993	19,388	18,874	18,074	17,539	17,011	17,805	18,544	19,517
Medium- and long-term 1/	16,963	17,650	17,814	17,191	16,460	16,004	15,635	16,328	16,955	17,804
International organizations	935	1,444	1,928	2,493	2,974	3,261	3,507	3,469	3,424	3,335
Official lenders	614	639	770	722	717	663	594	499	379	277
Private financial institutions 2/	14,226	14,482	14,070	12,601	11,069	9,866	8,675	8,893	9,149	9,711
Other	1,187	1,085	1,045	1,375	1,699	2,215	2,859	3,468	4,002	4,480
Short-term 3/	1,434	1,343	1,574	1,683	1,615	1,535	1,376	1,477	1,589	1,713
Total debt service 2/4/	2,646	2,373	2,335	1,975	2,204	2,361	2,407	3,321	3,414	3,695
Amortization	488	406	420	310	441	667	674	1,585	1,623	1,845
Interest	2,158	1,967	1,915	1,664	1,763	1,694	1,733	1,736	1,791	1,850
(In percent of GDP)										
Memorandum items										
Total external debt, end-period	95.5	118.6	115.2	99.6	86.3	76.3	67.4	64.3	61.1	58.6
Interest payments on external debt	11.0	12.3	11.4	8.8	8.4	7.4	6.9	6.3	5.9	5.6
(In percent of exports of goods and nonfactor services)										
Debt service payments after rescheduling 4/	58.9	53.1	45.6	31.3	28.9	30.1	27.7	33.7	30.5	30.0
Of which: interest	48.0	44.0	37.4	26.4	23.1	21.6	19.9	17.6	16.0	15.0
Total external debt outstanding at year-end 1/	409.4	424.9	378.6	299.1	236.9	223.9	195.8	181.0	165.8	158.5

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

1/ Excludes use of Fund credit.
2/ After refinancing. Excludes extraordinary amortization through purchase of debt at discount of US$324 million in 1985, US$989 million in 1986, US$1,983 million estimated for 1987, and US$1,500 million projected for 1988.
3/ Excludes short-term liabilities of the Central Bank and short-term trade related flows.
4/ Excludes IMF repurchase.

debt conversions; this would have the effect of lowering debt service by about US$400-500 million a year over the next 3-4 years (Chart 4).

The authorities consider that it would be appropriate to use the windfall reserve gains from current high copper prices for an official debt exchange or buyback operation to further ease Chile's external debt burden, and the reserve targets under the program may be adjusted downward by up to US$500 million for such operations.

The Government recently reached new understandings under its multiyear rescheduling agreement with foreign commercial banks. Interest spreads were lowered from 1 percent to 13/16 percent on previously restructured debt and from 1 1/8 percent to 7/8 percent on new money and cofinancing arrangements, yielding annual savings of about US$20 million. The amendment allows, inter alia, for debt exchange and/or buyback operations and for collateralization of loans. The authorities view these modifications as a further step toward re-establishing Chile's voluntary access to international credit markets while providing flexibility for new techniques for managing external debt. In this connection it may be noted that the authorities have begun to use interest rate hedging as part of their debt management policies. The Central Bank experimented earlier this year by hedging the interest rate for a period of one year on about US$1.5 billion of its external obligations, and the foreign exchange regulations were amended recently to allow hedging by the private sector.

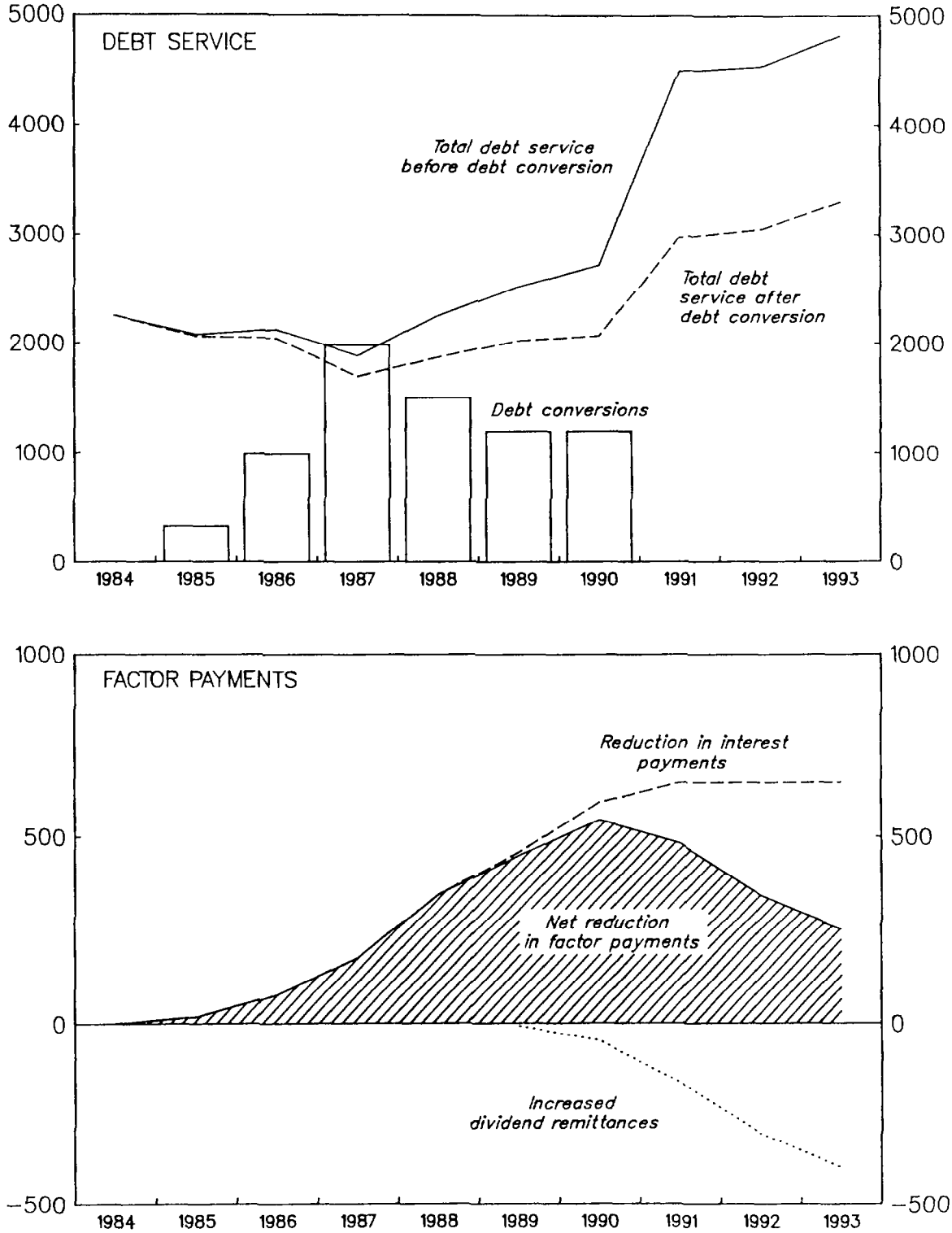
e. Medium-term outlook

Chile's medium-term prospects have been steadily improving as a result of the strong performance of exports and the progress in reducing the external debt burden (Chart 5). Chile's good economic performance has spurred a number of new domestic and foreign investment projects which will result in a further strengthening of the country's export potential. Among these are a new US$1.1 billion private copper mine (La Escondida), which will raise Chile's copper export capacity by over 20 percent when it comes on stream in 1991-92, and other large projects in the mining and forestry sectors.

The staff has updated and revised its medium-term balance of payments and debt projections to reflect these developments as well as changes in the external economic environment (the assumptions underlying the revised projections are shown in Statistical Appendix Table 9). The most recent projections indicate that Chile can achieve annual GDP growth of around 5 percent a year over the medium term while reducing the current account deficit and the burden of external debt (Table 7).

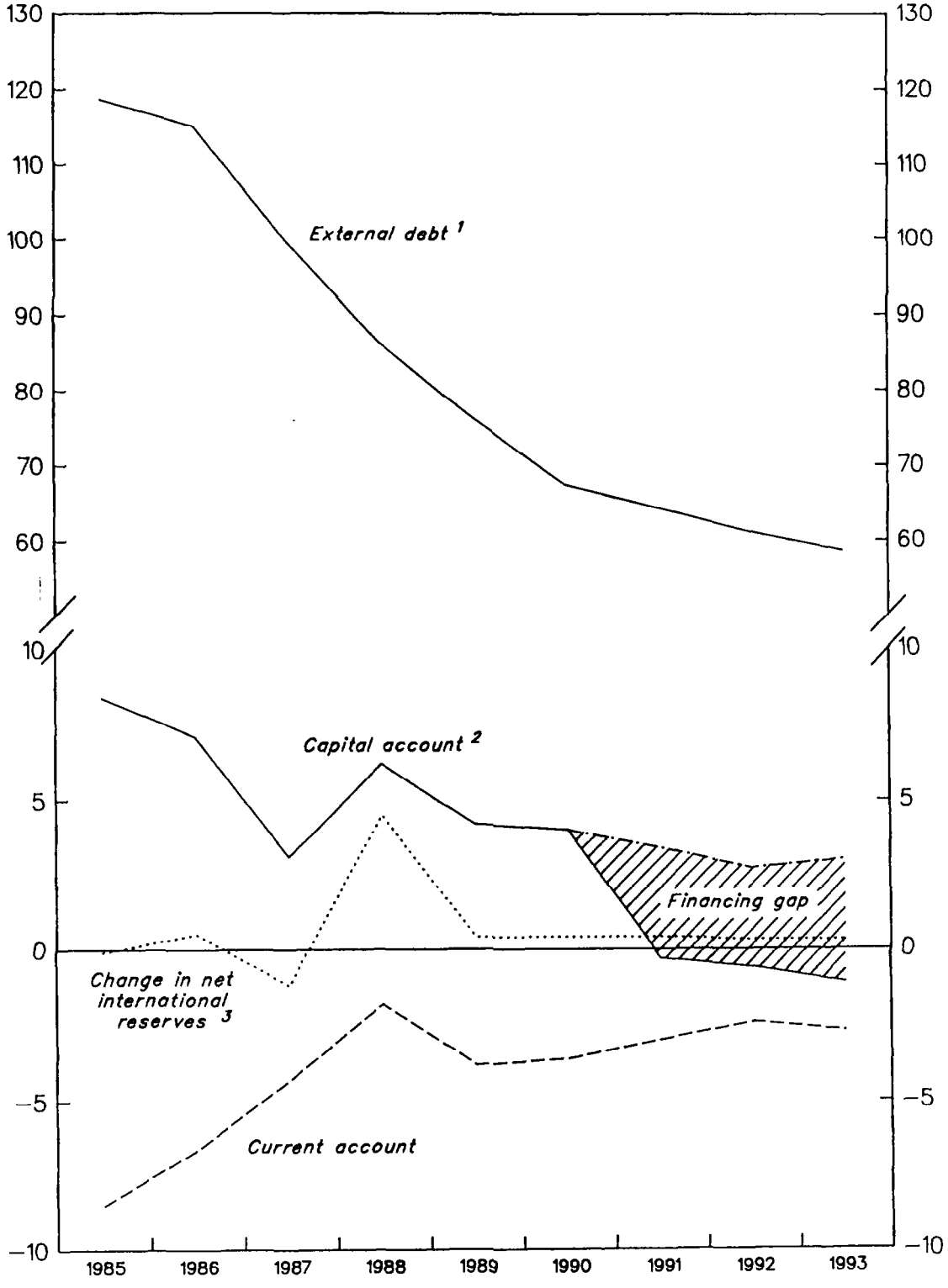
On the basis of the assumed long-term copper price and the continuation of present policies, the current account deficit would decline to around 2 1/2 percent of GDP by the end of the five-year period in the context of a rapid expansion of exports, rising imports, and sustained growth. As a result, the debt/GDP ratio, debt/export ratio and debt

CHART 4
CHILE
IMPACT OF EXTERNAL DEBT CONVERSIONS ON
DEBT SERVICE AND FACTOR PAYMENTS, 1984–93
(In millions of US$)



Sources: Chilean authorities; and Fund staff estimates.

CHART 5
CHILE
BOP AND EXTERNAL DEBT
(In percent of GDP)



Sources: Chilean authorities; and Fund staff estimates.
[1] Excluding IMF credit.
[2] Including errors and omissions and valuation adjustment.
[3] Increase (+).

Table 7. Chile: Balance of Payments--Medium-Term Projections, 1987-1993

	Prel. 1987	1988	1989	1990	1991	1992	1993
	(In millions of U.S. dollars)						
Current account	-808	-368	-880	-919	-828	-724	-892
Trade balance	1,230	1,843	1,229	1,315	1,611	2,009	2,088
Exports	5,224	6,392	6,424	7,116	8,084	9,226	10,131
Imports	-3,994	-4,549	-5,195	-5,801	-6,473	-7,217	-8,043
Nonfactor services and transfers	-338	-398	-412	-455	-503	-558	-620
Factor services	-1,700	-1,813	-1,697	-1,779	-1,936	-2,175	-2,360
Capital account	720	1,393	980	1,019	-76	-190	-363
Direct investment	98	122	243	293	236	243	268
Other capital flows	622	1,271	737	726	-312	-433	-631
Medium- and long-term (net)	744	770	737	823	-311	-384	-506
Disbursements	1,055	1,211	1,406	1,497	1,274	1,236	1,339
Refinancing	1,532	2,384	1,935	1,631	24	--	--
Scheduled amortization 1/2/	-1,842	-2,825	-2,602	-2,305	-1,609	-1,623	-1,845
Retiming	--	415	--	--	-112	-105	-198
Short-term (net)	-122	86	--	-97	111	59	73
Errors and omissions	-52	-82	--	--	--	--	--
Financing gap	--	--	--	--	1,004 3/	1,014 3/	1,355 3/
Change in official reserves (increase -) 4/	140	-943	-100	-100	-100	-100	-100
	(In percent of GDP)						
Current account deficit	4.3	1.8	3.8	3.6	3.0	2.4	2.7
Gross domestic investment	16.9	17.1	18.9	20.5	21.0	21.3	22.0
Nonfinancial public sector	6.9	6.2	6.2	6.5	6.5	6.5	6.5
Private sector and inventory change	10.1	10.2	12.8	14.1	14.6	14.9	15.6
National savings	16.9	17.1	18.9	20.5	21.0	21.3	22.0
External savings	4.3	1.8	3.8	3.7	3.1	2.5	2.8
National savings	12.6	15.4	15.1	16.8	17.9	18.8	19.2
Nonfinancial public sector	5.3	6.1	4.7	5.0	5.0	5.0	5.0
Private sector	7.3	9.2	10.4	11.8	12.9	13.8	14.2
Domestic savings	21.6	24.1	22.5	24.0	25.1	26.3	26.6
	(In months of imports of goods and nonfactor services)						
Gross official international reserves 5/	9.3	10.0	8.6	7.5	6.5	5.6	4.9

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.
2/ Excludes extraordinary amortization (through purchases of Chilean external debt at a discount).
3/ Of this total, US$766 million in 1991, US$766 million in 1992, and US$688 million in 1993 represent amortizations to foreign commercial banks on previous concerted lending and restructuring packages, and US$112 million in 1991, US$105 million in 1992, and US$198 million in 1993 represent the scheduled reversion of interest payments to six-monthly periods. If these obligations are refinanced, the financing gaps would be reduced to US$125 million in 1991, US$143 million in 1992, and US$469 million in 1993.
4/ Program definition (i.e., excluding valuation changes).
5/ Gold valued at US$300 per ounce.

service ratio before rescheduling would all be virtually halved over the period 1988-93. In view of the enhanced prospects for project-related borrowing from multilateral and other sources, there are no financing gaps in 1989 and 1990. Financing gaps--albeit lower than projected earlier--would re-emerge in 1991 when the grace period under the 1986-87 debt rescheduling arrangement expires. However, if new commercial bank lending or refinancing were to cover those maturities, the remaining gaps would be quite small (less than US$250 million a year).

Fiscal policies of the authorities are geared toward limiting the nonfinancial public sector deficit to about 0.5 percent of GDP a year over the medium term through continued tight control over expenditures and further privatization of public enterprises. To sustain the targeted rates of economic growth on the basis of historical capital-output ratios, domestic investment would need to rise by some 5-6 percentage points of GDP during the period 1988-1993 to around 19 percent and 22 percent of GDP, respectively, continuing the strong gains recorded in the last three-four years. In the authorities' view, the required increase in savings and investment should take place mostly in the private sector which they regard as the principal source of growth. The authorities expect that a continuation of their policies of structural reform and privatization, and prudent demand management, will stimulate a continued strong growth of private savings and plan to maintain public sector savings broadly unchanged over the next few years.

The medium-term outlook is highly sensitive to the assumptions for copper prices and interest rates 1/ and depends on the implementation as scheduled of the La Escondida copper project. If the latter project, should not take place, real import growth would have to be between 1 and 1 1/2 percentage points a year lower to attain the projected current account and debt profile of the central scenario, which could imply a slower growth of real GDP.

f. Ability to service financial obligations to the Fund

Assuming the full use of Fund resources available under the proposed extension of the EFF and no new financial arrangement from the Fund thereafter, 2/ repurchases over the next five years would average about US$200 million a year; this would reduce outstanding Fund credit from 220 percent of quota at the end of the EFF in mid-1989 to about 74 percent of present quota at end-1993. Debt service obligations to

---

1/ Any 5 U.S. cents a pound variation in copper prices from their assumed trend would alter export earnings by some US$200 million a year, while any 1 percentage point change in international interest rates would have the same effect on the current account.

2/ To comply with the rescheduling agreement with foreign banks Chile must have either enhanced surveillance or an arrangement in the upper credit tranches until the end of 1990.

the Fund, including charges, would decline from the equivalent of 5 percent of exports of goods and nonfactor services in 1988 to 2 percent in 1993, with annual repurchases and charges amounting to about 8 percent of gross reserves at the beginning of each year. Given Chile's past record in meeting its obligations to the Fund, its relatively comfortable reserve position, the prospect of a continued reduction of its external debt burden, and the fact that debt service to the Fund represents only a small portion of total debt service obligations, it is not expected that Chile will experience difficulties in meeting its financial obligations to the Fund over the medium term.

IV. Performance Criteria for 1988

The set of quantitative performance criteria for the lengthening of the EFF arrangement is the same as in the past, including the adjustments related to the Copper Stabilization Fund and for the use of reserves to buy back Chile's external debt (Table 8). The performance criteria for net international reserves and net domestic assets of the Central Bank and the limit on short-term external debt of the public sector incorporate the end-1986 margins that were built in last year (see Decision No. 8798-(88/25)). The authorities regard these margins as a necessary cushion to protect against unforeseen events and continue to be willing to discuss with the Fund staff in the event the margins are used.

V. Staff Appraisal

In recent years Chile has made significant progress toward returning to a viable external position with sustained economic growth. Led by exports, real GDP rose by over 5 1/2 percent a year in 1986 and 1987, and appears to be continuing at approximately this rate in 1988. Unemployment has declined, and so far this year the rate of inflation has come down substantially. The external debt burden has been lowered through the narrowing of the external current account deficit and the large scale use of debt conversions. These results reflect the maintenance of appropriate financial policies, coupled with a sizable gain in external competitiveness, the implementation of wide ranging structural reforms, and an improvement in Chile's terms of trade. Nonetheless, Chile's external debt burden remains relatively high, and the country faces the prospect of external financing gaps in the early 1990s.

Chile's medium-term outlook has been improving steadily, helped by rising domestic savings and by an upsurge in domestic and foreign investment in export production. Over the next few years, a further strong improvement in domestic savings and even higher levels of investment will be needed to achieve high growth while making continued progress in reducing the external current account deficit and the burden of external debt. In this connection a limited use of reserves to buy back

Table 8. Chile: Proposed Quantitative Criteria for the Period January 1 through June 30, 1988 1/

	Program Base December 31, 1987	Limits and Targets July 1- Sept. 30	Limits and Targets Oct. 1- Dec. 31
(In billions of Chilean pesos)			
Net domestic assets of the Central Bank 2/	941	996	989
Cumulative overall deficit of the nonfinancial public sector 3/	...	25.5	28.0
(In millions of U.S. dollars)			
Net international reserves of the Central Bank 3/	876	834	1,185
Contracting, rescheduling, and guaranteeing of foreign debt by the public sector 4/	...	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/ See tables attached to the Memorandum on the Economic Policies of Chile for details of the adjustments to these criteria for deposits in the Copper Stabilization Fund, buyback of external debt, and sales of shares of public enterprises.

2/ 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.

3/ 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.

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

external debt would be appropriate at this juncture, together with the continued use of other market-oriented mechanisms to reduce the debt burden.

The economic program for which the authorities are requesting Fund support through a lengthening of the EFF, will maintain the basic thrust of financial policies, preserve external competitiveness, and deepen the process of structural reform. The program is designed to be consistent with the achievement of 5 percent real growth in both 1988 and 1989 and to lower the rate of inflation to 11 percent in 1988 and 8 percent next year. Financial policies have been based on the estimated long-term trend price for copper, with the Copper Stabilization Fund (CSF) absorbing the bulk of any windfall gains and smoothing fluctuations around the trend. The CSF is now expected to accumulate close to US$500 million this year. This mechanism is an important feature of the authorities' program as it will facilitate the maintenance of steady economic growth.

Within the framework of the program, fiscal policy is being used to change the structure of the economy. Through expenditure restraint, room has been created for sizable tax reductions. The decline in the import tariff will help improve efficiency and promote exports, while the lowering of the value added tax from 20 percent to 16 percent should make a contribution to the reduction of inflation. The tax reductions appear to be consistent with the program fiscal targets for both 1988 and 1989, but it will be important to monitor the impact of these measures closely, and to be prepared to take compensating action if needed to achieve the desired levels of savings and investment.

Monetary policy should aim to achieve a significant slowdown in the growth of the monetary aggregates during the remainder of the year to be consistent with the price objectives of the authorities and to avoid any overheating of the economy. Thus, the authorities should be prepared to raise interest rates. A continuation of the current relatively wide spread between the official and parallel exchange rates could also be an indicator of a need to tighten monetary policies.

The maintenance of a high degree of external competitiveness is needed to sustain the process of export diversification and structural change. The moderate real effective appreciation of the peso in recent months only partially reversed the large depreciation that took place in 1987 and earlier years and does not represent a basic change in exchange rate policy. A further real appreciation of the peso from its current level, however, would not be advisable.

Chile maintains a relatively open exchange and trade system. The authorities have taken the first step to phase out the 120 day minimum financing requirement for imports, which is to be eliminated fully by mid-1990. An acceleration of this schedule would be helpful. A multiple currency practice still arises from the size of the spread between the exchange rates in the official and the parallel markets.

Given the past and planned progress by Chile toward eliminating exchange restrictions and multiple currency practices, the staff recommends their approval until February 15, 1989.

The authorities have requested continued Fund support for their economic program through a one-year lengthening of the current EFF arrangement. The staff believes that the macroeconomic and structural policies being followed by the authorities will contribute to the attainment of the objectives of their program, and supports the authorities' request.

It is recommend that the next Article IV consultation with Chile be held on the standard 12-month cycle.

VI. Proposed Decisions

Accordingly, the following draft decisions are proposed for adoption by the Executive Board.

A. Extended Arrangement - Review and Lengthening

1. Chile has consulted with the Fund in accordance with paragraph 12 of the extended arrangement for Chile (EBS/85/122, Supp. 3) and paragraphs 3 and 4 of the letter of December 29, 1987, from the President of the Central Bank of Chile and the Minister of Finance, in order to review the implementation of the measures described in that letter and attached memorandum.

2. The letter dated July 12, 1988 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, June 30, 1987, and December 29, 1987, together with the respective annexed Memoranda on the Economic Policies of Chile, shall be read as supplemented and modified by the letter dated July 12, 1988, together with its annexed Memorandum on the Economic Policies of Chile.

3. At the request of Chile, its extended arrangement is lengthened through August 15, 1989. Accordingly, paragraph 1 of the extended arrangement for Chile is amended by substituting "four" for "three", and by substituting "SDR 825 million" for "SDR 750 million."

4. Chile will not make purchases under the extended arrangement:

(a) during any period after August 15, 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 5 and Table 1 of the memorandum annexed to the attached letter of July 12, 1988; or

(ii) the target on the international reserves of the Central Bank, as specified in paragraph 6 and Table 3 of the memorandum annexed to the attached letter of July 12, 1988

are not observed; or

(b) during any period after August 15, 1988 in which:

(i) the ceiling on the net domestic assets of the Central Bank, as specified in paragraph 6 and Table 2 of the memorandum annexed to the attached letter of July 12, 1988; or

(ii) the ceiling on the contracting, rescheduling, and guaranteeing of external debt by the public sector, as specified in paragraph 9 and Table 4 of the memorandum annexed to the letter of July 12, 1988; or

(iii) 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 9 and Table 5 of the memorandum annexed to the attached letter of July 12, 1988;

are not observed; or

(c) after February 14, 1989, until the review contemplated in paragraph 3 of the attached letter of July 12, 1988, has been completed and performance criteria have been established for the remaining period of the extended arrangement, or having been established, while they are not being observed.

5. Purchases under this extended arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 750 million until November 15, 1988, the equivalent of SDR 768.75 million until February 15, 1989, the equivalent of SDR 787.50 million until May 15, 1988, and the equivalent of SDR 806.25 million until August 10, 1989.

B. Exchange Restrictions and Multiple Currency Practices

1. Chile maintains multiple currency practices relating to the dual exchange market system, and exchange restrictions relating to import payment deferment requirements, as described in EBS/88/139, that are subject to approval under Article VIII, Sections 2(a) and 3. In view of the intention of the authorities to eliminate these measures, the Fund grants approval of them until February 15, 1989.

Table 9. Chile: Assumptions Underlying the Medium-Term Projections

	1987	1988	1989	1990	1991	1992	1993
	(U.S. cents per pound)						
Copper prices	82.2	97.5	78.4	81.9	85.6	89.4	93.5
	(Thousands of metric tons)						
Volume of copper exports	1,368	1,416	1,594	1,594	1,777	2,001	2,046
CODELCO	1,053	1,086	1,180	1,230	1,255	1,280	1,305
Other	316	330	347	364	522	721	741
	(Thousands of barrels)						
Petroleum imports	20,015	25,784	28,892	31,721	34,562	37,429	40,334
	(U.S. dollars per barrel)						
Price							
f.o.b.	17.4	15.7	16.4	17.1	17.9	18.7	19.6
c.i.f.	18.6	17.0	17.6	18.4	19.3	20.1	21.0
	(Annual change in percent)						
Noncopper export prices	9.9	6.0	4.5	4.5	4.5	4.5	4.5
Noncopper export volume	11.4	10.7	7.0	7.0	7.0	7.0	7.0
Total export price	16.8	15.7	-6.4	4.5	4.5	4.5	4.5
Total export volume	6.5	5.8	7.4	6.0	8.7	9.2	5.1
Non-oil import prices	6.0	7.3	4.5	4.5	4.5	4.5	4.5
Nonfuel import volumes	20.6	6.5	8.3	6.5	6.5	6.5	6.5
Terms of trade	8.4	9.5	-10.4	--	--	--	--
Real GDP	5.7	5.0	5.0	5.0	5.0	5.0	5.0
	(In percent)						
Interest rates							
LIBOR 1/	6.5	7.5	7.5	8.0	8.0	8.0	8.0
	(Annual change in percent)						
Memorandum item							
Partner countries' demand for non-oil imports	5.1	6.4	4.4	6.1	6.1	6.1	6.1

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

1/ Effective interest rates; interest rates for payments falling due in 1989 were determined in early 1988.

Chile - Fund Relations
(As of June 30, 1988)

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 1,450.8 million or 329.4 percent of quota.

(c) Fund Credit to Chile:

	Millions of SDRs	Percent of Quota
Total	1,010.3	229.4
Under CFF	70.60	16.02
Credit tranche (SBA)	76.40	17.34
EFF	329.17	74.72
Enlarged access	534.14	121.25
Under stand-by	370.83	37.07
Under EFF	163.31	84.18

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 700 million
(iv) Undrawn balance: SDR 50 million

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

Date of Approval	Duration	Amount	Actually Drawn
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 June 30, 1988		
	Net cumulative allocation	121.9	100.0
	Holdings	1.4	1.2

V. Financial obligations to the Fund

	Overdue Financial Obligations	1988 July 1-Dec. 31	Principal and Interest Due 1989	1990	1991	1992
Principal	--	77.7	155.1	153.6	143.5	137.8
Repurchases	--	77.7	155.1	153.6	143.5	137.8
Trust Fund repayments	--	--	--	--	--	--
Charges and interest including SDR and Trust Fund (provisional)	--	36.6	66.4	56.5	40.1	29.9
Total --	--	114.3	221.5	210.1	183.6	167.7

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 0.5 per month. The official rate on June 30, 1988 was Ch$246.61 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 February 23, 1988, the Executive Board completed a review under the extended arrangement with Chile, including the establishment of performance criteria through June 1988. The text of the Board decision related to multiple currency practices and exchange restrictions is as follows:

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.

VIII. Technical Assistance: A mission visited Santiago in July 1988 to provide technical assistance in eliminating tax evasion and in improving the administration of the VAT.

IX. Resident Representative: A resident representative has been stationed in Chile since November 1982. Mr. Jorge Guzmán has been in Chile since March 1988.

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

Amount	Scheduled Availability Date	Conditions necessary for purchase 1/
SDR 50 million	After August 9, 1988	Compliance with quantitative performance criteria as of June 30, 1988
SDR 18.75 million	After November 14, 1988	Compliance with quantitative performance criteria as of September 30, 1988
SDR 18.75 million	After February 14, 1989	Compliance with quantitative performance criteria as of December 31, 1988
SDR 18.75 million	After May 14, 1989	Compliance with quantitative performance criteria as of March 31, 1989
SDR 18.75 million	After August 9, 1989	Compliance with quantitative performance criteria as of June 30, 1989

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 March 31, 1988)

Loan or Credit Number	Fiscal Year	Borrower	Purpose	Amounts (less cancellations) Disbursed Bank	IDA	Undisbursed
				(US$ million)		
30 loans and one credit fully disbursed				935.0	22.9 1/	--
2297	1983	Chile	Highway Reconstruction II	128.0	--	14.6
2481	1984	Chile	Agricultural credit	56.0	--	38.7
2482	1984	Chile	Housing	80.0	--	4.8
2504	1985	Chile	Public sector management	6.5	--	4.9
2589	1985	Chile	Road sector	140.0	--	78.0
2606	1985	Chile	Industrial financing restructuring	100.0	--	52.1
2613	1985	CORFO	Small and medium industry	40.0	--	30.0
2651	1986	EMOS	Water supply and sewer	60.0	--	58.3
2652	1986	ESVAL	Water supply and sewer	6.0	--	5.4
2832	1987	CORFO	Hydroelectric	95.0	--	95.0
2833	1987	ENDESA	Power Transmission	21.5	--	21.5
2892	1987	Chile	SAL III	250.0	--	125.0
Total				1,918.0	22.9	
of which has been repaid				287.6	6.6	
Total now outstanding				1,630.4	16.3	
Amount sold			7.2			
of which has been repaid				7.2		
Total now held by Bank and IDA				1,623.2	16.3	
Total undisbursed						528.5

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

2. Statement of IFC investments (as at January 31, 1988)

	Loan	Equity	Total
(In millions of U.S. dollars)			
Total gross commitments	177.75	12.35	190.10
Less cancellations, terminations, repayments, and sales	85.64	0.78	86.42
Total commitments now held by IFC	92.11	11.57	103.68
Total undisbursed	32.54	5.92	38.46

3. IBRD Disbursement forecast CY88-CY89

	CY88	CY89
Gross disbursements from approved loans	267.0	152.0
Gross disbursements from probable loans	--	132.0
Total gross disbursements	267.0	284.0
Amortization	42.0	90.8
Net disbursements	225.0	193.2

4. Recent IBRD technical assistance

Besides assistance to the ministries to prepare financeable investment projects and sector programs, the IBRD financed 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 has so far financed improvements in social pricing used by ODEPLAN, review of export potential by small producers, a review of public employment programs and improved information systems at PROCHILE, the Government export promotion agency, and assistance to improve INE's household surveys. In the context of the third 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. New investments are planned to support mineral export expansion during 1987-90 and a national commission has defined 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 infrastructure needed to transport exports. Road sector investments are to concentrate on cost-saving maintenance and rehabilitation.

6. Recent economic and sector missions

(a) A mission visited Chile in January 1988 to undertake a study of the industrial sector and capital markets.

(b) A mission visited Chile in June 1988 to review the mining sector.

Chile: Selected Economic and Financial Indicators, 1984-89

	1984	Prel. 1985	Prel. 1986	Prel. 1987	1988	1989
(Annual percent changes, unless otherwise specified)						
National income and prices						
GDP at constant prices	6.3	2.4	5.7	5.7	5.0	5.0
GDP deflator	14.3	32.8	19.2	21.2	17.7	10.4
Consumer prices (average)	23.0	26.4	17.4	21.5	11.0	8.0
Consumer prices (end of period)	19.9	30.7	19.5	19.9	14.5	9.4
External sector (on the basis of U.S. dollars)						
Exports, f.o.b.	-4.7	4.2	10.4	24.4	22.4	0.5
Imports, f.o.b.	18.0	-12.0	4.9	28.9	13.9	14.2
Non-oil imports, f.o.b.	20.6	-15.1	12.6	28.2	13.6	14.1
Export volume	0.1	10.8	7.4	6.5	5.8	0.7
Import volume	15.7	-13.5	4.4	19.5	8.8	9.3
Terms of trade (deterioration -)	-6.7	-7.3	1.9	8.4	9.7	-10.4
Nominal effective exchange rate (depreciation -) 1/	3.6	-17.0	-10.5	5.1	...	...
Real effective exchange rate (depreciation -) 1/2/	-13.4	-30.0	-8.3	-11.1	...	...
General government operations						
Revenue	23.8	32.2	25.7	28.2	19.1	8.2
Total expenditure (excluding amortization)	26.1	33.0	17.8	24.4	15.4	10.8
Money and credit						
Net domestic assets 3/	112.1	135.3	51.0	55.3	11.6	12.1
Public sector	9.7	-3.7	-3.9	-2.2	-5.7	-2.1
Private sector	76.3	68.1	42.0	39.7	28.6	14.0
Money and quasi-money	31.4	53.0	35.1	43.3	24.1	14.1
Interest rate (effective annual short-term deposit rate)	26.1	31.6	18.9	25.1	--	—
Velocity (GDP/broad money)	2.6	2.3	2.2	1.9	1.9	1.9
(In percent of GDP)						
Nonfinancial public sector savings	0.6	3.8	4.6	5.3	6.1	4.7
Overall nonfinancial public sector suprlus or deficit (-)	-4.4	-2.6	-1.9	-0.4	1.1	-0.5
Net domestic financing	1.7	-1.5	-0.7	-0.9	-3.4	-1.2
Net foreign financing	2.7	4.1	2.6	1.2	2.3	1.7
Gross domestic investment	13.6	13.7	14.6	16.9	17.1	18.9
Gross national savings	2.9	5.4	7.9	12.6	15.4	15.1
External current account deficit (-)	-10.7	-8.3	-6.8	-4.3	-1.8	-3.8
Medium- and long-term public and private external debt (end of year)	88.2	110.2	105.6	90.7	79.0	69.8
Debt service ratio (in percent of exports of goods and nonfactor services) 4/	58.9	52.9	46.3	31.3	28.9	30.1
Interest payments (in percent of exports of goods and nonfactor services)	48.0	43.5	37.9	26.4	23.1	21.6
(In millions of U.S. dollars, unless otherwise specified)						
Overall balance of payments	-82	4	154	-140	943	100
Gross official reserves (months of imports f.o.b.) (end of year)	8.5	10.2	9.7	9.3	10.0	8.6
Gross official reserves (months of current payments)	4.0	4.9	4.7	5.0	5.5	4.9

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

1/ Based on end-of-year exchange rates.
2/ On the basis of consumer prices.
3/ 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.
4/ After rescheduling.

Chile: Summary of the 1988-89 Economic Program

I. Major Assumptions

1. Real GDP is expected to grow at an annual rate of 5.0 percent in both years.

2. The volume of copper exports is projected to increase by 3.5 percent in 1988 and by 7.8 percent in 1989; that of noncopper exports by 7.4 percent and 7.0 percent; and that of imports by 8.8 percent and 9.5 percent.

3. The average price of copper is projected at US$0.975 a pound in 1988 and S$0.784 in 1989; noncopper export prices are expected to rise by 9.2 percent in 1988 and 4.5 percent in 1989. Average import prices are expected to rise by 4.7 percent. Under these assumptions, the terms of trade would improve by 9.7 percent in 1988 and to fall by 10.4 percent in 1989.

4. For calculating Chile's interest payments in both years, the U.S. prime lending rate is projected to average 8.5 percent a year and the LIBOR 7.5 percent a year.

5. Real financial assets held by the nonfinancial private sector are projected to increase faster than GDP in 1989 and in line with GDP in 1989. The net domestic assets of the financial system are projected to increase (with respect to their 1987 base) by 6 percent in 1988 and by 7.4 percent in 1989. Credit to the private sector is expected to increase by 19 percent in 1988 and by 10 percent in 1989, while net credit to the public sector is expected to decrease in both years.

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 11 percent in 1988 and 8 percent in 1989.

2. The current account deficit of the balance of payments is expected to fall from US$808 million in 1987 to US$368 million in 1988, while the trade surplus is projected to rise from US$1,229 million in 1987 to US$1,843 million in 1988. In 1989, the current account deficit will rise to US$880 million, with a trade surplus of US$1,229 million.

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$943 million in 1988 and US$100 million in 1989.

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. In both years 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 0.5 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 a range of 10 to 15 percent in June.

3. Fiscal policy

The program envisages an overall surplus of the nonfinancial public sector of 1.1 percent of GDP in 1988 and an overall deficit of 0.5 percent in 1989. Public sector savings are projected at 6.1 percent of GDP in 1988, while public investment in 1988 would be equivalent to 6.2 percent of GDP. In 1989 public savings would amount to 4.5 percent of GDP, and public investment would be 6.2 percent.

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 - Statistical Issues

1. Outstanding statistical issues

Chile's economic statistics are of a high quality, comprehensive and timely. However, certain minor issues are outstanding, as follows:

a. Government finance

The 1987 Goverment Finance Statistics Yearbook contains data through 1986 for all sections except those reporting outstanding debt of the consolidated central government. Data on outstanding debt by type of debt holder (Table F) and by type of debt instrument (Table G) are available only for 1982. This single year of data was prepared by the Contraloria General de Chile at the request of the GFS correspondent.

b. Monetary accounts

No new data for the deposit money banks are available because the authorities have experienced reporting difficulties as a result of the implementation by the Superintendency of Banks of a new system of bank returns.

2. Coverage, currentness, and reporting of date in IFS

The table below shows the currentness and coverage of data published in the country page for Chile in the June 1988 issue of IFS. During the past year the data have been provided on a timely basis.

Status of IFS Data

		Latest Date in June 1988 IFS
Real Sector	National Accounts	1986
	Prices: Home and Import Goods	March 1988
	Home Goods	March 1988
	Consumer Prices	March 1988
	Production: Manufacturing	March 1988
	Mining	February 1988
	Employment	n.a.
	Earnings	Q1 1985
Government Finance	Deficit/Surplus	1986
	Financing	1986
	Debt	n.a.
Monetary Accounts	Central Bank	September 1985
	Deposit Money Banks	June 1985
	Other Financial Institutions	n.a.
External Sector	Merchandise Trade: Value	January 1988
	Unit Value: Copper Exports	November 1987
	Copper Exp. (wholesale price)	April 1988
	Import prices (in pesos)	March 1988
	Balance of Payments	1986
	International Reserves	March 1988
	Exchange Rates	April 1988

CHILE -- Basic Data

Social and Demographic Indicators

Population Characteristics and Health (1986)	
Life expectancy at birth	71 years
Infant Mortality (aged under 1)	1.9 percent
Population per physician (1984)	1,000
Education (1983)	
Primary school enrollment	111.0 percent
Pupil-teacher ratio	33.2
Nutrition (1983)	
Calorie intake as percent of requirement	105.5
Per capita protein intake (grams per day)	66.7
GDP per capita (1987)	SDR 1,183
Area and population	
Area	756,626 square kilometers
Population (1987)	12.4 million
Density	61.5 per square kilometer
Annual rate of population increase (1984-87)	1.7 percent
Unemployment rate (Oct.-Dec. 1987)	7.9 percent
GDP (1987)	SDR 14.7 billion
	US$16.8 billion
	Ch$4,159.8 billion

	1984	Prel. 1985	Prel. 1986	Prel. 1987
		(In percent)		
Origin of GDP				
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	20.8
Construction	5.1	5.8	5.5	5.8
Commerce	16.9	16.7	16.7	16.9
Other	39.4	38.8	38.7	39.0
Ratios to GDP				
Exports of goods and services	25.0	29.1	31.7	34.3
Imports of goods and services	36.3	37.8	39.0	39.2
Current account of the balance of payments	-10.7	-8.3	-6.8	-4.3
General government revenues	29.9	29.0	28.9	29.4
General government expenditures	33.4	32.7	30.5	29.6
Public sector savings	0.6	3.8	4.6	5.3
Public sector overall surplus or deficit (-)	-4.4	-2.6	-1.9	-0.4
External public debt (end of year)	61.7 1/	85.9	93.7	85.3
Gross national savings	2.9	5.4	7.9	12.6
Gross domestic investment	13.6	13.7	14.6	16.9
Money and quasi-money (end of year)	38.3	43.1	48.2	52.4
Annual changes in selected indicators				
Real GDP per capita	4.6	0.8	3.9	4.0
Real GDP	6.3	2.4	5.7	5.7
GDP at current prices	21.5	36.1	26.0	28.1
Domestic expenditures (at current prices)	26.3	30.9	24.6	27.8
Investment	68.8	36.9	34.2	48.3
Consumption	21.5	30.0	23.0	24.1
GDP deflator	14.3	32.8	19.2	21.2
Consumer prices (annual averages)	19.9	30.7	19.5	19.9
General government revenues	23.8	32.2	25.7	28.2
General government expenditures	26.1	33.0	17.8	24.4
Money and quasi-money	31.4	53.0	35.1	43.3
Money	12.0	11.3	47.2	5.4
Quasi-money	35.9	60.9	33.5	48.7
Net domestic assets of the financial system 2/	112.1	135.3	51.0	55.3
Credit to the nonfinancial public sector (net)	9.7	-3.7	-3.9	-2.2
Credit to private sector	76.3	68.1	42.0	39.7
Merchandise exports (f.o.b., in U.S. dollars)	-4.7	4.2	10.4	24.4
Merchandise imports (f.o.b., in U.S. dollars)	18.0	-12.0	4.9	28.9

	1984	Prel. 1985	Prel. 1986	Prel. 1987
General government finances	(In billions of pesos)			
Revenues	565.3	747.1	939.4	1,204.3
Expenditures	632.5	841.3	991.0	1,232.4
Current account surplus or deficit (-)	-38.0	-24.3	30.1	90.6
Overall surplus or deficit (-)	-67.2	-94.2	-51.6	-28.1
External financing (net)	14.2	78.8	75.1	n.a.
Internal financing (net)	53.0	15.4	-23.5	n.a.
Balance of payments	(In millions of U.S. dollars)			
Merchandise exports (f.o.b.)	3,650	3,804	4,199	5,224
Merchandise imports (f.o.b.)	-3,357	-2,955	-3,099	-3,994
Investment income (net)	-1,955	-1,901	-1,887	-1,699
Other services and transfers (net)	-398	-277	-349	-337
Balance on current account	-2,060	-1,329	-1,136	-807
Official capital (net) 3/	1,634	1,204	807	213
Private capital (net)	156	299	340 4/	507 4/
Errors and omissions	188	-171	-143	52
Allocation of SDRs	--	--	--	--
Valuation adjustment	--	--	--	--
Change in net official reserves (increase -)	82	-4	-154 5/	139

International reserve position 6/7/	Dec. 31 1985	1986	1987
	(In millions of SDRs)		
Central Bank (gross)	2,283.6	2,063.5	1,862.5
Central Bank (net)	999.4	975.3	680.3
Rest of banking system (net) 8/	-241.0	-341.9	-468.5

1/ Includes US$1.2 billion of short-term debt which was converted to medium-term loans in early 1984.

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 an adjustment to net international reserves for a provision of US$15 million to cover the 1985 cash payments arising from the rescheduling agreement reached with Chile's main official creditors, which took place in February 1986.

6/ Gold valued at US$42.22 per ounce.

7/ 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.

8/ Includes position of banks liquidated in January 1983. Net amounts included are SDR 18.5 million on December 31, 1985, SDR 18.2 million on December 31, 1986, and SDR 15.9 million on December 31, 1987.

ATTACHMENT 1

Santiago, Chile
July 12, 1988

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

Dear Mr. Camdessus:

1. In August 1988 Chile will complete the third year of its medium-term economic program that has been supported by an Extended Arrangement from the International Monetary Fund. Although major progress has been made under this program in restoring growth, expanding exports and reducing the burden of external debt, it will be necessary to deepen the process of structural adjustment and to maintain current policies in order to achieve the program's goal of sustained growth in conditions of external viability, including full restoration of access to the international capital market. In these circumstances the authorities believe that continued Fund support of Chile's economic program would be helpful. Therefore, the Government of Chile is requesting that the EFF arrangement be extended for a year with access to Fund resources of SDR 75 million, in support of its medium-term program.

2. The attached memorandum on economic policies reviews the progress in the implementation of Chile's medium-term program, and sets out the policy intentions for the remainder of 1988 and 1989, including quantitative targets and ceilings for the period through December 1988.

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 period of the arrangement, the Government 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. The Government of Chile will reach understandings with the Fund before February 15, 1989 on the quantitative targets and ceilings for the remaining period of the arrangement.

Yours truly,

Enrique Seguel Morel
President
Central Bank of Chile

Hernan Buchi Buc
Minister of Finance

ATTACHMENT II

July 12, 1988

Memorandum on the Economic Policies of Chile

1. Since 1985 the Governement of Chile has been implementing a medium-term economic program aimed at strengthening the country's external position and laying the basis for sustained economic growth. During the last three years the deficit of the nonfinancial public sector, which stood at 4.5 percent of GDP in 1984, has been virtually eliminated; the Chilean peso has been depreciated by about 35 percent in real effective terms, significantly improving competitiveness; and wide-ranging structural measures have been implemented, including reductions in import tariffs, tax reform, financial sector reform, and privatization.

2. As a result of these policies and of improvements in the external environment, substantial progress has been made towards achieving the goal of sustained economic growth and external viability. Led by rapid increases in exports, real GDP has been expanding by over 5.5 percent a year in the past two years, unemployment has declined significantly, and there has been a surge in private investment financed by an even stronger rise in private savings. The external current account deficit narrowed to US$0.8 billion in 1987; and the external debt burden--albeit still heavy--has been reduced markedly as a result of the strong export growth and relatively large-scale use of debt conversion mechanisms. This performance has strengthened confidence as evidenced by the pick-up in domestic and foreign investment, which augurs well for Chile's growth and balance of payments outlook.

3. The medium-term economic program of the Government of Chile is designed to maintain steady economic growth and to reduce inflation, while further lowering Chile's external debt burden and external current account deficit relative to GDP. Economic targets and policies are centered on the estimated long-term trend export price for copper, and fluctuations in copper prices around this trend price are to be absorbed by the Copper Stabilization Fund, which is described in our memorandum of Economic Policies dated December 29, 1987. Under this mechanism, resources will be set aside when prices are above the trend export price and will be utilized when prices fall below the trend.

On the basis of current copper prices there will be a windfall gain for Chile in 1988, which is expected to lead to a major reduction in the current account deficit this year. However, copper prices are projected to return to their trend level in 1989, and the current account deficit would widen again to about US$870 million (3.8 percent of GDP).

4. Financial policies for the rest of 1988 and 1989 have been designed to be consistent with annual real GDP growth of around 5 percent, further gains in employment and per capita consumption, and a reduction in the rate of inflation from 21.5 percent in 1987 to 11 percent in 1988

and 8 percent in 1989. These policies are also consistent with the maintenance of the margins on net international reserves, net domestic assets and short-term external debt that have been preserved under the program since the end of 1986. In any event, the Chilean authorities will discuss with Fund staff any use of these margins.

5. Fiscal targets will be implemented in the context of the authorities' longer term objective of gradually reducing the size of the public sector. The authorities believe that the present level of public investment relative to GDP is adequate to sustain growth, while public savings will tend to rise in relation to GDP because of the policy of tight control over current expenditure. This policy will generate enough room to allow initiatives to reduce public revenues relative to GDP, which are relatively high in Chile in comparison with other countries. Accordingly, the Government has decided effective June 23, 1988 to reduce the value added tax rate from 20 percent to 16 percent. This measure can be accommodated within the macroeconomic framework of the program, under which, based on the trend price of copper, the overall deficit of the nonfinancial public sector will not exceed 0.5 percent of GDP in both 1988 and 1989. To sterilize transitory increases in revenues the fiscal targets will continue to be adjusted for changes in the deposits of the Copper Stabilization Fund. The authorities also plan to maintain the process of privatization. The sale of shares of CORFO enterprises is expected to yield Ch$44 billion this year, and all receipts above this level will be used to lower the public sector deficit. Consistent with the 1988 fiscal targets, limits have been established on the cumulative financing of the nonfinancial public sector for September 30, 1988 and December 1, 1988 as described in attached Table 1.

6. To support achievement of the program targets, the Central Bank will limit the expansion of its net domestic assets according to the targets set out in attached Table 2 and will aim at an increase in net international reserves 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. Interest rates will remain market determined.

7. The government's wage policy is consistent with maintaining external competitiveness, reducing unemployment, and lowering the rate of inflation. In line with these objectives, effective June 1, 1988 wages in the central government were increased by 10 percent (with additional bonuses for the lowest income workers), which compensated for the change in the cost of living since the previous adjustment in September 1987. At the same time, the minimum wage was increased by 24 percent in order to protect the lowest income workers. Further, an employment tax was eliminated so as to help promote employment expansion. Wages in the private sector will continue to be set by collective bargaining or individual agreements, and will remain free from government interference.

8. In early 1988 the government took measures to improve further the competitiveness of Chile's exports by reducing the import tariff rate from 20 percent to 15 percent and at the same time depreciating the central exchange rate by 4 percent. At the same time, the band around the central rate was widened to plus or minus 3 percent. More recently, the import duty drawback system was expanded to include goods used as inputs for export production. The government believes that it is important to maintain the present level of competitiveness of the Chilean economy so as to stimulate economic growth and the further diversification of exports. Accordingly, in 1988-89 the peso will continue to be depreciated daily vis-a-vis the U.S. dollar 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 6 percent a year. In implementing this policy, the government will follow domestic and foreign price developments on a month-to-month basis.

9. Chile's external debt strategy continues to aim at reducing effective interest rates, improving the maturity structure of the debt, establishing mechanisms that allow accelerated amortization at market prices, limiting new borrowing or debt guarantees by the public sector, and facilitating voluntary access to credit markets. In line with these objectives, the government is in the final stages of obtaining new understandings under its rescheduling agreement with foreign commercial banks that will increase its flexibility and reduce interest spreads. In line with the program objectives of further reducing Chile's external debt and debt burden, 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. The government will also 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 sector outstanding as of January 31, 1983 and subject to restructuring in the context of the 1987 financing package.

10. The government remains committed to the gradual elimination of the remaining multiple currency practices and exchange restrictions. The current spread between the parallel market and the official exchange rates constitutes a multiple currency practice. In recent months this spread has widened from about 6 percent to, at times, as much as 20 percent. Since pressure in the parallel market may be attributable in part to the high volume of debt conversion operations effected in recent months, the Central Bank in March cut back and later suspended auctions of rights to debt conversions under Chapter XVIII of the Foreign Exchange Law, except for mortgage-related debt conversions authorized in March. More recently, the period for these mortgage-related operations was extended by three months in order to avoid a bunching of demand for foreign exchange, and the supply of foreign exchange for these operations was expanded. Any restoration of auctions for nonmortgage debt

conversions under Chapter XVIII will proceed cautiously to avoid adding to pressures in the parallel market. While the Government believes that the parallel market mechanism can play a useful role in discouraging short-term capital outflows, it intends to follow policies that over time should result in a convergence of the exchange rates in the two markets.

The remaining exchange restriction is due to a required 120-day deferment period for import payments, which is to be phased out gradually by mid-1990. The first step will be taken by June 30, 1988 and will eliminate the financing requirement for imports of up to US$5,000; a second step will free imports of up to US$10,000 by December 31, 1988. The phase out process 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.

11. The authorities believe the economic policies and targets for 1988 and 1989 form an integral part of a medium-term program directed at establishing a profound change in the structure of the Chilean economy. Since 1985, economic policy has been geared towards stimulating exports and raising investment and savings. Exports have been boosted by a flexible and realistic exchange rate policy and a lowering of import tariffs. Higher levels of savings and investment have been encouraged by tight control of public current expenditure, which made possible an increase in public savings while allowing reductions in the level of taxation. Internationally competitive interest rates, tax incentives, and privatization of state enterprises also helped stimulate private savings and investment. The authorities believe that the economic program for 1988 and 1989 constitutes the necessary macroeconomic framework for an intensification of the process of structural change, in particular by making possible--through further reduction in the size of the public sector--additional increases in private savings and investment. This, in turn, is essential for the achievement of strong growth with external viability.

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

(In billions of pesos)

	Limits
January 1-September 30, 1988	25.5 1/2/
January 1-December 31, 1988	28.0 1/2/

1/ These limits will be adjusted downward (upward) for any cumulative increase (decrease) in deposits in the Copper Stabilization Fund at end-March 1988. 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$44 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 Chilean pesos)

Period	
December 31, 1987 (program base)	941
	Ceilings
July 1-September 30, 1988	996 3/4/
October 1-December 31, 1988	989 3/4/

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/ 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 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 to the extent that such reserves are used for buying back external debt.

4/ This ceiling shall be adjusted downward by Ch$17.3 billion which represents the excess of deposits in the Copper Stabilization Fund above the estimated level of US$80 million in the first quarter, plus an adjustment downward (upward) for any cumulative increase (decrease) in deposits in the Copper Stabilization Fund during subsequent quarters in 1988.

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

(In millions of U.S. dollars)

Date	
December 31, 1987 (program base)	876
	Targets
September 30, 1988	834 2/
December 31, 1988	1,185 2/

1/ 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 to the extent that such reserves are used for buying back external debt.

2/ This target shall be adjusted upward by US$72 million which was the excess of the deposits above the program estimate of US$80 million in the first quarter, plus an adjustment upward (downward) for any cumulative increase (decrease) in deposits in the Copper Stabilization Fund during subsequent quarters in 1988.

Table 4. Chile: Ceilings on the Contracting, Rescheduling, and Guaranteeing of Foreign Debt by the Public Sector

(In millions of U.S. dollars)

	Ceiling 1/	Subceiling 2/
January 1-December 31, 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.

Table 5. 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)

Period	
December 31, 1987 (program base)	952
	Limit
July 1-December 31, 1988	992

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